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Let the Bullet Fly A While Longer

The World Cup is in full swing in Qatar with daily surprises already. On the first day, Qatar broke the "host nation wins first game" rule and lost against Uruguay. On the second day, world's number 3 Argentina lost to number 53 Saudi Arabia, becoming the biggest upset in World Cup history. On the third day, the mighty Germany led 1:0 at the half against Japan, only to succumb 1:2 at the final whistle. If the investors are to take some lesson from these shocking results, it'd be to don't become over-reliant on any single asset class.

For most people, they are used to the high volatility of stocks – it's a high return, high risk asset class. As for bond market, people can easily equate the low return with low risk. In China, many retail investors equate fixed income with principle-protection. For the fixed income funds to generate higher yields, the managers would need to extend maturity, lower credit ratings, or increase leverage. Those fixed income funds that did well historically took more risk to achieve that result. For those who are more keenly aware of fixed income fund's market risks, it's worth keeping tabs on the maturity/rating/leverage parameters. And there's another risk that's unexpected: the liquidity risk that came from large redemptions. When there's insufficient funding or offsetting new subscriptions, mutual fund managers will have to liquidate positions to fund the redemptions, which typically involves suffering a discount to its valuation. The subsequent downward adjustment in valuation will trigger more investor anxiety, generate yet another wave of redemption as investors race for the door. **Liquidity is like the air we breathe - we don't feel it most of the time, but we can't live without it**. While 1% or 2% drop may be normal daily volatility for equity funds, it may be half of a fixed income fund's annual return. When the storm hits the fixed income market, your painstakingly accrued return may evaporate quickly.

When the avalanche hits in the snowstorm, no snowflake is innocent. If human nature is incorrigible, how do we prevent a stampede? We saw some guidance by China CSRC for money market funds. In the guidelines published at start of 2022, CSRC called for sufficient asset liquidity by requiring assets by single issuer must be less than 5%; active position in illiquid assets must be less than 5%; average maturity for the Money Market Fund portfolio should be less than 90 days. In addition, CSRC asked for central managed liability side: avoid single investor taking up more than 5% of the fund; for those with larger than 5% holdings, there should be restrictions on redemption, such as limiting daily redemption to less than 5% of the fund, or delaying part of the redemption proceeds, etc. There also should be risk capital set aside that account for at least 40% of monthly management fee and 20% of custodian fee. In other words, the main framework promotes diversification both in investing and in fund raising, shorter duration, and limit large subscription or redemptions. This impossible trinity of "returns, liquidity, safety" will require some sacrifices in return to create more liquidity and safety. But for bond fund and equity fund that seek higher returns, it's necessary to take on bigger volatility.

The key first step in all investment is to establish reasonable expectations. For investment, the most dangerous thing is not the visible market volatility, but the invisible risks. For bond fund, chasing yields at all costs does put it at the mercy of the market. When we invest, we're not avoiding risks but managing them. For the equity fund, we should proactively face the market volatility and seek medium- to long-term returns. In the current round of market rebound, there's been very volatile moves with little trace of clear themes. Market is taking two steps forward and one step back, as expectations and stock prices are bobbing in the waves. We've already seen the low in stock valuation, but we still need confirmation in the return of profitability. There's a long window of 5 months after the 3Q22 returns before we get more earnings data.

Market has been crowded with themes lately: new drugs, ventilators, internet, real estate, video games, SOE… as different sectors take turns rallying a few points a day, is there a strategy that follows the hottest stocks? Believe it or not, there is actually an index called ShenWan Active Stock Index that and tracks the 100 companies with highest turnover for the week. The index started in late 1999 at 1000, and finally closed at 10.11 in 2017. Yes, that's not a typo, that is a 99% drop over the 17-year period.

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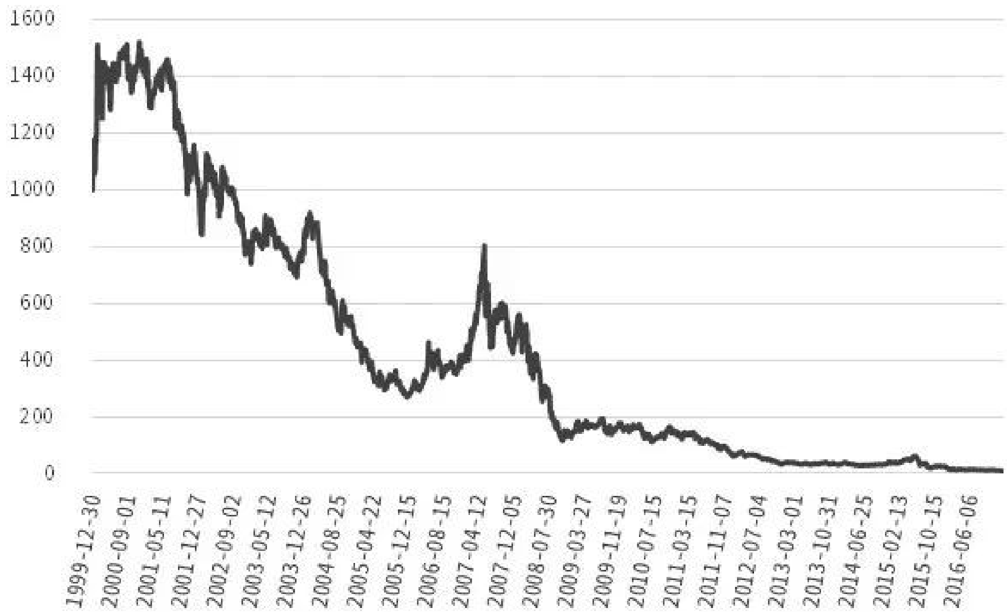

Source: Wind.

People will naturally chase the sought-after things. Psychologist Stanovich did a "red light blue light" experiment. He asked volunteer to sit in front of two lights and guess which one will light up next. For the experiment, they'd set the frequency of red light on at 70% and blue light on at 30%, albeit in random order. After a number of rounds, the volunteers noted quickly that the red light turns on more frequently than the blue light. Thereafter, they tend to pick red light more frequently. In theory, if the volunteer just guesses red light all the time, they'd get it right 70% of the time. But the result is surprising: when Stanovich tabulated the long-run accuracy of the volunteers, it's only 58%, or a full 12% less than the simple "all red" strategy. This may reflect people's investment decision process. In the long-term, investors know the equity market will go up, just like the red light will turn on more frequently. But people aren't satisfied with a boring buy-and-hold strategy, and instead wants to predict short-term up or downs in order to generate higher returns. Stanovich concluded from the experiment that we should learn to accept mistakes in order to minimize them. **In other words, investors should be selective in their approach and actively avoid investment opportunities that are either unclear or too challenging. It may look like we're decreasing our choices, when in fact it's decreasing our probability of making a wrong decision.**

In the World Cup games, within 90 minutes there are literally hundreds of passes, just so that they will eventually land under the foot of the striker in front of the goal. The success conversion from shots to goal is not only dependent on how many times you shoot, but more on the quality of your shots. Looking now at our investment world, as the market formulate a trough, it's important to keep our cool by not dropping our chips nor blindly chase hot stocks. **Let the bullet fly a while longer, and let the underappreciated assets welcome the eventual return of value.**

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

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