Tao Value Q4 2017 Letter

January 19th, 2018

Dear partners,

For the quarter ended December 31, 2017, we recorded a return of +7.79%, compared to a gain of +5.73% of MSCI All Country World Index (ACWI). This brings our 2017 full year return to +27.91%.

	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%	+2.65%	+1.76%	+1.31%	+4.69%	+1.34%	+1.60%	**+27.91%**
Since Inception (*January 1st, 2017)													**+27.91%**

Contributors & Detractors

Contributors		Detractors	
Position	*Performance (bps)*	*Position*	*Performance (bps)*
Long CACC	184	Long SOHU	-125
Long YY	167	Long HBB	-106
Long NXRT	150	Long GILD	-56

This quarter, our largest contributor is Credit Acceptance Corp (ticker: CACC) of +184 bps, it's also our largest position. The second and third contributors are YY Inc. (ticker: YY) and Nexpoint Residential Trust (ticker: NXRT), adding 167 bps & 150 bps respectively.

A few things are worth noting about NXRT, 21 months after I wrote about it last time. https://taovalue.wordpress.com/2016/04/07/thoughts-on-nexpoint-residential-nxrt/ NXRT started as a special situation play after its spinoff from its close end fund parent, but now became a "Great Operation at Reasonable Price". This position worked out almost exactly as my original thesis laid out (that its sole mission is to "flip", not to operate properties), except that their execution and profitability exceeded my most optimistic expectation. To fully appreciate Nexpoint's value, one has to understand profit from property turnover are essentially "operational" for a flipper, which means one has to account "gain on asset sales" as its "real" profitability. That also means accounting earning may be a better evaluation than AFFO in this case. This can be verified that Nexpoint's NAV growth rate is more in line with its earning yield, than FFO yield. Of course, this is not a strategy can last forever as a key premise is a healthy growing residential real estate market. Until we see residential market turns frothy next time, I'm happy to continue to hold when NXRT can grow its NAV at a 10+% annual tick (Note its historical 20+% NAV growth is partly due to its utilization of balance sheet, i.e. leverage up) while also providing 3~4% dividend yield. Additionally, as a shrewd asset manager (rather than a property manager), CEO and major owner James Dondero may be able to identify bubble much better than I could. If Dondero starts to unload like something Sam Zell did in 2007, I will know it's time for me to act accordingly.

The largest detractor this quarter is SOHU with -125 bps. HBB was among the best performers last quarter working out quickly after the spinoff, however gave back all the gain this quarter, a good sign that market may still not be fully efficient for spinoffs. GILD this quarterly dragged a modest -56 bps, an anticipated pull back after the excitement for its deal acquiring Kite Pharma.

Top 3 Positions

There is no change in our top 3 positions, compared to last quarter. Credit Acceptance (CACC), Alphabet (GOOG) and Dell Technologies (DVMT) stand at 12.55%, 11.37% & 8.83% of total capital respectively as of 12/31/2017.

A relevant new development is the "social responsibility risk" for tech behemoths, including our holding, Alphabet. Jana Partners along with California State Teachers' Retirement System (CalSTRS) recently issued an activist letter to Apple, claiming excessive usage of technology by kids reduced their mental health and productivity, and pushing for more functionalities for parent control in Apple's system. It is interesting that Jana went after a hardware company (which is just an intermediary distributing addictive software applications) for better policing, instead of going after the software companies directly. This is however not new to me, as I always try to evaluate company's Tao (e.g. societal value it creates vs. the return it takes from the value chain). As I said before, I evaluated Alphabet to have the highest social awareness among its peers and its core ad business is also least susceptible to this "prey on psychological vulnerability" phenomenon.

Portfolio Updates

YY Inc. (Ticker: YY)

YY is a new special situation position this quarter. YY has a debt-free cash-gushing main business, YY Live, which is poised to take more market share as the industry start to consolidate, and a fast-growing Twitch-like platform, Huya, which is close to a potential IPO/Spinoff. I believe YY has an enduring moat around its ability to "cultivating new habits". both businesses achieved market leading positions without promotion and YY Live has successfully fended off competitors who tried to copy their business model. YY also has a deep-thinking founder-CEO with some track records of continuous innovation in fast changing market environment. Overall, I think the low valuation Mr. Market gave to such a good business was absurd. The price has already rallied on strong Q3 earning release from our entry point, approaching my conservatively estimated fair value. But I believe Huya business has much more potential as the e-sports industry starts to mature. If the Huya spinoff materialize, I will revisit this position closely with more Huya side's disclosure.

Interested investors can visit my detail thesis in this blog post https://taovalue.wordpress.com/2017/11/13/yy-an-under-followed-chinese-tmt-play-with-margin-of-safety/

Sohu (Ticker: SOHU)

Sohu is a special situation position. It is a repositioned investment from an existing holding, Changyou. Sohu is an unloved (but deservedly so) Chinese tech company, there are a few aspects of this opportunity. First, taking-private proposal on Changyou end is still sitting on the table. Second, another Sohu's subsidiary Sogo went IPO. Last, Sohu has two more lagging business: news portal & video, but there are signs of good executions in the video segment. Chairman & CEO Dr. Charles Zhang is a major owner and seemed to be very keen on turning the company around. On Sogo side, it has a non-performing asset, Sogo Pinyin input software, which dominates market shares and creates decent societal value but has no clear way of monetization. The video segment, as the laggard among peers, however spent the most (in absolute term) in programming, an obvious copied tactic from Netflix. Some of its original content turned out to be received well according Douban (a Chinese equivalent of IMDB). Overall, it is a catalyst-rich underperformer going through transitions by a motivated owner. I have shifted half of the rest CYOU position to SOHU.

