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Rosefinch Research | 2023 Series # 15

Being Victorious without Spectacular Victories

Although this year's China Mutual Fund issuing activity is sporadic at best, the number of changes to fund managers has reached a new high since at least 2016. Just looking at the first half of the year, 327 fund managers were added this year and 148 fund managers left, with changes affecting 15% of total mutual fund managers.

In terms of active equity funds, many people firmly believe that "buying funds is buying fund managers." Fund managers are constantly under the spotlight, and those who stays in front of the pack tend to get more votes. In the story of human landing on the moon, everyone knows Armstrong and his classic quote: “One small step for [a] man, one giant leap for mankind." Do you know who the next person is walking on the moon? It was Buzz Aldrin, who landed on the moon only 19 minutes later, but has since faded into the veils of history.

Aerospace, much like the financial market, ranks according to a “winner takes all” principle. Just like no one remembers the second person that walked on the moon or the third country that launched a satellite,

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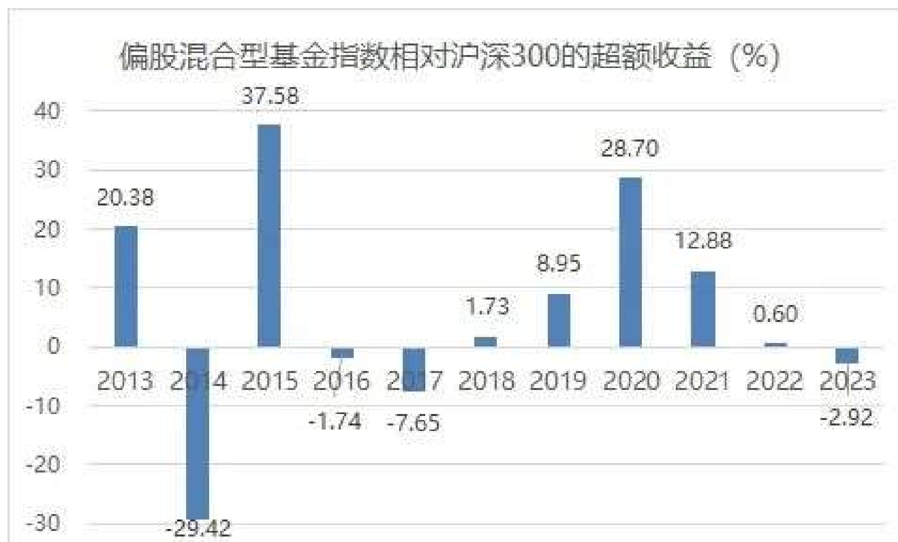
the market zooms in on the first-place finisher on the podium of fund performances. This glorified race for top finish breeds a group of fund managers who chase returns with concentrated portfolios. They may successfully lead the market in the short term or even for some time, but they will eventually flip the wrong side of the coin.

Returns are very important, but investors should also ask where these returns come from? Is it from the stocks selection, or from the sector beta, or from well-timed top-down allocation? One needs to know not only the result but also the reason behind it. Can the successful cases be replicated again? This is the soul-searching question that every investor should ponder for their fund holdings.

Investment returns are non-linear: any long-term effective investment method will inevitably encounter intermittent periods of ineffectiveness in the short term. Conversely, if it remains effective in the short term, it will inevitably attract a large number of followers, resulting in the disappearance of excess returns.

The halo of star fund managers often raises investors' expectations, but historically, almost no one can escape the cycle of rotation. Every time the fund manager's excess returns disappear, investors inevitably fall into self-doubt: Has the fund manager become complacent? Is the scale of management too large? Will they be able to outperform in the future? From history, we can see quite a few periods like this. In the past decade, the China equity-bias fund index on average outperformed the Shanghai Shenzhen 300 index by 6% per year. But from a single-year perspective, there were 3 years of underperformance, and the excess returns in two of the years were below 2%. In other words, even though active equity funds significantly outperformed the index over the past decade, about half the time, investors did not obviously feel the "enhancement" brought by active management, such as 2016-2018 and from 2022 to the present.



Source: Wind, Rosefinch. Data as of July 24th, 2023.

Perhaps even more difficult than creating star fund managers is retaining star fund managers. Known for active investing, Fidelity International relied on star fund managers such as Peter Lynch and Gerald Tsai

