January 16th, 2022

Net Investment Returns:

Year	Longriver	Benchmark	Relative Return
Since Inception – Per Annum	18.3%	13.3%	5.1%
Since Inception – Total	174.9%	111.3%	63.5%
2016	5.8%	7.9%	(2.1%)
2017	27.3%	24.0%	3.4%
2018	(7.3%)	(9.4%)	2.1%
2019	49.4%	26.6%	22.8%
2020	43.0%	16.3%	26.7%
2021	3.1%	18.5%	(15.5%)
2021 – 1st Half	*23.6%*	*12.6%*	*11.0%*
2021 – 2nd Half	*(16.6%)*	*5.2%*	*(21.8%)*

Note: Longriver results are unaudited. Benchmark is the MSCI All Country World Net Total Return USD Index (Bloomberg: M1WD Index).

Dear Family,

Our investments declined 16.6% during the second half of the year, trailing well behind our benchmark's 5.2% gain.

Reflections on a Tricky Year:

I suspect 2021 will be remembered as a year of excess in financial markets as the emergency liquidity and economic stimulus launched in 2020 during COVID fuelled greed and euphoria. Lockdowns pulled forward demand for many digital services and as we entered the year, the market extrapolated 2020's growth ad infinitum. Cryptocurrencies went to the moon, while new concepts like DAOs, DeFi, meme stocks, metaverse, non-fungible tokens, wallstreetbets and Web3 entered the popular lexicon. Price to earnings multiples were out and price to sales multiples were in.

The benchmark's superlative return does not tell the whole story, however. Stocks which couldn't deliver on lofty expectations began correcting as early as February and money crowded instead into stocks which could. For example, while the NASDAQ Composite Index rose 21.4% for the year, Gavin Baker of Atreides Management estimates returns (as of December 10th, 2021) would have been just 5.8% excluding the top five contributors – Apple, Microsoft, Alphabet, Tesla and Nvidia. Meanwhile, as of earlier this month, more than 40% of that index's constituents have fallen more than 50% from their fifty-two-week high. There is a broad bear market within this narrow bull market.

Our own portfolio was affected this half first by the storm of new regulations in China (more on this later); then by an incendiary – but inaccurate – anonymous report accusing Evolution of money-laundering and breaching US sanctions; and finally, by the broad sell-off in Tech stocks and emerging markets which began in early November when US Federal Reserve Chairman Jerome Powell signalled the start of tighter monetary policy. And while it was frustrating to lose substantially all our performance for the year in its last six weeks, volatility like this is a feature of a concentrated portfolio – not a bug – which has heretofore served us well by maximising my limited time.

I'm in general very pleased with the operating performance over the year of our largest investments like Amazon, Evolution, HDFC Bank, Meta (née Facebook) and Tencent. But less so with my own performance as a portfolio manager. For example, I sold substantially all our investments in Alphabet and Microsoft to put the money into new ideas. Forget about the results; this was a failure of process because those new ideas were nowhere near as good. As James Anderson of Baillie Gifford wrote in his swansong letter, "distraction through seeking minor opportunities in banal companies over short periods is the perennial temptation. It must be resisted".

I also wrote in my 1H21 letter that "unless we can time the market better than everyone else, holding cash is a poor choice for increasing our long-term purchasing power, let alone preserving it". What I didn't weight enough though is the utility of "rebalancing"; that is, taking some profits on winners when prices are high to make room to add back when prices fall for whatever reason. This was brought home to me when Evolution's stock took a dive and I was hesitant to add given my already large position. Overlook Investment's CIO James Squire argues that rebalancing can actually let you hold onto winners for longer and perhaps he's right. In a way, I guess, this is what we did when I helped re-allocate some of your money at the end of 2020 away from this portfolio, as I explained in my 2H20 letter.

To quote Shopify CEO Tobi Lütke, "Nothing can become truly resilient when everything goes right". So, with these lessons learned, let's draw a line under 2021 and look forward.

Why Invest in China?

I write these letters – and my ad hoc blog posts – to allow you to make an informed assessment of my performance, my investment process and the prospective returns of our portfolio. What I'd like to emphasise in this letter is that we are substantially invested in China, with Tencent now one of our single largest investments. Why invest in China, I hear you ask, given the policy risk, slowing growth and the high degree of information asymmetry? Not to mention how business growth has not translated historically into share price performance for investors in publicly equities like us, at least as measured by the Chinese stock market indices.

