Tao Value Q4 2020 Letter

January 20, 2021

For the quarter ended December 31st, 2020, Tao Value recorded a return of +26.43%, compared to +14.4% of MSCI All Country World Index (ACWI). This brings our full year return to +60.66%, compared to +16.33% of MSCI ACWI. Please note the past performance does not guarantee future performance.

	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%	+0.52%	+2.42%	+1.25%	**+17.88%**	**+26.58%**
2020	+1.88%	-2.56%	-12.32%	+10.50%	+10.68%	+11.56%	+2.92%	+8.16%	-3.80%	+4.74%	+14.88%	+4.99%	**+60.66%**	**+16.33%**
Since Inception (*January 1st, 2017)													**+135.14%**	**+65.35%**
Annualized													**+23.83%**	**+13.40%**

Contributors & Detractors

Contributors		Detractors	
Position	*Performance (bps)*	*Position*	*Performance (bps)*
Long PDD	861	Short SPY	-65
Long BILI	302	Long DOYU	-48
Long SE	238	Long GILD	-30

Our top contributors this quarters are Pinduoduo (ticker: PDD), Bilibili (ticker: BILI) and Sea Ltd (ticker: SE), adding 861 bps, 302 bps and 238 bps, respectively. The largest detractor this quarter is Short SPY ETF (ticker: SPY) with -65 bps. It was followed by Douyu (ticker: DOYU) and Gilead Sciences (ticker: GILD) dragging -48 bps and -30 bps, respectively.

As of the end of this quarter, our top 3 positions are Pinduoduo (ticker: PDD), Alphabet (ticker: GOOG) and Sea Ltd (ticker: SE). Collectively, they are 29% of the portfolio.

Pinduoduo (ticker: PDD) reported a very strong Q3 2020, beating key KPIs all-around (GMV, active buyers & Revenue). It even surprisingly recorded the first non-GAAP profit (RMB466 million). Yet, the more important development is Duoduo Maicai, a new fresh grocery initiative. It is a natural extension of Pinduoduo's deep root in agriculture e-commerce, and I think the logistic expertise it accumulated over years should help them compete. It is also a very nascent market, which attracts other tech giants (including Meituan & Alibaba). I will watch very closely on the developments.

Bilibili (ticker: BILI) similarly reported a blast Q3 2020. Bilibili reached average MAU of 197m with high 7.6% pay ratio, showing strong user growth and high engagement. Additionally, the high margin advertisement segment showed exceptionally strong trend, growing 126% yoy. Though surprising to many, I think it is a natural outcome of building an ever-more valuable user generated contents platform. If it is not by ads, I believe these values created by Bilibili will accrue to it in other ways. One interesting data point is that management mentioned the average age of new cohorts are still around 20, indicating it is still in its early stage of a long growth runway. I am happy to see this position played out like how I envisioned in original thesis and will be excited to continue to follow its progress.

Sea Ltd. (ticker: SE) had a beat & raise quarter across segments. E-commerce saw GMV acceleration and better monetization. Gaming saw higher than expected active users' growth. Last but least, the digital finance services arm (SeaMoney) saw strong adoption. In October, more than 30% of Shopee's total gross order across markets combined were paid using the mobile wallets. I believe the SeaMoney will be a very important value driver in mid-term future.

On the detracting side, our largest detractor is our hedge SPY Short, which dragged 65 bps, followed by Long Douyu (ticker: DOYU) and Long Gilead Sciences (GILD). DOYU was one leg of our merger arbitrage position (the other leg is Short HUYA), thus not representative. Combined, this arbitrage dragged 22 bps. I am confident in Tencent's commitment in this deal.

General and Market Commentary

The Importance of Remain Invested

The surreal 2020 marked the 4th year of our partnership. I am happy that we achieved better performance than the broad markets, but it was not a smooth ride. At the height of the pandemic turmoil in March, our portfolio was down 30% from the peak. It could be a very different story if I did not stick to the principle of "remain invested".

Even an investor is confident in the long-term prospect of a company, the price movement could be tempting to make him/her to think "well, looks like the price is plummeting, why don't I sell and sit out the drawdown and I could buy back at a lower price". The problem of such thinking is that the conditional probability of short-term return after a big price drop (which made the investor to think about this timing strategy at the first place) is generally tilted toward positive, and the investor will likely "sit out" the positive performance after an overaction.

