Tao Value Q3 2019 Letter

October 30th, 2019

For the quarter ended September 30th, 2019, Tao Value recorded a return of +1.26%, compared to +0.05% of MSCI All Country World Index (ACWI). This brings our YTD return to +13.09%, compared +16.40% of MSCI ACWI.

	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%	+2.40%	-1.53%	+0.43%				**+13.09%**	**+16.40%**
Since Inception (*January 1st, 2017)													**+40.41%**	**+30.71%**
Annualized													**+13.14%**	**+10.23%**

Contributors & Detractors

Contributors		Detractors	
Position	*Performance (bps)*	*Position*	*Performance (bps)*
Long NXRT	158	Long YY	-125
Long PDD	152	Long CACC	-62
Long GOOG	138	Long DISCA*	-50

* Exited position

Our top contributors this quarters are **Nexpoint Residential Trust (ticker: NXRT), Pinduoduo (ticker: PDD)** and **Alphabet (ticker: GOOG)**, adding 158 bps, 152 bps and 138 bps respectively. The largest detractor this quarter is **YY (ticker: YY)** with -125 bps. It was followed by **Credit Acceptance Corp (ticker: CACC)** and **Discovery Inc. (ticker: DISCA)**, contributing -62 bps and -50 bps respectively.

NXRT, GOOG & **CACC** are among our top 3 positions for which I will provide comments in the next section.

PDD was a relatively new position since last year (refer to our 2018 Q3 letter for detailed thesis: [[Link](https://taovalue.files.wordpress.com/2018/10/taovalue_2018_q3_final.pdf)]¹). PDD returned +56% over this past quarter, helped by the very positive earnings surprise. In its announced Q2 18 results, PDD booked +169% YoY revenue growth, +171% YoY GMV growth, 41% YoY active buyer growth & a +98% annual spending by active buyer, all beating street's estimate by big margin. However, it was no surprise to us as our evaluation has concluded that PDD highly possibly stood a chance to compete with the incumbents. Now that the question changes from "whether" PDD can compete to "how" it competes, it may become a fiercer battle. But given its superior mission & vision, we can be patient with its exploration in other adjacent playfields. I am particularly intrigued to seeing the development in their brand cultivating (C2M) & logistics initiatives.

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¹ https://taovalue.files.wordpress.com/2018/10/taovalue_2018_q3_final.pdf

YY had another poor stock performance quarter, however its business actually showed some positive growth, particularly in HUYA & Bigo segments. According to the management, the overseas live-streaming & short video expansion will remain as the focus for the foreseeable future. This emphasize implies heavy Sales & Marketing spending will weigh down the margin in near future. I'm comfortable on the live streaming side as they have proved to be the best operator in mainland China, however, will be prepared to monitor closely on their execution on short video front. As many of you are aware of, Douyin (or Tik Tok) is "eating the world" on this playing field. The stock may be "dead money" for some time, as it would appear more "expensive" in quantitative value terms.

DISCA – Discovery Inc. contributed -50 bps to our portfolio this quarter. I decided to exit it after holding it since Q1 2018. This is a typical holding period for our "Distressed" category positions. We think the market gradually realized the limited impact of secular "cord-cutting" on content creators, reverting from the overly pessimistic view when I built our position.

Top 3 Positions

Our top 3 positions remain the same, they are **Credit Acceptance (ticker: CACC), Nexpoint Residential Trust (ticker: NXRT),** and **Alphabet (ticker: GOOG).** Collectively, they are 36% of the portfolio.

Credit Acceptance (ticker: CACC) contributed -60 bps to the portfolio. I focus on its dealer productivity, which came in mixed in its Q2 results. For average volume per new dealers, I saw a positive 13% uptick (from 5.4 loans/dealers to 6.1) as the new signed dealers ramp up. However, existing dealers' productivity deteriorated -9.6% (from 13.2 to 11.9 loans/dealer). Additionally, the management disclosed they will start to report more next quarter on the implementation of the new CECL (current expected credit loss) accounting standard. I think sell side's obsession on CECL is overdone. After all, imprudent & dishonest lenders will always find ways to distort accounting regardless standard, while prudent & honest lenders will always report their own view of the real economy (usual non-GAAP) which their investors rely on for understanding the business performance. Thus, determining the lender's integrity is the utmost important thing, and I see CACC as both prudent and honest.

Nexpoint Residential Trust (ticker: NXRT) contributed +158 bps to the portfolio this quarter. NXRT has been firing on all cylinders on deal making. On 8/13/2019, it announced that it entered into agreements on two more deals, one $322 million property in Pembroke Pines, a suburb of Miami, and one $62 million property in Nashville. That brings year-to-day acquisitions up to 5 properties amounted $535 million, more than doubled its target of $250 million. It is a sign that management sees opportunities at right price. The stock price also performed very well, returning +36% YTD helped by a strong residential REIT market.

