Frame Funds.

In the Frame

Keeping you up to date with Frame Funds and financial markets.

September 2021 // Issue 8

Investing

AN ALTERNATIVE APPROACH

FUND PERFORMANCE

How our strategies performed in August

STOCKS IN PLAY

Our most recent addition to our Long Short Australian Equity Fund

What I saw in August 2021

NSW LOCKDOWN, CHINA& HONG KONG, FUND PERFORMANCE

August saw the 11th consecutive month of positive performance for the S&P/ASX 200. It was the fourth month in a row where the Australian market hit a new all-time high. On the surface you would assume investors would be cheering this performance, however August saw the bulk of FY21 reporting take place.

Extreme price action in both directions was the natural result. Companies like Wisetech Global (**ASX: WTC**), Blackmores (**ASX: BKL**) & Redbubble (**ASX: RBL**) benefitted. Market darlings such as Reece (**ASX: REH**), Bendigo and Adelaide Bank (**ASX: BEN**) and Boral (**ASX: BLD**) were sold off aggressively as they struggled to build on a solid FY21.

Iron ore implosion

In August, Fortescue Metals Group (ASX: FMG), BHP Billiton (ASX: BHP) and Rio Tinto (ASX: RIO) declined by -15.70%, -14.73% and -14.35% respectively.

Iron ore declined by approximately 22% as China continued to ramp up its commitment to reduce emissions by cutting steel output. There was some respite for FMG near the conclusion of the month as they released outstanding results for FY21 and declared a $2.11 dividend. This brings their total dividends for FY21 to $3.58, a whopping 20.90% yield.

Lockdown continues

NSW & most parts of the country continued to be in lockdown during August. In July, communication around when the lockdowns were going to end was non-existent. Thankfully in August there was a pivot to the acceptance of living with the virus, as cases in NSW breached 1000 per day.

The shift in communication provided some light at the end of the tunnel and thankfully gives people in lockdown something to look forward to. New South Wales is forecasted to have 70% of the vaccine eligible population immunised on October 17, which doesn't seem too far away now.

Portfolio performance

We saw mixed performance across our strategies during August. Our long short Australian equity strategy declined by -1.55% whereas the Global Macro strategy appreciated by +2.28%.

The Long Short Australian Equity Fund (FLSAEF) was at the mercy of a mediocre reporting season. The majority of our investments rallied aggressively in the lead up to August but were subsequently sold off after their results were released to market.

Largest contributors for the Frame Long Short Australian Equity Fund were Blackmores (+1.45%), S&P/ASX 200 SPI Future (+0.89%) and Virgin Money UK (+0.34%). The largest detractors were Mineral Resources (-0.93%), Boral (-0.89%) and BHP Billiton (-0.77%).

The three, six & 12-month performance of the FLSAEF continues at a solid +4.00%, +6.16% and +11.23% respectively.

The Frame Futures Fund (FFF) had a solid month of performance. The trading strategies generated +1.49%, while the core strategy generated +1.27%.

The six-month performance of the FFF continues at a solid +4.93%. Impressively, the 12-month performance is tracking >20% p.a.

If you would like to discuss any of these points, please email me at hue@framefunds.com.au or call our office on 02 8668 4877.

Hue Frame
Managing Director

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Investing - An Alternative Approach

WRITTEN BY HARRY HEANEY

PART 1 - THE PROBLEM WITH THE INDEX

When launching a new strategy, the first thing to consider is its purpose in the investment universe.

Our objective (along with many other individual and institutional investors) is relatively simple – we aim to outperform a market index on a risk-adjusted return basis, providing a superior alternative to passive equity index investing or other actively managed funds.

In order to design such a strategy, we first need to consider the dynamics of the index we want to beat.

Most readers will be familiar with the S&P/ASX200 index. It comprises the largest 200 publicly traded companies in Australia, weighted by their market capitalisation (subject to liquidity conditions). Simply, the index is just another trading model – it 'buys' stocks when their market capitalisation rises and 'sells' them when it falls.

This means the manager is already on the back foot when benchmarking to an index. We are effectively trying to beat a trading model that has no fees, commissions or slippage. Looking at the index this way, it becomes apparent a 're-packaged' S&P/ASX200 product with fees will not succeed. Some outside the box thinking is therefore in order.

