

# Tao Value Q1 2018 Letter

April 19<sup>th</sup>, 2018

Dear partners,

For the quarter ended March 31, 2018, we recorded a return of -5.53%, compared to -0.54% of MSCI All Country World Index (ACWI). It is my belief that a concentrated portfolio with 15 positions or so will produce higher long-term return than board market indices by higher frequency and/or larger scale of positive deviation from them. However, that also means deviation to the negative side in an arbitrary short period is destined. This calendar quarter is such one. Negative contributions from a few positions are reviewed as temporary disagreement of Mr. Market, but there are lessons need to be learned on others.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year/YTD
<b>2017</b>	+1.94%	+2.34%	+0.33%	+2.80%	+4.14%	+0.07%	+2.65%	+1.76%	+1.31%	+4.69%	+1.34%	+1.60%	<b>+27.91%</b>
<b>2018</b>	+2.07%	-3.86%	-3.74%										<b>-5.53%</b>
<b>Since Inception (*January 1st, 2017)</b>													<b>+20.84%</b>
<b>Annualized</b>													<b>+16.35%</b>

## Contributors & Detractors

Contributors		Detractors	
Position	Performance (bps)	Position	Performance (bps)
Long 1448 HK	69	Long YY	-105
Long TEAM	37	Long SOHU	-104
Long VST*	29	Long CYOU*	-101

\* Exited position/s

This quarter, our largest contributor is **Fu Shou Yuan (ticker: 1448 HK)** of +69 bps. The second and third contributors are **Atlassian (ticker: TEAM)** and **Vistra Energy (ticker: VST)**, contributing +37 bps & +29 bps respectively.

Both **1448 HK** and **TEAM** are long time holding from the “Great Operation at a Reasonable Price” category. **Fu Shou Yuan** is a Chinese burial and funeral services provider, its burial side (think of real estate developer for tombs) operates in an 80+% gross margin with a land reserve (i.e. fixed low COGS) for 50 years if assuming current usage rate. The industry is highly fragmented and **Fu Shou Yuan** is the leader but with only 1% market share. China also is entering an aging demographical era. With strong meteorological and topographical tail winds, it really cannot go wrong as long as the management is not moron or fraud. More importantly, CEO Jisheng Wang shows deep awareness of life and the essence of the burial & funeral services. The firm offers training programs for competitors on best practices, which is a sign of the management is trying to build an industry (even an ideology), not merely to make

money. Wang also revealed in a public interview that they didn't really need to go public if on financial consideration alone (it's a negative working capital business after all as they collect fee upfront for both burial and funeral services). The main reason for IPO, according to Wang, is that he wants to alter public perception of burial industry and build a brand can attracts top talents for long term welfare.

**TEAM** is a collaboration software business I liked very much. Different than **1448 HK**, I was not able to fully build my intended position size, as its price never reached a level I deem cheap enough since the initial purchase from Q1 2016. Retrospectively, I incurred large opportunity cost by “sucking my thumb” (Warren Buffett's expression for being too cheap to pay up for a great business). I will elaborate my thesis in future communications if/when I am able to build up a meaningful position.

The largest detractor this quarter is **YY Inc. (ticker: YY)** with -105 bps. It was followed by **Sohu (ticker: SOHU)** and **Changyou (ticker: CYOU)**, contributing -104 bps and -101 bps respectively.

The same favorable thesis for **YY** still holds as YY Live main business proved its steady revenue growth over 2017, and the recent Huya (the game streaming platform, or Twitch of China) spinoff IPO filing should be a catalyst for Mr. Market to realize YY's full value. Although some shareholder value may be diluted by the recent sale of 34.6% of Huya to Tencent, I think the benefit from Tencent's ownership (branding, traffic flow & game licensing cost saving, etc.) in longer term will make up some if not all this dilution. We have added our position at a favorable price, thanks to this round of market correction.

