

Tao Value Q1 2020 Letter

May 4th, 2020

For the quarter ended March 31st, 2020, Tao Value recorded a return of -12.96%, compared to -21.05% of MSCI All Country World Index (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%										-12.96%	-21.05%
Since Inception (*January 1st, 2017)													+27.39%	+12.22%
Annualized													+7.73%	+3.61%

Contributors & Detractors

Contributors		Detractors	
Position	Performance (bps)	Position	Performance (bps)
Long 1268.HK	156	Long CACC	-555
Long GILD	93	Long NXRT	-328
Long TEAM	80	Long ADS	-248

Our top contributors this quarters are **China Meidong Auto (ticker: 1268.HK)**, **Gilead Sciences. (ticker: GILD)** and **Atlassian (ticker: TEAM)**, adding 156 bps, 93 bps and 80 bps respectively. The largest detractor this quarter is **Credit Acceptance Crop (ticker: CACC)** with -555 bps. It was followed by **NexPoint Residential Trust (ticker: NXRT)** and **Alliance Data Systems (ticker: ADS)** contributing -328 bps and -248 bps respectively.

As of the end of this quarter, our top 3 positions are **Cash**, **Alphabet (ticker: GOOG)** and **China Meidong Auto (ticker: 1268.HK)**. Collectively, they are 39% of the portfolio.

Below are brief comments on mentioned names:

China Meidong Auto (ticker: 1268.HK) released results of another record year in late March. It scored 46.5% Sales growth & 51% EPS growth, both record high. On the key metric of inventory turnover, it reached 17 days! compared to its own record of 28 days in 2018, and 30~ days of major competitors. Yet as stock price is always forward & short looking, I'm still surprised the stock withheld coronavirus macro impact so well. Based on anecdotal evidences of luxury car sales after China reopen business, I see the luxury car market remain strong as demand of middle to high classes are likely unaffected, rather delayed. Management also disclosed for the first time its progress on integrating acquired assets (6 BMW dealers from Anhui acquired in 2018), which sounds positive. E.g. For the first year, they were able to turn them from a running units of 1,000 BMWs & loss of about 10 million RMB dealerships to 2,602 units &

profit of 18.3 million RMB ones, with inventory at 20 days, which is among the lowest in the BMW dealership system. On valuation though, I see the price approaching fully valued. It now trades at 25 X trailing EPS, and around 17x forward earning per share. I decided to trim it slightly to control its relative position in our portfolio.

Gilead Sciences. (ticker: GILD) is one of our long term “great business at reasonable price” holding since 2017 Q3¹. It had a major acquisition of Kite Pharmaceutical (for its CAR-T therapy) since, but the end market of the subsequent commercial drug – Yescarta turned out to be much smaller than anticipated. The stock price went nowhere since. It came to the spotlight this past quarter as its old Ebola drug, Remdesivir, has the highest hope to be an effective therapeutic against COVID-19. As my original thesis laid out, what attracted me the most was the mission (part of the Tao factor) of this company. The management decision making during this pandemic displayed exactly what convinced me initially. E.g. on a leaked internal townhall meeting video in January (when COVID-19 affected primarily China only), one employee asked the CEO Daniel O’Day what the company thinks of Wuhan Institute of Virology applied a patent with China authority for using donated Remdesivir to treat COVID-19 (which was rejected later). O’Day expressed no bitterness rather stated that Gilead will focus on doing what is right by putting the patient first. This “patient first” mission was resonated by later decisions like 1) voluntarily asking to rescind an FDA granted orphan drug designation for Remdesivir (giving up revenue), 2) ramping up production when still in experiment (potential wasted cost) & 3) gifting up to 1.5 million doses (giving up revenue). With such a mission and strong cash generating ability from existing HIV & HCV drugs, Gilead remains a very safe and promising asset in biotechnology industry.

On the losing side, our top 3 detractors’ stock price were all hammered due to their heavy exposure to COVID-19 pandemic. **Credit Acceptance (ticker: CACC) & Alliance Data Systems (ticker: ADS)** are impacted due to their credit exposure to low tier consumers whose financial wellbeing will significantly deteriorate as the economy keeps shut down. Based on CACC’s history, it benefited from 08-09 crisis in as its more aggressive competitors gave up market shares since they were impacted worse, or even wiped out. However, this pandemic is different than the last financial crisis in that it may fundamentally alter the indispensability of cars to unprivileged classes - the cornerstone of CACC business model - at least for an extended period. For example, stay-at-home/work-from-home will lead to much less people needing cars to “go to work”, and if some UBI-like benefit program becomes new norm, unprivileged may become less unprivileged and may not want to work. I expect all these changes will lead to higher inclination of borrowers to default on auto loans, compared to past crisis. I thus decided to trim CACC, which has remained one of our top positions for years, to a moderate but still meaningful position.

