Rosefinch Fund
Ⓣ [021]2030 5888 Ⓕ [021]2030 5999
Ⓐ 58 Floor, New Bund Center, NO.555 West Haiyang Road/588 Dongyu Road, Pudong New Area, Shanghai
上海市浦东新区海阳西路 555 号/东育路 588 号前滩中心第 58 层，邮编：200126

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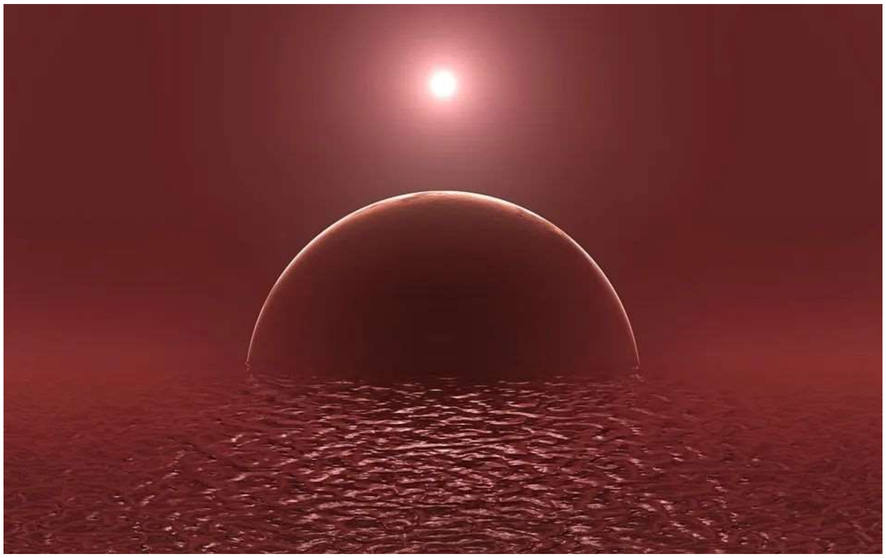
Farewell to the Old World



As the world turns in this year of change, peace and cooperation are no longer the default setting, and conflicts and competitions are intensifying. With the Russia-Ukraine conflict heading into its 200th day, there's no sign of ceasefire. G7 declared cap on Russia oil price, and Russia promptly retaliated by stopping supplying gas via the Nord Stream I pipeline. The European energy crisis continues to escalate with new highs in natural gas and electricity prices and a historical high 9%+ inflation rate. The upcoming winter seems even more ominous now. On the other side of the Atlantic Ocean, FED has learned much from the 1970s: Powell is becoming Volcker #2. At Jackson Hole, he stressed: "We are taking forceful and rapid steps to moderate demand so that it comes into better alignment with supply, and to keep inflation expectations anchored. We will keep at it until we are confident the job is done." After consecutive 75 bps hikes, USD index strengthens further. To counter RMB devaluation risk, PBOC reduced the foreign currency reserve ratio, which effectively releases more USD supply in the onshore market. This tool was only utilized for the first time ever in May this year.

1. Don't Ignore the Macro

Farewell to the old world! We're in the new world of many "unprecedented" Macro scenario that were only contemplated in textbooks. Even Buffett who used to ignore macro factors and paying close attention. Back in August 2020, Buffett invested in 5 Japanese trading companies who had healthy cash flow and invested in global resources and real economy. In 4Q 2020, Buffett added energy company Chevron, and added investments in Occidental Petroleum this year. He's also invested in insurance company, railroad, and telecom companies, which are consistent with investing in a stagflation environment.

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Buffett's recent investments look familiar… Back in the 1970s, the markets were volatile with the collapse of Bretton Woods, crash of Nifty-Fifty, Oil crisis. Initially the high input costs caused temporary production stagnation. When Kaiser Aluminum dropped 40% with a PE ratio of 4.5, Buffett stepped in. Under stimulus policies, US economy recovered steadily to push up industrial production with strong annual double-digit PPI rates. By 1977, Buffett revealed in shareholder letter that he had allocated 6% of total AUM in Kaiser Aluminum, with a cumulative return of 674%.

At the same time that traditional industries were recovering, Buffett also noticed consumer and media companies. In 1977, his top picks included Capital Cities Communications, Interpublic Group of Companies, Ogilvy & Mather International, The Washington Post, and of course maintained his 'dream business' See's Candies. In May of 1977, Buffett published a long article on the Fortune magazine titled "How inflation swindles equity investors." https://fortune.com/2011/06/12/buffett-how-inflation-swindles-the-equity-investor-fortune-classics-1977/ In his view, only by deploying new investment capital into modern manufacturing equipment can the average investor improve their economic circumstances. And if the industry lacks innovation or don't purchase new equipment, then it'll eventually fall behind. Clearly, even if Buffett doesn't dwell on Macroeconomic themes, he has clear macro logic. His portfolio composition also reflects the evolution of the macro-environment and shifting industry structures.

