QUARTERLY COMMENTARY

31 March 2023

Manager Update: April 2023

John Qiu, Founder

We seem to live in a Chicken Little era where a continuous procession of heavenly things, floating and falling, threaten mass havoc and hysteria below. Financial markets, like Chicken Little, is both a culprit and victim in these events. Some, like the recent U.S. and European banking crisis, seemed inevitable given the excessive feast and famine policies of the past few years. Yet it should come as no surprise when governments drag in a deus ex machina to avert near term disaster. Markets have a short memory (remember Greece?) and reshuffling the cards alongside whispered sweet nothings usually ends most problems. Perhaps given the way politics and business interests align behind short-term policies, we're forever fated to patch over yesterday's mistakes with tomorrow's problems. Therefore a few ants occasionally getting squashed by these falling acorns is nothing unusual (and most ants were pardoned in this U.S. pre-election year), though the colony is rarely ever at risk.

Then there is the other risk event - the apocalyptic, 'sky is falling' variety, which may occur for example if U.S. and China tensions continue to worsen. Financial markets have been pricing variations of this risk on and off for the past year. Our view is:

1. All equities will fall precipitously in an extreme scenario
2. The odds are impossible to estimate

Hence we do not believe our fund is the right vehicle to protect against this risk. If protection is sought, it should come from asset allocation considerations (buying gold and a bunker in New Zealand?). Within our fund we only consider the impact at the individual company level e.g. sanctions' effect on operations and P&L. This is just another non-systematic risk factor which we seek to diversify within our portfolio.

For the above reasons and the fact that China is independently growing as a major global source of capital (driving flows into its own assets), we have treated these types of systematic price shocks as opportunities to capture additional mean reversion upside. This was a rewarding position to take in 2022 and correct in terms of the strong operational recovery seen so far in our China related companies in 2023. But despite the steadily improving fundamentals, offshore Chinese equity prices have been on another rollercoaster ride over the past three months. Similar to last year, we benefited from selling shares into excessive optimism during the strong January rally and buying back at much lower prices in March. Today we own considerably more shares in our favourite companies than we did at their peaks. We consider the use of our valuation roadmap to harvest volatility an essential part of how we generate outperformance. If a fundamentals focused manager doesn't have the ability or conviction to do this, we think they're giving up significant value to those who do, especially in this environment.

Despite our contrarian philosophy, we didn't purchase any U.S. or European banks post their March decline. Banks is one of the businesses we generally avoid as we don't think we'll ever fully appreciate their balance sheet risks or have any unique insights into their lending practices and macro variables. Other investments we shy away from include: early stage biotechs, speculative miners, turnaround dependent retailers and apparel brands. The commonalities among these companies include:

- Our inability to fully understand or analyse the risks and/or economics of the business
- Requires accurately predicting a certain outcome
- Our inability to form strong differing views

Simply put, these are companies where we lack conviction on when or why valuations are cheap. A special case of this is hot new sectors where we struggle to grasp how the competition landscape unfolds. Enthusiastic capital and individuals chasing growth is rarely profitable with history full of such examples: railroads, automobiles, airlines, computers, online businesses, etc. We're happier being consumers and bystanders to new gold rushes which today include industries such as: EVs, AI, autonomous driving, metaverse, fintech, cleantech, etc. As competition matures via consolidation and rationalisation, the survivors may become quality companies which we are able to analyse. Many of our highest conviction ideas belong in this camp.

Our 2023 first quarter net fund performance was -5.4%[1] which includes the negative impact from our decision to side-pocket some illiquid and sanctioned equities in February. These assets are no longer counted as part of NAV in performance calculations. If the side-pocket hadn't occurred (31/3/2023 Fund NAV still includes the market price of side-pocket assets), the YTD net performance would have been 3.4% or alternatively, if ignoring the side-pocket assets entirely (31/12/2022 Fund NAV excludes the 31/12/2022 side-pocket NAV), the YTD net performance would have been 4%[1]. For simplicity, our reported performance figures and future commentary will not make adjustments or reference to the side-pocket impact and just treat it as a permanent one-off reduction in NAV. Although the side-pocket assets had appreciated significantly in value since purchase, they were unsuitable for the main fund and better held at the individual level. This clean-up is part of the preparation for the main fund to open to external capital in the future.

[1] Updated: 2023.4.21. Previous version of report had incorrectly adjusted for side-pocket and performance fees

At quarter end our gross gearing of 144% (128% long, 16% short) was towards the high end of our limit. We feel greedy about the investments we own and we've been busy recycling capital into the best ideas within our portfolio. As mentioned in our 2022Q4 report, we had been turning our research efforts westwards and even initiated a few new positions during the early March market sell-off. However, prices recovered before we could establish anything material and we sold down. Unless we can buy a meaningful position with a large margin of safety, we prefer not to own it at all. Currently western markets are still playing the exciting guessing game of Fed-Cession and asset prices are being dragged around daily depending on the flavour of the moment interpretation on rates vs economy/earnings. We don't care to understand most of it but assume the worst: 1) earnings will worsen, and 2) Fed will prioritise fighting inflation above all else. We can afford to be patient.