NexPoint Residential Trust (ticker: NXRT) low class residential real estate markets will be impacted similarly due to financial deterioration of lower income classes. More importantly, the changed capital market landscape would invalidate their flipping strategy, as they will have trouble sell its assets at a desirable valuation. I decided to trim it on the day CEO & Chairman James Dondero disclosed sales of \$5.6 million of shares (4% of his ownership). Since NXRT’s management has been very committed to

¹ See original thesis summary on p.4 https://taovalue.files.wordpress.com/2018/04/taovalue_2017_q3_final.pdf

insider holding (basically no insider sales for years) and from time to time bought when price is undervalued, I have laid out my exiting strategy clearly in my 2017 Q4 letter – “*If Dondero starts to unload like something Sam Zell did in 2007, I will know it’s time for me to act accordingly.*”

The company on the next day (3/23/2020) made a public release specifically explaining that it was liquidation sales by new owner of Highland Capital Management (HCM), which was helmed by Dondero but went through bankruptcy recently. Since HCM held NXRT shares with Dondero as beneficiary, the sale, even though decided by new owner, has to be filed under Dondero’s name. This liquidation program subsequently dumped another \$33 million worth of shares in following week. While I find the reason plausible, I prefer to see what they do rather than listen to what they say. Until Dondero started buying materially, I see such insider sales suspicious and will position ourselves accordingly.

Portfolio Updates

Bilibili (BILI)

We took the opportunity to build a moderate-sized new position in **Bilibili (BILI)**. BILI is undergoing a transformation from a niche ACG (anime, comics & game, or 二次元 in Chinese) media market leader, to a multifaceted business with leading positions in mid-form PUGC (professional users generated content) market, yet heavily under-monetizing the value it generates. By a rough comparison, BILI runs a YouTube of China without in-feed ads.

Tao: BILI started as ACG video site and game operator targeted Generation Z, and gradually grew to a multifaceted media business with expanded user base. It now has 4 main business: 1) mid-form PUGC (basically a YouTube); 2) ACG mobile game (publishing & operating games); 3) Live Streaming (content creators hosting live streaming); 4) E-commerce (directly selling ACG merchandises). One unique culture about BILI’s video platform is that it decided to not run in-feed ads for most content, which created superior user experience compared to prevalent multi-minutes mandatory in-feed ads for free users among all other mid-to-long form video platforms in China. To some extent, all three subsequent businesses are experiments of non-ads-based monetization came to fruition. By revenue, game is its main business (generating 50+%), but I see the mid-form PUGC video platform its core assets. Stripping out game revenue and assuming all game users are also users of at least one of BILI’s other services (which is a safe assumption), I estimate BILI currently generates about RMB 26 (\$3.7) revenue per user, which is under-monetized both absolutely compared its intrinsic value, and relatively compared local & global counterparties.

Meteorology: BILI built alliances with both Alibaba & Tencent, who own 6.8% & 12.7% strategic stake respectively. This is rare as the two giants are competing head-to-head in many fronts and usually require their portfolio companies to explicitly pick side. Such alliances allow BILI to flourish in both

games & e-commerce segments. Although BILI competes with any business that requires users' screen time, which include long-form video (iQiyi, Youku, Tencent Video) and short-form ones (TicTok, Kuaishou), the direct head-to-head competition comes from ByteDance-backed Xigua video. From user profile, BILI has younger & more active users, as Xigua has older audiences. Regulatory risk is another major consideration, as any "YouTube" imitator in China may encounter censorship issue someday.

Topography: I believe BILI has built a moat around its mid-form PUGC platform. It now has 130 million engaging monthly active users, and wide range type of content. The network effect of attracting high-quality content creators is evident, as it organically expands user base to older millennials (in their 30s) who has no ACG-related hobby. Also based on BILI's top 100 hosts of 2019, the top 2 segments are now Life & Game, consisting of over 50% of all hosts, an indication of strong influence over expanded topics. BILI is also exploring other approaches of monetization, e.g. Online education (like Coursera) & incubating agency.