Many of our holdings are in their early life and their prices are inherently volatile. The cost of timing market would be more detrimental. Let me show it using Pinduoduo (ticker: PDD) as an example, for the 600+ trading days we have been holding it, it turned $1 we initially invested into $9.03. However, had we missed the best 5 days (reminder again among 600+ trading days), we would end up with $3.57. Missing the best 10 days would reduce it to merely $1.84!

Our portfolio will not be immune to market turmoil and could suffer paper losses that makes you want to sit out. When that happen, I hope you could apply this “stay invested” principle and avoid the mistake of sitting out our deserved long-term gain.

Evolution of Investment Process

After four years, it is a good time to update you about my investment process[1], which I believe, has evolved over years. The Sun Tzu’s five factors business framework remains very effective for me to pick the best breed of business. I would like to briefly relist them:

- Tao: The “spiritual” consideration of a business, including mission, value, culture, and benefit to all stakeholders.
- Meteorology: Addressable market, competitive landscape
- Topography: Profitability, moats, financial strength
- Commander: Management (integrity, capital allocation skills, transparency, fairness to minority shareholders)
- System: Governance, incentive system, etc.

I have simplified the grouping our investments (which were 3: “Great Operation at a Reasonable Price”, “Special Situations” & “Distressed”) to 2 buckets: 1) Mindful Compounders & 2) Opportunistic.

Mindful Compounders is a natural evolution of the Great Operation at a Reasonable Price type, with heavier focus on the mindfulness of the management (which I believe is a critical long term value driver, please view my analysis excerpt here[2]). This type of investments (e.g. **Pinduoduo** & **Meidong Auto**) also has made the most money for us in dollar term and will remain my top focus onward. We intend to build meaningful position sizes and hold long term (3+ years) for these businesses.

Opportunistic serves as a “catch all” bucket that does not belong to above core positions. It includes, but not limit to, special situations, distressed, “moonshot” bets & alternative asset classes. I typically size these investments conservatively and expect to hold them in short to mid run (1-3 years). They, as smaller positions, will be discussed in brief onward, however I can discuss further in private if you are interested in learning more about them.

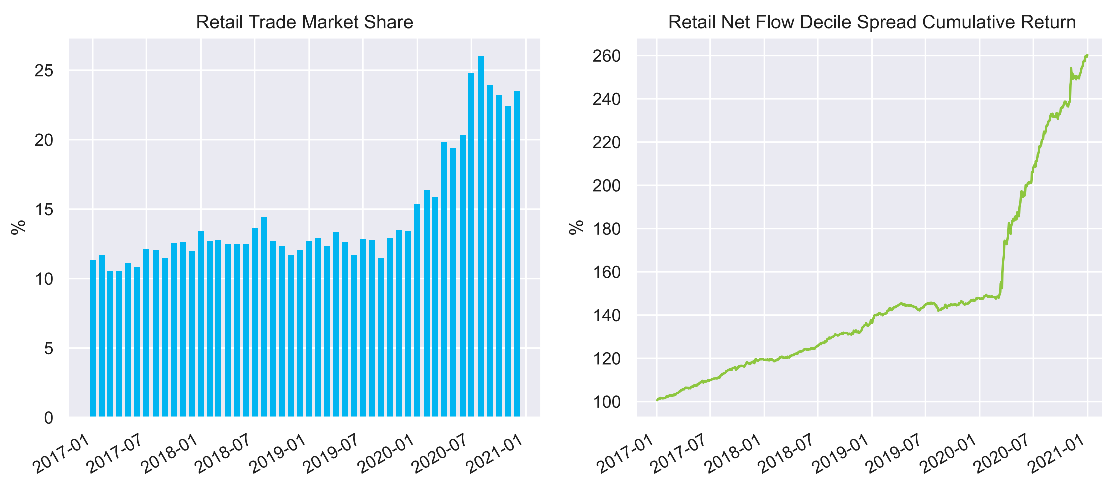
The Great “Retailization” of the US Market

One hallmark of US equity market in 2020 is what I called the great “Retailization”, where the asset pricing function seemed to heavily shift to the hands of retail investors. Lately, I was able to get hands on a proprietary dataset which confirmed this phenomenon. On left chart below, you can see the retail

[1] “Sun Tzu’s Five Factors” Business Analysis Framework http://taovalue.net/2017/07/17/sun-tzu-five-factors-framework
[2] In Search of Mindful Compounders http://taovalue.net/2020/11/21/in-search-of-mindful-compounders/

trades in % of total equity market trades held at a level of 12% from 2017 to early 2020, then jumped up to a level of 25% in late 2020.

