Tao Value Q2 2019 Letter

August 8th, 2019

For the quarter ended June 30th, 2019, Tao Value recorded a return of -2.06%, compared to +3.45% of MSCI All Country World Index (ACWI). As communicated in past letters, our concentrated portfolio's performance is designed to differ from the market in any arbitrary short period of time. This quarter, it was mainly our China tech exposure got hurt by the geopolitical disputes between US and China. A relevant context is that one popular ETF tracking China tech & consumer sectors KWEB lost 6.69% over Q2 2019.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year /YTD	MSCI ACWI
2017	+1.94%	+2.34%	+0.33%	+2.80%	+4.14%	+0.07%	+2.65%	+1.76%	+1.31%	+4.69%	+1.34%	+1.60%	**+27.91%**	**+23.97%**
2018	+2.07%	-3.85%	-3.74%	-0.80%	+4.81%	+2.99%	+2.20%	+4.16%	-0.87%	-7.26%	+3.79%	-5.53%	**-2.93%**	**-9.42%**
2019	+7.68%	+2.62%	+3.19%	+1.46%	-6.54%	+3.28%							**+11.67%**	**+16.33%**
Since Inception (*January 1st, 2017)													**+38.65%**	**+30.63%**
Annualized													**+13.96%**	**+11.28%**

__Contributors & Detractors__

Contributors		Detractors	
Position	*Performance (bps)*	*Position*	*Performance (bps)*
Long CACC	96	Long YY	-128
Long NXRT	92	Long ADS	-116
Long TEAM	75	Long GOOG	-92

Our top contributors this quarters are Credit Acceptance (ticker: CACC), Nexpoint Residential Trust (ticker: NXRT) and Atlassian (ticker: TEAM), adding 96 bps, 92 bps and 75 bps respectively.

Credit Acceptance (ticker: CACC) and Nexpoint Residential Trust (ticker: NXRT) are among our top 3 positions for which I will provide comments in the next section.

Atlassian (ticker: TEAM) is a long term holding since the inception of our portfolio. This position grew from an insignificant one to a modest one after the share price quintupled since our initial purchase. To determine the economics of a SaaS business, I track the combination of its revenue growth + its free cash flow margin. This metric came in as 65% for TEAM this quarter (36% revenue growth + 29% FCF margin), in line with its historical average of 60%. It also shows no sign of slowing down as its software development supporting offering is believed to have a very long run way when every business is going to be a "software" business in the next decade or so. The valuation looks rich at 25+ times sales and it was the main factor causing me to under-allocating capital to it as it never appeared cheap.

The largest detractor this quarter is YY (ticker: YY) with -128 bps. It was followed by Alliance Data Systems (ticker: ADS) and Alphabet (ticker: GOOG), contributing -116 bps and -92 bps respectively.

YY (ticker: YY) reported first time after it consolidated Bigo's financials. As I mentioned in last letter, I think the Bigo deal was not structured fairly for external minority shareholders. Although the top line and operating income numbers came in strongly. The reported earnings per ADS shows a different picture, which was RMB9.32 in 2019 Q1, versus RMB10.96 of 2018 Q1. Obviously, the YY core business' domestic market saturation issue is also a factor to the staggering of per share earning growth. That means we as minority shareholders, must wait for Bigo to continue perform to get the value from this new asset. Another "interesting" development is that YY raised $1 billion through a convertible bond sale at the end of June. However, I noticed that the management cited on Q1 2019's call, which was hosted on May 2019, roughly a month before the close of the convertible financing, that they "don't have immediate plans for fixed income products or bond offering in near term." as the reason for dropping S&P's relationship. Despite of these deterioration in "System" & "Commander" factors, I remain YY is still very cheap to its intrinsic value especially the price has dropped close to 52 weeks low.

