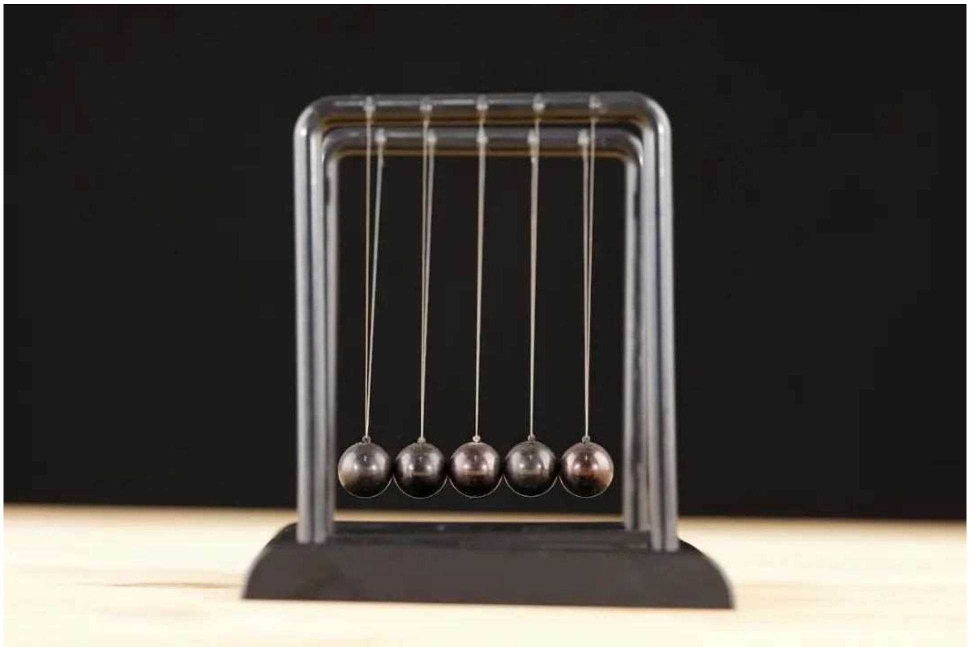
Rosefinch Research | 2022 Series # 30

The Pendulum Swings



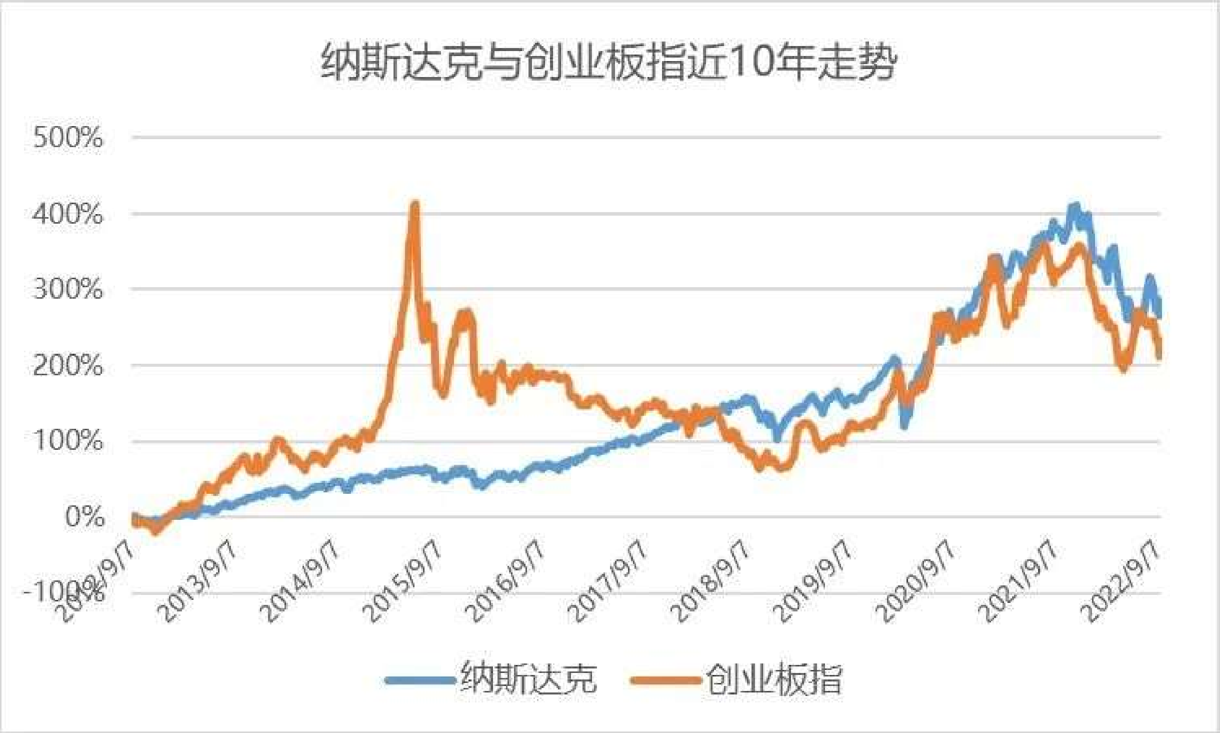
Up and down it goes, and the market has returned to the initial starting point. Missing the last rally seems okay now, while the most regrettable path would have been fully loaded in 1Q, cut by May, and then rebuilt in July. Just like many life decisions, they may seem wrong in short term, then look right in medium term, how will they do in the long term?

