Linden Rose Investment

2017 Annual Letter to Clients

Annual Return

Year	Linden Rose Investment	S&P 500 Index
2017	55.51%	21.82%
2016 2nd Half	18.41%	7.82%

Dear Partners:

For the full year of 2017, the consolidated return of Linden Rose Investment (net all fees) was 55.51% versus the 21.82% return of the S&P 500 index. We are very pleased with the way things turned out in 2017 but are keeping our expectations for the future at a reasonable level. In January 2016, when we founded Linden Rose Investment, we set a goal of beating the S&P 500 Index by 3-5% per year. So far, we have achieved that goal and are happy with our investment performance in the last one and a half years. As always, we will keep striving to continue our success.

About Linden Rose Investment

Two years has made all the difference. When we founded Linden Rose Investment on January 14th, 2016, we did not know what to expect as we had no prior professional experience managing other people's money. What we did have was a dream, passion, and determination. We also had a few questions to keep in mind. Would we be able to find clients that would trust us with their money to manage? Would we survive the first few years with enough money to keep the lights on? Could we generate a good rate of return for our clients in the first few years?

Some of these questions are still valid today, but over the last two years, we have managed to build a solid foundation to grow upon.

(1) Our firm and partners have obtained proper business and security licenses since inception.
(2) We completed analysis of the first potential investment and optimized the research process and workflow afterward.
(3) We now have a diversified portfolio of 8 to 10 stocks.
(4) Both Feng and Bing resigned from other activities and have worked for Linden Rose Investment full time for over a year now.
(5) During 2017, our AUM has tripled and currently we have around 40 accounts under management.
(6) For the 2nd half of 2016 and the whole year of 2017, we had wonderful returns (net all fees) of 18.4% and 55.5% respectively, giving us a total return of 84.1% since July 1st, 2016.

No one ever said starting a new business from scratch would be easy. However, we have been fortunate so far and everything has gone better than we expected. Of course, this does not mean that everything has gone perfectly. We are always looking to improve and fix mistakes that have been made. Franklin D. Roosevelt was right when he said, “the only thing we have to fear is fear itself”. Nothing else is worth fearing because it can be conquered. Life is kind of like the stock market where it is very hard, if not impossible, to predict what is going to happen. Whenever we felt frustrated, were stumped on something, or did not meet our own expectations, we heard the voice of Steve Jobs from deep in our hearts. He said that, “your time is limited, so don't waste it living someone else's life. Don't let the noise of others' opinions drown out your own inner voice. And most importantly, have the courage to follow your heart and intuition.” His words ring true but this philosophy is much easier said than done. However, another saying is also true: a thousand miles begin with a single step. The key is to take the very first step and just do it! We are deeply grateful to our clients for their trust and we will continue to work very hard to fulfill our responsibilities. To us, this is still day one and we have only seen the tip of the iceberg that is our potential gain.

What Constitutes Value Investing?

A business's intrinsic value is the sum of all future discounted cash flow (DCF) of the company. An overpriced business is one that trades at a premium to its intrinsic value, and an undervalued business is one that trades at a discount. For nearly a decade, we thought that only buying a company trading at a low Price/Earnings ratio was considered value investing.

However, this idea makes little sense when factoring in what we know today. The path that different companies' cash generation takes can vary enormously. Some companies may generate large cash flows quickly while others have cash flows that only grow large much farther down the road. At an appropriate price, either of these companies can be considered value investments. While an undervaluation of the former will likely go hand-in-hand with a low multiple, the latter's multiple will probably be high or even negative. This has no bearing on whether it is cheap or not because only the size and the duration of future cash flows relative to the price can tell you that. For example, when Elon Musk sold PayPal to eBay in 2002 for $1.5 billion, he correctly predicted that most of PayPal's value consisted of the company's expected cash flow 20+ years into the future.

In recent years, we have come to appreciate that the type of company whose cash flow is expected to grow over a longer period provides a far more fertile ground for finding undervalued investments. Why is this?

First, companies in a fast growth stage have historically been ignored by value investors. As discussed, this is most likely due to the above-average multiples such companies command. Second, investing in this type of company requires a longer time horizon. This makes them unattractive to most capital market participants with shorter time horizons. Finally, it requires thoughtful due diligence and analysis to figure out which companies are positioning themselves correctly for an uncertain future.

