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February 12, 2020

Dear Partners and Friends,

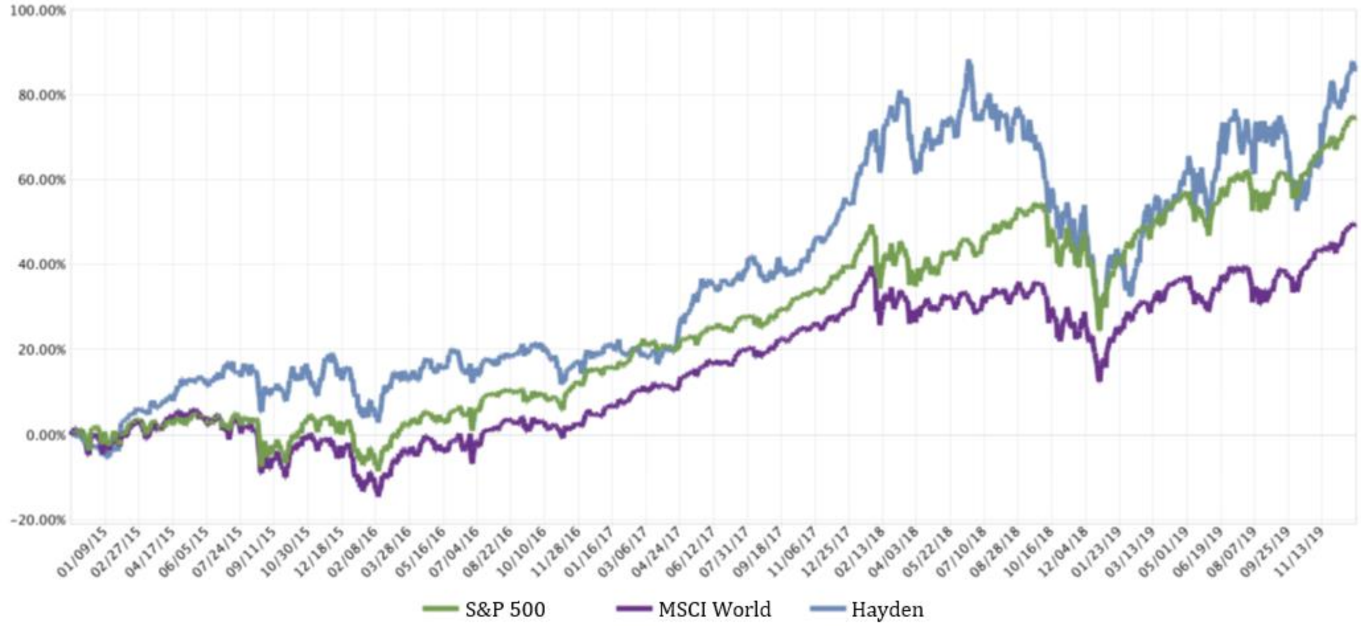
Our portfolio ended on a good note in 2019. Markets rose into the year-end, with both the global and US market indices returning high-single digits. Meanwhile, Hayden's portfolio gained +16.8% in the final quarter.

Looking back, 2019 was a fruitful year for us. Most notably, the theses for two of our newest positions started to play out, and the market in turn gave them recognition for it. Our partners will remember that both of these investments were made during a highly volatile period towards the end of 2018. These "dark days" for the markets certainly turned out to be a blessing in disguise for us, and something we're lucky we can take advantage of given the exceptional stability of our partner base.

