Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2019			0.1%	0.3%	4.3%	-4.2%	0.1%	-0.1%	0.9%	-4.1%	7.5%	6.0%	10.5%
2020	-6.2%	-2.0%	2.5%	12.4%	3.6%	-6.6%	19.6%	12.1%	-3.0%	-7.1%	2.1%	11.9%	41.6%
2021	1.1%	3.5%	-0.5%	6.3%	19.5%	-3.2%	4.0%	-5.2%	6.0%	9.9%	-8.1%	-1.4%	33.0%
2022	1.5%	11.5%	5.7%	3.7%	1.6%	-5.9%	-1.9%	1.0%	0.2%	-1.4%	4.9%	4.6%	27.5%
2023	-2.0%	-0.1%	-0.3%	-0.5%	-4.7%	0.3%	0.4%	0.9%	3.0%*				-3%*

- **The Cypress Fund managed small gains in recent months; YTD our returns are -3%*.**
- **On the importance of names: we share why we picked "Cypress" and the traits we want to embody.**
- **We also touch on a less-discussed pillar of our investing strategy that complements our real assets focus – finding opportunities amidst distressed situations.**
- **We share three sectors in distress that interest us: US commercial real estate, US residential real estate and offshore wind; we discuss some of the potential investments in each.**
- **Curious trivia: Nvidia is named after one of the deadly sins - Envy.**

Dear investors,

Since our last investor letter in June, we have enjoyed a string of positive, albeit small returns. June and July were similar months in the sense that they were risk-on periods for risk assets – our longs made money while our hedges gave back some, netting small positive returns both months. In August, markets took a tumble, in part due to the poor economic news coming out of China as well as the credit rating downgrade of the United States by Fitch. Our hedges thus helped us to achieve a small positive return. September will be a strong month despite the continued risk-off tone in markets; we estimate +3% returns. Positive contributors include nuclear which had a particularly strong month as uranium spot prices exceeded $70 as well as hedging gains; most of our other long exposures were down in tandem with broader markets. Year-to-date, the fund is down approximately 3%.

Regular readers will know that we have been very concerned about the global economy for a while now. Despite the strong performance of financial markets this year, the fundamental data we see around the world continue to deteriorate. In this letter, instead of harping on the same string, we will take a detour from macro and share a bit about our Cypress name, and how we are preparing to take advantage of the market weakness that we see ahead of us.

What's in a Name? Part I: Why Cypress

Investors sometimes ask us why we chose to name our fund after the Cypress. Let us devote a few lines here to the symbolism of names, while also taking the opportunity to elaborate on a second pillar of the Cypress strategy – looking for opportunities amidst distress.

When naming our children, the choice often goes beyond mere phonetic preference. Many parents select names with the hope that their children will inherit or live up to certain attributes and virtues associated with those names. This fund is our baby, and it is our hope that it will embody the traits of the Cypress – longevity, resilience, adaptability. Cypress trees have long lifespans, some growing to over

*Based on preliminary estimates for September a thousand years old. The wood's density and hardness make it particularly resilient to environmental adversity; the genus is well-known for its adaptability, thriving in varied environments from wetlands to arid landscapes. In essence, the name "Cypress" encapsulates our goals of delivering strong long-term capital growth to our investors by adapting to and even taking advantage of challenging financial conditions.

Before Cypress, it was the Ternary Distressed Asset-Backed Fund

In fact, we had originally planned to name the fund literally, after the two pillars of our investing strategy:

1) Investing in companies backed by Real Assets
2) In Distressed sectors/trading at deeply discounted prices

As we shared in our very first letter in 2019:

> *What is distressed, asset-backed investing? …This is a fundamental, value-based investment approach that is oriented towards investing in assets, or companies that own assets (hence asset-backed), at prices representing substantial discounts (hence distressed) to reasonable estimates of intrinsic value… By investing only in hard, tangible assets… we anchor valuations to an objective reality. In further insisting that we only invest when we are acquiring said tangible assets at steep discounts to intrinsic value, we are building a big buffer for errors, the proverbial "margin of safety". Just as importantly, these discounts are often a reflection of widespread investor pessimism, which also means that the potential for price gains is considerable should sentiments change (as they often do).*

In previous investor letters, we have described in some detail the first leg – our real assets focus. In this letter, we will touch upon the second leg of our strategy and show how sectors that are facing headwinds can sometimes offer investments with attractive risk-reward that are hard to come by in more stable ones. Below, we discuss three sectors where trouble is brewing and the opportunities that we find interesting. While we have not pulled the trigger on any of them, the next 3-to-6 months could offer up some outstanding opportunities. These are:

1) US Commercial Real Estate – Investing in Premier Real Estate Well Below Replacement Cost
2) US Residential Real Estate – Earning 20+% Returns with Zero Default Risk
3) Offshore Wind – Taking Advantage of Downturn Amidst Long Term Secular Growth