Alphabet (ticker: GOOG) I remain very positive on the long-term future of GOOG. However, I decided to trim slightly to reflect our newest evaluation of the socioeconomic expense (elaborated in our 2019 Q2

letter "General and Market Commentary" section, p3-5). It is still among our top 3 position after the trimming.

Portfolio Updates

<u>China Meidong Auto (1268.HK)</u>

Meidong Auto is a new position from the "Great Operation at Reasonable Price" category. It doesn't come often that a CEO's shareholder letter alone made me think seriously to become a shareholder. Meidong had made to this list. In short, it is a easy to understand business (luxury auto dealer), who had an exceptional "outsider" CEO who was able to communicate transparently and sincerely about its strategy and execution. It has been executing its strategy very well, generating excellent return on equity (25+%) over past 3 years.

Meteorology: China has seen its auto market slowing down after a few years of high growth. Luxury car however still enjoyed healthy growth. According to CPCA's data, luxury brands have maintained a 10~% annual growth rate from 2016 to 2018 (while overall auto market observed +13.9%, 3% & -2.8% for the same three years respectively). Furthermore, CPCA's most recent July 2019 data even shows an accelerating +24% yoy growth rate for luxury cars. This trend, while perplexing, could be explained by the secular shift of the consumption power in China (from tier 1 cities to lower tier ones, & a growing middle class in all tiers cities, etc.) and further inequality in wealth distribution.

Topography: Meidong uniquely chose to position as the sole dealer of a luxury brand in tier 3-4 cities. Such position allows Meidong to earn a high gross margin (on average about 100 bps higher than multi-dealers in a city) due to weak competition. Such position also increased the stickiness of lucrative after-sale service business. it however is a narrow moat because if competitors really want to imitate this strategy, they could achieve so and drive the margin down. In terms of the sustainability of such narrow moat, I think it is still in good position at least for short term (2-3 years), based on our evaluation of incumbents (who are at least a few years behind Meidong's business principles & executions).

Commander: The management of Meidong is the most impressive factor. In fact, the CEO Ye Tao, reminds me the CEOs from William Thorndike's book "The Outsiders". Ye Tao has technical backgrounds, graduated from MIT with both engineering and MBA degrees, also served as executives to various software business in United States & in Asia. The way Ye Tao approaches car dealing business can be described as quite "rational", which can be seen by reading a single shareholder letter from him. Ye Tao think the most important principles of his business are 1) high inventory turnover, 2) grow service revenue (the high margin business) & 3) focus on new store ROI. It may worth quoting directly from its 2018 letter. On the inventory turnover, it is refreshing to read something like "*We live or die by inventory turns. Fast-turns make us a cash printing machine; slow-turns turn us into a cash-sucking black hole.*" In addition to the principles laid out, the company's reporting also provides metrics to track how they performed in these three areas. On capital allocation, the management preferred to use dividends. That

is not the most favorable way of distribution value back to shareholders, given the price is still a bit underpriced in my opinion.

System: One thing to note is that Meidong is still very closely held by insiders. 65% of the shares are held by the family trust of Ye's brothers.

Valuation: we have built a material position at about 12x 2019 est. earning, a reasonable price for such a high-quality business.

Sea Ltd. (SE)

Sea is a new position from the "Great Operation at Reasonable Price" category. It is a Singapore based technology company with an interesting combination of businesses, namely a cash-gushing game business called Garena (think of Tencent), a market leading and near-monetization-inflection marketplace business called Shopee (think of Taobao) & a small but fast growing fintech business called AirPay (think of Alipay).

Sea crosses all my Sun Tzu's five factor check and is undoubtably a high-quality business. It has accomplished at least 2 exceptional achievements: 1) As a latecomer, it organically built Shopee and surpassed Alibaba-backed first comer Lazada to reach leading position in most countries in the region. Note this is quite rare in network effect enabled platforms, where the "first comer advantage" term was coined; 2) it organically transitioned from game publishing/operating to game developing, with the launch of the widely successful Free Fire (a mobile battle royale games swept all ASEAN, also South America). Based my study of factors driving above two achievements, I conclude Sea has structural advantages in both e-commerce & gaming segments within ASEAN markets.

In term of valuation, Mr. Market has started to recognize the high-quality businesses of Sea. The stock rallied 150+% year to date. However, I still think the current price is fairly valued, if not undervalued to its intrinsic value. Even assuming Sea at the similar quality of peers (thus using comparable' multiples), I value the gaming business for $14.4 billion (at mobile game peer P/E low end of 18 times $800 million 2019 Adj. Income), and the ecommerce business for $4.5 billion (at Chinese ecommerce peer P/E low end of 0.3 P/GMV times $15.5 billion 2019 GMV). This gives us $19 billion equity value (translates to $42.7 per share,) without even considering AirPay business. It is compared to the stock currently trading at $29. If revisiting the assumptions and adjust for the fact Sea is in a much earlier stage market and better quality than peers, I think Sea could be priced more than double of current price in a few years.

