Fairlight Alpha Fund LP

Q1 2023 Letter

Dear Partners,

Fairlight Alpha Fund's first quarter 2023 returns were 9.9% net of fees. This compares to 7.5% for the S&P 500 Total Return index. Overall, since inception the fund has returned 447.2% net of fees and 51.6% on an annualized basis.

Performance vs. the S&P 500

We track the net asset value of Fairlight Alpha Fund (the "Fund") over time as calculated by our fund administrator based on our portfolio positions and prices over time on a dollar basis. The fund financials are also audited each year by an independent auditor with the assistance of the Fairlight management company and the fund administrator.

The tables below show the S&P 500 total return and partnership net returns, after fees, for each year 2019-2023, followed by the compounded returns over the same period, as well as the annualized gains.

Annual Returns

Year		Fairlight Alpha Fund	S&P 500 (Total Return)	Difference
2019[1]	………………………........	38.1%	17.9%	20.1%
2020	…………………………	26.3%	18.4%	7.9%
2021	…………………………	146.5%	28.7%	117.8%
2022	…………………………	15.8%	-18.1%	33.9%
2023 (YTD)	…………………………	9.9%	7.5%	2.4%

Compounded Returns

Year		Fairlight Alpha Fund	S&P 500 (Total Return)	Difference
2019[1]	………………………........	38.1%	17.9%	20.1%
2020	…………………………	74.4%	39.6%	34.7%
2021	…………………………	329.9%	79.7%	250.2%
2022	…………………………	397.9%	47.2%	350.7%
2023 (YTD)	…………………………	447.2%	58.2%	389.0%
Annualized Gain	…………………………	51.6%	11.9%	39.7%

(1) The S&P 500 returns represent the total return index, i.e., with dividend reinvestment included. Increases in value arise from stock price appreciation as well as dividend reinvestment. This provides a fairer comparison to the fund.
(2) The Fairlight Alpha Fund performance is shown net of partnership fees and expenses.

[1] The Fairlight Alpha Fund was launched on 01-Mar-2019 and so the 2019 performance and any returns are presented for a 10-month period.

The fund has outperformed the S&P 500 total return for 2023 to date. The first half of the quarter was perhaps more positive, but the second half saw increased volatility in the US markets. In particular, the US banking sector was shown to have inadequately hedged interest rate risks relating to purchased securities that we will discuss in the next section.

Current Market Conditions

In recent events, the financial world has been rocked by a banking crisis, which draws comparisons to the global financial crisis of 2008-2009. Over the last two years we have witnessed high inflation, post-pandemic uncertainty, the UK pension crisis (which we discussed in a previous letter), and bank failures. The collapse of several banks in March brings to mind the Northern Rock moment, possibly an early indication of further issues in the financial sector.

Several banks, including Silicon Valley Bank, Signature Bank, and First Republic, have encountered significant difficulties. Shockingly, Credit Suisse, a 166-year-old bank, has ceased to exist. This could be just the first wave of a larger crisis looming on the horizon, or are these events specific to these institutions? One common theme is that interest rates are rising across the western world to combat high inflation that has then uncovered the specific weakness seen in these banks.

Reflecting on the early stages of the 2008 crisis, we recall the Bear Stearns moment in March 2008. Following on from this, in the period from March to August, there was an eerie silence, while almost every financial institution in the Western world operated in crisis mode. Due to heightened counterparty credit risk, inter-bank funding dried up, LIBOR rates spiked, and money market rates increased (also recall the buck was broken on money market funds for the first time[2]).

In 2008, after six months of underlying market tension, and dried up liquidity, the cracks finally gave way, leading to Lehman Brothers' bankruptcy. This event marked the end of the pure "broker" business model, which had been in existence for many years. Morgan Stanley and Goldman Sachs rushed to secure banking licenses to survive as their share prices plummeted. By obtaining these licenses, they aimed to reassure investors that they could access the Fed discount window in times of crisis.

It is impossible to know for certain, but it seems to us that a regime change has occurred in the last two months in the financial markets. On the one hand US depositors have become more concerned with the safety of their deposits resting in small community and regional banks, on the other hand, larger institutions are now sensing an opportunity to use their relative safety and financial strength to grow deposits by offering much better terms to consumers.

In recent days Goldman Sachs and Apple have combined to create a high-yield savings account for Apple Card users that pays 4.15%. It will be interesting to see how other banks compete and thrive by either increasing deposit rates or offering other services such as money market accounts or CDARS accounts[3]. Our belief is that some of the banks that have a business model that focuses on the local economy will thrive if they are able to overcome this depositor headwind.

[2] During the global financial crisis, the buck was broken on September 16, 2008, when the Reserve Primary Fund, a large money market fund, announced that its net asset value (NAV) had fallen below $1 per share. This was largely due to the fund's exposure to Lehman Brothers' debt, which became nearly worthless after the investment bank filed for bankruptcy on September 15, 2008.

