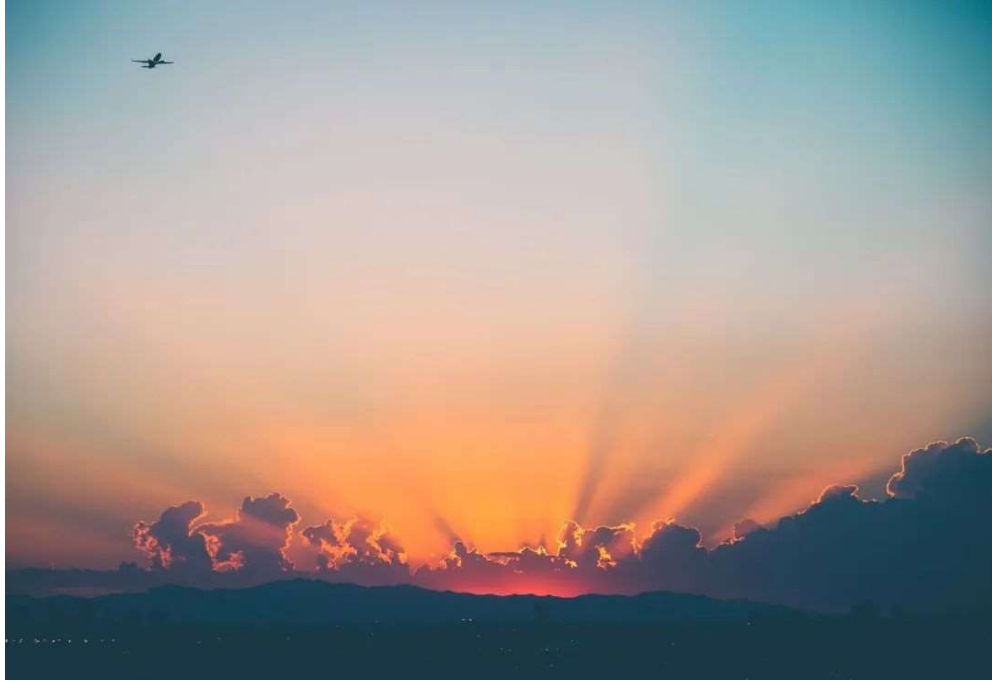


Rosefinch Research | 2022 Series # 36

Hang On till the Dawn



Hope is borne out of despair, and rally is borne out of hesitancy. We are seeing that in front of our eyes as A-share rallied last week with volume returning to trillion-RMB mark. The Hang-Seng Tech index rose 16% in a week. We're seeing large appreciations not just in A-share, but also in RMB exchange rate and the H-shares, which reflects the increased market confidence in Chinese assets. The undervalued market is ripe for a rebound as investors take on more optimistic forecasts. Market is becoming more sensitive to bullish news and less sensitive to bearish news. The market has after all already priced in a lot of the negative news and outlooks. Because the nature of the market is to value future cashflows, it will respond earlier than the actual economy, and certainly sooner than the backward-looking data releases. The market is like a tightly coiled spring: with the investment logic and asset valuation ready, we just need a catalyst to trigger the energy release. We're seeing a lot of headlines that point to a more promising future: German chancellor Scholz's visit; opening of 5th China International Import Expo and World Internet Conference; running of Beijing and Shanghai Marathons; and completion of US PCAOB on-site audit in HK.

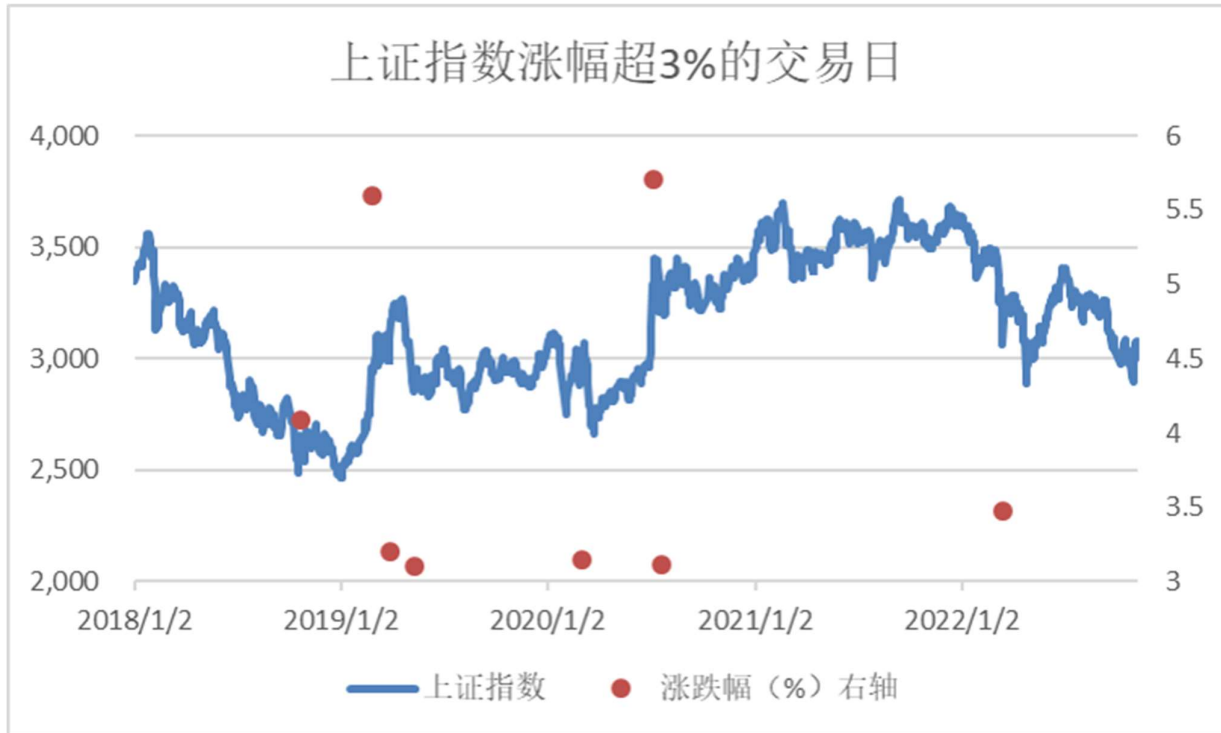
Zhongtai Securities research wrote that in different stock market cycles, macro-environment, valuation, and sentiment play important roles.



