

Tao Value Q2 2017 Letter

July 17th, 2017

Dear partners,

It is a great pleasure for me to write the inaugural investor letter of Tao Value to you. As the early investors, you have put your trust in me that I can only hope to repay by exceptional returns in many years to come.

The Origin

Although most of you know me well, it is important to outline the genesis of Tao Value. I have been managing personal assets subscribing to a concentrated, value oriented strategy since 2012. The performance for the past 5 years has been satisfactory, warranted that it was (and still is) one of the longest and strongest bull markets in the history. One thing became very clear to me is that continuously learning and analyzing businesses, then subsequently allocating and compounding capital is something constantly excites me and something I would like to do for a life time. To continue my investing practice in a larger scale (and potentially as a career), I offered to manage capital for some close family members and friends.

The mission of Tao Value could be best illustrated by its Chinese name 匡值 (Kuang Zhi). Kuang stands for assisting and Zhi for value. Tao Value is here to be your capital steward, assisting you to preserve and grow your valuable assets.

It is my belief that the right incentive system should have as strong interest alignment between the principal (you, the asset owner in this case) and the agent (me, the money manager) as possible. To achieve this goal, my wife and I will maintain the majority of our discretionary liquid assets in Tao Value's strategy.

Rather than the prevalent 2/20 hedge fund model, the fee structure I decided to adopt is the early Buffett partnership's 0/6/25 model. To be specific, that is 0% management fee, 6% hurdle rate & 25% incentive fee of the return above 6%. The reason is simple: it's the right incentive system, not only to me, but also to the whole money managing industry. The 0/6/25 model would allow capable managers to earn what they deserve meanwhile eliminate incapable ones (as their businesses will be losing money). To me, the 2/20 is an inferior incentive model that does not have proportional downside punishment, which ultimately attracts incapable investors (however who may be perfectly suited talents for other occupations) and causes sub-optimal resource allocation of the whole society.

Investment Approach – The Philosophy

My investing philosophy is, to some extent, a hybrid of 1) classical value investing doctrines, and 2) Traditional oriental philosophy (Taoism, Buddhism & Confucianism). It also should be noted that it is an ever-evolving philosophy. Buffett in his 30s were still picking the cigar butts and didn't get the beauty of compounders, so I'm sure my philosophy would keep evolving in the years to come. Below are some key creeds surrounding Tao Value's investment decision making.

- *Market is like a pendulum, MOVING CONSTANTLY between euphoria and depression:* The pendulum is a metaphor I borrowed from Howard Marks, an investor I highly respect. However, the idea behind it is really derived from Taoism's "Reversion is the motion of the Tao" (反者道之动) and Buddhism's "Impermanence" (无常). In an extended context, it indicates all objects in this universe are constantly moving/changing from one extreme to the other, financial market being no exception.
- *A DEEPER SENSE OF UNIVERSE is a trait of great business & people:* By "deeper sense of universe", I try to generalize many characteristics belong to the top of the Maslow's pyramid (Self-actualization). This includes purpose, integrity, societal value, etc. I highly value these characteristics and think businesses/people with them have much less unfavorable surprises and much lower probability of failure than the ones without.
- *The mismatch between VALUE and PRICE is the main driver of long term return:* Any asset has intrinsic value (yes, even commodities or currencies, whose value is just more supply/demand driven) and market price and they don't align with each other all the time. Identifying and capturing the mismatch is the key approach to achieve long term investing success as these two will eventually converge.
- *Financial instrument is a fractional OWNERSHIP, or CLAIM of an entity (business, government & people, etc.):* The abundance of liquidity in modern financial market created an illusion that financial instruments are just pieces of paper that one can turn around and make quick bucks. On the contrary, I believe digging into the fundamental bottom and understanding thoroughly of the underlying entity is the only way I can confidently allocate capital to such entity and go sleep every day without worrying about the price the next day.
- *The real risk is not volatility, rather is the PROBABILITY of permanent capital loss, and the most important risk factor is the PRICE you pay for an asset:* Another common fallacy modern financial theorist help foster is to see the volatility as the risk of an investment. To a real investor, the risk should be the probability of permanent capital loss, which volatility was used just to approximate for. Unfortunately, volatility fell short to do so and is an oversimplification. I also realize that valuing an asset is a tremendously difficult job and ultimately requires subjective

judgments. Thus, I believe the price I paid is the key risk factor determining the probability of the permanent capital loss and buying with a sound margin of safety is the best risk control practice.

