2019 1st half Performance

Our gross return for the first half of 2019 is 14.40%, which is behind the S&P 500 return of 18.54%. Since inception in 2015/3Q, our annualized return is 13.60%, above the S&P 500's 11.90%.

	1Q	2Q	3Q	4Q	Full year	S&P 500 (including dividends)
2015	NA	NA	-4.42%	9.51%	4.67%	1.40%
2016	0.39%	-0.07%	1.95%	10.03%	13.87%	11.96%
2017	3.82%	5.45%	6.32%	9.75%	27.77%	21.87%
2018	-0.58%	5.08%	1.05%	-10.05%	-4.54%	-4.39%
2019	12.86%	1.36%			14.40%	18.54%
Total Return					66.30%	56.80%
Annualized Return					13.60%	11.90%

In the first half of 2019, the stock market logged strong gains from its December 2018 bottom. While all of our holdings contributed positively to our returns, the contributions were uneven. Some of our smaller holdings rallied significantly, while our largest holdings, such as Berkshire Hathaway and Alphabet, lagged behind the market.

We made several portfolio changes during the second quarter of 2019. We took advantage of the market rally to trim or exit a number of our smaller holdings, including Broadcom, Facebook, Micron, Tencent, and T-Mobile, which have all had strong performance since beginning the year. We used the proceeds to concentrate on our existing financial holdings including Berkshire Hathaway and Bank of America.

This portfolio rebalancing has impacted our short-term performance, as the financial sector has lagged behind the broader market, particularly in the second quarter of 2019. Finance-related stocks have been under heavy selling pressure in recent months due to a number of global macroeconomic developments, such as US–China trade tensions and an inverted yield curve, which may trigger the Federal Reserve to cut interest rates. Depending on the magnitude of these cuts, a lower interest rate may, in turn, impact financial companies' revenue growth and operating margins.

Today, certain financial stocks such as large-cap banks are trading at their lowest discount to market in nearly 40 years. Despite the fear of interest rate cuts, we believe our financial holdings have solid earning power and are significantly undervalued regardless of the Federal Reserve's decision. We explain our rationale further below.

In addition to adding to our financial holdings, we also increased our position in Alibaba and Amazon during the first half of 2019. We have started to build a position in Salesforce after the Tableau acquisition announcement. Our average cash position was 11.8% during the first half.

Below, we summarize our existing and new holdings. We then discuss our recent thoughts on the technology landscape.

Existing Holdings

- ***Net Adds***

Berkshire Hathaway (BRK.B)

During the first half of 2019, we significantly increased our holdings in Berkshire Hathaway at an average price of $202 per share. Our position in Berkshire now accounts for 22.5% of our portfolio. This is the first time since mid-2017 that we have added to our position in Berkshire.

After enjoying strong gains in 2016 (28.0%) and 2017 (17.3%), Berkshire's share price was largely flat in 2018 (1.9%) and 2019 (5.5%). This underperformance may be due to a number of factors: a) Berkshire's large equity exposure to bank stocks, b) Warren Buffett's reluctance to make large acquisitions at premium valuation, and c) a general negative sentiment toward valued stocks.

We, however, disagree with the market sentiment. As laid out by Buffett, Berkshire's value resides in its five "groves": its non-insurance businesses, equity investments, controlled interests, cash, and insurance business. All five, except its controlled interests (largely Kraft Heinz), have grew steadily in recent years, which greatly contributes to Berkshire's intrinsic value. We estimate the sum of parts at Berkshire is worth at least $650B currently, and it adds an additional $35-$40 billion in intrinsic value per year.