Our aim as a value investor is to put capital to work in whichever company offers the most value, or in other words, has the highest present value of future cash flow. Admittedly, we derive more satisfaction and confidence from owning stakes in businesses that invest in future growth. Simple math can explain the reason. Great businesses continue to grow and the cash flow that is 5, 10, or 20 years down the road can be 10 or even 100 times what the cash flow is in the first couple of years. People can easily tell if a stock is selling at a low earnings multiple, but it is much more difficult to see that a stock selling at 30 times earnings is still very cheap. Therefore, we drew a conclusion: the biggest discount of value investing comes from a company's future growth. The faster and longer a company can continue to grow, the more discount the company can be selling at today even if the earnings multiple seems high.

Investing in "Technology"

Our investing hero, Warren Buffett, is famous for only "investing in what he understands". Historically, this meant avoiding the "technology" sector. The wisdom of this approach was spectacularly vindicated in the dot-com crash of the early 2000s. Historically, value investors eschewed the tech sector because it was too fast-moving. Today's hot and new technology was likely to be replaced by something better only a few years down the line. For a long time, we thought the technology sector was not investable. However, a few lessons we learned gradually wore down our reluctance to invest in technology sector.

The first lesson was Google (now Alphabet). When Google went public on August 19th, 2004, its earning per share was around $0.50 and the stock was selling at a split adjusted price of $50, a whopping 100 times earnings multiple. This looked very expensive to cheap value investors like us. Now, 13+ years later, the stock price has gone up by 2,300% and is selling at a P/E ratio of 37 which looks more reasonable. So, what happened? The stock price grew by a factor of 23, but the earnings per share grew by a factor of 60! A seemingly expensive technology stock price turned out to be very cheap in the long run. We realized that maybe high multiples were not that high if you factored in that technology companies like Google can grow earnings very fast and sustainably for a very long time.

The second lesson was Visa. In 2011, we bought Visa stock at around $17, at a reasonable earnings multiple of 12. The stock quickly went up to $23 and we happily sold it for a 34% gain after holding it for only a few months. Unfortunately, this turned out to be an expensive mistake. Visa's stock price continued growing and is now $123, almost 6 times as much.

After a few painful lessons like the above mentioned, we began to seriously consider the possibilities of investing in technology stocks. In early 2013, we took the plunge and bought a big stake in Apple. Clearly, companies like Apple, Amazon, Facebook, Alibaba and Tencent are far too entrenched in our modern, Internet-driven economy to be considered not investable. In fact, it is the traditional media companies and retailers that seem to be moving outside the generalist's circle of competence. For example, anyone who claims to have a better understanding of the future of a department store than Amazon, is in our view being disingenuous.

We frequently hear some members of the value investing community complain that "value investing no longer seems to work". However, from our perspective, paying less than something is worth – the essence of value investing – will continue to work until the laws of mathematics fail to apply. We guess what they mean is that paying low multiples for mature, apparently "easy-to-understand" businesses no longer seems to work.

This fact continues to become clearer as technology advances. The changes brought about by the Internet, mobile, and eventually AI (just to name three major technological shifts) are fundamentally changing the economic basis of nearly every established business. A refusal to engage intellectually with these changes means that not only are you missing out on the investment opportunities they present, but also being blind to the fundamental changes taking place at every “easy-to-understand” business.

To his enormous credit, Warren Buffett acknowledged at last year’s shareholder meeting that Google and Amazon were well within his circle of competence and that he had missed both opportunities. He too has made his first investment in the technology sector, most notably in Apple. Interestingly, he views Apple more as a branded consumer goods company than a technology company. Welcome to the wonderful world of technology stocks, Warren, it is better late than never.

Conclusion

As an investor, much of our time is spent thinking about the development of business models, industry frameworks, where to invest within them, and understanding where investment advantages may come from and why. Crucial to this process is voracious reading and having the time and space to step back to think about the significance of these ideas in a broader context.

On the operational front, LRI’s minimum investment will increase to $100K and the annual management fee will increase to 1.2% of AUM for newly engaged clients going forward.

As always, we’d like to thank our investors for their continued support and trust. While in the short-term our results may occasionally be volatile, we know that overtime, our profits will be worth it. If you have any questions, please feel free to contact us. You can either call us at (973) 841-7158 or email us at bing@lindenroseinvestment.com. We are always happy to meet new investors who you think may benefit from our services, or who would like to learn more about our investment philosophy. If you know anyone who may be a good fit, please have them reach out.

Stay hungry, stay foolish!

Thank you very much!

Yours truly,

Binglin Li	Feng Peng
Managing Partner	Managing Partner

January25th, 2018

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