Well, as my wife Lizzie likes to tell me: there is no such thing as a perfect relationship, you just choose your set of problems. And what's true for marriage is true for investing!

For me personally, Hong Kong is home and our family has deep roots here. Sovereignty of Hong Kong was returned to China in 1997 and our future lies in an ever-closer union with the mainland. So, I have a natural interest in studying Chinese entrepreneurs and the world-class businesses they are building. But is this time well spent? Can I generate good investment results? Given the increased politicisation of the economy and how abruptly the playing field changed this year, I really had to ask myself this question.

So far, the answer is yes: our investments in Alibaba, Gree Electric Appliances, Tencent and Wuliangye have all contributed materially to our gains over the past six years. The thing to note is that these are all large companies with long histories as public companies. Competition in this space is less based on an information or analytical edge, and more based on a behavioural edge. That is, the ability to weather storms and look beyond near-term headwinds.

But that's backwards looking. What about the future?

I think carefully about where we invest using two frameworks. The first is that the world is complex and uncertain. When I invest in a company, I am essentially outsourcing the responsibility to management to profitably navigate that complexity and uncertainty on my behalf using their ingenuity and the assets at their disposal. This is why I believe it's so important to study a company and management's history. It's the opposite of the warning label put on investment products: past performance *is* a great guide to the future.

The second is that companies do not exist in a vacuum; they are part of a system. Like fish swimming in water, it's easy for American investors to not realise how perfectly designed their system is for capitalism to flourish: there are clear property rights; the rule of law and independent courts; a large and unfettered domestic market; easy access to finance; abundant human capital; supportive government policy; and a Horatio Alger spirit of working hard to get ahead. On top of that, America Inc. enjoys a technological advantage, clusters of expertise and institutions which can leverage resources far more quickly and efficiently than elsewhere. So, when Buffett says he was lucky to be born American, I read that as meaning there's simply no better place to be a capitalist – that is, to sustainably earn high returns on your capital.

Less perfect systems can still create opportunities for clever entrepreneurs too. Spotify's CEO Daniel Ek has said, "The value of what you are building is the sum of all the problems that you solve". In some sense then, more problems can mean even more opportunity to create value. I had this epiphany when thinking about Tinkoff, the Russian bank, which would almost certainly trade at a higher multiple if it wasn't Russian. But it's precisely because it's Russian and the frictions that exist in the Russian economy that Tinkoff has the opportunities it does. A system shapes a company's opportunity set and even its competitive advantage.

The same is true for companies in China. Yes, the Party and State are central actors and the directors in all aspects of life, politics and the economy. Yet they preside over an incredibly vibrant economic machine with an unprecedented track record of wealth creation. And China is not short of problems to solve, from avoiding the middle-income trap as costs and wages rise; to technological self-sufficiency; to the urban/rural wealth gap; to its declining birth rate and ageing population; to its over-leveraged balance sheet etc. Not to mention the simple and universal desire of a sophisticated and affluent people to enjoy a better and more fulfilling life.

If an economy is the aggregate of its companies, and the companies the aggregate of their people – then Chinese entrepreneurs give me very good reason to be optimistic about the future. And I believe the system will continue to reward entrepreneurs for marshalling physical and human capital to make China better. I also believe that China will increase its economic productivity, allowing more and more to be had from those resources. As Himalaya Capital's Li Lu would say, China is firmly on the path to Civilisation 3.0 and becoming a continuously compounding social and economic machine.

Last year, Beijing formalised something they've been saying for a while: the age of growing the economy at breakneck speeds is over. And under the mantle of Common Prosperity, the age of higher quality growth with more fair distribution is hopefully just beginning. Yes, they have resolved

that government intervention is required to address urgent social, economic, environmental and technological imbalances. Housing, healthcare and education are priorities to relieve the burden on Chinese families. And the market needs more competition to foster innovation and productivity growth – not just in the Tech sector, but everywhere. To a large extent, I think future returns on capital for many businesses will be lower under this regime, warranting a de-rating of their equity – and in the case of the after-school tutoring industry, a de-rating to zero.

