2023 1H Investor Letter

	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%	0.01%	10.65%	26.6%	31.49%
2020	-11.78%	15.90%	16.51%	5.85%	26.14%	16.03%
2021	3.67%	11.15%	0.71%	3.56%	20.18%	28.71%
2022	-12.32%	-25.24%	-2.90%	-1.23%	-37.56%	-19.3%
2023	13.90%	13.3%			29.0% *(YTD)*	16.4%
Total Return						
Annualized Return since Inception					11.10%	12.0%

Summary:

Our portfolio increased by 29.0% by the 1st half of 2023. This compares the gains of S&P of 16.4% to 31% of Nasdaq in the same period. Since inception, our annualized gain is 11.1% vs. 12.0% for S&P 500. We remain committed to outperforming the S&P index over time.

In last year's letter, we commented that the 2022 year-end sell-off in mega-tech stocks was overdone, and we added our megatech position. This decision bolstered our performance this year as the seven largest companies contributed mostly all of the index gain. During 1H/23, we exited our position in CRM and Netflix as shares rebounded sharply from a low point. We also trimmed some of the AMD's holdings as the AI-driven rally reduced its risk-reward profile. During this period, we boosted the positions in Microsoft while initiating two mid-sized positions in NVIDIA and TSMC, which we discuss later in this letter.

While we remain optimistic about long-term AI potential, we have become much more conservative since the recent market rally. Valuation has become stretched for some AI leaders. As we are yet to see evidence of mass adoption of revenue-generating AI applications, we would like to limit our overall AI exposure. By the end of 1H23, we reduced our semi holdings while maintaining our cloud service provide (CSP) exposure, as their non-AI-related revenue offered better earning visibility.

For our non-tech holdings, BAC is the top distractor. The BRK and RH holdings remain stable. Our cash position is approximately 12%. Below is a chart of the top and bottom distractors of 1H/2023.

Top contributor	Top distractor:
AMD +8.16%	BAC – 1.10%
AMZN +6.51%	PYPL – 0.09%
GOOG + 2.61%	
MSFT + 1.47%	
BRK + 1.47%	

In this letter, I review our equity strategy in an increasingly dynamic AI landscape and update the business progress of our major portfolio names.

AI outlook:

In early 2023, we added our exposure to AI-related semi names, such as AMD/NVDA/TSM. Our thesis is that the "arms dealers" of the AI race will be the first to benefit from the AI compute demand. The strategy has worked well so far this year. However, with the recent rally in AI names, the risk-reward of owning "arms dealers" has been reduced.

There has been tremendous speculation regarding potential AI monetization, which can be divided into three categories: "GPU revenue,"; "cloud revenue,"; and "application revenue."

For "GPU revenue," the street estimates that NVIDIA's data center GPU sales could top $70 billion by FY25, a seven-fold increase compared to $10.6 billion in FY21. This thesis has largely play out with the surge of NVIDIA's share.

For "cloud revenue," it is expected that CSPs would collectively add anywhere from $20 to $80 billion in annual revenue by selling GPU-related services (such as AI training, fine-tuning, or inferencing). We are at the lower end of the forecast. In our opinion, GPU cloud revenue would likely experience a steady increase rather than a sudden surge, as enterprises' adoption of large language models (LLMs) tends to be slow.

For "application revenue," monetization remains in the early stage. Technology giants infuse LLMs into their existing applications, such as search or productivity tools, rather than creating something entirely new. The incremental revenue from LLM-powered applications, such as Google Search and Microsoft Copilot, is still early. For startups, despite tens of billions of funds from ventures, none, except ChatGPT, have achieved a billion-dollar revenue.

In the near term, the lack of revenue for AI applications will cause concerns over whether there will be a decrease in the initial demand for GPU or AI hardware. A sky-high GPU price does not make the ROIC easier for developers. In the long run, the sustainability of GPU demand will depend on the size of leading-edge foundational LLMs and the inferencing demand for AI applications, which are currently unpredictable.