Berkshire's Five "Groves"

In billions	2015	2016	2017	2018	2019 1st half
a. Non-Insurance business operating income:	18.8	19.3	20.2	21.6	10.8[1]
b. Equity investments	110	121	164	173	202
c. Controlled interests	N.A	N.A	21.0	17.3	17.2
d. Cash:	71.7	86.3	116	119	122
e. Underwriting Income: Dividend & interests: Float:	1.8 4.6 87.7	2.1 4.5 91.6	-3.2 4.9 114.5	2.0 5.5 122.7	0.9 3.1 125.0

[1] Excluding equity method earnings from Kraft Heinz

Berkshire's intrinsic value, in Buffett's view, is significantly larger than the sum of its parts. In previous letters, we have discussed how Berkshire uses "float" and 'production tax credit" to grow its cash file and maximize shareholder value. Below, we briefly discuss another key factor: ***Berkshire's increasing retained earnings from its major equity holdings.***

In Berkshire's 2018 annual report, Buffett stated that its top five holdings generated $3 billion in dividends while retaining more than $6.8 billion in earnings that are not reflected in its financial statements.

Six of Berkshire's top ten holdings are banks, including three of the top five. Since the financial crisis, banks have retained the majority of their earnings to build up their capital. Banks now have far more capital than they need to operate their businesses, and in the last two years, Federal Reserve started to allow banks return their excess capital back shareholders. In the 2019 stress test, almost all banks plan to return ***more than 100% of their earnings*** to shareholders, with the portion of repurchases far exceeding the dividends. By repurchasing stocks at current depressed levels, we expect Berkshire ownership in banks, as well as its portion of retained earnings, to increase at high single-digit to double-digit rates annually without Berkshire laying out any money.

Berkshire recently report 2nd quarter 2019 earning that shows stable results in both its operating businesses and equity gains. Its book value increased 5% from sequential quarter. At a price of $202, Berkshire is trading at 1.28x of its book value - a low end of its historical valuation range. Catalysts that may unlock Berkshire's value in the near term could include the following: a) Berkshire could step up its own repurchase, and b) the Fed could ease bank ownership rules from 10% to 25% (currently under review). We will stay patient with our Berkshire holding and wait for the valuation cap to close.

Bank of America (BAC)

We more than doubled our position in Bank of America in the first half of 2019. Our average buying price in the 1st half 2019 was $28.00, bringing our cost basis to $26.70. BAC now counts for 10.8% of our position.

BAC's share price has rallied more than 20%, from $25.00 in the beginning of the year to $30.80 in April 2019. The share price has since decreased based on worries about Fed rate cuts. We think the market may be overreacting to the forward curve. In the most earnings release, BAC management expects that even pricing in three rate cuts, the impact will be relatively small: **3% NII vs. 1-2% NII** growth, which translates to less than $1 billion revenue, compared with a $92 billion revenue-plus company.

Instead of predicting the various outcomes of rate cuts, we stay focused on what drives Bank of America's long-term EPS growth. Below, we discuss three important factors:

- Digital transformation: By spending billions in technology infrastructure annually, money centers like BAC are gradually transitioning themselves to the nation's largest Fintech platforms. BAC is the first mover among large banks to leverage both SAAS (Workday) and Public Cloud (Microsoft) to modernize their business. Today, the adoption of BAC's digital banking platform, both for consumers and enterprise businesses, rivals some of the largest technology platforms.

BAC vs. PYPL

in billions	2016/2Q	2017/2Q	2018/2Q	2019/2Q
BAC Digital Payment	299	335	387	432
BAC P2P Payment	8.3	14.5	35.2	69.0
vs.				
PayPal TPV	86	106	139	172
Venmo TPV	3.9	8.0	14.0	24.0

- Consistent expense control and credit profile: For many consecutive years, BAC has done a great job of expense management and maintained an industry-leading credit profile. The management remains confident that the strong asset quality will continue in the foreseeable future.

	2018/2B	2018/3Q	2018/4Q	2019/1Q	2019/2Q
Total Expense: *(in billion)* Efficiency Ratio:	13.2 58.7%	13.0 57.3%	13.1 57.7%	13.2 57.5%	13.3 57.5%
Net-charge offs: *(in million)* NCO Percentage	996 0.43%	932 0.40%	924 0.39%	991 0.43%	887 0.38%

- Capital returns: In the 2019-cycle stress test, BAC hiked its dividend payout by 20%. It also announced a $30 billion net repurchase plan—a 50% increase compared to 2018 and the highest among large-cap banks. JP Morgan CEO Jamie Dimon stated in his annual letter that buying back shares at more than two times tangible book value makes sense. Buffett also implied that banks generating above 15% ROCTE should be worth more than three times tangible book value. By the end of 2019's second quarter, BAC's share price was $29.40, well below twice its tangible book value of $37.80.

