Fairlight Alpha Fund LP

2022 Q1 Letter

Dear Partners,

Fairlight Capital's first quarter 2022 returns were -17.1% net of fees. This compares to -4.6% for the S&P 500. Overall, since inception[1] the fund has returned 256.4% net of fees and 50.9% on an annualized basis. Needless to say, we are not happy with the performance for this quarter. However, due to our focus on global microcap securities, we expect and are not surprised by periods of downward volatility in the fund. With this knowledge, we remain committed to our investment process and focused on finding undervalued companies. This begs the questions: what is our investment process and how do we determine undervaluation?

The Fairlight Investment Process

The Fairlight investment process focuses on identifying companies in a given market that are undervalued relative to other available investment options. And in today's world, the market for stocks is truly global and we hope it remains so. To begin to identify the cheapest stocks, we focus on companies with the smallest market capitalization as these have historically outperformed larger capitalization stocks, and then begin to go through each name one-by-one. While this is very time consuming, and boring (imagine setting in an office reading boring financials on thousands of companies), it has the great benefit of allowing us to spot anomalies. Further, bigger anomalies exist in smaller capitalization stocks because there are fewer market participants (hedge funds, mutual funds and smart individuals) operating in this area.

There are structural reasons competition is weak in the space. First, hedge funds and mutual funds need a large asset base to generate fees to pay for fund managers and support staff salaries. So, the larger the asset base, the higher the management fee earned by the fund company and the higher the salaries of fund personnel. Further, these larger funds need to manage liquidity which means they have a difficult time buying small capitalization companies. Thus, it is uneconomical and risky for normal investment funds and their management teams to invest in the nanocap and microcap area.

Second, smart, enterprising individuals face a conundrum when looking at microcap stocks. Imagine you are a young ambitious person (which likely means you don't have a lot of capital) and you want to invest in the microcap space. You can go and try to raise money but being young and short on capital makes it difficult to raise capital. Further, by not having a large amount savings, a young investor has a hard time making a living off his own capital. Thus, it makes much more sense for smart, ambitious young professionals to go work for large, established investment firms. Smart investors who specialize in the smallest market

[1] [1] The Fairlight Alpha Fund was launched on 01-Mar-2019.

capitalization space have had to sacrifice more lucrative careers to develop the specialization of microcap investing. Investing in illiquid stocks is something one does early in one's career not for money but out of passion and interest. On the plus side, after doing it for over ten years, an investor builds a knowledge base and skillset that would be impossible to obtain working for a large investment fund.

Determining Undervaluation

Determining undervaluation is really easy, just take the market capitalization of the business and divide it by earnings a year or two in the future, and then pick the stock with the lowest ratio. If you can divide one number into another and then rank order smallest to larger, you are on your way! As simple as this sounds, most investors don't do this. Why? Because first off you need to go through a very large number of stocks and do a lot of boring reading to figure out true earnings power. If an investor doesn't really enjoy flipping through stocks and reading reports, the above method won't work.

Second, performing the above filtering process only gets an investor about 60% there. The next 40% comes from thinking deeply about the numerator in step one of the above algorithm. The most important determinate in valuation is the level of future cash flows. If an investor could determine this with a very high degree of certainty, the investor could just apply a discount rate to a DCF model and arrive at the correct valuation. Unfortunately, in the real-world estimating earnings/cash flows over a long period of time is fraught with endless complications. And thinking about these complications also takes a lot of time. Not only does an investor need to think about the earnings/cash flow estimate, but he also needs to estimate the uncertainty of the earnings estimate to perform the rank order function. The higher the certainty of the estimate of earnings/cash flows the higher it should be place in the rank order function versus other investment options.

As Jim Grant states:

> *"To suppose that the value of a common stock is determined purely by a corporation's earnings discounted by the relevant interest rates and adjusted for the marginal tax rate is to forget that people have burned witches, gone to war on a whim, risen to the defense of Joseph Stalin and believed Orson Welles when he told them over the radio that the Martians had landed."*

Our job as fund managers is to determine what is the most correct narrative for a business's future and act when the share price does not match our estimate of the most correct narrative.