2. Innovation drives the cycles

Kondratiev Wave tracks modern world economy over 40 to 60-year cycles over four phases of recovery, expansion, stagnation, and recession. The economic cycles are like seasons that rotates over time. But what drives the cycles? Austrian economist Schumpeter categorized three types of drivers for economic cycles: external factors, growth factors, and innovation. According to him, economic development "is spontaneous and discontinuous change in the channels of the circular flow, disturbance of equilibrium, which forever alters and displaces the equilibrium state previously existing." **Developments therefore consists in the new combinations that differ from stationary equilibrium which can come about in the form of innovation.** Schumpeter stated that innovation is a micro-behavior. The micro-innovation can grow to become an industry, ushering in the wide-spread impact of innovation. As economies develop and technological innovations advance, the traditional leading industries that led the economic development cycle will be replaced by the new industries that have sufficient innovation.

Email ir@rosefinch.cn

朱雀基金
Rosefinch Fund
(T) [021]2030 5888 (F) [021]2030 5999
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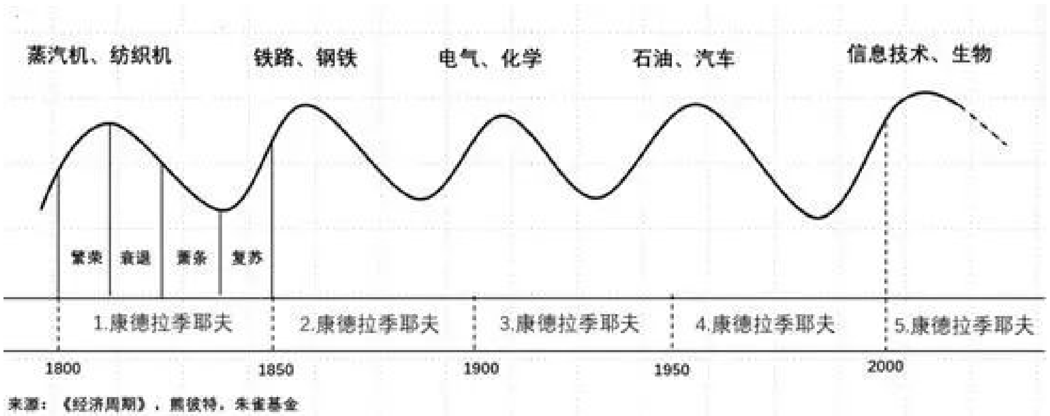

Source: Schumpeter, Rosefinch. The five cycles: steam engine; railroad; electricity; oil; Information Tech.

Over two hundred years ago, the invention of steam engine allowed machines to replace human or animal labor, hydropower, or wind power. Factories no longer must situate by the river, and the weaving machines' productivity increased by over 40%. Long-distance railway became reality and the first industrial revolution started.

From end of World War II to end of 1950s, global economies grew at a fast pace as we enter into age of heavy industries. The top US stock market capitalizations came from fossil fuel, automobile, base metals, and Chemicals.

In the 1980s, heavy industries were replaced by consumer companies. With low inflation rates, consumer power increased, and a wave of US consumer companies made a killing. Whether it's consumer staples like Walmart or Unilever, or consumer discretionary like Ford or Chrysler, they all enjoyed fast growth curves.

By the 1990s, the traditional electronics companies have transitioned into information technology companies, led by Cisco, Oracle, and Microsoft. After the .com bubble of 2000, Apple OS took off. After the huge success of iPod, and followed by Apple computer and iPhones, the golden age of consumer electronics is upon us.

In China's 40+ years since economic reform, we also experienced similar trajectories. In the past, the high growth eco-system was led by government, driven by real estate/infrastructure, supported by indirect funding via banks. **As industrialization and urbanization encounter maturity, the economic growth slows down and a new development eco-system: led by industry or enterprises, driven by technological innovation, and supported by direct funding via capital market.**

Digital economy, biological economy, and green economy are the three main drivers of China's economic cycle. **To China, it may lack influence on semi-conductors; it may be still behind in**