Source: Zhongtai Securities research. Weightings by macro/valuation/sentiment at different stages of the stock market cycle. The stages are (L to R) trough, early recovery, bull market, top of bull mkt, bear market.

In the bear market, sentiment weighting is 50% where fear sinks market to its trough. And in the early recovery stage, valuation becomes key as attractive opportunities emerge. We may not be able to identify the exact pivotal turning point for the market, but we are reasonably confident that downside now is limited. We believe it's key to identify the trend rather than specific timing. When the market is trading near the lows, it's more important to be in it because if you miss the key recovery phase, the long-term returns will become mediocre. Howard Marks had said a key risk is not taking enough risk when the time comes.

In the China market, when you buy equity with Shanghai index at 3000, it's less risky than when you buy equity with Shanghai index at 5000. You may capture 10% from both investments, but the risk-reward scenarios are very different. We are human after all, and our emotions often cloud our judgments which lead to the regrettable buy-high-sell-low behaviors. Looking back, the extreme market volatility often occurs during periods of extreme emotions, which are typically respective market tops or bottoms. In the last few years, Shanghai index's +3% days were mostly at end of 2018, after first wave of pandemic in 2020, and after this March after state council meeting on financial stabilization. In all cases, market welcomed rallies afterwards.



Source: Wind, Rosefinch.

CISI Financial analyzed the median returns of active equity mutual funds in China and noted that there's never been two negative years in a row. The first year's suffering is unlikely to be repeated in the next year. But to keep an even keel in a downward market is not easy. Even the famed contrarian investor John Templeton acknowledged that he may lack the courage to jump in at the most pessimistic moments. That is why Templeton will make a "wish list" when market is relative calm. On this list, he'll list companies that are well-run but over-valued. This way, when the market drops excessively, he can pick up good companies on the cheap.

If our goal is to smoothen portfolio volatility, we can adapt David Swensen's asset allocation and rebalancing strategy. For example, if our portfolio is 60/40 ratio of \$60 equity and \$40 cash, then when the equity portfolio drops from \$60 to \$40, the portfolio ratio is now 50/50 with \$40 each of equity and cash. In order to maintain the 60/40 ratio, we'll need to buy more equity so we can have \$48 equity and \$32 cash and retaining the 60/40 ratio. Therefore in order we maintain the asset allocation ratio, we must rebalance the portfolio so that when equity drops, we buy more. This behavior was exhibited by the pension fund community during the internet bubbles era from 2000-2003. When SP500 halved, CEM Benchmarking noticed that the 220 pension funds they track retained the equity allocation of about 65%. This means they had rebalanced to maintain the equity exposure. Similarly, during the sub-prime crisis, US stocks again halved, but the pension fund's average equity exposure was only slightly reduced from 58% to 52%, meaning they again bought more equity in a down-market. CEM Benchmarking noted that portfolio investors that withstand such market volatilities must have defensive allocations, as well as timely rebalancing mechanisms, i.e. buy-on-dip.

Whether it's the pension funds' "asset allocation and rebalancing" or John Templeton's "wish list," these investment approaches are not trying to predict the exact future, but to prepare the game plan based on long-term valuations and implement such plan expeditiously.

'Tis darkest before dawn, but know that the dawn will always come. There is a Chinese saying that: on a 100 miles journey, finishing 90 miles is just completing half the journey. Or to borrow a Kobe Bryant quote: "what's there to be happy about, the job is not finished." **It's those last leg of the journey that tests our body, our brain, and our heart the most. Know that on this journey, you're not alone. There are others like you, so join us and hang on together till the dawn.**

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

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