Investment Approach – The Process

I will start with where I spend my time and our capital to. It's mainly 3 investment themes: special situations, distressed assets and great operations at reasonable price. The core idea of all three is “buy low sell high”, however the way of analysis for each is somewhat different.

- In special situations category, I look for entities undergoing some type of corporate event that might lead to a mismatch of value and price (e.g. depressed prices due to forced sells, or under-appreciated prospect that could increase the value). Examples of special situation investments include, but are not limited to, spinoffs, corporate restructurings, mergers, liquidations, asset sales, and rights offerings.
- In distressed assets category, I look for asset that is priced well below its value due to unfavorable developments. a.k.a. “There is always a price to make a crappy business an attractive investment.” Since the risky nature of distressed assets, heavy analysis is performed on balance sheet and solvency side. It also is the most time consuming from tracking perspective as any new development and disclosure could have huge impact on the value of the assets. I typically size ideas in this category conservatively. Examples of distressed assets investment include, but are not limited to, cigar butts, scandals and high yield corporate debts.
- In great operations at reasonable price category, I look for, as the name itself says, great operating businesses at reasonable price. This is what Buffett does for the late part of his career, and examples include well known Berkshire Hathaway's holdings of Coca Cola, American Express and Wells Fargo, etc. The return of this category comes not from the price/value mismatch in current day per se, rather from the compounding growth of the value in future. Thus, my research spent on this category is mainly on the industry, business model and moat of the business, which drive the value compounding ability of an entity.

Next, I will talk about the process of how I approach analyzing an opportunity. I usually start with the business itself, trying to understand the business model, industry landscape & whether there is moat around the business. Then I will move on to balance sheet, to get an idea of what assets it has, last to its profitability (i.e. income statement). There are well documented metrics and valuation methods for analyzing the latter two, but the first (also the most important, in my opinion) item – business analysis – may worth more elaboration.

I use a self-developed “Sun Tzu's 5 factors” method to analyze businesses. Sun Tzu's classical military treatise, The Art of War, starts with the 5 most important factors affecting wars: Tao/Dao (道), Meteorology (天), Topography (地), Commander (将), System (法).

1. Tao/Dao, as a term, is very hard to interpret (even for Chinese) because Taoism thinks the essence of the universe is not describable, thus intentionally keep it as general as possible. It is commonly interpreted as “morality” in this context as Sun Tzu elaborates it in subsequent texts saying “Tao causes the people to be in complete accord with their ruler, so that they will follow him regardless of their lives, undismayed by any danger”. In my framework for business analysis, I extend it a bit to include more “spiritual” consideration of a company.

- **Mission/Purpose** – Does the company have a big mission/purpose? What societal problem is this business trying to address? How much is the business meaningful for the society?
- **Morality** – Does the company always adopt moral and prudent business practices?
- **Sense of the Position in the Value Chain** - Does the company understand the value it creates for the world? And only take fair return for the value it created?
- **Benefit to All Constituents** – Does the business create value for all constituents (including suppliers, employees, customers and the society)? Does the business have support and belief from all the constituents?
- **Range of Vision** - Does the company have a short-range or long-range outlook in regard to profits?

2. Meteorology literally means the weather, seasons etc. In business analysis, I look at all the influential forces that are NOT IN the company's own control.

- **Addressable markets** – How large is the addressable markets of the company's products/services? Does the company have products or services with sufficient market potential to make possible a sizable increase in sales for at least several years?
- **Industry Trends** – What are the secular and cyclical trends affecting the business?
- **Competition** - Are there other aspects of the business, somewhat peculiar to the industry involved, which will give the investor important clues as to how outstanding the company may be in relation to its competitions?

3. Topography literally means the likes of positions, distances. In business analysis, I look at all the influential forces that are IN the company's own control, the most important of which is the moat.

- **Moats** – Does the company have moat? Are they narrow or wide? Are they susceptible to disruption/erosion?
- **Profitability** - Does the company have a worthwhile profit margin? And what is the company doing to maintain or improve profit margins?
- **Financial Strength** - Does the company have relative strong/healthy financial position? Does the company use leverage prudently? Does the company need external financing to achieve its stated goals?