Time Period	Hayden (Net)[1]	S&P 500	MSCI World (ACWI)	Avg. Cash Exposure[2]
2014[3]	**(4.92%)**	**1.29%**	**(0.91%)**	**55.22%**
2015	**17.23%**	**1.37%**	**(2.22%)**	**26.31%**
2016	**3.90%**	**11.95%**	**8.40%**	**26.03%**
2017	**28.22%**	**21.82%**	**24.35%**	**14.98%**
1st Quarter	6.61%	(0.76%)	(0.54%)	12.58%
2nd Quarter	5.69%	3.43%	0.30%	8.74%
3rd Quarter	(4.97%)	7.71%	4.42%	8.54%
4th Quarter	(21.03%)	(13.53%)	(12.78%)	9.91%
2018	**(15.44%)**	**(4.39%)**	**(9.15%)**	**9.93%**
1st Quarter	14.73%	13.65%	12.45%	5.10%
2nd Quarter	11.98%	4.30%	3.45%	3.70%
3rd Quarter	(6.02%)	1.70%	0.05%	1.58%
4th Quarter	16.82%	9.06%	8.75%	4.49%
2019	**41.06%**	**31.48%**	**26.58%**	**3.72%**
Annualized	**11.78%**	**11.64%**	**8.24%**	**-**
Total Return				
1 Year	**41.06%**	**31.48%**	**26.58%**	**-**
5 Years	**86.27%**	**73.86%**	**51.58%**	**-**
Since Inception	**77.12%**	**76.03%**	**50.19%**	**16.19%**

[1] Hayden Capital returns are net of actual fees. Individual client performance may differ based on fee schedule and date of funding.
[2] Includes cash and hedging instruments.
[3] Hayden Capital launched on November 13, 2014. Performance for both Hayden Capital and the indexes reflects performance beginning on this date.

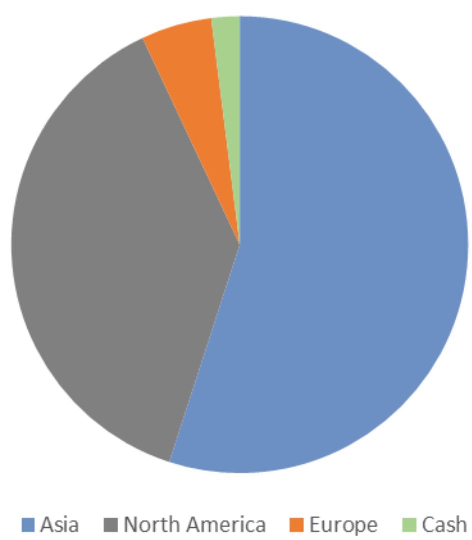
Performance Since Inception



Our portfolio rose +16.82% this quarter, outpacing the S&P 500 and MSCI World's returns of +9.06% and +8.75%, respectively. During full-year 2019, our portfolio was up +41.06% vs. +31.48% for the S&P 500 and +26.58% for the MSCI World indices.

Notably, our portfolio is now heavily invested in Asia – far greater than any other geography. As of today, ~55% of our investments are headquartered in Asia, ~38% in the US, and the rest split between Europe and Cash. Even with that, most of our American companies derive a significant portion of their earnings from abroad, while our Asian and European companies are predominantly domestic.

Geographic Allocation %
As of January 2020



When I originally added the MSCI World index to our performance table, I mentioned "we have found more opportunities in Europe and Asia… Because of this, you may notice the MSCI World (ACWI) index has been added to our comparison table" (LINK). Three years later, I still find this to be the case.

We now have seven core positions + one tracking position in the portfolio. Cash levels remain in the low single-digits.

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Sea Ltd and Carvana continue to be large positions for us, as I'm confident these companies are just getting started in achieving their potential.

Sometimes I describe businesses like these, who are in an earlier-stage of their business lifecycle, like "children". Even from a young age, you can usually tell when an exceptional child has qualities that set them apart from their peers (KPIs, usage metrics, etc.). However just because they show these signs early on, it doesn't mean their future is destined to be remarkable.

As they grow up, there are many influences that can de-rail them from achieving their full potential – whether it's:

- being influenced by the "wrong" peer group (if all your peers are gaming GMV figures, juicing financial metrics just to make their pre-IPO numbers look good, at the detriment of long-term business value),
- being in an environment that fails to challenge them adequately so that their innate talent "muscles" are never trained / honed (being in a geography where business culture is more "laid-back" and thus slower to move. Only to find when they try to expand outside their home country, that competitors from other countries are much more formidable and have been attending after-school training programs since birth), or
- becoming reliant on drugs to make themselves seem stronger / smarter than they naturally are (access to cheap, undisciplined capital)

And these are just a couple aspects out of hundreds (thousands?) that could go wrong as these companies "grow up".