Additionally, retail is <u>not "dumb" money anymore</u>! At least judging from short term return perspective. On the right-hand side chart below, you can see a hypothetical one day holding period L/S strategy to buy the 10% most bought stocks by retail investors on that day and short the 10% most sold stocks at the close and exit positions at the next close. The most obvious thing you would notice is the <u>clear infection point in March 2020 when US shut down for the pandemic</u>. Even before that, this signal still predicts positive one day forward return (i.e., the prices follow what retail investors flow), yet in a milder form (13~% annualized return). Since March 2020, such signal started to show stellar predictive power, leading to a 97% annualized return! This is a solid confirmation, using data, that Mr. Market now is basically a retail trader.



Source: Tao of Value

Now that we see the "what", it is important to think about the "why" (it happened), and the "how" (to prepare for it). There is more retail participation as the market share analysis shows, but there is still 75~% of institutional flow. However, if we try to break it further down by active & passive flow, and assuming passive institutional flow are not pricing assets, we can argue retail now has a much stronger hand against active institutional flow, especially in certain sector (e.g. tech), or certain stocks (e.g. Tesla).

Looking forward, I start to think about the implication, here are what could happen (or may already be happening):

- The rise of a new breed of investor, who make "profiting in stock market" seemingly easy.
- The rise of star fund managers using new paradigms.
- Capital Market are transformed by an influx of new personnel who only had experience of a prolonged bull market.

In case you have not noticed, I just copied some description for the Nifty Fifty bubble in 60s to 70s. The parallel between now and then seems obvious, yet I think there are a few nuances in today's market: 1) I believe businesses today have a sounder fundamental, which probably only seen in the last Industry Revolution; & 2) The speed of information is exponentially faster than in the 70s. This leads to me to think that we may be at the beginning of <u>a larger "bubble" than Nifty Fifty, yet in a faster pace</u>. I think that new paradigms today have their merits but will very possibly be pushed to extreme by elevated retail participation. One key lesson from Nifty Fifty era is that <u>valuation still matters even though one can do fine in long term if holding great businesses through a huge bubble</u>.

Portfolio Updates

<u>Yihai International (ticker: 1579.HK)</u>

Yihai is a new position in the "Mindful Compounder" category.

Tao: Since its split from the famous hot pot restaurant chain - Haidilaoa in 2016, Yihai has evolved from a first-party hotpot condiment supplier to Haidilao to a well-rounded compound condiments manufacturer. I have identified Zhang Yong, Yihai's major owner & director, as a mindful leader and a master builder of culture and incentive systems. Under Zhang Yong's leadership Haidilao and Yihai exemplified "creating value for stakeholders across the whole value chain". They are among the very few businesses in China that created upward social mobility ladder for employees without high education, which I believe is of tremendous value.

Meteorology: Backed by strong tailwinds of rising household income & upgraded consumption structure in China, the compound condiment (including hot pot condiment) sector enjoyed strong growth over the past decades. Yet, the penetration of compound condiment (20~% of total condiment market) is still low compared to global peer markets (50+%). I think certain secular structure changes underway will help close such gap. e.g., standardization and franchising of restaurant industry; the prosperity of food delivery; & young generation's lack of cooking skill from scratch (or lack of cooking skill at all). Yihai has grown its revenue at a 50+% rate for past 3 years and still have long runway.

Topography: Condiment by nature is a great high margin business where consumers usually stick with brand by generations. Haidilao has established itself as the best hotpot brand with strong consumer mind share. Furthermore, Yihai, though shared ownership, <u>have the right to use Haidilao brand for free indefinitely</u>, basically sharing the valuable intangible assets without the cost of building it. This leads to a sustainable lower cost structure than competitors, which can be seen that Yihai maintained high-teem net profit margin even after years of hype growth. As a results Yihai enjoyed very high ROE at 30% level, majorly driven by profit margin & high asset turnover, as it basically has 0 debt. I believe Yihai has very strong moat and can earn us strong return in years to come with very high certainty.