4. Commander probably needs the least explanation. It simply means the management in business analysis.

- **Integrity** - Does the company have a management of unquestionable integrity?

- **Determination** - Does the management have a determination to continue to develop products or processes that will still further increase total sales potentials when the growth potentials of currently attractive product lines have largely been exploited?
- **Transparency** - Does the management talk freely to investors about its affairs when things are going well but “clam up” when troubles and disappointments occur? Are executives promotional?

5. System means laws and discipline in Sun Tzu’s context. I include all governance & incentive related items here. The most important one that I focus on is incentive systems (including both rewarding and punishing).

- **Culture** – Does the business have a good culture, cultivating prudent value creation?
- **Interest Alignment** – Does management/insiders have material ownership or material portion of equity in their comp package? How does the management’s incentive plan tie to the business’ profitability and shareholder value?
- **Corporate Governance** - How good are the company’s cost analysis, asset evaluation & accounting controls?
- **Capital Structure/Dilution** - In the foreseeable future will the growth of the company require sufficient equity financing so that the large number of shares then outstanding will largely cancel the existing stockholders’ benefit from this anticipated growth?

Lastly, I want to touch on some miscellaneous items of my investing process. In terms of concentration, I typically hold 10 to 15 instruments, with each of the position consisting between 5-10% of the portfolio. From time to time, some highly convicted ideas in the great operations at reasonable prices category could have larger position up to 15% of the portfolio. My typical holding period is 1 to 3 years, with special situation and distressed ideas on the short side, and great operations ideas on the long side. The implication for you as an investor is that your capital may experience higher volatility (as measured by the change of market prices) due to the concentration, however that doesn’t mean it carries higher probability of permanent capital loss. Rather, the margin of safety (i.e. paying prices very conservative to estimated value) will ensure your hard-earned wealth, along with my own, to bear smaller probability of loss.

Performance Commentary

Going forward, you will not see me repeating Tao Value’s origin and approach every quarter, so the following quarters’ letters should typically start from this section.

The composite, time-weighted return of the strategy was 7.12% for the quarter ended June 30, 2017. For the same period, worldwide equity markets as measured by MSCI All Country World Index (ACWI) returned 3.53%. It doesn’t mean I manage the portfolio with reference to this particular benchmark as I could also allocate capital to other asset classes (e.g. debt instruments, REITs), but the

index return serves as an opportunity cost estimate for your capital. I will guarantee you that our performance will zig and zag differently to any index benchmark, as a fundamental differentiator of value investing is to think independently and act not per the board markets. Our goal is to achieve long term above-market return.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year/YTD
2017	+1.94	+2.34	+0.33	+2.80	+4.14	+0.07							+12.13
Since Inception (*January 1st, 2017)													+12.13

Contributors & Detractors

In this section, I will list the top 3 contributors to the overall performance both from the positive and negative sides and provide comments on selected ones. This quarter, our largest contributor is CYOU, who got boosted mainly by its chairman's taking private offer. We initially started our long in October 2016, and thought it was a oversold business in an inflection point after the new management started executing the turnaround strategy. The buyout offer confirmed our view. Interested investors can refer to my analysis published in my blog [link: <https://taovalue.wordpress.com/2016/10/19/changyou-com-cyou-a-value-buy-with-potential-near-term-earning-catalyst/>]

The largest detractor this quarter is ELON, who is, in my view, a promising business hidden in an underperforming legacy umbrella. To some extent, it is a PE-like investment as the new business (IoT lighting) is still in its nascent stage. However, the good thing is that ELON had plenty cash in its balance sheet, and in this situation, cash buys time. Since the market movement is not related any particular new development in the business side, we still maintain a positive view of this position. Interested investors can also refer to my analysis published in my blog [link: <https://taovalue.wordpress.com/2017/04/12/thoughts-on-echelon-corp-elon/>]

Contributors		Detractors	
Position	Performance (bps)	Position	Performance (bps)
Long CYOU	356	Long ELON	-100
Long CACC	185	Long DVMT	-38
Long GOOG	97	Long CLDR	-33

Top 3 Positions

In this section, I will discuss the top 3 largest holdings of the portfolio. They are usually the highest convicted ideas.