We start by examining some of the index's flaws. The most obvious problem with investing in indices that are market cap weighted is unintentional destruction of diversification. For instance, the top ten stocks in the S&P/ASX200 contribute fifty per cent of index weight, while the bottom quarter of the index constituents contribute approximately three per cent.* This means index returns are dominated by the performance of a small number of very large companies, while the remaining index constituents contribute very little, even if they 'outperform' the broader market.

Given this design flaw, what happens if we remove the index's bias towards large companies? We take a portfolio of 50 equally weighted, randomly picked stocks within the S&P/ASX200 universe (using historical index constituents) and rebalance monthly. That is, we randomly select 50 new companies at the start of each month to invest in for the next month. Running 1000 Monte Carlo** simulations on this strategy for the 20 years ending 1 January 2021, we find the average return is **10.68%**. The S&P/ASX200 returned **8.03%** inclusive of dividends for the same period!

This means by selecting 50 random stocks and allocating equally each month, you would have had a high probability of outperforming the market. In our trial, only the bottom 1.5% of simulations returned less than the market return of 8.03%.

While this simulation is very simple and doesn't include any transaction costs, its relative success gives faith to the idea that outperforming a benchmark index over the long run is a real possibility.

By approaching the market from a different point of view rather than 'index tracking', we may be able to develop statistically significant strategies that achieve our objectives of out-performance on a risk adjusted basis.

**As of August 23, 2021.*

*** Monte Carlo simulations generate a range of possible outcomes by running a strategy with a random element repeatedly. This allows an approximate probability distribution of the strategy to be constructed and analysed.*

PART 2 - BAD DECISIONS & HOW WE STOP THEM

History is replete with examples of investing going wrong for both individuals and institutions. Anyone who has participated in financial markets will have made an investment based on a poor decision or faulty logic. Of course, hindsight is always 20/20, however that does not prevent these mistakes from happening in real-time.

In 1979 Daniel Kahneman and Amos Tversky developed Prospect Theory by observing investors actual behavior. They began by posing 2 pairs of investments to subjects and asked which choice they would make in each case.

In a positive scenario, would you prefer:

- A sure gain of $3,000 **OR** a 50% chance to gain $6,000 (otherwise no gain).

In a negative scenario, would you prefer:

- A sure loss of $3,000 **OR** a 50% chance to lose $6,000 (otherwise no loss).

Note that in each case, the expected value of the investment is identical – when weighting the outcomes with the probability of each event occurring, the options in each case are the same.

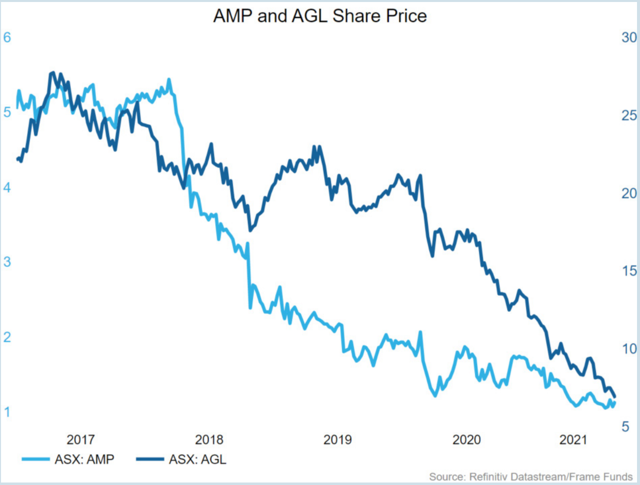
At this point I'm sure readers have made their own choice regarding which options they would take. Kahneman and Tversky found that 84% of respondents preferred the certain $3,000 gain, a decision consistent with ***risk averse*** behavior.

In the second option, 84% of people chose the coin flip for the chance to lose nothing or $6,000 – this is consistent with ***risk seeking*** behavior. It also implies the pain of losing is greater than the gain of winning, known as loss aversion.