Commander: The founder Zhang Yong, although serving as a director at Yihai, remains as the soul of the company. Zhang is one of the most mindful businessmen I have studied. Growing up in rural part of Sichuan and starting his first hotpot restaurant in early 1990s, Zhang has no glamorous education background or corporate experiences. However, Zhang demonstrated deep understandings of management and business very early on. Zhang believes that full trust in employees not only gives them the dignity but also reduces corporate management costs and boosts innovation. As an example, all Haidilao employees (including busboys) have the authorization to apply discount or waive the full bill for customers, if they deem it is right to do so. This is the exact drastic & rational decision making I am looking for.

System: Yihai has great culture, which instills strong value of hardworking & integrity by giving workers trust and dignity. In return, it sparks tremendous responsibility. Although Zhang Yong and Reed Hastings may not know each other, their approaches of building culture are essentially the same, basically finding the right talents, granting full freedom, which naturally unleashes responsibility and innovation. In addition, Yihai also has very strong incentive systems. Adapting from the famous "Apprentice" model from Haidilao, Yihai created "Partner Fission" model. For example. It gives performing sales teams chance to participating regional net profit pool. To align training and talent developments, it also gives the "master" 3% of his/her 1st-level "apprentices" earnings & 1.5% of his/her 2nd-level "apprentices" earning. More importantly, Yihai also actively reviews the efficacy of incentive systems and update them & create new ones over time.

Valuation: Yihai does not look cheap, rightfully so. The P/E multiple at one time expanded to 90+ in Sep 2020 and the price dropped 35% peak to trough in Q4. I took the selloff opportunity to build a meaningful position at 60~ P/E. Given its high growth with high certainty, I believe it is a fair price to be able to participate Yihai's growth at this market environment.

Palantir Technology (ticker: PLTR)

Palantir is a new "Opportunistic" position. Government & Military works are mission critical and require fundamentally different design and execution than consumer tech. Take prediction modeling for example, consumer tech solutions (e.g. lending, shopping recommendations) largely try to minimize error on average, yet such prediction would be useless if not dangerous for military missions. On the way to is public market, Palantir seemed to get controversies over its "unethical" collaboration with ICE and its scalability (as customers need significant customization in implementation & support). By my evaluation though, I think founder CEO Alex Karp is a thoughtful leader and the ethics arguments were overblown. Although the operating metrics will not be as good as traditional SaaS, I see the customization as a necessity and rather a source of switching cost moat. Additionally, competitors seem to be yielding market shares to Palantir due to ideological biases. I saw Palantir as a unique asset and decided to build a small position right after its underwhelming direct listing debut.

Grayscale Bitcoin Trust (ticker: GBTC)

GBTC is a new "Opportunistic" position. As a long-term holder of Bitcoin (from November 2013 to date), I saw it as a great social experiment and now on the cusp of institutionalization. In short, I see money as a trust-based ledger of energy and information debt which is designed to be repaid by others. I also think certain part of humanity's energy & information debt will be stored in good money, for which Bitcoin has established itself as one important form. Below low of the year price table (or think it as the "bubble-free" value) tells this message, more specifically, we see the price after each "bubble" (highlighted 2013 & 2017) remained at an elevated level, a sign of increased trust & adoption. For more information, you can refer to my detailed thoughts and valuation model in this old post[3].

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Min Price	$0.06	$0.30	$4.83	$13.30	$286.37	$170.08	$353.28	$746.69	$3,122.34	$3,343.34	$3,867.09

Short: Wunong Net Technology (ticker: WNW)

WNW is a new "Opportunistic" position. When I thought the notorious days of Chinese frauds pump & dump is long over, Wunong Net reminded me not yet. it IPO'd on 12/15/2020 at $5 and jumped up to $144 (or $3+ billion market cap) two days later. After research, I believe it is a clear pump & dump. First, their app simply did not work and none in my network in China even heard of its name. Second, there are Ponzi-liked scheme run this company in the most rural part of China (Shaanxi), promising company's stock for participation & recuirting. Finally, the sole underwriter Boustead Securities has various connections to Chinese reverse merger booms decade ago.

Others

We sold Huya (ticker: HUYA) on the day (10/12/2020) when Tencent announced the details of the merger between Huya & Douyu and entered a risk arbitrage position by buying Douyu & shorting Huya.

Final Note

I would like to thank our partners for entrusting your hard-earned wealth to us in the past 4 years and look forward to growing with you in the years to come. If you have any questions, feel free to reach out to me. I look forward to reporting to you next time.

[3] A Valuation Framework for Bitcoin: https://taovalue.net/2017/12/08/valuation-framework-for-bitcoin/