Relatedly, sometimes I'm asked why we spend so much effort analyzing all these minute data-points, when it's often such a small facet of the business, and questionable if it will ever move the needle at all in the long-term business value.

My response is that doing drugs once probably won't cause permanent damage (for example, an ill-conceived acquisition), but a long-term habit of doing so will. Because these businesses are so young and susceptible to bad influences, I want to know it sooner, rather than only realizing it after the habit has caused irreparable lasting damage. Perhaps it's just the helicopter parent in me. But I reason that bad habits, cultures, ways of thinking about the world, etc. are mostly formed during early development after all[4]. Luckily unlike human children, the difference is we can always sell our "investment children" if we don't like the path they're going down.

[4] Similar to humans, corporations develop internal cultures, and "personalities" / ways of dealing with unforeseen stresses too. Just like with humans, I believe these innate qualities are among the hardest aspects to change later on.

"It's not whether you're right or wrong that's important, but how much money you make when you're right and how much you lose when you're wrong."

– Stanley Druckenmiller on what he learned from George Soros

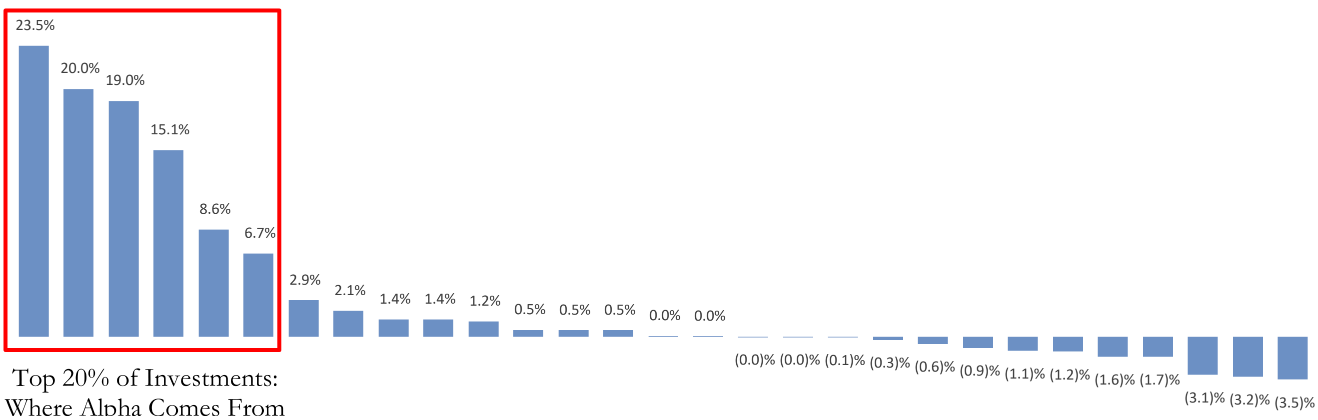
As we end another year, I took some time to review the portfolio and how I can improve our investment process. While doing so, I was reminded of just how present the Pareto principle (also known as the 80/20 rule) is, in our style of investing.

The Pareto principle states that within many systems, 20% of causes generate 80% of the results. Vilfredo Pareto originally observed the principle when studying wealth and income distributions in Europe (20% of the people owned 80% of the wealth). However, the principle is just as relevant to sales & marketing strategies, management techniques, health habits, sports, and a variety of other fields.

It's certainly true in investing too. And especially so for concentrated portfolios with a long-term investment period, such as ours. For example, you can see below that out of the 29 investments we've made since Hayden's inception, the top 20% of positions (6 investments) accounted for over 100% of our gains (108% to be exact)[5]. We're wrong often, and that's okay.

