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Rosefinch Research | 2022 Series # 8

Great Investment Starts from Discomfort

Economic slowdown, tightening FED, Ukraine conflict… before we can finish off the macro and monetary analysis, we have to pick up European history books. The short-term equity market gyrations are always led by the marginal pricing powers, with rise or fall determined by the most optimistic and the most pessimistic groups. There will always be the uncertainty around emotional impacts, with discomfort surrounding us.

Seeing is believing

You've got to see it to believe it! Napoleon swept back to Paris in 1815, going from exile to emperor in a single month. The local Paris newspaper had the following daily headlines that chronicled his march as the "cannibal" arrived as "His Majesty" in Paris:

1. The cannibal has come out of his lair
2. The Corsican ogre has landed at Golfe Juan
3. The tiger has arrived at Gap
4. The monster has spent the night at Grenoble
5. The tyrant has crossed Lyon
6. The usurper was seen 60 leagues from the capital
7. Bonaparte is advancing with great strides, but will never enter Paris
8. Napoleon will be below our ramparts tomorrow
9. The Emperor has arrived at Fontainebleau
10. His Imperial and Royal Majesty has made His entry in the Tuileries yesterday, amid His faithful subjects

These dramatic turns are everywhere that we look. In the world of fund investment, investors may have very different opinions about their investments depending on their perspectives. **Those who lack a clear understanding of the drivers to their strategy's returns will base their investment decision purely on the near term returns, with their emotions pulled by the changing colors of the PnL reports.** This is what Howard Marks called "First level thinking", where the investor reacts immediately to the superficial observations. The investor will jump with joy as the market rallies, and droop with despair when the same market crashes. As China's A-share corrected this year, the equity market sentiment reached deep freeze level. On one hand, the public mutual fund companies have slowed new product issuance, with only 25 equity mutual fund launches in Feb, even less than the monthly average during the bear market in 2018. On the other hand, the mutual fund investors have cut back their appetite, with some fund launches severely under-subscribed. Is now really an awful time for investment?

Source: Wind, Rosefinch. Blue bar is China equity mutual fund issuance volume; red is Wind A-share index.

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In the market, the prices of securities reflect expectations of market participants. But these expectations include not only the investor's valuation of future profits, but also the overlay of market sentiments. The market's emotion pendulum will always swing between greed and fear. Just like the coin has two faces: on the negative side, the market pendulum creates massive swings and high volatility, pulverizing those investors who lose control to their basic emotions; on the positive side, there's never a lack of opportunities, which will make themselves available to those patient investors that can see through the cycles.

When the stocks fall, the first level thinkers say: "The market is falling, so people are pessimistic about the future trend, we should also sell our stocks and funds." Howard Marks have warned before: you can't do the same thing other do and expect to outperform. So what if we follow Marks' advice and think a little deeper: after the correction, has the stock price fully reflected market's bearish expectations? If these pessimistic investors are continually selling off, will the shorts start to turn? If first level thinking is a singular linear thinking, then second level thinking is a multi-dimensional contemplative thinking. For the second level thinker, the future forecast is not a single number, but a probability distribution. Coming back to China's equity market, as of end of Feb, 3421 or over 70% of the stocks have fallen. New energy, defense and other earlier hot sectors have corrected over 10%, releasing some of the over-valuation tensions. Right now, A-share's overall valuation is at 20% of historical range, which means there's relatively good valuation now.

Source: Wind, Rosefinch. Ratio of Inverse Wind A-share index P/E ratio over 10yr CGB yield

The hot stocks that everyone loves are fully valued with high prices and little chance of a cheap entry. So those great investment opportunities can only come from a place of discomfort. In 2013, China's photovoltaic sector had excess capacity and faced headwinds from both European and US trade disputes. The market leader Wuxi Suntech Power declared bankruptcy, and the whole industry was at a point of extinction. At that time, the deep consolidation phase came with those left standing the main flag-bearers who barely hung on. Then in 2018, the strictest photovoltaic government policy came out that limited capacity and reduced subsidy. This round actually helped to push the industry towards more market-driven innovation rather than purely policy driven capacity. These innovations kick started the new trend towards lower cost and increased efficiencies. Those companies that thrived embraced

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innovation, invested in R&D, and started the new era. Those investors like Rosefinch who grew with these companies also benefited from the alpha of the times.

The Courage to Go Against the Trend

The great investment starts from discomfort, and the dangerous investment starts from euphoria. But it's not so easy to buy on the way down and position for the long term. You need to avoid crowded trades, know how others fail, and have the courage to go against the trend. Where does the courage come from? For trend investors, this comes from sensitivity about the changing market cycles; for value investors, this comes from deep bottom-up research on individual stocks. It's rare to have successful market-timing. Take the mutual funds for example, Qinghua university published research in 2021 on China Public Mutual Fund performances. In the five years 2016 to 2020, there are 49% current and 21% former fund managers that have clear stock picking capabilities, but only 12% current and 11% former fund managers that have clear market timing capabilities. But you can't have the cake and eat it too – the research found that there's negative correlation between stock picking and market timing capabilities: the stronger the stock-picking record, the worse the market-timing record. Conversely, those fund managers with strong market-timing capabilities have the weaker stock-picking track record.

Rather than being exposed to immediate emotional swings and short-term market fluctuations, the stock pickers tend to focus on long term valuations for the company. This will include the industry's competitive landscape, the company's core advantages, the management's entrepreneurial spirit. And these are precisely the key lasting elements that build the moat and protect the company's long-term value. **If market-timer is the Winter Olympic athlete that executes the perfect left double 1620 in the Freeski Big Air competition, then the stock-picker is more like the mountaineer that goes up Mt Everest – with persistence, resilience, dedication, and clear long-term goal.** Only by seeing through the superficial observations can we jump out of first level thinking and truly appreciate the deeper truth. Choosing carefully the investment strategy that suits us - and staying with it - may be the true path for successful investors.

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