April 17th, 2023

Dear Partners,

We are continuing to execute on our strategy, as laid out in previous letters, of searching for companies with amazing products, continually deepening our research of our holdings to grow our monetizable conviction, and closely managing position sizes relative to prospective IRRs to make sure we are squeezing every drop possible out of our precious capital deployed (when cash yields 5% and a potential recession looms).

As the economic clouds darken, I am intensely focused on preserving our capital and leveraging any meaningful downturn to our advantage, maximizing the opportunities presented by such an environment. Buys made at extremely attractive prices have the potential to catapult our capital forward.

To be clear – we invest based on risk reward, not macro forecasts. We are in a constant search for 4-year 30%+ IRR opportunities (i.e., 4-year triples), which we would, and are, buying aggressively today regardless of the macroeconomic environment. But most opportunities we see in our universe are currently in the high-teens to low-20s IRR range, which we consider not good enough given the overall risks in the current context as well as the specific risk that our forecasts, however conservative, could be thrown off dramatically by a recessionary environment.

Maintaining conviction in difficult times

Our conviction in our holdings has been tested through waves of drawdowns since our launch, and I anticipate we will continue to be tested, possibly more than before, in this coming year. In this context, we are focused on only owning companies where we have very high confidence in their terminal value, i.e., that they will become much bigger businesses 5-10 years from now no matter what happens in the near term. This in turn allows us to maintain conviction when their stock prices drop significantly, and in an ideal case buy a lot more, rather than become paralyzed by doubts as declining prices drive changing narratives.

Price driving narrative is a real and dangerous phenomenon in investor psychology, including (unavoidably) our own. Price drops tend to lead to a resurfacing of previous bear cases that are difficult to disprove with certainty. For companies with sizable competitors, competitive risks become prominent; for companies where significant growth is expected, TAM sizing questions suddenly become salient; for companies with debt, debt refinancing issues come to the forefront; etc.; even if the original price drop had nothing to do with any of these factors.

Our strategy was designed from the beginning to combat this. As we discussed in our partners' manual, a key reason why we only invest in companies with amazing products is so we can have more confidence about their terminal value. Great products that provide a ton of value to customers are harder to displace. By contrast, underinvestment in product, which pulls future profits forward to today, comes at the expense of providing space for competitors to thrive and thus shaking the stability of terminal value.

Fundamentally, we derive our confidence in terminal value from intensive research that aims to verify that no other competitor comes close on product quality to that of our companies. If we subsequently develop doubts about this issue, the decision to hold or buy in the face of a drawdown becomes much more difficult. Our investment in Okta is an example of a mistake we've made on this front – where our lingering and growing doubts about Microsoft's product strength and bundling advantages in identity coincided with a downturn in Okta's business performance and stock. We knew that Okta's immediate business downturn was mostly self-inflicted and likely not related to Microsoft, but our concerns about

the future distorted our confidence in the right amount to pay for the business. We ended up exiting the position with a modest loss versus our purchase price, whereas greater conviction in the terminal value would have, if we had held on, resulted in a large gain. Our mistake was not necessarily in selling the position when we lost confidence (though mechanically, selling cost us return), but in getting involved in such a situation where our judgment of terminal value turned out to have such uncertainty.

This mistake reinforces our conviction in the philosophy described above. In terms of specific takeaways, this experience, and our deep respect for and fear of Microsoft as a competitor, leads us to stay away from investments in Crowdstrike, SentinelOne, and GitLab, which are otherwise great companies with amazing products. Each of these companies today has a strong competitive advantage against Microsoft, but in each case the trend is toward a closing product gap and, as a result, lingering doubts that we anticipate will increase the difficulty of maintaining conviction during drawdowns.

In addition to terminal value, another driver of conviction is valuation. We aim to pay low multiples, ideally absurd multiples (some of our investments today are in this category), without compromising on the quality of the products we invest in. All else equal, lower multiples linearly reduce what we need to believe for an investment to be a success, and reducing what we need to believe likewise linearly increases our conviction in that belief being true (e.g., it is much easier to underwrite revenues growing at >15% for multiple years than revenues growing at >25%). Of course, especially when comparing between companies, the "else" is not equal, and it can be much worse to pay a low multiple for a bad business than a high multiple for a great one. Nonetheless, valuation is a key consideration for us and one that we track and consider constantly. I strongly disagree with the notion, increasingly in vogue as pod investment styles predominate, that valuation is of only limited relevance and beats/misses vs. expectations are all-important. At the right entry prices, we are more than willing to hold great companies through periods where valuation does not matter to periods when it does.

We are laser-focused on having the *right amount* of conviction for each investment. Having the wrong level of conviction, either too much or too little, is dangerous. Too much conviction, especially if pounded in at the start and not constantly updated against new information, leads to overconfidence, missing warning signs, and significant drawdowns on mistakes that become clear in hindsight. Too little conviction results in a skittish investment style that flees at the first sign of danger (even if unjustified), missing out on big returns that come from holding great companies through both difficult times and seemingly-high, but actually not, valuations. We aim to balance a deep research approach (through the first quarter, we are at an annualized rate of 244 expert calls on our investments) with constant wariness about risks and the realities of the fog of war ever-present in public market investing that limits perfect understanding.

Okta is not the only mistake we've made, and inevitably we will make more mistakes in the future. All I can promise is that we will approach investing with humility and an extreme willingness to change our minds if the facts change and we realize we are wrong.

Conclusion

In the past quarter we made a few exciting new investments, which we are not ready to share yet. And in line with the theme of this letter, we have continued deepening our conviction in our holdings through a continued steady accumulation of research.

As always, I am immensely grateful for the opportunity to manage our capital and am hard at work trying to compound it at the highest rate that I can.

Yours,

Tim Liu