Hayden Capital's Attribution Per Investment

Since Inception; As of February 6, 2020



Years ago, while I was still finding my personal investment philosophy prior to starting Hayden, I studied the portfolio composition of the investors I admired – those who follow this concentrated, low-turnover style of investing. Studying investors such as Charlie Munger, Hillhouse, Himalaya, Nomad Investment Partnership, Prescott General, among others sparked the realization that it's a handful of investments that really drive the long-term outperformance of these funds.

For example, strip out Tencent and JD from Hillhouse, Moutai and Ping An from Himalaya, Amazon and Costco from Nomad, and the track records of each would be greatly diminished. The commonality was that these notable investors had the conviction to allow their best ideas to become a large enough portion of their portfolio, to capitalize fully on the rarity of such situations. When the ideas worked, a single investment

[5] As of February 6, 2020.

would often comprise 40%+ of the portfolio, due to large unrealized gains[6]. They simply resisted selling their best ideas.

The book "[The Art of Execution]" by Lee Freeman-Shor describes this style of investing aptly[7]. In it, he talks about a style of portfolio management, that he calls "The Connoisseurs". A couple quotes include:

"The Connoisseurs are the last and most successful investment tribe I discovered among the top investors who worked for me… They treated every investment like a vintage of wine: if it was off, they got rid of it immediately, but if it was good they knew that it would only get better with age… It takes a lot of nerve to do nothing or merely trim a position when winning."

"In terms of hit rate, as a group they actually had a worse record than the average for my investors. Six out of ten ideas the Connoisseurs invested in lost money. ***The trick was that when they won, they won big. They rode their winners far beyond most people's comfort zone.****"*

*"**Because the Connoisseurs believed earnings growth drove stock prices, the stock price should therefore drift higher over time**. The main risk of buying these stocks was if they were rated highly at the outset (i.e. with high price/earnings ratio). This could mean that the company fundamentally performs as expected but the share price doesn't follow earnings upwards due to it getting de-rated."*

*"Given the average success of an investment idea is 49%... it really does matter that when you win, you win big… Where many investors go wrong is in investing in too many ideas with limited upside potential (of, say, 10-30%)… The secret of the Connoisseurs was not only to do away with such unambitious limits (**they never used price targets**) but also to eschew investments that might only ever perform so modestly.* ***They just weren't interested in small-scale success.****"*

"When the Connoisseurs were very confident in an idea, they built up big positions. ***They could end up with 50% of their total assets invested in just two stocks. It was these stocks that made them so successful."***

"One of the key requirements of staying invested in a big winner is to have (or cultivate) a high boredom threshold. Meeting some of my Connoisseurs could be very, very boring because nothing ever changed. ***They would talk about the same stocks they had been invested in for the past five years or longer.*** *On the days I had a meeting scheduled with a Connoisseur, I sometimes struggled to get out of bed… It is very hard to do nothing but focus on the same handful of companies every year, only researching new ideas on the side."*

And if you look at how Hayden's performance record was derived, it's been exactly that. To use a baseball term, our "Hit Rate" is 55%, but the "Slugging Ratio" is 4.8x.

This means that although we get slightly more names right than wrong, the investments that we do get right return 4.8x on average that of our "losers". Our best investment has added +23.5% to our cumulative returns (and counting!... it's still in our portfolio), while our worst investment has a comparatively small -3.5% impact on our portfolio (a 6.7x differential).

This is why for every potential investment, I'm looking for it to return multiples of our initial capital. Anything less, and the math doesn't work[8].

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[6] The cost basis was typically a fraction of the position size. Similarly for this reason, at Hayden we have a soft rule around how large our positions sizes can be *at cost*, but no limit on how large a position can ultimately grow to with performance.

[7] Thank you to one of our partners (M.C.) for recommending this book!

[8] There's a similarity with the venture capital model, where given the low hit rate, new investments need to have the potential to return the entire fund. Venture funds have a lower hit rate, but a much wider range of potential returns / a higher slugging rate.