**SOHU & CYOU** are different stories. **SOHU** suffered another sliding quarter, partially because of this quarter's tech selloff, it appears even cheaper to its intrinsic value. CEO and Chairman Charles Zhang continued his capital market maneuvers to realize value. On February 1<sup>st</sup> 2018, Zhang issued a letter to reiterate his commitment of the non-binding buyout offer however hinted a lowered offer price. On April 2<sup>nd</sup>, 2018, Sohu announced its plan to liquidate its Delaware entity shares and swap it with its Cayman entity shares, which could be driven by tax consideration. On April 5<sup>th</sup>, 2018, **Changyou** announced its plan to distribute a \$9.4 per ADS special dividend, effectively financing Sohu (Changyou's parent and major owner) for buying itself out at the cost of taxes. I was right about its “catalyst-rich” nature. However if Zhang pursues some short term value realization event (e.g. taking Sohu private with low-ball offer), the probability for our position to generate return has significantly decreased. This is a classic example of “Even you can predict future events, you cannot predict the perception towards these events.”

As for **CYOU**, I have made a mistake of what I called “50/50” fallacy. Jason Zweig of WSJ had an interesting story about the grandfather of Modern Portfolio Theory, Harry Markowitz. When talking about his own portfolio allocation, Markowitz said “...I visualized my grief if the stock market went way up and I wasn't in it -- or if it went way down and I was completely in it. My intention was to minimize my future regret. So I split my contributions 50/50 between bonds and equities.”<sup>1</sup> This shows how “lazy” human brain is, even for the masterminds, to reach for a simplest however not optimal solution. When I determined

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<sup>1</sup> <https://www.wsj.com/articles/SB123093692433550093>

SOHU as a better target to hold and to exit CYOU in Q4 2017, I have made the same mistake, unloading half of CYOU and swapping it with SOHU. Retrospectively, buying Sohu may not yield a good outcome either, but my decision process for exiting CYOU should have avoid this fallacy.

### Top 3 Positions

**Credit Acceptance (ticker: CACC)** and **Alphabet (ticker: GOOG)** remain our top two holdings. **Cash** now stands third (10.64%), as we exited two positions.

The next largest position except cash, **Dell Technologies (ticker: DVMT)**, is worth discussing. Michael Dell, made notorious to public equity market by his fight against Carl Icahn and Mason Hawkins' Southeastern Asset Management on a questionably priced privatization in 2013, is planning to come back to public again. This time he is not afraid of screwing public shareholders of VMWare, which is majorly owned by Dell, by a potential reverse merge. If that goes through, the effect is that **VMWare (ticker: VMW)** will be rolled up with Dell Technologies in a single publicly listed entity, making the rolled-up much less attractive due to the slow growth of Dell's main business and the huge debt burden carried from Dell's buy out. **DVMT**, as a tracker to **VMW**, in this case will be eliminated at a premium to an uncertain market price in the future. This uncertainty, unsurprisingly, caused huge price reaction on both **VMW** and **DVMT**, causing both to lose about 25% of their market cap. The discount between **VMW** and **DVMT** was also further widen to almost 40%. Although such worst scenario event moved the potential return of this position to its lowest end, I determined that right after the event was not the optimal time to exit. Mr. Market is known for its tendency to overreact, this time being no different. Also given the discount widening, I believe it is more possible **DVMT** will be priced favorably than adversely from this point.