Alliance Data Systems (ticker: ADS) welcomed a new executive management team in a surprising announcement. Melisa Miller and Tim King who are long time card business leaders have assumed the roles of CEO and CFO. Since I was skeptical about previous CEO Edward Heffernan's overly promotional style, the management shake up didn't come in as an entirely negative thing. ADS continue to confirm its commitment on using $1.1 billion of proceeds from Epsilon sale for share repurchase in earl July. Based on the current share price, the committed amount implies a 14% yield, if everything else remain the same. I reevaluate the thesis and think it's intact. I decided to add the position slightly.

Alphabet (ticker: GOOG) is our 3rd largest position and will be commented in the section below.

Top 3 Positions

As of the end of Q2 2019, our top 3 positions are Credit Acceptance (ticker: CACC), Nexpoint Residential Trust (ticker: NXRT), and Alphabet (ticker: GOOG). Collectively, they are 37% of the portfolio.

Credit Acceptance (ticker: CACC) remains as our largest position. It was a lackluster quarter operationally. As the management communicated, that they have reached the goal of a round of sales team expansion, the loan portfolio growth quieted down as well. For Q1 2019, The unit volume growth came in flat at 0.4%, and dollar volume growth was 5.1%. The next step would be executing on ramping up these new signed dealers as they are much less active than existing one, which would be something we as an investor need to track closely. Fortunately, Credit Acceptance discloses new dealers' performance along with that of existing dealers' and all dealers' quarterly. This is a reminder that how transparent CACC's management have been, which we value greatly in our "System" factor. The company gives out the very detailed information that their executives would need to understand the performance of their business.

Nexpoint Residential Trust (ticker: NXRT) is now our 2nd largest position. The large size is a result of price appreciation over the years from a modest initial position. As analyzed in detail before (refer to our letter of 2017 Q4 [Link]), this business is, in essence, a flipping partnership under a REIT shell with both strong management incentive alignment and capital allocation discipline. The key concern for such a business has always been how they could sustain such a rehab-flip growth strategy. Judging by deal flows so far this year, it seems that they are doing quite well on growth. On acquisition front, Nexpoint acquired 4 properties (3 in Arizona & 1 in Texas) totaled at $151 million, accomplishing 60% of the guidance for the year of $250 million. On disposition front, it has closed a bundled deal of selling 6 properties in different regions to a buyer for $290 million.

Alphabet (ticker: GOOG) in foreseeable future, will likely maintain its leading position in searching. Some recent challenges operationally have been higher traffic acquisition cost (TAC). The second quarter results showed positive signs that they see TAC to stabilize, and a re-acceleration of top line growth. The only concern I have for Alphabet is still around its regulatory outlook. You can see my further thoughts on this topic in General and Market Commentary section below.

Portfolio Updates

There was no major update regarding new position or exit in the past quarter. For existing positions, we added Alliance Data Systems (Ticker: ADS) for reasons elaborated before.

General and Market Commentary

There appears to be more pressure on big tech companies' regulatory outlook. Furthermore, one 2020 Democratic presidential candidate Andrew Yang brought up an important issue – social welfare during an industrial revolution - to main street which may have significant implication of future profitability of tech industry. As one of our largest positions, Alphabet is at the center of this looming storm. This quarter, I tried to think harder on this topic and would like to share my thoughts with you.

The first question I want to address: <u>why does tech industry attract such level of scrutiny and do they deserve these pressures?</u> In my opinion, the answer is yes, because big tech is at the <u>central role of creating and designing rules for a new world</u>. For someone has such super power, certain public scrutiny is absolutely warranted.

To illustrate this super power, I would like to share a fascinating story about restaurant, well a fake restaurant to be precise – The Shed at Dulwich. A UK Vice journalist, Oobah Butler, set up an ingenious hoax social experiment using Tripadvisor's review system to create a top-rated restaurant out of his own shed. While boosting a fake virtual listing to top 1 in London is impressive enough, Butler decided to open up one night to 10 customers. After being served by thinly disguised £1 frozen meal, some of the customers even wanted to come back and would recommend it! I highly recommend you to read Butler's own entertaining depict of this story at this link[1]. This is a bizarrely enlightening experiment that shows how much power the information has in reshaping the reality.