This behavior was confirmed when the respondents were asked whether they would prefer either (a) no change in wealth; or (b) 50% chance of a $100 loss and 50% chance of $100 gain. The majority preferred option (a) to (b), which explains why insurance exists – people prefer to pay a small sum to avoid a low probability but high loss event.

The results of these simple experiments are very telling about how most people approach financial decisions and reveal some of the irrationality humans display when investing. Another common fallacy people make when assessing investments is acting based on *anchoring bias*.

Anchoring bias is a cognitive bias that causes people to make judgements about something based off a reference point (or anchor). Practically, this means if we see a stock trading at $1 which last month was trading at $1.50, we naturally think it is 'cheaper' or a 'good buy'. The stock will be able to go back up to $1.50 simply because it has been there recently, right? Recent examples of where this flawed logic would get you into trouble are AMP Limited (**ASX: AMP**) and AGL Energy (**ASX: AGL**).



When you combine these behavioral obstacles, we as humans are always going to struggle when making investment decisions.

We will not always have the time to think carefully and rationally through every buy and sell order, meaning the possibility of acting on these biases increases.

We believe the solution to this is **systematic investing**. Systematic investing is a rules-based approach to investment management, where the rules are determined by extensive quantitative analysis. By applying this approach, we eliminate emotion from our trading decisions, ensuring our entries and exits are based on statistically significant factors. We enter positions knowing we are exploiting our 'edge' over the market and exit ruthlessly without emotionally holding on to losing trades.

Part Three *will discuss a variety of systematic strategies such as momentum investing and mean reversion trading. It will explore the principles guiding these approaches, how we test them and the statistical edge they provide.*

HUE FRAME
Portfolio Manager

HARRY HEANEY
Research Analyst

Global Macro

WRITTEN BY HUE FRAME

Frame Futures Fund

Units of the Frame Futures Fund appreciated by +2.28%. Both the core & trading strategies contributed +1.49% and +1.27% respectively.

Equity and Currency investments added approximately +2.88% and +0.18% respectively, while Commodity and Fixed Income investments were largely flat.

Global equity markets continued to rise in August. Iron ore, copper and crude oil all experienced profit taking, while foreign exchange markets saw a bout of repositioning, as the Delta strain impacted traditional risk currencies. Fixed Income markets were largely unchanged during the month as market participants awaited further information as to the path of policy tightening.

Our event-based trading added +2.07%, with our investments in China & Hong Kong adding +1.39%. This was positive considering the poor performance seen in this region last month. We have started to see a change in the communication from the People's Bank of China (PBOC) in recent weeks. This, in combination with restarted liquidity injections, may mean the large retracement we have seen in these markets could well be approaching a short-term bottom.

Largest contributors to the performance were our active trading strategies on the S&P/ASX 200 future contract (+1.16%), our investment in a listed blockchain technology company (+1.18%) and our active trading on the China A50 future contract (+1.38%). Our investment in Fortescue Metals Group was the largest detractor to performance (-0.80%).

In terms of fund activity, we reduced our lower conviction holdings within the core strategy which can be seen in the decreased number of Fund investments. We also actively traded in and out of the Delta impacted 're-opening' businesses (as noted in prior months). We trimmed our lithium & rare earth materials holdings. In our view the euphoria seen in some of these investments at present is somewhat irrational.

At the conclusion of the month, the Fund held 28 investments.

FUND PERFORMANCE as at 31st August 2021

	1 month	3 months	6 months	1 year
Frame Futures Fund	**2.28%**	**-0.90%**	**+4.93%**	**+23.16%**
RBA Cash Rate + 3%	+0.26%	+0.78%	+1.55%	+3.18%
Excess Return	**+2.02%**	**-1.69%**	**+3.39%**	**+19.98%**

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HUE FRAME
Portfolio Manager

HARRY HEANEY
Research Analyst

Australian Equities

WRITTEN BY HARRY HEANEY

Frame Long Short Australian Equity Fund

Units of the Frame Long Short Australian Equity Fund decreased -1.55% in August. Comparatively the S&P/ASX200 rose 1.92% for the period.