Calendar year	2017	2018	2019 estimate	2020 estimate	2021 estimate
Gross Repurchase	$12.8	$20.1	$27.6	$22.0	$22.0

(in billions)					
Average Price Paid	$15.40	$25.20	$30	$30	$30
Shares repurchased	509	676	920	733	733
Period end shares (in millions)	10,287	9,669	8,749	8,016	7,283
Implied market cap (in billions)	N/A	N/A	$276	$240	$218

We think that a) strong fundamentals, b) depressed valuation, and c) a large repurchase program will not be a sustainable combination for a very long time. As illustrated in the chart above, the math is simple: if BAC's stock price remains at the current level until 2021, the bank will be able to shrink its share count by a whopping 25%. With a company generating above 16% ROTCE trading at single-digit multiples, we think our position in BAC will worth significantly more in long term.

Other Net Adds

We also added to our positions in Alibaba, Amazon, and Wells Fargo at an average price of $160.90, $1,640, and $47.30 during the first half of the year. The former two have contributed to our performance, but the latter (WFC) has been a distractor. Although Wells Fargo faces many regulatory and management challenges, the underlying business shows signs of improvement. The stock remains extraordinarily cheap and is supported by a high dividend yield (3.8%) and large repurchase program (11% of market capitalization).

- ***Net Sells***

We exited four existing positions during the first half of 2019. These holdings have appreciated nicely since our inception prices. We evaluated that their risk reward was less attractive than our existing holdings. In retrospect, we should have been more patient with the pace of our trimming and use more cash to build up our other positions.

	Average Cost Basis	Average Exit Price	Return Compared to Cost Basis	YTD Return in Portfolio	Averaging Weighing	YTD Contribution
Facebook	$167.6	$175.9	4.9%	37.3%	3.1%	1.0%
Micron	$31.6	$43.3	53.7%	34.5%	2.4%	0.70%
Tencent	$27.4	$45.3	65.2%	16.2%	5.3%	0.92%
T-Mobile	$58.7	$72.2	22.8%	14.6%	3.4%	0.48%
Total:						3.10%

New Holdings

- **Salesforce**

We initiated a mid-sized position in Salesforce at an average price of $153.60 in the second quarter of 2019. On June 10th, Salesforce announced its all-stock deal to acquire the data analytics firm Tableau for $15.7 billion. Investors initially sold off the stock due to concerns about the deal's high premium (42%) and share dilution (12%). Although we think such concerns are valid in the short term, investors may underestimate Salesforce's ongoing transition from a pure CRM provider to a large software platform. We continue to build up our position in 2019's third quarter.

Salesforce has long been a leader in CRM technology. As the digital economy takes off, companies face emerging IT problems, such as application integration, agile software development, and many more. To solve various pain points for clients' digital transformations, Salesforce has set out a plan to broaden its offerings and gradually transition itself from a pure CRM vendor to a large software platform.

For example, Salesforce's latest innovation, Customer 360, is *a "cross-cloud technology initiative that help companies move beyond an app- or department-specific view of each customer by making it easier to create a single, holistic customer profile"*. Early adopters of Customer 360, such as Adidas and Marriott, are strong success examples.

Salesforce's visionary CEO, Marc Benioff, has long emphasized that acquiring next-gen software capacities is just as important as self-developed ones. Since 2014, Salesforce has acquired a number of next-generation software companies, such as Quip (productivity software) and MuleSoft (a data integration firm). Most of the acquired companies have shown the ability to grow faster after acquisition as Salesforce cross-sells their solutions. With the addition of Tableau, Salesforce is now a leader in an underpenetrated business intelligence market with a 27% share. Below is a snapshot of some of Salesforce's most recent efforts beyond its core CRM solutions.