Microcap Investing Challenges

Microcap investing involves buying shares in businesses with market caps that can range anywhere from $5 million to around $300 million. Liquidity in such shares can range from very liquid where millions of dollars' worth of shares trade a day to where just a few thousand dollars' worth of shares trade in a month. Part of the Alpha Fund's advantage is that we invest along the whole spectrum of market size and liquidity which gives the Fund a much larger number of securities to analyze and potentially invest in. Investing in microcap stocks, however, creates several structural challenges for investment managers. Often, a microcap stock can go through sustained periods of very low trading volumes. During these periods, very few shares will trade—often for months at a time. This creates several problems. First, building a meaningful position can be difficult. If the fund wants to invest a larger percent (say 5% to 15%) of assets in the illiquid stock it can take months or years to build the position. Managers and partners need patience.

Second, once a fund owns an illiquid stock, it may be difficult to exit the position. At times, a microcap stock may have a high level of liquidity. However, at other times, the same stock may have very low levels of liquidity. This makes managing flows into and out of the fund more difficult. If a fund faces large redemptions and has to sell positions, it can easily drive down prices in order to raise the needed funds to return money to partners. Also, if fundamentals change, it can be very difficult to exit the position quickly.

Third, thin trading can cause mark-to-market accounting with no regard to business fundamentals. This can cause volatility for the fund, which makes the fund appear riskier than it is in reality. Illiquid names can drop 15% to 30% in a quarter, month, week or even a day on no news flow. How nice it would be to manage a venture capital or private equity fund, where we only had to monitor the valuation at fund raising rounds!

So, what does the Alpha Fund get in turn for taking on extra liquidity risk and having to mark-to-market an illiquid position?

In general, we get to play poker against an opponent in Mr. Market who can be at times crazy with fear or greed and at other times driven to action out of boredom. Do you own shares in a great company trading at a low valuation but still need to pay the bills? If so, we are there to buy your shares. We like to play games against opponents who trade based on non-fundamental reasons.

More specifically, the increased volatility caused by bouts of illiquidity gives The Alpha Fund the opportunity to buy shares in businesses at valuations that can be much lower than either larger cap stocks in the public markets or the valuation given to companies in private markets. At times, we are able to invest at low valuations in fast growing companies that have strong competitive advantages, generate high returns on invested capital, are cash flow positive, sometimes pay dividends, and can have large and growing total addressable markets. Overtime, we expect the Alpha Fund to outperform the S&P 500 by being able to take advantage of volatile price moves in less liquid stocks that are followed by fewer analysts.

Current Outlook

The Fairlight Alpha Fund invests globally and invests in all regions around the world. Historically, we have focused on North American and Asia. Due to valuation differentials, we are deeply invested in Asia with a focus on Singapore and Hong Kong markets at the current time. Most Westerners have no problem investing in Singapore due to the city-state's well developed legal framework. However, liquidity for many stocks in Singapore can be very low. This favors Fairlight and we will continue to invest in Singapore's capital markets. Hong Kong, on the other hand, has higher liquidity and more companies involved in a wider breadth of industries but the influence of the Chinese government scares many Westerners. While, we also have our worries about Hong Kong, we think many Western investors fail to grasp China's historical development trend.

In *Engines That Move Markets,* Alasdair Nairn wrote:

> *In the period to 1850, roughly $372m (over $50bn* (in 2001 dollars)) *had been invested in the railroads, but in the seven years to 1857 a further $600m (over $80bn) was invested – a figure three times that which had been sunk into canals over their life time. The surge in capital for the US railroads involved funding from outside America on an unprecedented scale, together with the creation of an industry which attracted the most famous (or notorious!) corporate figures of 19th-century America.*
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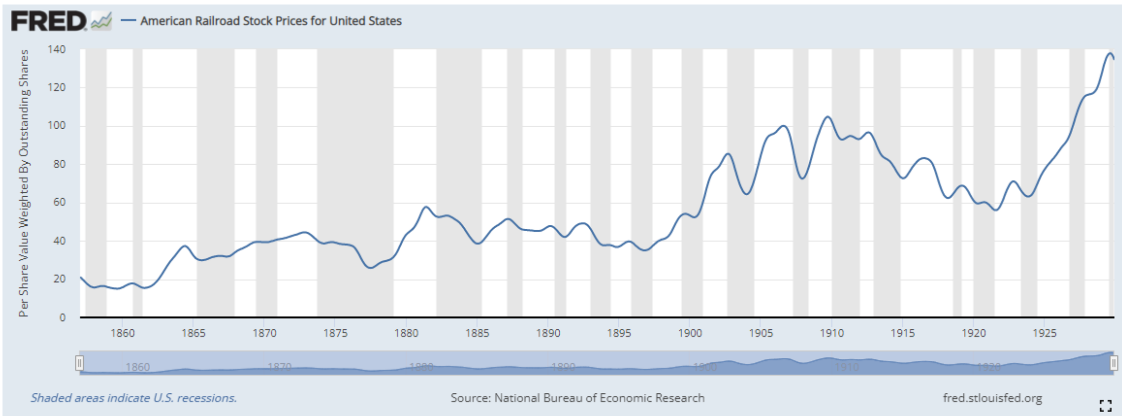
> *While the development of the American railroads followed a similar pattern to their counterparts in Britain, there were significant differences. Britain was in many ways the world's economic superpower, and America was an emerging market. In Britain there was an established legal and governmental system; in America, the delineation of the legal province of the individual states and central government was in many was unclear. In America, land on which to lay track was readily available; in Britain it often had to be secured against entrenched opposition. The final and most notable difference was that, as the major financial centre of the world, Britain was an exporter of capital – and, as a developing market, America was an importer.*