Commander: CEO Chen Rui is a serial entrepreneur, also an old lieutenant of Lei Jun, a highly regarded tech entrepreneur and current CEO of Xiaomi. I evaluated that Chen has genuine passion of ACG culture (Anecdotes has it that he was one of the earliest users of BILI and bought in as an angel investor when BILI still hosted servers in founder Xu Yi's apartment). He seems to be credible in designing & executing strategies, yet not as deeply-thinking, based on his public writings & interviews, as some other Chinese founder/CEOs that I highly regard (e.g. Lei Jun of Xiaomi, Colin Huang of Pinduoduo & Li Xueling of YY, to name a few). Interestingly, the generation X founder Xu Yi still holds president role of the company, and actively involves in BILI's community (like Jack Dorsey's active Twitting). Xu Yi, although very young, seems to have strong opinions and sense of value. For example, the no-in-feed-ads was his early public commitment and is still currently honored even he's in a back seat. This type of dual-leadership (one operational, one communal) is not common and is not easy to evaluate. I rather to see one leader processes both traits, but it seems to work well for BILI thus far.

System: BILI's story could one day be a great case study of "how to build a profitable YouTube without ads". It has made great strides to this goal thus far. Mobile game is a proven lucrative business and is strengthened by Sony's new strategic investment. Both live streaming & e-commerce are also promising as the monetization models are well built & tested in China, for example, tipping streamer (for which platform can take a quick cut) widely becomes a convention, and mobile payment & logistics infrastructure are mature for e-commerce. Therefore, BILI can focus on fostering high quality PUGC which attracts traffic for further downstream monetization. To achieve this, BILI had built a well-designed incentive system for creators yet without diluting the "culture" from its origin.

Valuation: BILI looks reasonably value optically at 4.5x sales. However, I think the simple revenue multiple overlooked the mixture of a lucrative game business & rest under-monetized best-of-breed PUGC video business. I estimated BILI's game business could worth about \$3b on a 15x forward earning, which, at our cost basis, implies \$2.8b for the rest operating businesses, or \$22 market cap for each MAU. This is very cheap considering such a business should be able to easily monetize at \$10/user (using either opportunity-cost-based survey or Chinese video/streaming/social media peers) from current

mere \$3.7/user when they see appropriate. A reference point is that YouTube currently monetizes at \$8/user globally, which is also under-done in my opinion. So, we paid 2.2X “fair” revenue for a YouTube of China, where I think a fair multiple should be between 5 to 10 times (depending how much growth you believe is still left). It doesn’t mean BILI price won’t go down than what we paid, but I estimate it could worth twice to 5 times more in 3-5 years with decent probability.

Others

We added Berkshire Hathaway (BRK B) We trimmed China Meidong Auto (ticker: 1268.HK), Nexpoint Residential Trust (NXRT), & Credit Acceptance (CACC), for the reason elaborated above.

General and Market Commentary

Over the past quarter, stock market globally experienced unprecedented volatility, S&P 500 index had its fastest 30% drop in history (in 22 days from 2/19/2020 to 3/23/2020), surpassing previous records set in Great Depression era. It is followed by sharp rebound of 26% (from 3/23/2020 to 4/30/2020). Market’s behavior looks to me a confirmation of my “ever-more elusive Mr. Market” theory discussed in my 2019 Q3 letter. To make sense of it, I think it’s important to study the dynamics between “Business value-based” market participants and “Non-business value-based” ones.

Most of asset pricing theories as we know them (CAPM, Fama-French etc.), are developed during a period from the great Depression to 80s & 90s. The period witnessed a secular institutionalization of active asset management from a news, technical price signal & retail investor driven market, to a business value driven investing style (be it “value” like Warren Buffett or “growth” like Philip Fisher). Thus, it is possible that the patterns factor investing learned over multiple decades (e.g. value outperforms growth & small cap outperforms large cap) are from a Mr. Market consists of mainly business value driven investors. Yet since the birth & growth of passive & quantitative investing, the market has been secularly reverting to a “non-business-value-driven” style. In essence, quant/factor investing is not too different than news & technical approach in the early 20s, they all try to predict how security prices react to information (be it news, historical price pattern, financial reporting or earning announcements, etc.) regardless of the underlying business value.

I believe this secular reversal would have strong implication on how market behaves. One example is fundamental value’s suffering in the past 10 years when the “non-business-value-driven” investing gained significant market share. I think this COVID-19 pandemic induced volatile market was also a manifestation of such shift, all major US indices experienced over +-5% movement on all 8 days from 3/9/2020 to 3/18/2020, and Dow Jones Industrial Average had a back to back 9% swing. We also need to go back to Great Depression era to see the last 9% back to back daily swing.