Beijing could certainly have used some help with its PR. The onslaught of announcements over the summer hit the market like a tonne of bricks. But from a long-term perspective, isn't reform exactly what a responsible government should do? And isn't it a good thing that the Chinese leadership feel a sense of crisis and take nothing for granted?

As I write this, entrepreneurial spirits and offshore Chinese stock markets certainly feel down in the dumps. But it pays to understand that there is a policy cycle in China which amplifies the economic cycle as lower-level officials try to interpret and please their higher-ups. Right now, Beijing has put the brakes on the economy to tackle festering problems, particularly over-leverage in the Real Estate sector. Sooner or later though, it's a safe bet that its focus will return to growth. We should also see Common Prosperity in context: Xi Jinping himself wrote that it is not the end of the market system and nor does it mean egalitarianism. Finally, let's remember that old Chinese saying that the government has its policies and the people have their way around them (上有政策，下有对策).

So that is the Chinese system as I see it: a vibrant and intensely competitive market economy guided by the state; with abundant human, physical and intangible capital; which rewards entrepreneurs for contributing to the development of the nation. The Superforecasters among you will immediately recognise that these are generalisations and assertions, not hypotheses which can be tested. Nonetheless, I still think it's important to make my framework explicit so we can kick the tyres and monitor for change.

Why Invest in Tencent?

Of course, we're not investing in China Inc. itself; we're investing in Tencent. And Tencent is one of the finest companies in China, if not the world. Since Tencent was founded in 1998 and listed in Hong Kong in 2004, key executives Pony Ma, Martin Lau, James Mitchell and their colleagues have profitably navigated multiple shifts in technology, an ever-changing competitive landscape and numerous regulatory regimes. They are a class act worthy of the highest praise for their obsession with the best products; their strategic deftness; and their contrarian investments. They are a humble bunch who shun the limelight, like the yin to Jack Ma and Alibaba's yang. And crucially, they have ensured Tencent's business success has translated into superlative returns for shareholders.

I first came across Tencent in 2011 when seemingly overnight, my mainland colleagues at CLSA all began using WeChat. I next crossed paths with it in 2014 at The Bank of East Asia when I assisted the Deputy CEO negotiate an agreement with Tencent subsidiary WeBank to jointly issue a credit card product. It soon became evident to both sides that our balance sheet was a commodity while their customer acquisition channels were worth their weight in gold. Finally – finally! – I invested in Tencent in late 2019 after attending the ChinaChat conference in Shanghai, which brought home to me the imperative for advertisers to be on WeChat.

Tencent sees itself as an 'assistant and a connector' and Chinese internet users spend more time in WeChat, its core messaging app, than any other service. Tencent has built a conglomerate of digital services to monetise users' attention, offering value-added services within its social networks; video games and entertainment; advertising; payments and financial services; and enterprise software and

cloud services. It also uses its surplus capital to invest in other companies, often tilting the odds in its favour by directing traffic to them from WeChat.

It's important to understand that WeChat is the operating system for daily life in modern China. It was launched eleven years ago and now has almost 1.3 billion monthly active users. WeChat mini-programs were launched in 2017 as a simple way for businesses and local governments to offer users goods and services without leaving the app (the only example I know where Apple has permitted an in-app app store). At the annual WeChat conference held earlier this month, Tencent revealed that 450 million users use mini-programs every day. And that mini-programs have dredged WeChat's moat even deeper, with time spent in them up 32% last year. I wouldn't be surprised if the value of commerce within WeChat now rivals China's largest eCommerce players.

Video games are Tencent's cash cow and it is the largest developer, publisher and distributor of these in China (primarily through QQ, its other social network). Games are a lucrative business when done well thanks to their virtually zero marginal costs and ability to scale to serve hundreds of millions of users. Moreover, Tencent's most popular games centre on digital worlds in which players build identity and community. This makes players sticky, improving games' longevity and return on investment. Developing new games can be hit and miss but there are factors which tilt the odds in Tencent's favour like being a magnet for the best development talent; being the first-choice partner for foreign IP-holders looking to come into China or transition to mobile; and owning its own distribution channels (which keeps customer acquisition costs down).