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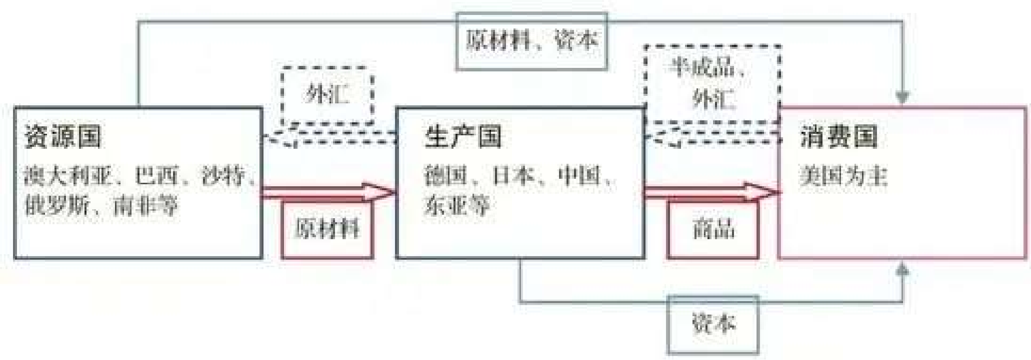
biopharmaceuticals; but it is a world leader in carbon-related technologies. In 2021, China's photovoltaic industry contributed over 75% of global production across the major segments of polysilicon, silicon wafer, batter panels, and assembly. According to International Energy Agency (IEA) estimates, by 2025, China's polysilicon and silicon wafer production may be 95% of total global production. In 1H22, photovoltaic assembly export was 78.6GW, a YoY increase of 74%; total photovoltaic exports amounted to 25.9 billion USD, a YoY increase of 113%.

In the new energy vehicle field, based on current technology, Chinese companies have clear scale and cost advantages, which makes it extremely difficult for the US to completely free itself from Chinese suppliers. According to the Chinese custom data, 1H22 Lithium battery export totaled 130 billion RMB, a 75% increase YoY. Gross exports totaled 3.4 billion batteries, a 36% increase YoY. China is becoming the world capital of Lithium Battery.

In the late 1970s, the 5th Kondratiev cycle showed clear sign of globalization as national advantages differentiated countries into resource, production, or consumption. In this eco-system, cooperation delivers higher value then decoupling. Fast forward to now, few would have expected US-China trade increased after the Covid pandemic. China has replaced EU as US's biggest trading partner.



Source: 《涛动周期论》

3. Investing with the destiny of our times

In a time of peace, key for investing is to look for opportunities; in a time of volatility, key for investing is to avoid blowing up. Very few people are bankrupt because of inflation, but many people are bankrupt because they want to beat inflation. In the past, real estate linked trust products often promote annual returns of 10% or more. In comparison, A-share stock market with its higher volatilities and short bull-runs became a second fiddle. But that was the good old days. We see many headlines of investors losing millions on wealth management products. Even the CSRC official had come out and reminded the investors back in 2018: question any wealthy management products that guarantee more than 6% return; anything more than 8% guarantee is dangerous; and if it's more than 10%, beware of losing your entire capital.

The first step in investing is to establish reasonable return expectations. If your expectation is too aggressive or greedy, it's easy to fall prey to market traps or risky situations.

The second step in investing is to diversify asset allocations. The goal is not to maximize returns but to increase risk-adjusted returns. For example, if by taking one unit of additional risk, you can get two units of additional return, then it's a good portfolio. Diversification also serves to hedge away asset risk. For example, when you purchase stock, bond, and CTA assets that have low correlations, it's like you put eggs in different baskets and then put these baskets in different cars. This can prevent suffering unacceptable losses on any single asset.

In a recent investor survey by Ant Financial, there are some young investors named "kings of mutual funds", with one owning over 3000 mutual funds, or roughly 1/3 of the entire universe of Chinese mutual funds. Unless you're applying for the Guinness World Records, you probably don't need to invest in so many funds. An effective approach is invested in different low-correlated products, and for each product, invest in products with different but stable styles.

The third step in investing is to maintain a long-term investor mindset. Is time an equity investor's friend or enemy? This depends on if you can make the logical decisions at the appropriate time. The best strategy is to grow with great companies when they're neglected by the markets. **In the age of high-quality development driven by technological innovation, the key is to find the "future stars" today who will go on to dominant the market and capture the lion share of future profits.**

4. Conclusions

After the 2008 financial crisis, Buffett shared that in the US's 200-year history, there were about 15 economic crises. There were 6 recessions in the 1900's. But even though recessions or fear will happen from time to time, it's not a black hole. Every century will have years of weak performances, but overall the good outnumber the bad. Overall then, this country will continue to advance. Both US and China are countries like this. **In the marathon of investing, there will never be a lack of opportunities. The worst fear is, when the opportunity comes, you had lost the ticket of entry.**