Others

We exited **Discovery (DISCA)** and trimmed slightly **Alphabet (GOOG)** as discussed above. We also exited our small **JD (JD)** position.

General and Market Commentary

The past quarter has witnessed the most significant factor rotation in years. For readers that don't know what factors are in investing context, they are basically quantitative ratios to represent certain stock/company characteristics, which are subsequently used to explain/predict stock price returns. For example, academia uses Book-to-Market ratio to represent the "cheapness" of stocks. To form an investing strategy, one can construct a portfolio buying the top decile (in the Book-to-Market ratio example, the highest ranked or the cheapest 10% stocks), and shorting the bottom decile (similarly, the lowest ranked or the most expensive 10% stocks). What happened in the past 5+ years was that the factors represent "value investing" didn't work well, however it rebounded strongly in the past September. I have done a quick study and published my thoughts in this blog post [[Link](https://taovalue.wordpress.com/2019/09/18/some-thoughts-on-recent-factors-trends/)][2], you can read it further if interested.

This event is quite relevant when I was contemplating on asset pricing theories the past quarter. Over the past few years, I have heard many active fundamental managers argued that the passive investing trend should help them to better pick stocks (as passive will misprice stocks by ignoring stock specific fundamentals), yet a few actually delivered. I think many of such struggle can be attributed to **the failure to accept a regime shift of asset pricing**. in fact, using the word "misprice" itself reflects a subjective bias which assumes they hold keys to the "right" way to price stock.

To illustrate it, let's walk through a thought experience of a special case of asset pricing - price action on earning news. Over the years, I felt the price action to earnings became much more elusive and instantaneous. Don't take my words only, anecdotes from a corporate investor relation contact mentioned that they saw their stock started to move drastically 10 seconds after they released it. Also, the famous Stan Druckenmiller stated in a late 2018 interview that he could not figure out the price action to news anymore[3]. Excerpts:

> … I've also struggled mightily - and this is really concerning to me. It's about the most trouble I've about my future as a money manager, maybe ever - is what you mentioned the canceling of price signals. … These algos have taken all the rhythm out of the market and it becomes extremely confusing to me. And when you take away price action versus news from someone who's used price action to news as their major disciplinary tool for 35 years, it's tough and it's become very tough.

Now let's suppose we have two different data sets from a recent company's earnings announcement – one GAAP earning (including unrealized investing gain/loss) and one Non-GAAP earning. First, let's put ourselves into a discretionary earning trader's shoes, which data would you reply on? Most of us would go with Non-GAAP one as we may think it reflect the company's real economics better. Next, let's approach this same question as a quant, how would we decide? We don't care which is one is more "right", instead we will pick whichever one worked the better in backtest/training, or we may use both

[2] https://taovalue.wordpress.com/2019/09/18/some-thoughts-on-recent-factors-trends/
[3] https://www.youtube.com/watch?v=G-MlrpoMig0

and build multiple models (or ensembles, a Machine Learning jargon). The point here is that: <u>there is no right or wrong data to quants (as they couldn't even tell), there is only distinguish between "useful" data that moves the market with statistical significance vs. "useless" data that doesn't.</u> I believe the dominance by systematic strategies in stock pricing around earning is the key reason why the price action becomes more "elusive" (to human eyes).

With the regime shift hypothesis established for asset pricing around earning news, we can visit the long-term pricing mechanism. We just need to adjust our thought experiment with a longer time horizon and more information inputs (not only pertain to earnings). Do we really know how, and by whom, stocks are priced in 1-3 years horizon these days? Do we know which "value" factor (Book-to-Market, earning yield, cash flow yield, EBITDA/EV, etc.) quants are using? Do we know how they exactly calculate free cash flow? It's very hard to answer for lack of data. But many anecdotes in the industry point to similar "elusive" long term price actions, which I think can also be attributed to the rise of systematic strategies (both passive and active) who cares more about whether data works than whether data reflects "subjective truth".

To improve our investment process, I feel strongly that I should include insights of quantitative investing to our future decision making. There are 3 implications:
- **Study the forces**: I should research more on systematic strategies (e.g. low volatility & risk parity), their prevalence and performance;
- **Ride the forces**: I should identify opportunities that fundamental and systematic strategies reach certain consensus. This may mean that I will start building quant models to complement our existing fundamental stock selection process;
- **Escape from the forces**: I should mismatch my expected holding period, as most systematic strategies typically rebalance no more than 1 year.

Final Note

While I evolve as an investor, there will be evolution of my investment philosophy and process. Whatever evolution it will be, it will stick strictly to my original mission and purpose, which is to steward and grow your assets. With that been said, I look forward to report to you next quarter.