Mr. Nairn goes on to document all the financial shenanigans the American's pulled over the next half century. He chronicles Cornelius Vanderbilt's, Jay Gould's, and Henry Hill's activities that included watering down of minority shareholders through stock issuances, channeling of funds out of companies, the withholding important information to buy stock on the cheap or issue it at inflated prices, short squeezes, price fixing, inflating costs, deflating costs, paying excessive dividends to insiders, paying off politicians and buying judges.

During this time, share prices of many railroads tanked and minority investors (often Europeans) lost money whilst insiders profited. By the mid-1870s, almost 40% of American railroad bonds were in default and by 1879 some $234m ($19bn) had been foreclosed as almost double the amount of track required was laid. In the six years up to 1879, it is estimated that European investors alone lost some $600m ($50bn) in American railroads. This occurred because there was no clear legal framework for either US company or securities laws. Property rights existed during this time, but were easily expropriated due to corrupt judges and politicians. British investors, however, fared better than their continental counterparts. British investors having suffered losses due to financial excesses in the railroad industry during the 1830s and 1840s focused on routes between established centers of economic activity as opposed to financing ventures farther west in more remote parts of America. The British finance houses had agents in America monitor their investments and report back on progress. They also formed investment vehicles to spread risk laying the groundwork for the modern mutual fund industry.

During the second half of the 1800s and into the 1920s, prices of American railroad companies would increase rapidly during short periods of enthusiam and then flatline or decline over the next twenty or so years as overbuilding and corruption plagued the industry.



We see a similar pattern in the Hang Seng China Enterprises Index (HSCEI). The HSCEI constituents are leading Chinese companies that trade in Hong Kong. We can see that the index has been flat since 2006 after a burst of enthusiasm in 2008. Hong Kong traded shares are heavily owned by European and American investors and mainland Chinese investors have limited access to these shares.

The Shanghai Stock Exchange Composite also follows a similar pattern as the American Railroad shares 150 years ago but compressed into ten-year intervals as China has developed more rapidly.

Undoubtedly, we could easily replace Cornelius Vanderbilt, Jay Gould, and Henry Hill with more modern Chinese (and American) characters that have fleeced investors during the last twenty years through activities that include watering down of minority shareholders through stock issuances, channeling of funds out of companies, the withholding important information to buy stock on the cheap or issue it at inflated prices, short squeezes, price fixing, inflating costs, deflating costs, paying excessive dividends to insiders, paying off politicians and buying judges. Just as American railroad barons fleeced continental European investors in the second of the 19th century, Chinese businessmen fleeced American investors in the 2010s. China's laws and ideas around private property rights were not (and still are not) fully developed. In our recent paper *Corporate Governance in China*, we document how China is rapidly developing new corporate governance laws, frameworks and institutions. Just as China *borrowed* the West's intellectual capital around manufacturing and technology, it is borrowing Western institutions to develop the country's capital markets.

On March 16th, 2022 the Chinese Security Regulatory Commission (China's equivalent to the SEC) issued the following statement:

> *Shortly after the meeting of the Financial Stability and Development Committee under China's State Council (FSDC) on March 16, the leadership of the China Securities Regulatory Commission (CSRC) convened to plan measures for implementing the requirements of the FSDC.*
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> *The CSRC recognizes the FSDC meeting as timely and important against the complexity of situations. The meeting places high priority on capital markets by fully addressing market concerns and providing very targeted guidance for actions to be taken. This year, China's national economy continues the pace of recovery. Major economic indicators stay in appropriate ranges as pro-growth policies on all fronts are*

taking effect. Listed companies report better financial results, further consolidating the foundation of the capital markets. Short-term market volatility has not changed and will not change the long-term prospects for sound development of China's capital markets.