General and Market Commentary

If anything is to be remembered for the financial markets in 2017, the lack of volatility will be on the list. S&P 500 index, for an example, finished positive for all 12 months, unseen for majority of the investors living today. The unprecedented financial market quietness was also accompanied by the mania in cryptocurrency as all major cryptocoins pocketed astronomical returns for 2017. It is not hard to identify bubbles everywhere under traditional definition, but I find it is meaningful to think through a level deeper. Below is my attempt to find some common lessons by doing quick studies of "bubbles" in three distinct markets. As always, I like to think about the most controversial ones, as they are the most "information-rich". I hope they are interesting read for you as well.

Tesla (Public Market)

> 2017 is not Tesla's best year, as it underdelivered the dream they sold before about Model 3 by large margin. However, Tesla bears are bewildered by the lack of reaction of Mr. Market to negative developments. One possible reason to this phenomenon is the bulls' almost religious belief in Tesla. That means the time for Tesla short to work out is not the "change of the fact", but rather "change of collective perception towards the changed fact".
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> To see whether this positive collective perception is justified, I think of the Tao (i.e. the societal value it creates and the corresponding return it takes) of Tesla. An alternative way to see it is that Tesla may be Elon Musk's clean energy social campaign disguised as a corporation. If you in 2003 were given a mission to push the global auto industry to a more innovative and socially responsible (e.g. cleaner energy) direction, what would be your estimate of the time line and budget? Tesla single-handedly took about a decade and 0.08% of the societal value created in 2017 (Tesla EV/Projected 2017 Gross World Production). Not a bad score for a social campaign.

However, whether the incremental societal value would be entirely accrued to Tesla in forms of shareholder value is uncertain. This is why I wish Tesla could have remained private, thus funded by more loss-tolerant classes' wealth. I also wouldn't short it, because there is still possibility some incremental value could accrue to Tesla through M&A.

Juicero (Private Market)

Made famous by a mockery Bloomberg article in April 2017, Juicero found itself in an awkward position where people start to realize its $600 "high tech" juice machine just does things what human hands can easily do - Squeezing. Five months later, it decided to shut the company down. It can be interpreted simply as a sign of overheated VC industry, I see a level deeper. I think the reason why VC (including Google Venture) seriously considered Juicero is that they agreed with the potential of altering collective perception of how human consume fruit & vegetable, in a not too dissimilar way from Keurig does to coffee. In essence, both Keurig and Juicero try <u>to cultivate a neater hardware-dependent habit of consuming staples, and to monetize on the distribution such staples</u>. Although there are other defects (including lack of fresh food logistic system, pricing of the hardware, etc.) contribute Juicero's demise, the failure of "habit cultivating" is a major one in my opinion. This case also shows how easily and quickly collective perception can be altered in a centralized informational world nowadays. I think this new way of how society is organized has huge implication to the definition of a "brand" moat.

Bitcoin/Cryptocurrency (Emerging Asset Class Market)

Thinking through how to value such an asset like Bitcoin led to the essence of "money", which I deduced it to one word – trust (another way of saying positive collective perception). Interested investors could read my blog post: https://taovalue.wordpress.com/2017/12/08/valuation-framework-for-bitcoin/ for further details. This thought process also revealed that all assets in modern history are quoted in an arbitrary and unstable unit – fiat money.

It should be noted that thinking about it (even still holding it since 2013) doesn't mean I endorse investing in it at current price. On the contrary, as history tells us, the first wave of mass adopters (after the hobbyists and researchers) of financial innovations usually is dominated by <u>bad exploiters</u>. I believe we are flipping to this page with activities like dubious ICO, shady intermediaries, pump-and-dump, scalping, cornering and fraud, all of which can be found in playbook of the last big financial innovation - stock market, from the past century.

In essence, Bitcoin, as the first application of decentralizationism, represents a new ideology of how society should be organized. History is not unfamiliar with new ideology gained massive traction in short period of time and went obsolete before long – Communism is one recent example. The right way to invest in cryptocurrency space to me is to 1) study it so you <u>fully</u>

understand and believe in such ideology; 2) size it (in % of your net worth) as if a “donation” to that ideology; and 3) buy it only at the point of maximum pessimism against that ideology.

It is obvious to see one important factor popping up in all three cases affect both the price formation and value estimation – collective perception (belief, habit & ideology being its different forms). Using Shelby Davis’ famous return decomposition, I add one component and elaborate my new thoughts on each applicable component.

Stock Return = Liquidity Expansion/Contraction + Profitability Growth + Multiple Expansion + Capital Allocation Return

- Component 1 – One should be aware of liquidity cycle as all assets are quoted in and distorted by fiat money. “bubble” caused by it is essentially purchasing power erosion, and is almost impossible to avoid.
- Component 2 – One should value profitability in a more universal unit. e.g. economic & societal value, rather than value in fiat term. Amazon was a good historical example, and Netflix may be the next good example on this point.
- Component 2 – One should update understanding of brand moat. The legacy type of brand is much more susceptible to erosion in current centralized information age. An evolved enduring brand should have characteristics like “habit forming”, “culture building” or “collective perception altering”.
- Component 3 – One should understand perception’s elasticity to information and think through why certain counter-intuitive phenomenon persist. “bubble” caused by this component is madness, and can be avoided with discipline.

In summary, I believe what an intelligent investor of new age should do is to understand the evolution of collective perception and invest in opportunities that are attractive after adjusting perceptional distortions.

Final Note

As an investor who hasn’t been through a full cycle, I keep reminding myself a quote from one great philosopher of our age - Mike Tyson: “Everybody has a plan ‘till they get punched in the mouth.” I believe the punch will inevitably come, and our wealth’s paper value will suffer. However, we will need to remember that paper value merely is an illusion created by changed collective perception.