Tencent did not escape Beijing's ire last year and it was criticised sharply for allowing minors to spend too much time on its games. One semi-sanctioned government writer went as far as to call games "spiritual opium" before his article was quietly taken down (in most places but perhaps as a warning, not all). Tencent was also criticised for the "disorderly expansion of capital", code for the proxy war it has been fighting with Alibaba for much of the last decade, in which Tencent used a 'rebel alliance' of its investees to counter Alibaba's aggressive expansion. Like a game of Go, the fight followed every new 'next big thing' to ensure no one lost users' attention. A lot of money was burned. And young start-ups were forced to take sides early on, precluding perhaps the emergence of new, independent forces in the market. The government decided this behaviour is wasteful and Tencent, Alibaba and their backers must stop spinning their wheels.

I don't think this new regulatory regime is going away – Common Prosperity is a paradigm shift. I do think Tencent's games will lose revenue because of new restrictions on minors – but it won't be material, at least not in the short-term. It may be some time before new game approvals resume – though this benefits incumbents like Tencent and has flushed out many small developers. And I'm not sure how the plane of competition will shift when Tencent and Alibaba eventually open up their 'walled gardens' – though I am inclined to believe that Tencent's 'top of the funnel' traffic becomes more valuable and Alibaba's 'bottom of the funnel' eCommerce becomes more commoditised.

What I do know, however, is that the next drivers of Tencent's growth are already in place: advertising, overseas games and enterprise software. In advertising, WeChat launched a new short-video product called Channels in early 2020 and it is gaining traction – though must attract more creators to increase its relevance. Assuming Channels succeeds though, it will materially increase Tencent's advertising inventory. Overseas games comprised one quarter of Tencent's total games revenue in 3Q21 (when management first disclosed their size) but grew 20% year-on-year. Tencent has invested heavily in its overseas presence in the last eighteen months, both organically by hiring and founding new studios, and inorganically through acquisition. It is strong in Mobile games today and hopes to push into PC and Console.

And in enterprise software, Tencent hopes to play the role of 'assistant and connector' again and become the fabric tying together various third-party niche SaaS applications. This will be anchored by its popular WeChat Commerce app, as well as its hit video conferencing, office productivity and security services. This business is what analyst Ben Thompson calls a 'strategy credit' where Tencent can do well by doing the right thing. Enterprise IT spending in China is a small fraction of America's, even when adjusting for GDP per capita. Part of the reason is a chicken and egg problem where local software companies cannot achieve the scale they need to create great products because customers aren't opening their wallets. By taking a longer-term view (i.e. shouldering short-term losses), Tencent can start the flywheel spinning. And because better enterprise software will raise China Inc.'s productivity, this business perfectly aligns with the goals of the state.

Tencent trades today at a bargain valuation. Taking the mean of sell-side forecasts from Bloomberg, the stock today at HKD473 represents ~21x 2023 PE. Excluding investments per share of ~HKD151 (per Tencent's most recent disclosure), this comes to ~14x 2023 PE. And as Tencent reminded us this month with the sale of part of its investment in SEA and in-specie distribution of part of its stake in online retailer JD.Com, this investment portfolio is real and can be accessed without capital gains taxes. Furthermore, the company is using the proceeds in part to buy back its own stock at the fastest rate in its history.

As measured by the Kraneshares CSI China Internet ETF, Chinese Tech stocks peaked in February 2021, right before the 4Q20 earnings season when Meituan and the other eCommerce players pledged to pour billions of dollars into 'community group buying', a land grab to bring eCommerce to rural China. The index corrected 31% by the end of June before going into freefall when Beijing's regulatory storm broke. From July to its bottom two weeks ago, the index fell another 52%, completing a 67% top-to-bottom swan dive. Needless to say, China Tech is very unloved right now.

I call myself a value investor, which to me means investing only when the odds are overwhelmingly in my favour. This, I believe, is one of those situations.

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Thank you again for your trust and patience. Our success wouldn't be possible without it.

With my best wishes,

Graham F. Rhodes
Longriver

PS: You can receive more regular updates and company specific discussion through my blog, to which I encourage you to subscribe at www.longriverinv.com/subscribe