Under the guidance and coordination of the FSDC, the CSRC will earnestly implement the decisions made by the Central Economic Work Conference and the "two Sessions". Pressing ahead with reform and opening-up in a market-based and rule-of-law way, the CSRC will actively engage with macro-economic management and industrial regulatory authorities to ensure stability and coherence of policy measures, so as to stabilize the macroeconomy and the financial system. Undertaking the tasks assigned in the Government Work Report, the CSRC will steadily roll out the registration-based IPO regime for the full market, support bond financing of private companies, and enhance the development of venture capital. Tapping into the market's endogenous stabilizing mechanisms, the CSRC will place priorities on the quality of listed companies, and optimize the rules for stock buybacks by listed companies and for fund management companies to take units of funds under their management. Nurturing long-term and value investment, the CSRC will further improve the legal framework that facilitates participation of long-term institutional investors of all categories. Further expanding market opening-up, the CSRC will support capital market cooperation between the Mainland and Hong Kong to jointly safeguard soundness and stability of the Hong Kong Market. Closely working with regulatory authorities in the United States to agree on an actionable arrangement for bilateral cooperation on audit supervision. Moving faster for an early implementation of new draft rules for overseas listings and rendering continued support for eligible companies seeking listings in overseas markets. Continuing to support reasonable financings of the real economy, and assisting relevant regulatory authorities in effectively mitigating risks in the real estate sector and guiding the platform economy onto a track of sound development and greater international competitiveness.

Moving forward, the CSRC will work out detailed plans for fully implementing the requirements of the FSDC, so as to safeguard capital market stability with firm confidence, pragmatic attitude, and effective measures.

We remain focused on the long-term trend of development and economic growth in the world. While we are aware of and take into consideration short-term fluctuations and macroeconomic and geopolitical events, it is our belief that human society will create an enormous amount of wealth in the coming decades and our goal is to provide the stable capital that is needed for businesses to operate in the global economy. Sound capital markets are necessary for capital formation which is necessary for the continual improvement in global living stands. Thus, we will continue to put our efforts and resources into finding undervalued business and being a long-term investor, which will lead to above average returns over the coming decades for our limited partners.

The skills we have developed in analyzing microcap investments in American and Asian markets position the Fairlight Alpha Fund to achieve superior results for decades to come by investing in global securities. The companies you own through the Fund are well financed, generate cash flow (and often dividends), have a good history of sound corporate governance, and are in stable or growing industries. While we do take concentrated bets, we aim to mitigate risk by owning a basket of stocks in diverse industries and geographies.

Your continued support and committed capital helps ensure a stable financial system that is able to fund business operations that are important for the long-term development of global economies. The small capitalization companies in the Alpha Fund provide employment, goods, and services in countries around the globe and are the engines of future growth.

Yours,

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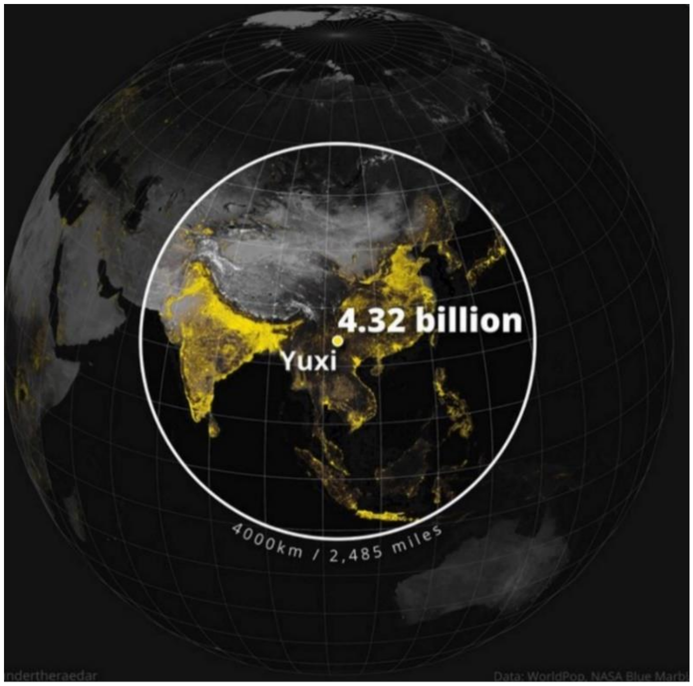
Appendix: population density in East Asia



The circle centered on Yuxi, China contains a population of 4.32 billion people within its borders. It has the largest population on earth that can be contained within a circle with a 4,000 km radius. For reference, the US is 4,583 km from NNW to SSE.