When you're underwriting your investment thesis on multiple expansion, your upside is naturally capped. Shorter-term investment strategies that rely upon a change in perception (and thus underwrite multiple expansion for returns) can perhaps generate a 20%, 50% or rarely a 100% return (i.e. a 5x P/E stock going to 6x, 7.5x or 10x)… but it's almost impossible to generate a 1,000% return (5x to 50x).

This means that under this type of strategy, you need to have a very high hit rate, to make up for the narrower range of outcomes (lower expected return per bet). The name of the game is consistency, and the great players will exhibit low volatility in their strategies. The institutional assets in our industry have been shifting towards this style in the last decade, which means more assets chasing after the same investment theses in this style bucket[9].

On the opposite end of the spectrum, I'm searching for "fat" returns. While a P/E ratio may not expand 10-fold, a company's earnings certainly can. When you underwrite for earnings growth, your odds of being right are going to be lower, since predicting the future is inherently imprecise. However, if the investment process proves correct, the odds of today's $1 Billion market cap company becoming tomorrow's $10 Billion or even $100 Billion company is much greater. Given the magnitude of the payoff, your hit rate can be closer to 50% (or even below), while still making above-average returns.

The real "career-making" investments are where you have a combination of both earnings growth and multiple expansion. I've found in my experience this usually this happens when 1) when the market doesn't fully appreciate the potential of a new product, that is more attractive than the existing business (higher margin, stickier, etc.), or 2) the company is relatively new (perhaps a recent IPO or startup), that gains the market's confidence over time as management proves their executional abilities. This results in the multiple drifting higher over time (perhaps the market thinks the company is a 1-hit wonder at first, but management continues to launch new products successfully and extend the lifecycle of their existing products).

Notice though, it's the earnings trajectory that's the real driver in these situations and what investors should be focused on understanding. The multiple expansion is just the output of the earnings growth path. There's almost no possibility of a multiple expanding from say, 5x P/E to 50x P/E, without a change in the earnings trajectory as well.

Lastly, these attributes explain why so many successful investors in this investment style also run concentrated portfolios. Remember, the low hit rate is the weakness in this investment strategy, so we should focus on moving the aggregate hit rate as far above 50% as possible. The easiest way to do this is by concentrating in just the highest conviction ideas. Most likely our 30th best idea has a far lower confidence in the thesis playing out (hit rate) and also lower return potential (slugging rate), versus our top ten ideas.

A beneficial side-effect is that this can also be self-fulfilling, since fewer ideas also means more time and effort can be dedicated to studying & monitoring each company carefully. Hopefully this results in spotting weaknesses and positive developments in the thesis sooner. We can then size the position larger or smaller to fully capture that insight (increasing the slugging rate) or have more time to do the initial investment research on a new idea (resulting in a higher eventual hit rate).

It also explains why portfolios in this style tend to be very volatile (mark-to-market wise). The concentration is a feature, not a bug – something that's necessary to generate superior returns under this method.

All this seems to be a "dirty secret" to those inside the investment management community, but something that's not widely understood outside of it. There are numerous ways to make money in the financial markets,

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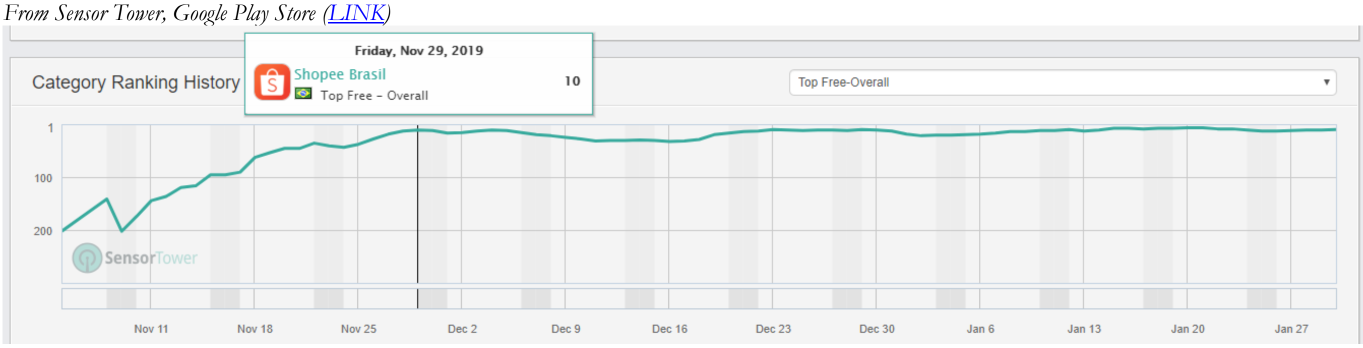
[9] Ironically, this can actually make this investment style more attractive. Returns are derived from multiple expansion, which in turn comes from other investors buying into the thesis. So the more capital that chases this investment style, the quicker the multiples will expand & the quicker the investment will "work".