If it was still a myth how the digital power shaped the reality in last US election, it now becomes clearer to politicians around the globe. With partisan objectives, a rational politician would do whatever it takes to gain more digital power (against opposing forces, be it parties, journalism or human rights activism) via these biggest digital platforms, whether that means more campaign spending, alliances or threats. I believe the current regulatory pressure is a form of threat. With more awareness of such power, I expect to see more, rather than less, of such pressure in future.

The second question I try to find answer is: If above is true, what is the implication to large tech businesses? Andrew Yang is known for his proposal of Universal Basic Income (in a context of industrial revolution) funded by big tech. But a more important question to think is that: whether we are in an industrial revolution at all?

One key feature of an industrial revolution is exponentially increased efficiency and production enabled by new technology. Many would argue we are not seeing such a "exponentially increasing" in production measured by GDP. My counter argument is that GDP itself is an insufficient metric to measure the "production" in new age. Let me walk through an example – information storage, a valuable function both for knowledge transfer on societal level (think of books) and personal utility on individual level (think of photo and video of personal memories). In the old world, every piece of storage activity goes through the physical world and left a GDP trace. For example, encyclopedia books were once a great business model Buffet has invested in, now all this information is created and stored in Wikipedia without any physical or GDP trace. Additionally, pictures or videos taken prior digital age usually incurred a physical/GDP trace via Kodak or Fujifilm's income statements. Whereas now, no such trace exists for value creation tracking. Do we now have vastly more information, which is a form of production and efficiency, stored and shared than before? Absolutely yes. The point I want to make is that we are certainly in an era of exponentially increased utility, just without a proper way to measure it.

The next key feature of an industrial revolution is population shift. In the past, it was from agricultural jobs to industrial jobs. It is surely to happen this time as we already observed the tip of it. Automation (a form of AI) already eliminated many types of jobs, and the hottest job these days are data scientists, who make sense of huge amount of information. However, I think the job security threat would more likely be a short-term pain rather than long term issue. There will be one generation of human being suffering this pain, like in past revolutions, however I think there will be enough new jobs to stabilize the society. Think of this way, how could a late 19th century (in wake of 2nd industrial revolution) ordinary person imagine jobs like phone switchboard operator? One thing I'm sure is that in the new informational/digital age, there will be more jobs which require informational outputs (i.e. renting neuron cells), than energy

[1] https://www.vice.com/en_us/article/434gqw/i-made-my-shed-the-top-rated-restaurant-on-tripadvisor

outputs (i.e. renting muscle cells) from human being. We just won't know in what form these outputs will be until we see it.

Although it may be a one generation pain, we know that inequality or unfairness (in distribution of new value created) could create huge social problem. Now we see similar deterioration in newer jobs' working condition as China tech industry introduced this "996" schedule (that is 9am to 9pm, 6 days a week). We also see in the other side of the Pacific of the frustration of old jobs as they are gradually eliminated. Remember the raise of Socialism starts as a response to the inequality in Prussia/German in late 19th century. Otto von Bismarck, then the German Chancellor, had to introduce the first ever social welfare system in human history, as an investment to prevent further socialist revolution. So, it seems obviously that the ruling parties nowadays need to come up with something similar.

If we agree on that we do need an additional social security net for unprivileged caused by this round of revolution, the next obvious question is <u>where the capital should come from</u>? I personally think big tech, as both the deepest pocketed player and the most obvious culprit, is very hard to get away from directly contributing to this new system. Regardless of the form of such contribution, investors in big tech companies should expect a lower long-term profit margin than previously perceived.

Final Note

If what I perceived about the informational industrial revolution is true, we are in one the greatest ages of investing. After all, investing essentially is identifying great businesses (which will be more) and participating in their growth (which will be faster). Despite the short-term volatility and uncertainty in market, it is an exciting time to start to embrace a longer view of the economy and the investing landscape. I look forward to reporting to you next quarter.