August was a very busy month for the Australian share market, as a significant amount of companies reported their results for FY21. The focus seemed to be on outlook, which most companies found difficult due to the lockdowns currently taking place across Australia. The 'peak growth' narrative continued to persist, which explained the premium placed on companies that issued positive forward guidance. A weakening Chinese economy fuelled this perspective, as soft steel consumption and production data caused a sharp sell-off in iron ore. The S&P/ASX200 materials sector suffered as a result, finishing the month down -7.93%.

Blackmores Limited (**ASX: BKL**) was the top equity contributor this month, it contributed approximately +1.45%. BKL rose as much as 25% off the back of their annual report where they announced increased revenue and gross profit margins. Virgin Money UK CDI (**ASX: VUK**) contributed +0.34% as the market continued to digest a positive third quarter update from late July. Premier Investments Limited (**ASX: PMV**) added +0.29% as investors looked past current lockdowns to the expected wave of spending once the New South Wales and Victorian economies reopen. Discretionary trading in the S&P/ASX200 SPI futures contract also contributed +0.89%.

Our investments in the materials space were the main detractors from performance. Mineral Resources Limited (**ASX: MIN**) detracted approximately -0.93% after they missed EBITDA expectations in their 2021 financial year report. Boral Limited (**ASX: BLD**) and BHP Billiton Limited (**ASX: BHP**) also detracted. The latter suffered at the hands of the iron ore price decline, while the former faced headwinds after an underwhelming financial report and continued fallout from the failed Seven Group Holdings (**ASX: SVW**) takeover. The general theme in August was many of our investments struggling to meet market expectations after moving aggressively higher prior to the release of their annual reports.

We exited our investment in Costa Group Holdings (**ASX: CGC**) as they failed to signal any real expected growth over the next year. Our largest sector continues to be materials, however its weighting has decreased to 41.97%. We were able to take advantage of volatile price action in A2 Milk Company Limited (**ASX: A2M**) and Nuix Limited (**ASX: NXL**) as investors positioned themselves prior to the release of their financial reports.

At the conclusion of the month the fund held 23 investments.

FUND PERFORMANCE as at 31st August 2021

	1 month	3 months	6 months	CYTD
Frame Long Short Australian Equity Fund	**-1.55%**	**+4.00%**	**+6.16%**	**+11.93%**
RBA Cash Rate + 3%	+0.26%	+0.78%	+1.55%	+1.81%
Excess Return	**-1.82%**	**+3.22%**	**+4.59%**	**+9.85%**

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HARRY HEANEY
Research Analyst

Stocks in Play

WRITTEN BY HARRY HEANEY

Key Investments

For this month's edition of *Stocks in Play* we have focused on a selection of three companies held within the Frame Long Short Australian Equity Fund.

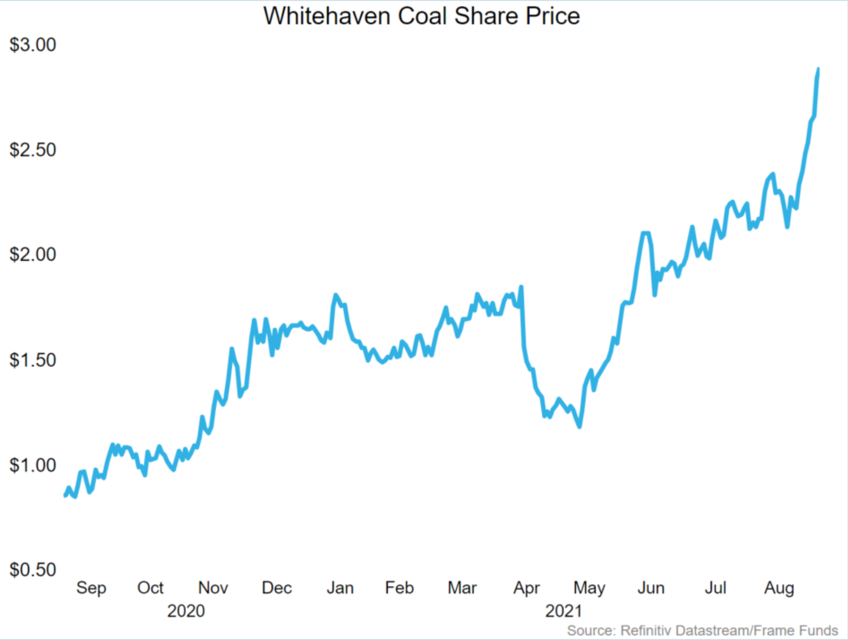
Whitehaven Coal (ASX: WHC)

Whitehaven Coal have had a very strong 4 months thanks to significantly higher coal prices. Whitehaven have cited increased demand from Asia, which has the youngest fleet of coal fired power stations in the world.