Given the uncertain AI semi-demand outlook, we materially reduced the semi-exposure. However, we are still quite confident about cloud incumbents. Their applications and cloud businesses will be among the first to benefit from LLM monetization. We are investing more energy in software companies as a wave of new LLM-powered applications have begun to hit the market.

<u>Existing Holdings;</u>

- **Non-tech:**

Berkshire Hathaway

Berkshire's share advanced 10% in the 1H/23, in addition to a solid gain in 2022. Berkshire's competitive advantage in its core businesses has strengthened significantly over the past three years. We previously discussed Berkshire businesses that showed resilient earnings during periods of inflation. Recently, Berkshire's largest core businesses–insurance and energy–have benefited uniquely from rising rates and new energy policies.

Many insurers suffer a significant loss in their fixed-maturity securities in the insurance business because of higher rates. Buffett has long warned about the risk of long-term bonds, and instead parked its cash in short-term treasury. The bets are now paying off. By 2023, Berkshire will earn nearly $6 billion in interest income annually from its massive $147 billion short-term treasury portfolio (or cash). Berkshire's equity portfolio also registers a $67.8B gain in 1H/23, erasing all its $67.0B unrealized loss in 2022. The equity portfolio is helped by Apple's stock and Buffett's successful bet on Japanese trading houses. Berkshire's unmatched financial strength will continue to allow the company to gain share in the insurance industry, especially in its reinsurance and primary groups.

Berkshire Energy is a unique growth story. Its setup is quite different from those of other utility players. It pays no dividends, borrows inexpensively, and provides the parent company with significant tax advantages. As one of America's largest energy companies, Berkshire Energy plans to invest $27.2 billion (from to 2022-2024), or nearly all of its operating cash, back into the business. The US electrical infrastructure is undergoing a massive makeover after the IRA bill. Berkshire is among the few to deploy near-unlimited capital during a building boom. It will not be long before Berkshire becomes the world's largest renewable energy company.

Bank of America(BAC)

BAC's share lost 14.3% in 1H/23. Its management made considerable mistakes by parking excess deposits in long-term assets from 2020 to 2021. BAC currently has an unrealized loss of $105.7 billion on its held-to-maturity (HTM) securities with a cost of $614 billion, primarily comprising mortgage-backed securities and treasuries.

BAC has ample capital. Thus, it is unlikely that BAC will sell any of its HTM holdings; instead, they will let them mature over time (probably seven years). However, this will put pressure on the BAC's earning power. BAC generates 4.8% of its cash but only 2.4% of its debt securities.

We still like BAC's core business. BAC's consumer business, a franchise with a trillion-plus deposit at a 22 bps funding cost, makes it nearly impossible for its peers to duplicate. BAC has one of the most profitable wealth management and investment banking businesses. However, the stock has not compounded over the years during our ownership of the BAC. We made some trading gains and dividend income, but the money would be much better for other compounders. We are likely to shift our BAC position toward more attractive ideas over time.

RH:
RH's share was up 23% at 1H/23. The RH stock was highly volatile in 2023. The management initiated a large buyback in 2Q/23 that retired 3.7 million shares, or 17% outstanding. The repurchase partially helped push the stock price from $240 to $400 before retreating after the most recent earning.

RH's business has faced tremendous headwinds since COVID-driven demand ended. US mortgage rate has surged from 3% to 8% since 2021. US existing home sales have decreased 39%, from 6.7 million in 2020 to 4.1 million this year. RH's business has also shrunk from peak of $3.7 billion revenue to $3.0 billion now.

We think the management has done an impressive job of navigating the company through business difficulties. RH has recently launched new products across all furniture lines (interior, contemporary, and modern), which is an accumulation of years of work. It successfully opened its first international stores in Aynhoe, UK, and is expected to open more stores across the EU. It also introduced RH Guesthouse in New York, which offers new hospitality experiences.