and no strategy is "the correct way". But a sure fire way to fail, is to structure a portfolio in a method that is conflicting with the investment style (for instance, having a diversified but low hit rate strategy). As investors, we should all evaluate the "mechanics" of our portfolio construction from time-to-time, and ensure that our portfolio construction is harmonious to how our alpha is generated.

Portfolio Updates

Sea Ltd (SE): On October 21, 2019, Sea Ltd. launched its app for the Brazilian market (LINK). In just a month, Shopee was among the Top 10 free apps in Brazil. And it's stayed in that position ever since.

Shopee Brasil App Rankings
From Sensor Tower, Google Play Store (LINK)



This is the first test for the ecommerce marketplace outside of its Southeast Asia home base. Will the platform's fun and addicting features overcome a lack of local knowledge and presence[10]? It's hard to predict consumer behavior and how accepting users will be to a platform – especially one that's a foreign culture and 10,000 miles away. The only way to know is to experiment and watch the results closely.

Empirically though, it seems that what consumers find entertaining in Asia, generally translates well to Brazil (and Shopee really is as much an entertainment platform, as an ecommerce one).

For example, just look at the top 10 free apps in Brazil. Two are utility messaging apps, so we'll ignore those (WhatsApp and Facebook Messenger)[11]. But among the remaining eight apps, they're all entertainment based and overwhelmingly Asian. Four are from China (Kwai, TikTok, VStatus, TikTok Lite), two from Singapore (Free Fire and Shopee, both Sea Ltd apps), and one from the US (Instagram). The commonality is that all these apps are experts at creating addictive habits, as evidenced by their personalized recommendations, avg usage time, number of logins per day per user, etc.[12]

Sea Ltd hasn't provided much details publicly on the Brazil initiative – only stating that it's an effort by the cross-border team and still a "test". Our impression is they're being coy about this, while becoming more aggressive behind the scenes. For example, Shopee's Brazil advertisements seem more geared towards the end consumer, vs. the drop shipping merchants which AliExpress targets. Additionally, the company is heavily subsidizing orders at the moment, with free shipping on all orders, across all of Brazil, with no minimum order value (a very aggressive promotion!).

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[10] At least for now, although the company is hiring to address that. Just see Shopee's hiring activity in Sao Paulo: LINK, LINK 2, LINK 3.

[11] Utility apps have high usage frequency but are very hard to monetize directly.

[12] See the "Social Commerce – Shopping Under the Influence" section of our Q3 2019 letter (LINK).

What's clear is that one way or another, investors should pay attention. Subsidizing orders to be shipped half way around the world is costly. If you're bearish, you can argue it's going to be a drain on cash flows in the near-term. Alternatively, you can make the bullish case that they've followed this playbook successfully in many other countries and Brazil shouldn't be any different, so it will eventually provide a high return on investment. Or else the degree of cash burn is fully in their control so they can shut it down in quickly, if need be.

Currently, the odds look good and the angle Shopee is pursuing is working (at least from a brand-awareness perspective, although three months of operations is still too soon to call). This is the same playbook they used in Southeast Asia – a way to build a dense network of users rapidly, but also a costly one. The key question is whether they can keep users sustainably engaged, until the business is strong enough to monetize.

