Tao Value Q2 2021 Letter

August 6, 2021

For the quarter ended June 30th, 2021, Tao Value recorded a return of -2.07%, compared to +7.11% of MSCI All Country World Index (ACWI). Our YTD return is +1.81%, compared to +12.34% 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%	+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%**
2021	+7.55%	+5.30%	-8.20%	+3.17%	-3.83%	-1.30%							**+1.81%**	**+12.34%**
Since Inception (*January 1st, 2017)													**+139.40%**	**+85.75%**
Annualized													**+21.41%**	**+14.75%**

Contributors & Detractors

Contributors		Detractors	
Position	*Performance (bps)*	*Position*	*Performance (bps)*
Long GOOG	218	Long 1773.HK	-318
Long SE	215	Long TAL	-228
Long TEAM	113	Long GBTC	-158

Our top contributors this quarters are Alphabet (ticker: GOOG), Sea Ltd. (ticker: SE) and Atlassian (ticker: TEAM), adding 218 bps, 215 bps and 113 bps, respectively. The largest detractor this quarter is Tianli Education (ticker: 1773.HK) with -318 bps. It was followed by TAL Education (ticker: TAL) and Grayscale Bitcoin Trust (ticker: GBTC) dragging -228 bps and -158 bps, respectively.

As of the end of this quarter, our top 3 positions remain Alphabet (ticker: GOOG), Sea Ltd (ticker: SE) and Pinduoduo (ticker: PDD). Collectively, they are 32 % of the portfolio.

Sea continued to execute above expectation. The gaming business continued strong momentum, recording bookings of $1.1 billion, growing 117% y-o-y. The major franchise Free Fire showed no sign of slowing down in established ASEAN & LatAm market and received positive reception from new markets like US. On e-commerce side, Shopee demonstrated early success in expanding to Brazil, by adopting a low-price category & gamification strategy. For 2021, Shopee is now top downloaded e-commerce app in Brazil, almost 2x of the second-place local leader Mercado Libre (MELI). I also see the most promising development is in its FinTech business – SeaMoney, which more than doubled its revenue in Q1 2021 from the previous quarter! With online lending products rolling out, SeaMoney is poised to grow rapidly, becoming the 3rd growth curve for Sea.

Atlassian is in the middle of a multi-year migration from on-premise to cloud. In Feb 2021, Atlassian stopped new sales of server license and increased price as planned. It created “pull-forward” effects that incentivize users to renew early, leading to strong revenue & billings growth. It also introduced its newest innovative product called “Point A”, which enables product development teams to collaborate with customers to drive faster and more targeted solution building. Outside of the financial numbers, Atlassian is also empowering many small teams that use its free tier enterprise cloud solution, including our team. I remain confident that Atlassian has the potential to serve all kinds of team collaboration regardless of sector, implying strong growth in years to come.

On detracting side, our largest loss came from our recent new education positions, TAL & Tianli. New legislation on both private K9 education & private tutoring materialized in the past quarter, and they turned out to be irrationally harsher & broader than anticipated. When such worst scenario fold out, the prospects of both companies undoubtably have changed significantly. Although I believe that market overreacted on these two companies, it appears that I have made a mistake underestimating the regulatory impact and picking them up too soon. Our position sizes reflected my evaluation of the risk, and I decide to stay put.

General and Market Commentary

The Rise of Mr. Government

Modern finance, as a school, was developed by western civilization. Investing, as a derivative of finance, can be said the same. Among all the value investing published, there are very few mentions of evaluating government as a stakeholder or risk associated. This is unsurprising because the whole western economy system is built upon free market economy theory which believes government should intervene as little as possible. When capitalism grows more mature, we started to see a reversal shift from such premise, most recently in Big Tech regulation, but that is nowhere close to the role Chinese government plays in its economy. This is why I stressed heavily on value creation for all stakeholders, including the government, in my framework.

In the past quarter, we have seen humbling evidence of how important Mr. Government is to Chinese businesses, as waves of looming regulations on Chinese businesses materialized. E.g. the new law curbing private education was released in May. It explicitly stresses the non-for-profit nature of K9 schools and strictly prohibits related party transaction to move the profits out and M&A of schools. In July, the Cyberspace Administration of China launched data-security investigation on a few newly IPO’d Chinese tech firms, most prominently Didi, the ride hailing dominator in China. As I’m writing this letter, government delivered another heavy blow to after-school tutoring industry by releasing the Opinions on “Double Reduction” for Students in the Compulsory Education Stage, which essentially ruled all subject-related tutoring should be non-profit. Against such backdrop, some Chinese stocks suffered panic selling in similar scale only seen in 2008 financial crisis.

