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Standing at Crossroad

There are a few popular stories making the rounds in the Chinese finance media these days. First is about a retired lady in Dalian who bought 50,000 RMB of stock in 2008 and then forgot her account password. By the time she went to reset the password, her account has grown to 5 million RMB. Another is about a gentleman who lost track of a stock account he opened 14 years ago that has since turned 10,000 RMB into 500,000 RMB. These stories were loved by retail investors. As the stories gain traction under the dark cloud of market retracements, they remind us of the stories of lottery winners when the lottery sales are down. Statistically, with 200 million stock investors in the A-market and 5000 listed companies, it's not surprising to hear about a few lucky ones. **But betting the house on a single stock and wait for it to become a ten-bagger is not a sustainable investment model.**

It is worth noting that both stories above happened in 2008, a typical bear market. Back in Sep 2008, A-share had gone down 11 months in a row from its peak at 6124 and CSI300 had lost over 70%. The drift lower is even tougher psychologically than the sharp drop, it's like a frog being boiled in warm water. By the time it realizes the danger, it's too late. And since the investor was already stuck, then just put it out of mind and eventually forgot about it – this is the likely path for the two "stock-gurus."

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Source: Wind, Rosefinch. Blue(L): Shanghai Stock Index; Red(R): A-share volume in 100mm RMB.

By the time stocks chopped, volume dropped, and IPO tanked through issue prices, a new trend began developing. A month after A-share reached 1664 low, with rate cuts and "4-trillion RMB" stimulus policy, the market welcomed the V-recovery. It has now been over a decade, but Shanghai index is still around 3,000. It has been the laughingstock of investor jokes, most accompanied by a sigh and a weary head shake. **But very few people point out that it's not that A-share not rising for 10 years, but that Shanghai index has lost its relevancy.** There are three key reasons for this observation:

1. The A-share listed companies' structure does not track the actual economic structural shifts. In the Shanghai stock market, the traditional industries' percentage is clearly higher than what's represented in the GDP. It's missing crucial and sizeable industries such as digital economy, high-tech, and other high-quality enterprises.

2. Shanghai index is calculated using market-cap weighted, while others use free-float weighted. This means Shanghai index is dominated by large or mega-cap stocks, thus not representing the actual market performance. In the Shanghai index, the traditional cyclical stocks like banks, real estate, coal, construction, petrochemical account for over 60% of its weights.

3. Delisting process is still being perfected. In the early years, many companies with low profitability or even annual losses were not actively delisted, thus pulling down the total index level. This is improving with 46 companies delisted this year so far, a historical high. We now see improvement in the quality

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of the companies in the index, with delisting accepted by the market.

Since 2007, we see that Shanghai index has largely stayed in place around 3000, Wind-A has rallied 230%, and stock-mutual-fund index has gone up 350%. Therefore, where Shanghai index is actually doesn't matter as much. **Shanghai index doesn't measure the market sentiment accurately, so it is not a good indicator for investment opportunities.**

In comparison, there are other more valuable market indicators such as sector valuation, economic data, net profit, liquidity, and policy changes. When we compare now to 6 months' ago, the hot sector of new energy sector valuation is back to baseline level, social financing and structure are improved, core CPI and PPI are falling, imported inflation is slowing down, and macro policy remain very supportive.

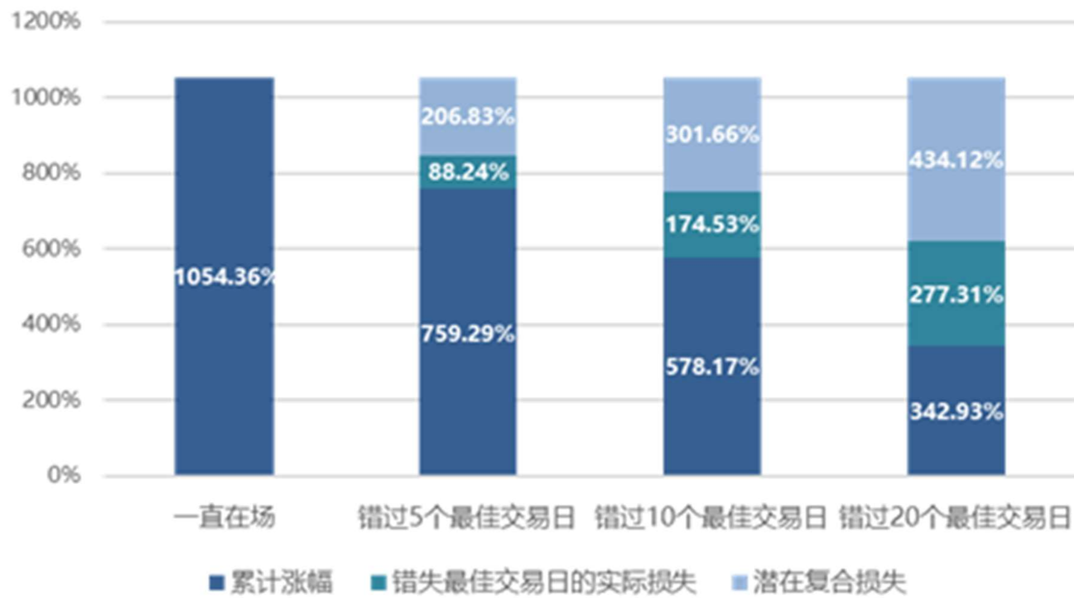
In the asset market, the relative dynamic of the longs and shorts are turning as well. In the last week, there has been announcements of over 2 billion RMB of self-purchases by mutual fund managers, which brings the YTD number to 86 billion RMB, a historical high. Even though the total market cap of Chinese stock market is about 80 trillion RMB, the daily turnover is only a few hundred billion RMB, which is why it won't take so much to cause the sudden turn.

This year's Nobel prize winners Diamond and Dybvig pointed out that the core cause for the bank-run crisis is not economic fundamentals, but the vicious cycle kicked off by the collapse of market confidence. As people's confidence collapsed, they cause a bank run, which leads to banks closing, which in turn shuts down financial liquidity, that breaks down company supply chains, forces bankruptcies, generates more fear and finally denting the confidence even more. This vicious cycle of fear and panic becomes self-fulfilling.

The stock market's fall is also caused by the loss of confidence. Investors try to redeem the assets into cash, but in the process, they're also removing valuable chips and any hope of future appreciation. Unfortunately, under extremely stressful situations, an ounce of emotion is more powerful than a pound of fact.

At the bottom of every cycle, when fear squeeze out the last drop out of the market, profits start showing. What welcomes the investors next is Shelby Davis' Double Play: the rally in both Earnings Per Share and Price Earning ratio.

In a highly volatile market, what determines the long-term returns are a few pivotal moments. In the past 18 years, China Stock Mutual Fund index rose over 10 times. If you stay in the market, you'd have achieved 1054% return. But if you miss the biggest 20 days, your return would have been reduced by 2/3!



Source: Wind. Dark: cumulative return; Medium: returns on missed days; Light: lost compounding effect. The four bars are (from left): always in; missed 5 top days; missed 10; missed 20.

A major market fall is not the first time, a rally to new highs after market fall is also not the first time, and we know this scenario will repeat again. We know how it'll play out, but just like Al Pacino said in the movie Scent of a Woman: **"Now I have come to the crossroads in my life. I always knew what the right path was. Without exception, I knew. But I never took it. You know why? It was too damn hard."**

It's always the toughest at the bottom of the cycle, it not only tests our investment acumen, but also our resilience and mindset.

We hope that by sharing Rosefinch's views, in a small way, we add value to your day.

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