RH's outspoken CEO, Gary Friedman, may have attracted many short sellers from Wall Street. In the end, however, we think that the company will perform well based on its products and services, not on what CEO's comments. We believe that RH's vision is one of a kind. We believe the stock offers substantial upside if housing market normalize.

- **Tech:**

AMZN:
We maintained a stable Amazon position during 1H/23. Despite rallying over 60% YTD, the stock has great potential.

Amazon's e-commerce business is expected to turn around by 2023. Its North American business revenue increased by 11% in the last quarter, with an operating margin of 3.9%, the highest since the pandemic ended. Amazon CEO Andy Jassy attributed the most important contributor to profitability to the redesign of logistics networks (from a nationwide network to eight separate regions).

According to management, regionalization of the delivery network enables lower costs and faster delivery, which is an excellent combination. The network is only possible because of advances in AI in both software (demand prediction and mapping tools) and physical hardware (automated logistics centers). Faster delivery results in an increased number of e-commerce transactions. The flywheel has led to growth in Amazon's other profitable businesses, such as subscription and advertising. Amazon may finally enter a period of sustained expansion of e-commerce profitability.

Amazon's AWS cloud business has also seen stable growth after nearly a year of enterprise optimization. Despite enterprise spending headwinds, AWS grew its massive $88 billion business by 12%. Management expects that the incoming growth rate will increase as enterprises gain new workloads in the coming quarters.

Regarding AI, AWS's cloud database capacities (S3, Aurora, and Redshift) are the backbone of many enterprises. As management states, "People want to bring generative AI models to the data, not the other way around." AWS invests heavily in its own LLM/silicon solutions while offering customer alternative leading-edge LLMs and NVIDIA GPUs clusters (P5). We believe that AWS can maintain its competitive position as long as it invests in customer requirements. We will learn more about AWS's AI offering at its upcoming reinvent conference.

Alphabet(GOOG):
We have added our position to GOOG in 1H/23, now our third-largest position. The street still does not view GOOG as an "AI winner" for reasons such as a) competition from Microsoft and b) the increased costs associated with LLM-powered search. We have a different view.

GOOG's core search/YouTube business generates large amounts of cash. After a challenging year for advertisers, GOOG's advertising business returned to growth as the economy recovered. After a series of layoffs, GOOG's operating expenses are now more aligned with its revenue. Even with an expected ramp in AI investments, the company is likely to churn $80 billion in free cash flows. Management is aggressively using excess cash for stock buybacks.

Within AI competition, we believe that GOOG is the only company that can scale up its next foundational model (Gemini) without relying solely on NVIDIA GPUs, which are expensive. The cost advantages are derived from GOOG's long-term investment in proprietary chipsets (TPU). From a user experiment, the speed of Google Bard and search general experience (SGE) has increased dramatically since its launch. The quality of answers and availability of services has also improved significantly. We anticipate further success when GOOG adopts new generation multimodal LLMs.

Google is probably the only tech giant with access to combination of "low cost" computing resource, proprietary data, and AI talents. If GOOG succeeds in becoming a leader in its foundational model, it will open up many monetization opportunities, given its several billion-user applications. Stocks can also trade materially higher because of earnings/multiple expansions.

AMD:
We increased our AMD position last year, and with a stock rally of nearly 80% YTD, our position has become too large (>15%), with a lower risk/reward profile. As a result, we recently trimmed our position in AMD by nearly 40%, in the range of around $110. Out AMD position remains sizable even after recent trimming.

Businesswise, AMD's client business has gone through a painful inventory correction since 2022 and is recovering. AMD's more stable gaming and embedded businesses continue to be cash cows, offering nearly US$ 4 billion in annual operating income. In the long run, however, the upside of AMD's valuation depends mainly on the success of its data center businesses, particularly on the GPU side.