[3] IntraFi® Network Deposits (formerly Certificate of Deposit Account Registry Service (CDARS)) help consumers with large deposits keep their money insured by staying under the FDIC insurance limit of $250,000 per depositor per bank. It effectively allows deposits larger than $250,000 to become FDIC-insured.

However, even in the absence of any new bank failures we believe that the deposit market will become more competitive and that the cost of capital and net interest margins for US banks will come under pressure in the coming quarters. This will be offset by higher rates for banks to loan or invest assets into, but even for the best banks that manage their loans book credit risk well and never set up HTM portfolios, the next few years could be more challenging than the last year. One thing that appears to be clear is that the outlook is less certain and predictable in this area of the market now.

Stocks in North America

We have talked before about the ECIP community banks, in particular the stocks MFBP and CZBS which we had built up in the middle of last year. These banks have been given ECIP preferred capital which has a low dividend, adds to the bank's book value and are enabling them to expand their business and loan books in local underserved communities. We believe that these are also good investments for the long term. Another recent development was the additional provision of capital through the CDFI Equitable Recovery Program (ERP) scheme. From this M&F Bank and Citizens were given an additional $2.5 million and $5.0 million respectively.

Since last year the ECIP banks have appreciated significantly, which will hopefully make them stronger institutions in years to come. And we believe they will continue to grow over time. However, as discussed above, with increasing interest rates, high inflation and increasing competition for deposits we think the picture is now more challenging for the smaller banks. It is clear from community bank earnings announcements over the last few days (to the time of writing) that deposit rates in almost all banks has increased, and deposit growth has slowed or reversed at many.

It is likely now that the net interest margin increases that smaller banks saw over the last year may reverse in the coming quarters. Given this, we have reduced our exposure to these banks, while keeping a smaller exposure based on the longer-term outlook. The remaining uncertainty is the possibility of recession which could challenge the loan books of certain banks (particularly for commercial real estate loans). But the above banks have historically been well and conservatively run and so are likely to achieve good results on that front.

We mentioned in our previous quarterly letter that we had built a position in Opera Ltd and that it had just declared a dividend (along with a host of other positive business developments). We continue to hold this position after building a position at prices between $5 and $6; the stock trades as of the time of writing at $10.95. This is one of those ideas that has several elements to the investment thesis as well as a continually evolving business picture.

To summarize, the thesis is a combination of value, substantial cash and investee balances creating an attractive enterprise valuation combined with growth and business opportunities. As of the last quarter cash balances were $119 million. The company also owns a portion of several investee businesses and managed to move its investment in Nanobank[4] to the more attractive OPay business at a good valuation. The cash plus investee balances total $436 million (depending on valuation assumptions that are likely conservative for OPay) giving the company an enterprise value of approximately $550 million at the time of writing. Performing a normalized earnings analysis, we estimate a level of net income of $119 million. This is then equivalent to an EVE of 4.6x. This is even after the share price doubled in the last two months.

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[4] OPay's diverse range of services, including mobile payments, digital wallets, and ride-hailing, provides it with a broader market appeal and the potential for higher growth in the expanding African fintech market. Additionally, its focus on multiple revenue streams reduces overall risk compared to Nanobank, which relies primarily on small, short-term loans that may be more susceptible to default.

The last (but definitely not least) leg of the investment idea is the business growth that could occur with this business. It operates a unique, custom browser model that, rather than just creating a vanilla functional browser, aims to provide additional functionality required by certain groups of users. For example, its Opera GX browser has now surpassed 20 million Gamer users. This browser was developed after research and discussions with gamers to determine their specific requirements.

In case you don't have young children who like gaming, they often flick between games and walkthrough videos on YouTube and other social media and so keep their browsers on for many hours a day. At the same time, they want to maximize gaming performance, each GPU cycle costs money! As well as optimizing processing power, data bandwidth and RAM usage they want a browser that gives them many other specific features. So Opera has bundled in free VPN (the only browser to do this), gaming graphics, 2-D games, relaxing music as well as ad blockers, Twitch and Discord sidebar integrations.

Based on the success of the gaming browser which hasn't been fully monetized as yet in the advertising dimension, with most revenue still coming from browser search revenue, Opera is looking at other verticals. They are experimenting with sports functionality in Opera Mini (live scores), recently added GPT functionality into their main browser to summarize web pages and have a host of other features that will boost user stickiness, revenue and growth. Given the size of the browser market, Opera's speed to market and their relative size there is a lot of potential for growth. The next few quarters should be very interesting for this company.

Earthquakes

The Opera Ltd situation has reminded us of an idea we once had to compare stock price movements to dynamic friction, earthquakes and seismic activity. Just as friction governs the motion of objects in the physical world, the anchoring of stock prices in financial markets can also be understood in terms of static and dynamic forces. Drawing a parallel between static and dynamic friction and stock price anchoring allows for a better understanding of how value and price interact in the market, ultimately leading to moments of sudden and significant price changes, much like earthquakes.