Self-developed vs Acquired

	Software Functions	**First release**
Self-Developed Capabilities		
Salesforce Lightning	Low-code Paas platform	2015
Salesforce Einstein	Business intelligence	2016
MyTrailHead	Human resource management	2019
Acquired Assets		
Salesforce Heroku	PAAS, container management	2010/12, Acquired for $212M.
Quip	Real-time collaboration tools	2016/08, Acquired for $750M

MuleSoft	Data integration	2018/05, Acquired for $6.5B
Tableau	Business intelligence	2019/06, Acquired for $15.7B

On the financial side, Salesforce has shown consistent billing growth and free cash flow (FFCF) expansion. In its most recent quarter, Salesforce grew its billing by 25% and FFCF by 34%. As we think that many of Salesforce's new products are only at the beginning of the "new software stack" cycle (we discuss this more below), the company has the ability to sustain 20% growth for years to come. We estimate that the company can surpass well over $10 billion annual free cash flow in the next five years.

<u>Thoughts on Technology Trends</u>

Since 2015, we have repeatedly discussed that several technology trends, including a public cloud, AI, 5G networking and advanced semiconductors (3D Stacking), were converging at the same time, enabling exponential growth in the data economy. Our exposure in tech giants has since benefitted significantly from such trends, with most tech giants valued today between $500 billion and $1 trillion. While we think tech giants have yet to reach their full potential because they are penetrating adjacent industries, the law of large numbers, as well as regulation, may cap their potential upside.

As we discussed in the Salesforce section, enterprises today are rushing to develop high-quality digital offerings at breakneck speed. However, there are bottlenecks and inefficiencies in the old paradigm of software development. In the last decade, many new software tools have emerged that help enterprises unlock their productivity. Industry insiders have called these the "***new software stack".*** Morgan Stanley, in its recent reports, has done a phenomenal job of analyzing the new stack. Below, we highlight the new stack's components and TAM.

"New Stack" Components and TAM

	Key Players	**New Stack 2018 TAM**	**New Stack 2022 TAM**
NoSQL Databases	Amazon Dynamo, MongDB	$5.1B	$13.3B
APM and Log Analytics	New Relic, Splunk, Elastics Search	$3.8B	$6.9B
Low-Code App Platforms	Appian, Salesforce Lightning, ServiceNow	$3.1B	$5.6B
Development Planning and Automation Tools	Atlassian, Microsoft, Slack, ServiceNow	$2.8B	$5.0B
Data Integration & API Management	Google Apigee, Salesforce MuleSoft	$2.5B	$5.6B

	Snap Logic		
Container Management	Docker, Pivotal, Salesforce Heroku	$1.5B	$3.3B
Others			
Total Market Size		$22.0B	$48.0B $136.0 B by 2030

The new stack companies as a group have gained significant scale in the last five years. Although we have followed companies such as Splunk and Atlassian since their early days, we either initially underestimated their growth potential or are reluctant to build a position due to their high valuation.

Looking to the future, the new stack is expected to generate over $48 billion revenue by 2022 and $136 billion by 2030. We believe next-generation enterprise software is still in its infancy, and many opportunities remain for investors. We expect to devote more time and resources to this area. In the meantime, we will also explore opportunities in traditional enterprises that are aggressively embracing the digital transformation.

Conclusion

We are value investor at core. With market trading at the high end of its valuation range, we aimed to run a balanced portfolio for our investors. Forty percent of our portfolio is in financial firms(including Berkshire) that have strong fundamentals and are trading at their lowest valuation in decades. The remaining portfolio is in leading technology firms with strong cash flow generation and limited downside risk. We also maintain a high-cash position to cushion any market shock. Although we may lag the market in the short term, we would never risk our investors' money to chase market highs. The preservation of capital is always the fund's top priority.

In the meantime, we strive to keep fees as low as possible for our investors. Our fund charges no fees for the first two years of investment, and after two years, we charge a 20% fee on returns above 6% (hurdle rate). We believe this is one of the lowest fees among our peers and perfectly aligns us with long-term investors. We look forward to reporting back to you by the end of 2019.