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Additionally, we saw Sea Ltd.'s Garena (their gaming business) acquire Phoenix Labs (a Vancouver-based game developer) just two weeks ago[13]. Details are scant, with no disclosure on the acquisition price, nor compensation package for Phoenix Lab's founder and senior team going forward.

What we do know however, is that Garena was one of the early investors in Phoenix Labs after its founding in 2014. Phoenix's team is largely comprised of ex-developers from Riot Games (Riot is owned by Tencent, who also owns a third of Sea Ltd).

Phoenix officially launched its debut game, Dauntless, in September 2019[14]. Since then, the game has amassed 20 million players across the PlayStation 4, Xbox One, Windows, and Nintendo Switch platforms, and has garnered an impressive ~80-point score on Metacritic. Similar to Fortnite, the game is cross-platform, allowing players to go on quests with friends regardless of the system they're using[15]. In fact, Dauntless plans to release a mobile version later this year, and it's what I would presume is a major reason for Garena's acquisition.

As with all of Sea's businesses, the social element is a big part of Dauntless' appeal. Quests (or "Hunts") are meant to be played with 3 other players in co-op mode, with players needing to work together to slay the target beasts. The average quest lasts just 5 – 20 minutes, which is similar to Garena's Free Fire game, and is an ideal length for making it work on mobile[16]. This facilitates an easy mobile transition, as mobile players want "bite sized" games to play on-the-move.

Another potential synergy, is that Dauntless utilizes a "Hunt Pass" system for monetization (LINK), similar to Garena Free Fire's Elite Pass system, or Fortnite's Battle Pass. In all instances, playing the game and completing objectives levels up the "pass", which earns the player rewards like cosmetic skins, in-game items, emotes, etc. Garena built a $1 Billion business largely off this Elite pass feature – knowledge that undoubtedly will benefit and accelerate Dauntless' monetization path.

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13 Garena acquired Phoenix Labs, on January 28, 2020 (LINK).

14 Dauntless has been in beta trials since May 2018, and launched the Nintendo Switch version in December 2019.

15 In fact, 60-70% of Dauntless quests involve players who are cross-platform.

16 Mobile players typically play "on-the-move", with shorter chunks of free-time available to finish a game. This is very different than typical console games, where players are expected (and willing) to commit hours to a single gaming session. This drastically changes the way the game needs to be designed from the onset, and is a bigger deal it would seem.

Upgrading the Hunt Pass to an Elite version costs 1,000 Platinum (Dauntless' in-game currency), which equates to ~$10 USD. Since the pass only lasts for one "season" (approximately a month), players would need to re-purchase the upgraded pass, if they want it for the following month.

Believe it or not, this pass mechanism is big business… in May 2018, Fortnite is rumored to have sold 5 million passes *on a single day*, or $50 million in revenue (LINK). In June 2018, Fortnite announced it had 125 million players and also 40 million active players per month (LINK). Putting these two pieces of information together, it implies that at the very least, 4% of registered players or 12.5% of monthly active players, bought the upgraded Battle Pass. And the percentage is likely much higher, since players continue to upgrade their passes well after the first day of the season.

The Garena / Phoenix Labs deal is rumored at a $150M valuation (LINK). Using my very rough math above, I estimate that Dauntless could be generating ~$8 million per month for Phoenix, or $96 million annualized[17]. This figure could be conservative, since Garena itself monetizes at a ~9% paying ratio (more than double our assumptions) and players continue buying passes well into a season[18].

If my assumptions are correct (and admittedly there's a lot of them), this implies Sea Ltd managed to snag Phoenix Labs at a 0.7x – 1.6x revenue multiple. This is for a game that's just beginning to monetize, plans to launch a mobile version shortly (which has a larger addressable market than gaming consoles), and also has yet to launch in Asia or Latin America. The math is likely in the ballpark. But even if I'm off by a magnitude or two, this is still a steal for a AAA game developer, potentially in the beginnings of hyper-growth mode.