Static anchoring of stock prices occurs when the market perceives the current price as relatively stable and reflective of the underlying value of a stock. During this phase, any changes in the stock's fundamentals, such as earnings or industry news, may not immediately impact the stock price. Like the force of static friction that holds an object in place until a sufficient force is applied, the stock price remains anchored despite the gradual accumulation of new information that could potentially affect its value.

When the accumulated information reaches a tipping point, the stock price can no longer maintain its static anchoring, and dynamic anchoring takes over. This transition is analogous to dynamic friction, which comes into play when an object is already in motion[5]. In the case of stocks, the market starts to recognize the value of the new information and adjusts the stock price accordingly. The movement of the stock price itself becomes a source of value as it signals to investors that a change in the underlying fundamentals has occurred.

The sudden shift from static to dynamic anchoring can be compared to an earthquake in the financial market. Much like tectonic plates accumulating stress before releasing it in a seismic event, stock prices can remain anchored for an extended period before the accumulated information triggers a

[5] This is because once an object starts moving, the microscopic irregularities on the surfaces in contact have less time to interlock, resulting in less resistance to the motion.

significant price movement. This sudden shift often results in a rapid and substantial adjustment in the stock price, mirroring the release of energy during an earthquake. Once the stock is in motion additional news can create larger price moves and the stock may often move more violently than before.

Global Markets in Q1 2023

After recently reviewing thousands of stocks in the US and Asia it has become increasingly evident that US stocks, in the aggregate, do not appear as affordable compared to those in Southeast Asia. However, although we have identified more compelling investment ideas in Asian markets than in the US, we will strive to maintain a balanced approach between the two regions to optimize our portfolio performance. And we do still find individual ideas in both of these sets of markets.

The power of flexibility and global diversity should not be underestimated in any investment strategy. By investing in different markets, we can benefit from their unique strengths and weaknesses. For instance, when one market is up and another is down, a well-diversified and rebalanced portfolio can help mitigate risks and improve overall returns. To illustrate this point, consider a simple example: a 50/50 split between two markets with a 50% correlation, as opposed to putting 100% of the investment in just one market. The risk adjusted return would be higher in the lower correlation example.

Moving forward, we plan to enhance our diversification efforts to provide additional protection against potential issues that may arise in various regions and sectors of the economy. This will involve allocating our resources more judiciously across different sectors and geographical areas. But this will still be balanced with concentration on specific ideas where we have a high level of conviction.

In our ongoing search for attractive investment opportunities, we have recently come across some potential positions that resemble the Tenneco investment idea of Charlie Munger from twenty years ago (companies in North America and SE Asia). We are still in the process of analyzing and building these positions, and so we will leave that discussion for the moment.

Stocks in East Asia

As discussed above from our review of East Asian markets there are many cheap names that provide diversification from any specific issues in US or other western markets. Although we look at stocks on a bottom-up basis this will give some protection from macro-economic problems. Sometimes we think that you need to move yourself from a higher weighting in one market compared to another.

For example, China and Hong Kong recently re-opened borders fully (February 6) after moving on from their zero Covid policy. Limited travel across the border with Hong Kong had started in January. This should provide a large and increasing boost to both economies as consumer activity, trade and movement of goods pick back up. There are a few investment opportunities that we are seeing that could benefit directly and indirectly from this opening up post after the recovery from the fifth Covid wave.

In relation to this it is perhaps surprising that we see time and time again that the economic results of many businesses in Hong Kong were worse in 2022 than in 2021. If one looks at the number of city lockdowns and Covid cases, there was a lot of disruption to economic activity that should ease this year. We think that this upsurge in economic activity in China, Hong Kong and Southeast Asia could be a surprise to the markets this year.

Outlook for the Remainder of 2023

It seems likely that the uncertainties of the past few months will persist. If inflation doesn't come down in a benign fashion in the coming months, the Fed will need to continue to fight it and as the UK pension crisis, Credit Suisse, Signature Bank, Silicon Valley Bank show that there are areas, sectors and companies within the economy that will come under stress through this process. On the other hand, steady money makes money, and so we search for opportunities thrown up by moving markets.

We aim to manage the fund in a way that protects us from these risks, while remaining fully invested and taking advantage of any mispricing that occurs for quality, growing businesses. We approach our investment process much like athletes preparing for a race; our focus remains on perfecting the process rather than fixating on the outcome. Just as a 100-meter sprinter meticulously hones their technique and training regimen, we concentrate on refining our investment approach to ensure long-term success, even in the face of short-term market fluctuations.

We sincerely thank our partners once more for their support. We will continue to tirelessly search the globe for businesses that will allow us to grow and prosper in the coming years.

Yours,

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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.

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