Heightened industrial production thanks to the COVID-19 recovery has also assisted their profitability and in turn, their share price. Global coal demand is expected to be strong until 2025.

After the release of their FY21 results, WHC are focusing on debt reduction and optimising mine productivity to service the strong demand for coal.

We believe Whitehaven still has room to move higher in the medium to long term, however we are looking for the share price to consolidate in the short run.

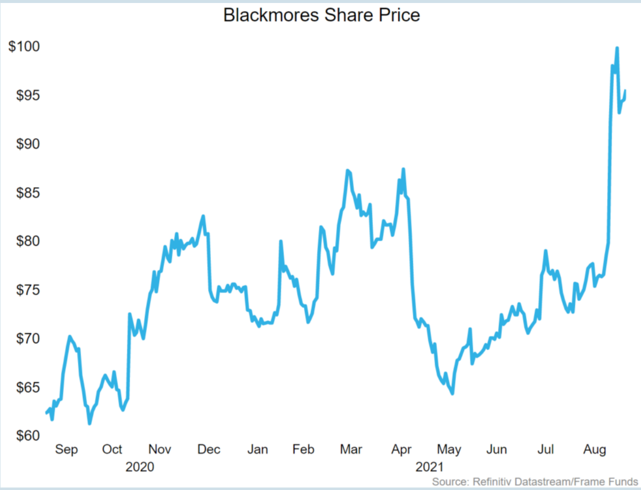


Blackmores (ASX: BKL)

Blackmores is another company that performed strongly after the release of their FY21 results as their share price increased as much as 25%.

Expansion into Asian growth markets proved to be successful for Blackmores, with revenue and gross profit margins both increasing. We believe the COVID-19 pandemic has led to a paradigm shift in the way the world views health and wellbeing. More emphasis has been placed on staying mentally and physically healthy which has naturally benefitted Blackmores vitamins and supplements business.

We believe their continued investment in global supply chains leaves them perfectly positioned to capitalise on a more considered approach to health, particularly in South-East Asian markets.

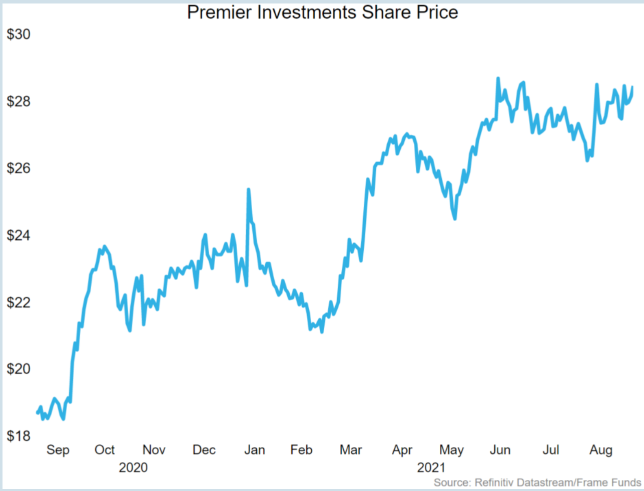


Premier Investments (ASX: PMV)

While Premier Investments has not yet reported their results for the 2021 financial year, we believe they are very much in play once they report.

While their holdings will be negatively impacted by the current lockdowns, we expect their guidance will be upbeat as the Australian economy begins to reopen with high levels of vaccination.

There remains a high level of household savings and suppressed demand in the economy and we believe once stores reopen, cash rich consumers will be ready to spend in the retail space. Especially in Smiggle, as children return to school. We also believe online distribution channels will have partially offset in-store sales losses during the lockdowns.



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