All in all, it's been a busy couple months for one of our largest investments. Hopefully we'll have more details into these two developments later in the year, but so far the company is firing on all cylinders. The Sea Ltd team continues to impress and exceed my expectations.

New Positions (Undisclosed): Partners will notice that we've purchased two new positions in the portfolio. Notably, these are the first purchases that we've made in over a year. Finding good investments has been tougher than usual, given the rising market valuations and our high-quality filter.

I am building our stake in one of the companies, while the other is still very much a "tracking position" as I wait (hope?) that valuations will come down to a more reasonable level. Both of these businesses operate in China, with very different business models and end customers. Most importantly, our primary research checks have indicated that both are the foremost leaders in their respective industries.

As I continue our research and finish building our positions, I aim to provide more disclosure on these companies and the opportunities we see for them. In the meantime, partners can reach me at any point to walk through our theses off-line.

Conclusion

The next few months will likely be a busy travel period for me. I had originally planned on returning to Asia this quarter, visiting Vietnam, China, Hong Kong, and Singapore. Afterwards, I had planned on making another trip to the United Kingdom, Germany, Spain, and possibly other European countries.

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[17] 20 million registered players x 4% paying ratio x $10 per month = $8 million revenue per month. A 9% paying ratio would equate to $18 million per month.

[18] Garena's paying ratio is calculated using quarterly users, while for Dauntless we use lifetime registrations. But given Dauntless was officially launched just 4 months ago, we assume the number of lifetime players is likely similar to number of quarterly players.

However, due to coronavirus outbreak and the subsequent travel restrictions, the exact timing for the Asian and European trips are still undetermined. 14 days quarantine doesn't sound fun (although maybe I'd finally get to that stack of research that's piling up on my desk...). As soon as I have more clarity on the outbreak and an easing of travel restrictions, I should have a better idea of the exact dates. My goal is still to make both trips in the first half of 2020.

What I know for sure, is that I'll also be back at Berkshire weekend for the annual investor pilgrimage to Omaha, from April 30 – May 3. I always tell people that while listening to Warren and Charlie speak is great, the real value is in the extracurricular events and impromptu meals.

I've met many fellow professional investors, personal investors, allocators, and entrepreneurs during these meetups. Many have turned into friends over the years, and despite the physical distance, we keep in close contact by sharing ideas regularly. If anyone is heading to Berkshire, and would like to grab a coffee or meal, please let me know.

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In December, Ryan of The Investing City was kind enough to have me on his podcast. If you'd like to hear me ramble about stocks, the genesis story of Hayden Capital, or just listen to a plethora of other interesting investors Ryan's interviewed, I'd recommend checking out his podcast page (LINK).

Recently, I also read an article by James Currier of NFX, on the role Network Effects play in determining important aspects of our lives – from who our friends are, to what college you go to, the career paths available to you, to who you marry (LINK).

I've talked before about how I believe the nature of "compounding" doesn't just apply to money, but also to knowledge, relationships, physical health, and many other aspects of life. This article is a slightly different take on that, and I suggest reading it to recognize the role environment plays in our personal development.

It's made me have a greater appreciation for the networks that are present in my life – whether intentionally curated over time (who you choose to spend your time with, making a conscious effort to expand your network into non-overlapping areas), or whether it's through luck (being born into a family that instilled a good value system, and that has the resources to provide opportunities).

I'm grateful for the all the new relationships I've gained, and the old ones that I've strengthened in 2019. Hopefully I'll have a chance to do much more of that in 2020.

As a reminder, our partners will be also able to find their 2019 tax forms available online from our prime broker, Interactive Brokers, within the next few weeks. I'd encourage our partners to consult their tax advisors for tax related questions. Please also reach out to me, if there are any questions with accessing these documents.

We're settling into our new office space in Midtown, but am still searching for the perfect coffee shop with ample seating… please let me know, if you know of such a place. And of course, if there's anything investing related I can help with too or to simply catch up.

Sincerely,

Fred Liu

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