Implications on Investors' Trust

Many called such interventions "unconstitutional", "confiscation" or "authoritarian", and starts to claim that Chinese stocks are not investable at all. I don't fully agree with such view. For private education, I was supportive for certain tighten-up by stating "*Without a sound regulatory framework, such a market is destined to be flooded by greedy and predatory players*" in my last letter. Chinese government & economy, in my opinion, is **a very complex hybrid system with its own merits**. It seems to me that most western observers do not understand it and tend to use century-old ideology to over-simplify it. Taking one recent example, Charlie Munger in his interview with CNBC on June 29th, 2021, touched on Chinese regulation, crediting China by saying "…a wise regulator stops this stuff [Archegos' meltdown] before it starts…what interests me in this is that the communist Chinese behave the way I am talking in favor of". Such response disturbed even many value investors who are known for following Buffett & Munger as a cult. It seems to me that such misunderstanding is widespread and now exacerbated by the political tension between US & China. Without a deep understanding of how China works, foreign shareholders won't be able to hold through turmoil like this one.

Widely in western investing frameworks, there are generally two pillars: fundamentals (related to the company) & valuation (related to Mr. Market). For a sound framework for future investing, I believe a third pillar of same significance on regulation (related to Mr. Government) should be added. Before this point is fully ingested by global investors, Chinese companies listed overseas may lose confidence in general and may carry lower valuation than global peers.

Our Understanding of the China Model

Helped by a hybrid model of socialism & capitalism, China, with over 1 billion population, grew its GPD per capita from $195 in 1980 to $10,262 in 2019. (i.e., a 52 folds jump or 11% annualized growth over a 39 years period!) Yet, critiques claim that this model is not based on a plural political system and that it is authoritarian. It is fair to say that the top priority of Chinese Communist Party (CCP) has always been **maintain its power**, which is true for any political party. What's **unique** about the China model, however, is that CCP desperately tries to justify the **legality of its power** in a practical way – that **it must be earned by improved welfare of the whole society**.

Without the Separation of Powers, Chinese public administrative system serves legislative & executive roles at the same time. A typical process runs like this: 1) Central government drafts, solicits feedbacks & finalizes guidance documents. Such documents are conceptual and brief in nature; then 2) Individual agencies or Local governments use discretion to interpret the guidance, to design detailed policies & to enforce the implementation.

Such unified power, while with good intention, can utilize the best parts from socialism & capitalism and can be very effective and flexible. Take one example from not far ago, China started promoting Electric Vehicle (EV) around 2010. The market was initially swamped by players who built "cars" that better to be described as toys, only to cheat for subsidies. Over time, the government iterate through few versions of regulation, e.g. using technical specs like range to scale subsidy. Nowadays, China has multiple EV brands that can compete locally at the same level with market leading Tesla. Some of the EV technology developed by local EV companies like BYD are also recognized global auto manufactures like Toyota in form of partnership.

After observing generations of such policies, I think the China model typically overshoots at the initial stage with little fear of making mistake (e.g. over-promoting if it intends to promote; & over-curbing if it intends to curb), but is generally fast in iterating and finetuning towards the conceptual goal identified by the central government.

Portfolio Updates

I added on our Tencent position, given its price became ever cheaper compared to its sound business. We exited our rest Futu position, as I believe the exit price still had optimistic earning growth built in, while it faces possible regulatory risk where the capital outflow legally is still restricted. We also unwound the Huya/Douyu risk arbitrage positions at a loss, as the spread kept widening. Subsequently, the deal turned out to be rejected by the regulator for anti-trust concerns.

Final Note

As I'm writing this letter, spurred by the latest afterschool tutoring new regulation, Chinese stocks across the board experienced another heavy sell off, and our portfolio is not immune to it. As discussed before, I believe Chinese policy makers behave similarly like a pendulum, just in much slower motion than Mr. Market. To take advantage of it, we will need to be more patient. With that been said, I look forward to reporting to you next time.