THIS IS NOT AN OFFERING OR THE SOLICITATION OF AN OFFER TO PURCHASE AN INTEREST IN FAIRLIGHT ALPHA FUND LP (THE “FUND”). ANY SUCH OFFER OR SOLICITATION WILL ONLY BE MADE TO QUALIFIED INVESTORS BY MEANS OF A CONFIDENTIAL OFFERING MEMORANDUM AND ONLY IN THOSE JURISDICTIONS WHERE PERMITTED BY LAW.

AN INVESTMENT IN THE FUNDS IS SPECULATIVE AND INVOLVES A HIGH DEGREE OF RISK. OPPORTUNITIES FOR WITHDRAWAL, REDEMPTION AND TRANSFERABILITY OF INTERESTS ARE RESTRICTED, SO INVESTORS MAY NOT HAVE ACCESS TO CAPITAL WHEN IT IS NEEDED. THERE IS NO SECONDARY MARKET FOR THE INTERESTS AND NONE IS EXPECTED TO DEVELOP.

THE FEES AND EXPENSES CHARGED IN CONNECTION WITH THIS INVESTMENT MAY BE HIGHER THAN THE FEES AND EXPENSES OF OTHER INVESTMENT ALTERNATIVES AND MAY OFFSET PROFITS. NO ASSURANCE CAN BE GIVEN THAT THE INVESTMENT OBJECTIVE WILL BE ACHIEVED OR THAT AN INVESTOR WILL RECEIVE A RETURN OF ALL OR PART OF HIS OR HER INVESTMENT. INVESTMENT RESULTS MAY VARY SUBSTANTIALLY OVER ANY GIVEN TIME PERIOD.

THE PERFORMANCE DATA SHOWN HEREIN REPRESENTS THE PERFORMANCE OF THE FUND. THE RESULTS REFLECT THE DEDUCTION OF: (I) AN ANNUAL ASSET MANAGEMENT FEE OF 2%, CHARGED QUARTERLY; (II) A PERFORMANCE ALLOCATION OF 20%, TAKEN QUARTERLY, SUBJECT TO A “HIGH WATER MARK;” AND (III) TRANSACTION FEES AND OTHER EXPENSES ACTUALLY INCURRED BY THE FUND. THE RESULTS REFLECT THE IMPLEMENTATION OF THE INVESTMENT STRATEGY DESCRIBED IN THE FUNDS’ OFFERING DOCUMENTS AND APPLIED IN THE FUNDS’ TRADING ACCOUNTS. ALL INVESTMENTS INVOLVE RISK, INCLUDING THE LOSS OF PRINCIPAL.

RESULTS ARE COMPARED TO THE PERFORMANCE OF THE S&P 500 TOTAL RETURN INDEX (THE “COMPARATIVE INDEX”) FOR INFORMATIONAL PURPOSES ONLY. THE FUND’S INVESTMENT PROGRAM DOES NOT MIRROR THE COMPARATIVE INDEX AND THE VOLATILITY OF THE FUND’S INVESTMENT PROGRAM MAY BE MATERIALLY DIFFERENT FROM THAT OF THE COMPARATIVE INDEX. THE SECURITIES OR OTHER INSTRUMENTS INCLUDED IN THE COMPARATIVE INDEX ARE NOT NECESSARILY INCLUDED IN THE FUND’S INVESTMENT PROGRAM AND CRITERIA FOR INCLUSION IN THE COMPARATIVE INDEX ARE DIFFERENT THAN THOSE FOR INVESTMENT BY THE FUND. THE PERFORMANCE OF THE COMPARATIVE INDEX WAS OBTAINED FROM PUBLISHED SOURCES BELIEVED TO BE RELIABLE, BUT WHICH ARE NOT WARRANTED AS TO ACCURACY OR COMPLETENESS. UNLESS NOTED OTHERWISE, THE RETURNS OF THE COMPARATIVE INDEX PRESENTED HEREIN DO NOT REFLECT FEES OR TRANSACTION COSTS, BUT THOSE RETURNS DO REFLECT NET DIVIDENDS, IF ANY.

PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.