AMD forecasted its data center business would grow 50% YOY in 2H vs. 1H, with both EYPC CPU and Instinct GPU as contributors. AMD's data center CPU has continued to grow despite the fear of GPU cannibalization. On the GPU side, the street currently forecasts AMD's newest GPU (MI300) to be a >2 billion GPU business in 2024. We believe that AMD's current valuation is fair by pricing in modest GPU success in 2024.

The MI 300 is a competitive product in terms of hardware and software, but we do not have sufficient insight into its potential market share. We closely follow this situation, and if AMD's GPU business can be substantially larger, we will add back our positions.

Microsoft:
We doubled our Microsoft position in early 2023. There are many good things to say about Microsoft and our views are similar to those of the street. Microsoft's advantage mainly comes from its ability to bring AI into its Office and Azure businesses. The ramping will likely take several years because of the law of large numbers.

- **Other portfolio adjustments:**

We slightly trimmed the position in WDAY during 1H/23 for valuation purposes. We maintain our position in ESTC and PayPal because we believe that both companies still trade well before their intrinsic value.

<u>New Holdings:</u>

NVIDIA:
We were late to the NVIDIA party. In 2Q/23, however, we saw a trading opportunity when channel checks suggest NVIDIA's upcoming quarterly earnings could to be far ahead of the consensus. We initiated a position at an average of $315. On May 24th, NVIDIA forecasted for 2Q/24 that its revenue will be $11 billion, 50% ahead of the consensus estimate of $7.2 billion. The stock rallied 30% after earnings.

The rise of NVIDIA is unprecedented in the technological world. In three years, it is likely to grow its data center business from $10 billion in 2021 to $70 billion in 2024. To put things into perspective, NVIDIA will sell more of its high-end GPU in units (>3M) than Tesla's sale of its EV cars by 2024. Each GPU has roughly the same price as a Tesla car (>$40K) but more than six times the profit.

In the short term, the only thing holding back NVIDIA is its supply chain; as its data center, GPUs will remain sold until mid- 2024. Beyond 2024, however, we are concerned about the potential GPU downturns, as previously discussed. In addition, NVIDIA's dominant position is a double-edged sword. NVIDIA is too strong, as it absorbs all profit pools from startups and tech giants. Serious competition is a matter of time. Consequently, we recently trimmed NVIDIA's position as it trades above $400.

TSMC:

We initiated a position in the TSMC in early 2023 at an average price of $90. TSMC still deals with a weak semi cycle. Despite some help from AI ramp-up, TSMC still forecasts a -10 % YOY drop in 2023 revenue.

We believe that TSM's growth rate could be much better in the next few years. First, datacenter AI will be a driver. Management expects its AI-chip-related revenue to grow at least 50% CAGR over the next five years, increasing from 6% to low-teens of total revenue during the same period.

In addition, TSM's large smartphone businesses are likely to return to growth as AI proliferates into edge devices. We believe that edge AI is a secular trend. Companies such as Apple and Qualcomm have already seen multiple benefits of running LLM offline, including better response times and security. TSM will naturally benefit as smartphone, IoT, and auto content costs increase.

TSM trades at a sizable discount versus its SOX peers. Given its commanding competitive position in foundry manufacturing, stable margins, and high probability of accelerating earnings in the next few years, we believe it is a good opportunity to invest in the company.

Conclusion:

This was an exciting time for technology. AI competition is likely to increase across all technology stacks. Several LLMs with capabilities that far surpass those of the GPT-4 will hit the market in the next few quarters. This will be followed by thousands, if not millions, of applications powered by leading-edge LLM. A shift in the computing platform is likely to result in new dominant players and a series of losers.

We are carefully following the development of the AI industry because of our tech exposure. Outside the technology domain, we are also researching new ideas owing to lower valuations. Our strategy remains the same—buying leading companies at a fair price. It is critically important for us to avoid bubble valuation.

The US equity market also remains choppy due to concerns about inflation and the Fed's interest rate path. We will likely deploy our cash position if the market presents more opportunities. We look forward to reporting back to you in 2H/23.