Cash – As of June 30, 2017, we had about 19% cash position. This is mainly (14%) the cash distribution we received from closing of the Johnson & Johnson acquiring Actelion deal on 6/16/2017 (which worked

out very well for us), and partially (5%) my cautious view of the market temperature. As the bull market goes into its 8th year since March 2009, whether we are entering a bubble stage is a problem every prudent investor should be thinking about. Although I don't try to time the market, I do find it's getting harder to spot appealing ideas that have the margin of safety I request.

Changyou (CYOU) – As mentioned in top contributors' section before, Changyou was one of my high conviction ideas which just materialized in May 2017 by the chairman-led MBO offer. The recent price surge has pushed this position's value to about 15% of the portfolio. The implication for me is that I will need to think about alternative deployment of this part of capital as the deal could be closing in short term (6-8 months).

Credit Acceptance (CACC) – Although I didn't write up anything about this position, I see CACC as one of the best ideas I've come across in recent years. It is now standing at 11% of the portfolio. On surface, it is one of the heavily shorted names in US as the subprime auto loan industry is poised for a burst. However, I think what short sellers missed is that CACC is operating with a unique, and more importantly, very prudent business model. Both CACC's operation and management incentive system have built in a strong "deferred gratification" model, which to me, is a very positive sign and a wide moat as it motivates and attracts "right-minded" business practices but not competition (as "deferred gratification" inherently goes against human nature). On the risk side, bears of CACC mainly had three arguments: 1) subprime auto industry headwind, 2) insider sells & 3) poor customer satisfaction. I will try to address all three briefly below:

- 1) Industry headwind: to me, a burst of the industry may not be a bad thing for CACC at all. In fact, in the Financial Crisis, it got more market share because imprudent competitors went out of business. The stock price may be under pressure, however the business value should not. Additionally, there are regulatory headwind that may affect the industry as Consumer Financial Protection Bureau ("CFPB") and Department of Justice ("DOJ") are aggressively investigating the subprime auto lending practices. However, my view is that CACC's model is promoting prudent lending thus should have smallest impact from whatever came out from the new regulation (whose ultimate goal should be "promoting prudent lending").
- 2) Insider sells: it is widely known, by SEC filings, that the retired founder of the company Don Foss is heavily cashing out its holdings (16.8% of the company). Regardless whether it is fair for executive to get a pass to liquidate its stock holdings after retirement, this selling activity should be viewed in the context of the compensation structure of current executives. Specifically, current CEO Brett Roberts was awarded 310,000 RSUs and 190,000 restricted shares in 2012, however approximately 410,000 of these shares/units are vested from 2022 onwards. It is not unusual too see such aligned interest between CEO and minor shareholders, especially from the deferred size and time line perspective. Thus, although I'd prefer to see Don Foss continue to hold his shares, it is not a purely negative sign after considering current executive's compensation plan.
- 3) Poor customer satisfaction: Another superficial bear argument is that CACC had very poor customer satisfaction according Consumer Affairs online review, thus is a poor business. I went through many these complaints and found majority is about its annoying debt collection (some

even went to court). It is arguable whether it is right (or moral) to aggressively collect what others legally owe you, when “others” are deprived and poor classes. However, aggressively going after debt collection is a good sign to me, because they could have simply sold the claims to another entity (presumably at some discount, however should still be profitable) and volume up using recycled capital. The fact that CACC didn’t adopt that approach is a sign of prudent business practice.

One unmentioned risk for CACC, as I see, is the automation (by AI) of these low skill required jobs in the coming decades. If that happens, a lot of these subprime borrowers will lose their income and potentially make the addressable market of subprime auto lending industry significantly smaller. At this point, this risk is very hard to measure.

Final Note

I must admit that it is nerve-racking to have launched an investment shop when almost all major indices reach all-time highs, however I also know that no one could time the market right and call for the exact peak. With the belief that I should be more prudent when others are less prudent, I will continue to try to get as fully invested as possible and to be more cautious and conservative in evaluating the margin of safety. My goal is to generate return after fees exceed the long-run equity board market return, over a full market cycle.

Lastly, I want to thank again for my initial clients for believing in me and helping me develop a record. I’m also deeply grateful to my incredible wife who supported me in this journey unconditionally.

Thank you for reading and I welcome your feedback.