To Rebalance or Not To Rebalance

During any crisis, investors like to talk about “rebalance”, value investors think it’s the time to sell names that dropped less and double down on the overreacted ones (let’s call it “reversion” rebalance), whereas growth investors think one should dump low quality which typically plummeted badly, for high quality ones which typically withhold better (let’s call it “momentum” rebalance).

To test which one worked better historically, I decided to backtest a 3-month momentum factor during the Great Financial Crisis (GFC). The basic idea can be explained as: I imagine different investors started to react at various points of time during the GFC and decided to rebalance based on past 3 months return. On Russell 3000 stock universe, we will slice all stocks up into 10 pieces (i.e. deciles) by ranking their past 3-months return, I ranked return ascendingly, so that decile 1 can be defined as the losers (returned the worst), & decile 10 the winners (returned the best). Below is a snapshot of each decile’s forward 3 months return from various “reaction” time. For example, if an investor decided to buy the worst performing 10% stocks in past 3 months leading to 9/1/2008, he or she will suffer -41.97% in the next 3 months (from 9/1/2008 to 11/30/2008).

Forward 3-Months Performance by Momentum Factor Decile										
<i>(Performance in %)</i>										
Date	D1	D2	D3	D4	D5	D6	D7	D8	D9	D10
3/1/2007	2.94	4.65	3.76	4.12	3.56	5.12	6.57	7.88	5.97	8.59
6/1/2007	(6.60)	(3.71)	(3.32)	(4.79)	(3.34)	(5.00)	(3.04)	(0.89)	(0.17)	3.05
9/1/2007	(14.29)	(10.88)	(10.37)	(8.20)	(6.07)	(4.31)	(2.28)	(3.02)	0.60	0.21
12/1/2007	(11.60)	(8.44)	(10.16)	(7.89)	(6.71)	(8.64)	(9.91)	(8.38)	(11.44)	(12.34)
3/1/2008	(2.57)	(2.98)	(3.71)	(1.17)	(3.18)	(2.11)	(2.48)	(1.53)	(4.16)	4.96
6/1/2008	14.05	4.89	4.71	1.50	2.53	(0.04)	(3.59)	(6.48)	(14.33)	(23.77)
9/1/2008	(41.97)	(37.86)	(31.98)	(28.44)	(27.16)	(25.63)	(26.18)	(23.99)	(21.96)	(18.61)
12/1/2008	(7.39)	(12.61)	(12.09)	(9.10)	(11.67)	(11.85)	(12.65)	(10.02)	(12.03)	(14.70)
3/1/2009	63.63	41.52	35.48	32.12	21.92	24.44	24.69	23.28	24.03	35.90
6/1/2009	17.89	13.78	14.92	17.19	18.78	22.42	22.49	22.44	28.34	33.10
9/1/2009	(2.56)	2.54	4.17	4.14	4.47	4.81	4.38	7.29	4.74	1.46

Source: Tao of Value

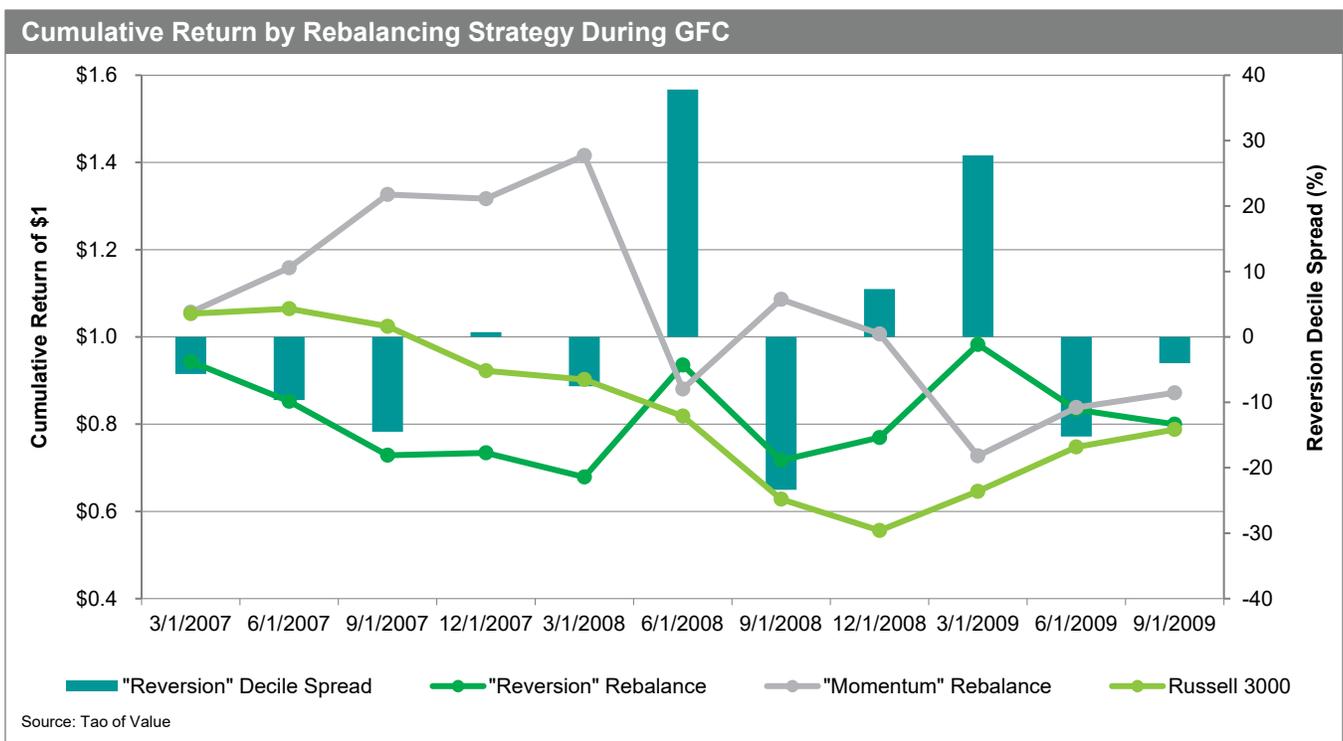
I see some noticeable observations:

- 1) In the early part of the crisis, (from 200706 to 200712), losers kept losing and winners held up;
- 2) During the first hit (from 200712 to 200803), names got hammered similarly across the row;
- 3) From 200806 to 200809, the “reversion” rebalance immensely outperformed (on a spread of +38% 3 month forward return). Also note that D1 generated +14% (recover of overacted losers) & D10 suffered -24% (delayed punish for underreacted winners)
- 4) The following 3 month (200809 to 200812) witnessed the entire financial system melting down catalyzed by Lehman Brothers’ bankruptcy. We saw dark red (negative) returns across the row,

and past losers were punished much worse than past winners (-42% D1 return vs. -19% D10 return)

- Starting from March 2009 (the trough), the market started to recover strongly. Surviving past losers started to outperform the less losers (D1 returned 64% in following 3 months), but not until it flipped in next 3 months.

Furthermore, at each point of time, a “reversion” rebalance could be constructed by buying the losers (D1) & shorting the winners (D10), vice versa for a “momentum” rebalance (buy D10 & short D1). If we calculate the spread between D1 & D10 (D1-D10 for “reversion” rebalance, and D10-D1 for “momentum” rebalance), we can see on cumulative basis, how each strategy may or may not add value for the most important task in a crisis – preserve capital. Below chart tells a very interesting story.



Note that the bar is the spread for “reversion” rebalance (i.e. D1 – D10), thus “momentum” rebalance would be simply the flip signed of such value. “Reversion” style tended to underperform in higher frequency (i.e. more occurrences), but when it reversed it tends to reverse drastically. This can be seen twice during 3 months after June 2008 (the bull trap) & March 2009 (the rebound after trough), which basically wiped out accumulated value from “momentum” rebalance completely. While you might think winning for one is losing for the other, both strategies (remind here they are market neutral) ended in red (\$0.8 for “value” & \$0.87 for “growth”). I also added the Russell 3000 index returns during same period as a reference of “do nothing” strategy, which ended at \$80, on par with the “reversion” rebalancing strategy.

This study brought me some very important insights for making decision during a crisis:

- Both rebalancing strategies work, yet in different phases of a crisis. Timing is crucial (as doing either way at the wrong time would heavily impair one's capital), if you decide to rebalance.
- Neither strategy could consistently add value for preserving capital purpose. I think it's important that buy & sell decisions should still be made on absolute value vs. price basis, rather than on relative price movement basis.
- "Do nothing" is not as bad as you might think, especially when you know you can't consistently time the market.

Final Note

Although this is the worst quarter we have suffered since the start of our partnership, I'm glad that we have preserved our capital better than the broad market did, especially considering we remained almost fully long until late March. Now with the quantitative toolset at hand, I can study history, test hypothesis and draw insights in an efficient fashion and apply them in action. The mission of our partnership has always been to preserve and grow our capital prudently. I feel that it's more important to get the former right than the latter at this point of time. With that been said, I look forward to report to you next quarter.