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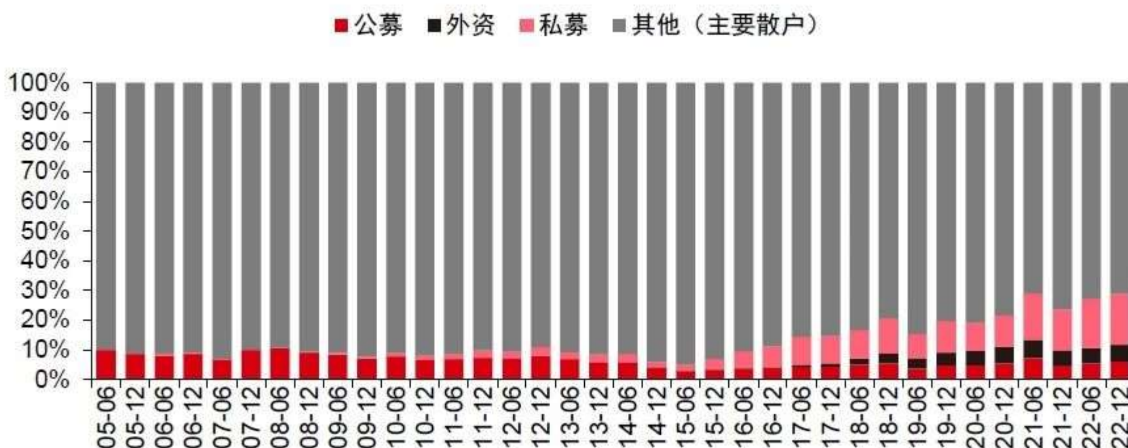
to market the funds and eventually became the largest public fund management company in the United States in the 1990s. However, the problems behind the halo have always existed. Morningstar once did a report on 150 US fund companies, and the data showed that the average tenure of Fidelity International's fund managers and employee retention rate ranked in the bottom 1/5 of the industry. Frequent personnel turnover, which is obviously not a good thing in the asset management industry where "people" are at the core. Warren Buffett had stated his business strategy as: finding economic castles with unbreachable moat. But if the moat requires regular repairs and frequent replacements of key parts, it’s no longer unbreachable.

So in addition to "star making", global asset management institutions have also explored other very different approaches. Vanguard and Pioneer Group, representing the index camp, compile index rules through quantitative methods, avoid fund managers' subjective judgments, and build a kingdom of passive investment. Vanguard founder Larry Fink once said, "Since the founding of the company, I have done everything I can to avoid the star fund manager culture from taking root within the company."

Capital Group represents the multi-fund manager and team decision-making camp. Simply put, Capital Group divides the funds of large public funds into multiple parts and assigns them to several fund managers to manage, not only avoiding restrictions from a single star fund manager but also effectively alleviating the problem of fund AUM expansion.

Although the recent "enhancement" of active management funds in China may not be obvious in the past two years, the conditions for generating excess returns have not changed. It is estimated that as of the first quarter of this year, transactions of A-share mutual funds and private funds accounted for about 22% of volume, foreign transactions accounted for about 6%, a significant increase from 2019, but individual investor transactions still accounted for more than 60%.

By comparison, institutional investors' transaction volume accounts for nearly 80% of the Hong Kong market. In the A-share market where individual investors are the main participants and the participation rate of institutional investors is relatively low, the probability of erroneous pricing may be higher.



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Source: Wind, CITIC Securities.

What investors need to do is build a sustainable mechanism for identifying and capturing these mispricing opportunities. For Rosefinch, this approach is known as the integrated research-driven investment model.

At Rosefinch, we often allocate sufficient research resources for the sectors we focus on, such as the green economy, digital economy, and safe development sectors. The researchers often have industrial backgrounds and conduct in-depth studies in their responsible sub-fields to become experts.

To arrive on specific investment targets also requires cross-validation between researchers from upstream and downstream of the industrial chain. For example, in the new energy vehicle companies in the advanced manufacturing sector, we have some researchers focusing on upstream industrial commodities, some studying mid-stream battery materials, and some tracking automobile data to find the most critical links in the industrial chain. Based on "industrial logic allocation", we also need to adjust based on the outlooks of each link in order to make forward-looking deployments, and make choices between different industries by horizontal valuation comparisons, which is "securities investment".

Mapping from research to investment is a part of the entire research process where inconsistency between words and deeds is relatively easy to occur. Short-term temptations and emotional interferences make it difficult for fund managers to avoid deviations in actions. At Rosefinch, fund managers must build and adjust investment portfolios based on the company's core stock pool and specific investment mandate. Our investment framework purposely minimizes the personal preferences of fund managers and relies more on the long-term accumulation of research capabilities of various industrial chain research teams.

In sports competitions, audiences may prefer the spectacular reversal of fortune as the hero snatches victories from jaws of defeat and beats incredible odds to become stuff of legend. While that is great drama for the theaters, we believe that in investment, it's better to be victorious without spectacular nail-biting victories. We'd rather be a little boring by emphasizing protecting the capital first, and only then seek upside potential.

What is most likely to determine the long-term returns of a fund is not any single shooting star fund manager, but the vitality of the research organization and values that the institution holds dear. Only by staying stable like a tree, with roots digging deeply into the fertile soil, will one be able to withstand the rain and wind of the market and remain resilient and sustainable.

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

We endeavor to provide timely English version of Rosefinch's publications. For any English translation of the original Chinese article, in case of any discrepancy, the Chinese version takes precedence.

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