Compared to the dark clouds back in April, September sees some sun light, but the undercurrents remain dangerously. Inflation remains stubborn as European, and US monetary authorities race to hike. US has hiked 75 bps for three times in a row, UK has 75 bps primed and ready, and Sweden is going straight for 100 bps. Meanwhile, US increased its sanctions against China across semi-conductor, biotech, new energy. The investors feel stuck with reduced liquidity holding back growth stocks and worsening fundamentals dragging down value stocks. In a market that lacks confidence, good news is often missed, and neutral news can be interpreted as bad. Future uncertainty is the Sword of Damocles, where even a minor hit can cause capitulation. We are living in a fearful time as the pendulum swings.

Looking back at the start of the new energy battery company's correction, which was back in August over the mid-year results. Despite strong results, the stocks nonetheless fell as the battle of expectations and crowded positions took their tools. As of now, the New Energy index has fallen 22% from the peak, back to levels last reached in March. The PE ratios are now down to bottom 20% of the last 5 years' range. So is this the correction of the upswing, or the final collapse of the crowded trade?

The Chief Strategist from China Merchant Bank Mr. Xia Zhang had a great perspective on this. He said that because institutional investors have periodic benchmarks like appraisals, returns, or ranking tables, they tend to find and chase the same high-performance sectors together. These crowded trades tend to follow the same patterns over time. First some investors buy in the sector; this sector goes up and attract more attention; then more capital catches on and invest in the same sector. This positive feedback loop inevitably leads to over-valuation, which is also when the most spectacular rally happens. The crowded trades collapse because there are better deals to chase. So don't be blinded by the market hype, but proactively look for the best sector to invest in.