Expanding on our thoughts regarding portfolio structure and the role of shorts, we see our job as allocating units of risk where the total sum of risk is represented by the fund's gross gearing limit of 150%. We are constantly thinking about the opportunity cost relationship of our risk units and our short position is compared directly to long opportunities and cash. In the current market we believe our short U.S. ETFs is superior to cash as 'risk dry powder' held in wait for the fat pitch. In other types of markets (e.g. strongly upward trending with expanding liquidity), we may prefer cash. Lastly, in contrast to most of our peers, we tend to adopt an offence mindset when markets are falling and/or volatility is high vs a defence mindset when markets are elevated. Currently we're playing a spirited offence game in one part of the market and waiting to shift from defence to offence on the other part.

Instead of the usual stock discussion this quarter, we will offer updated commentary on our top five positions.

Top Five Major Holdings

CNOOC
CNOOC remains one of the lowest cash cost oil & gas E&P companies in the world and the only Chinese E&P major still growing reserves and production. The share price has held up (>20% YTD) but drastically underperforming relative to western E&P majors.

At ~HK$12/share, we estimate one is only paying ~US$12 per EV/BoE Adj Proven Reserves (adjusting for Developed/Undeveloped and Oil/Gas reserves) and assuming ~$70/bbl oil, CNOOC trades on 5-6x P/E with 8-10% dividend yield (50% payout). Both production and earnings are growing at high single digits to ~10% pa.

DADA
DADA's volatility has delivered significant value to the fund in 2023. Prices peaked at >$15/share in late Jan (+118% from the start of 2023, +396% from its 10/2022 price trough) and has been volatile between $6.x-$8.x since late March. We think these price changes were driven less by fundamental factors and more by general China/tech related sentiment.

DADA's captive traffic pool and low penetration gives us a high degree of confidence in its continuing fast revenue growth. Non-GAAP breakeven is expected by 2Q23 and profitability should expand rapidly due to its operational leverage. It looks very cheap both relative to peers (e.g. Meituan) and on a standalone basis. Our only gripe is that sell-side is already very bullish on the company.

JD
As at mid-April, JD's stock price has fallen past its Oct 2022 trough and is at the lowest price since Jan 2020. Part of the reason is likely sentiment driven and exacerbated by news of Softbank's exit from BABA and Prosus' sales of Tencent shares. The other part is likely related to concerns over JD's RMB10bn subsidy program, uncertainty on competition and worries on slower Rev growth.

To us, nothing material has changed in the JD thesis. It continues to obsessively invest in operational efficiency and delivering customer value via price and service which history shows is the winning recipe in retailing. JD has a strong track record for investing rationally into price (the market just doesn't know how to calculate this ROI) and the RMB10bn subsidy is no different. It won't change JD's margin uptrend and if successful in its objective of smoothing out consumption patterns (away from heavy discount driven annual sales festivals), will greatly improve retail efficiency and sustainability. JD is the biggest beneficiary in that world.

The market has never been good at forecasting JD's operations or valuing its business. Sell-side's consensus figures and valuation multiples are largely irrelevant. We see JD as among the best risk/reward ideas in our universe with one paying <50% of fair value today.

KION
Forklift demand remains relatively resilient while Automation activity is down. KION is still working through its issues: 1) non-inflation protected contracts, 2) excess ITS inventory, 3) negative margins on some automation installations. In 2023 most of these issues should be resolved which sets up 2024-2025 for the mean reversion in profitability. Also, this is likely sufficient time for industrial and macroeconomic conditions in Europe and U.S. to improve while China should be a much larger business. We think valuation is undemanding where we see mid to high teens multiple on cross-cycle earnings as representing fair value for the company.

Spirit Aerosystems
Boeing 737 MAX orders and delivery targets were improving steadily until April 13 when SPR suddenly announced that two fittings joining the fuselage to the vertical tail were not attached correctly. It seems two (out of three) of SPR's suppliers had used 'nonstandard manufacturing process' to install the fittings and the issue affects planes going back as far as 2019. Details are still scarce but we know that: 1) all affected planes will need to be inspected and potentially reworked, 2) 737 deliveries and production will be delayed, 3) it isn't an immediate safety issue.

SPR's share dropped -30% over the two days since the announcement. We don't have enough information yet to assess the duration of the production delay or any other impact. But it won't change SPR's single supplier status for 737 MAX fuselages and primary supplier role to other Boeing and Airbus planes. SPR remains a high beta version of Boeing and the thesis is still dependent on earnings mean reverting based mainly on the 737 MAX production recovery.

Portfolio Overview

Top Five Major Holdings (in alphabetical order)	
CNOOC	Oil & Gas Exploration & Production
DADA Nexus	E-Commerce
JD.com	E-Commerce
KION	Materials handling
Spirit Aerosystems	Aerostructure Manufacturer

Performance[2]	
Annualised Net Returns in US$[1]	
Since Inception (Jan 3, 2022)	20.5%
1 Year	-1.2%
Non Annualised Net Returns in US$[1]	
Year to date	-5.4%
3 months	-5.4%
6 months	17.6%

1. Net of 1.5% annual management fee and 20% performance fee (excess return above 5% hurdle rate and subject to HWM)
2. Updated: 2023.4.21. Previous reported figures had incorrectly adjusted for side-pocket and performance fees

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