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## **Portfolio Updates**

### Discovery Communications (ticker: DISCA)

**Discovery** is a new Distressed position this quarter. It is an opportunity created by a secular entertainment distribution method transition from linear (viewer cannot control the playback, e.g. TV) to non-linear (e.g. Over-the-Top or OTT). The debt fueled acquisition of Scripps Networks added to the negative sentiment. However, I believe Discovery owns a unique set of content assets which have universal and timeless value regardless of distribution channel. Its content appears to be "culture-building", a crucial but overlooked trait for new age consumption. It also has a long term thinking major outsider owner John Malone who's known for his capital allocation skills. In the age of cord-cutting, many "bad" content historically relied on the inertia of cable bundle model will lose their pricing power or even go extinct. But I believe "good" content like Discovery's should at least keep its pricing power. In terms of valuation, I believe the new Discovery could generate a normalized \$4 Free Cash Flow per share once through this multiyear transition period, implying a high teen FCF yield from our cost basis. As usual in elevated market nowadays, such a bargain comes with some baggage. There are risks on the

way of normalization due to the leverage. If the decrease of traditional model revenue outpaced the increase of new model revenue abruptly before Discovery successfully de-lever, it may have liquidity issues causing permanent capital loss for equity holders. We have built a modest position and will keep closely watching on this risk factor.

## Exits

We have exited two positions this quarter: **Vistra Energy (ticker: VST)** and **Changyou (ticker: CYOU)**. We believe **VST** has realized our thesis fully as a special situation play, emerging from bankruptcy to being NYSE listed, and to stretching balance sheet for the Dynegy acquisition. We also decided to exit **CYOU** in light of a potential lowered offer from Sohu Chairman & CEO Charles Zhang. Overall, we didn't lose money on this position, but we paid heavy price in form of opportunity cost for suffering from the "50/50" fallacy discussed above.

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## **General and Market Commentary**

The market finally got the long overdue volatility this quarter. It was also an eventful quarter for our portfolio as you have seen updates on individual positions above. What I want to share briefly further is one observation I made on various occasions about ethics that has reshaped my view on management evaluation.

Charlie Munger had discussed a behavioral bias he called "inconsistency avoidance tendency", which revealed human brains are reluctant to change established ideas. In the case of evaluating the commander factor, I stress ethics, which is particularly important for emerging markets where security market misconducts are much more common than developed ones. However, ethics and work ethic don't always directly translate to "shareholder ethic". Michael Dell is known for his entrepreneurship, but had involved in accounting fraud<sup>2</sup> & controversial privatization deal squeezing out outside shareholders. Sohu's CEO & Chairman Charles Zhang is known for being the "good" guy in China tech industry and a disciple to Buddhism, but doesn't seem to mind using similar scheme to squeeze out **Changyou** outside shareholders.

One key revelation for me is: Public market investors should not fall for the misconception proposed by Milton Friedman and Jack Welch, that the only purpose of business, thus the only mission of management, is to maximize its shareholder value. Management even with heavy ownership of the firm simply do not follow such belief, and for rightful reasons. When a businessman has incentive tied to multiple entities, there will be priorities. In **Changyou's** case, it became clear to me now that all Zhang wants from **CYOU** is its cash, by which he may intend to fund other cash-burning businesses under parent Sohu. Now with cash drawn by the proposed special dividend, I wouldn't even be surprised to see Zhang withdraw the buyout offer. In addition, founder CEO may also see the business as a tool for

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<sup>2</sup> <https://www.sec.gov/litigation/litreleases/2010/lr21599.htm>

personal value realization. Take Dell for example, he could have retired and enjoyed his time in other activities after he stepped down the first time in 2004. Why did he come back to run Dell three years later? Most possibly, he doesn't want his namesake firm to fail. When such mentality prevails in an executive mind, it is not surprising s/he would throw any fellow shareholders under the bus if s/he thinks they are trying to stop him from "making his/her firm great again".

All been said, shareholder ethics is very hard to evaluate based on public records, thus I need to consider a wider spectrum of motivations of management, in addition to monetary incentives.

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### **Final Note**

Timely enough, the "punch in the mouth" came right after my last letter. Even though significant part of my personal wealth's paper value "suffered" same as yours, my focus has been on excitements for a few positions/new ideas as Mr. Market starts to offer the same good businesses at cheaper prices. I will make sure to find good use of our cash position if Mr. Market keeps behaving irrationally and look forward to reporting to you next quarter.