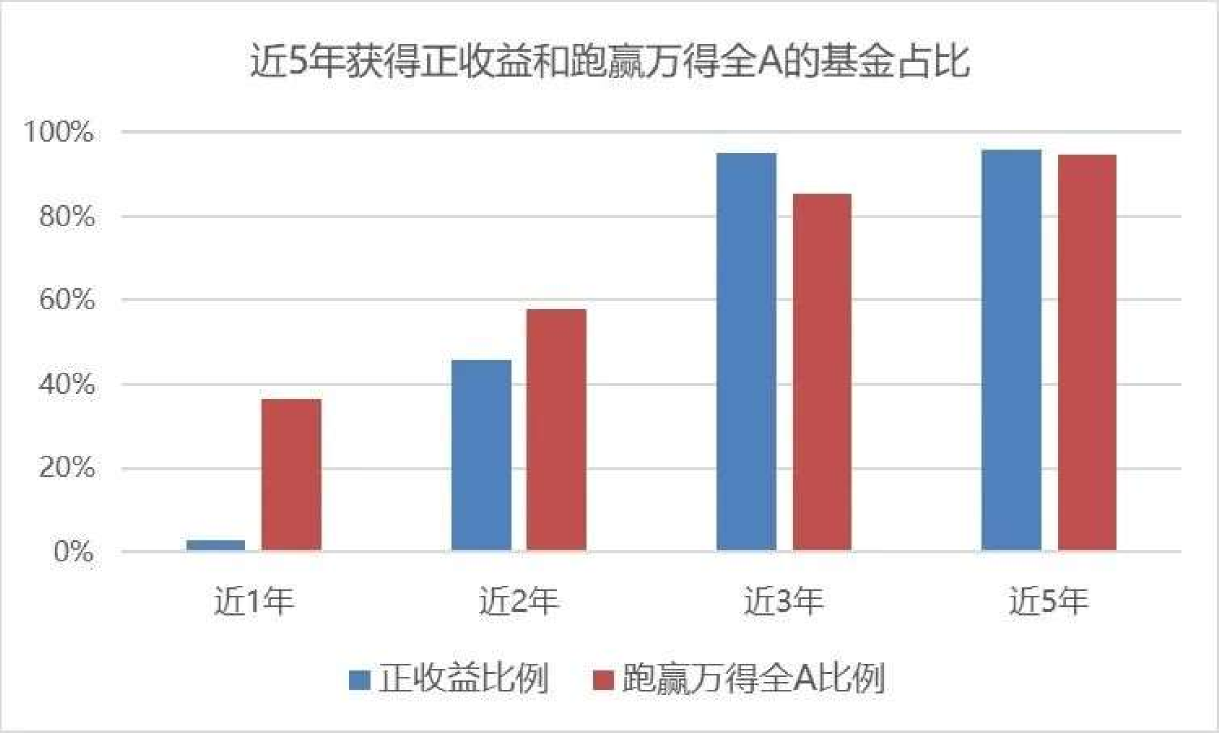
So in summary, crowded trades follow performance, and what determines performance is liquidity. From single stock to single sector to the index, high liquidity has been a key characteristic of China A-share. Both Chi-Next and NASDAQ are made up of mostly growth stocks in technology and biopharmaceutical companies. In the last ten years, these two had similar returns, with peak return at about 410%. It took NASDAQ 9 years but Chi-Next only 3 years. And what a roller coaster ride it has been!



Source: Wind, Rosefinch. Data from 2012/9/7 to 2022/9/16. Blue is NASDAQ, Orange is Chi-Next.

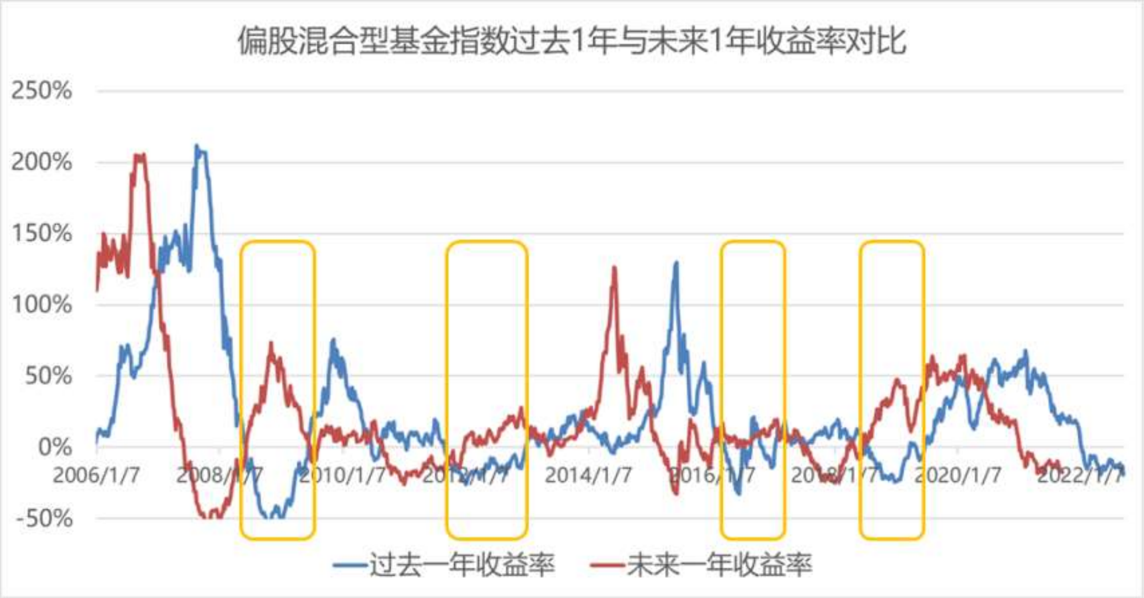
In a highly volatile market, it's very hard to passively capture high-quality beta. It's better to capture alpha from active management. Volatility means disagreement in the market, and disagreement means mispriced opportunities, which is the source of our excess returns. From end of 2003 till now, Wind A-index rallied 440%, yet Wind Equity Mutual Fund index went up 930% in the same period, showing that mutual funds outperformed the market. In contrast, Barron's analysts looked at large cap mutual funds in the US market and found that in the last 10 years, only 22% of the actively managed funds outperformed the S&P. While China market saw the equity mutual funds outperforming the index, it doesn't mean mutual fund will beat index in every period. Furthermore, even if it outperforms the benchmark, it doesn't mean it's generating positive absolute returns for the investors.

Looking at the historical distribution of China equity mutual fund returns, in the past year, over 60% of actively managed equity funds fall behind the index, and 97% of them are loss-making. But if we extend over 3y, 5y, or through the full Bull-Bear cycle, the percentage of funds that generate positive income or beat the index become much higher.



Source: Wind, Rosefinch. Labels are last 1y, 2y, 3y, 5y. Blue is % w/ + return; Red is % that beats index.

Statistically speaking then, while most of the funds would have generated positive returns over the long term, the short term is much harder. Looking back, it's precisely those most difficult periods that planted the seeds for future returns. Take Wind Equity-biased Balanced Fund index as example: looking at the rolling previous one year's return and the future one year's return, there is a clear negative correlation. Large short-term rallies tend to over-extend long-term return potential, and vice versa. **So when the previous one-year return turns negative, it's actually a signal for adding investments. Now is just such a time.**



Source: Wind, Rosefinch. Blue line is previous year's return; Red line is future year's return.

In psychology studies, there was an experiment. One good is selling for 100 in shop A with original ticket price of 150; and the same good is selling for 100 in shop B with original ticket price of 50. Even though consumers can buy the same good at the same price of 100 in both shop A and B, those who saw the original price tag of 150 are more likely to purchase. The behavior of consumer is therefore not only linked to the price of the goods today, but also how the price compared to its historical levels.

But in stock investment, this phenomenon seems to be reversed! When our stock or fund holdings drop, there are much less investors that "buy low." Why is that? Well, investing incorporates our future price expectations. When the market is falling, most investors will extend the price actions linearly and expect further downfall, hence they'll expect further drop and wait for a lower price. In consumer shopping though, goods price doesn't change often, so we often do not wait for further discount on an already discounted item. Aside from the future expectations, there's also the issue of uncertainty about the stock price. To some investors, stocks is just a trading instrument. They are unable to evaluate the true worth of the company, so they'll just trade it like any other asset. This is exactly where the professional investors have their advantage. In actual consumption, we roughly know the pricing range of the goods. So if a bottle of drink is normally 1 dollar, we'll be tempted to buy when it's selling for 80 cents, and we'll be stocking it up when it's selling for 50 cents. Similarly in investing, when we focus on evaluating the worth of a company, we can utilize the correct valuation framework and pass investments that's overvalued and choose stocks that's undervalued. **The failure of correct valuation is to become the source of other people's excess returns in the competitive world of investing.**

At this moment, the market trading volumes are reaching new lows for the year. The market pendulum has now swung deeply to the one side. **Just as Howard Marks said: "Rule number one: most things will prove to be cyclical. Rule number two: some of the greatest opportunities for gain and loss come when other people forget rule number one."**

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