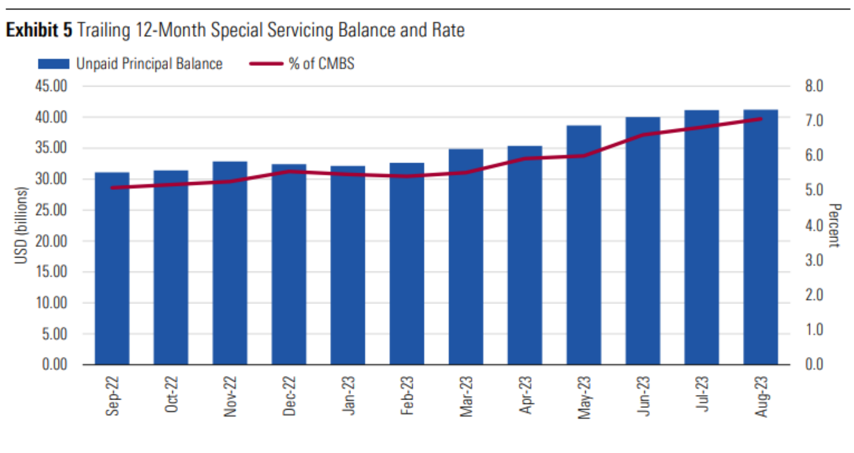
US Commercial Real Estate

Summary

The U.S. commercial real estate (CRE) sector, particularly offices, is facing a perfect storm of challenges. Two primary forces are at play – the growing work-from-home trend and sharply higher interest rates are resulting in higher CRE loan delinquencies and defaults. As a result, shares of office REITs are down substantially from post-Covid highs. As the cycle plays out, we expect to be able to own the securities of best-in-class office REITs (both bonds and equities) with upside well in excess of 100% and limited risk.

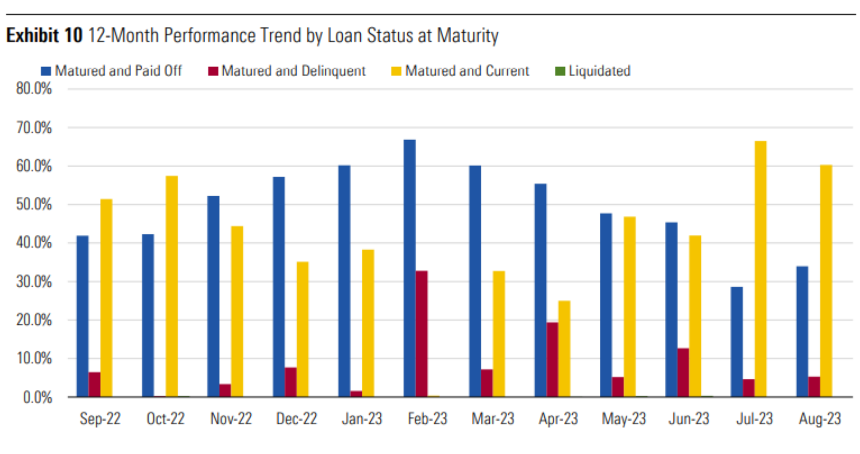
Background

First, work-from-home has deeply impacted demand for office spaces. Businesses have either reduced their office footprints or adopted hybrid models leading to increased office vacancies and downward pressure on leases. Second, the Fed rate hikes mean higher financing costs for landlords when loans mature, even as rental incomes decline and property values fall. In addition, regional banks, themselves victims of rate hikes, are significant lenders to the CRE space. As the CRE crisis unfolds, banks will face higher non-performing loan ratios, leading to tightening of lending standards, further exacerbating the liquidity crunch for landlords.



Source: DBRS Morningstar.

Chart 1: Loans are transferred into special servicing when they become severely delinquent or are at risk of imminent default. Remedies pursued by special servicers include payment modifications and maturity extensions to foreclosure and asset sales. The special servicing has risen for the seventh month in a row and has not been this high since November 2021, before the Fed started to hike rates.



Source: DBRS Morningstar.

Chart 2: Only 30% of maturing loans are able to be paid off in full; the rest default or have maturities extended. Higher interest rates, falling property values and tightening lending standards will continue to pressure borrowers; more pain is ahead.

Why This is Interesting

Given the headwinds, why do we find CRE a promising sector to look at? Precisely because the challenges seem so severe, many investors now consider this an un-investable asset class. As almost always happens, widespread pessimism will drive valuations even lower than the negative fundamentals warrant. In fact, some would argue that current valuations for some of the best-in-class office REITs may already be discounting more pain than will transpire.

Let us consider Vornado Realty Trust, a leading REIT that owns a collection of premier office and retail assets concentrated in New York City, including the global headquarters of Bloomberg and Neuberger Berman, historic sites like [The Farley Building] as well as [The Mart], the largest commercial building in the world and an icon in Chicago.

Chart 3: Vornado's stock has been in a 8-year bear market. We do not know when this will end, but it is clear that investor pessimism is widespread. The company has been smart to finance half of their assets via non-recourse loans; giving them tremendous optionality whether markets improve or deteriorate from here.

The company's share price has spent the past eight years plumbing new depths. Pre-Covid, it was hurt by sagging retail sentiments and worries about overbuilding in Manhattan; post-Covid it suffered from the double whammy of work-from-home and higher rates as mentioned above. The stock is down 77% from pre-Covid highs, and down 57% post-Covid. Over $18 billion in equity value has been lost.

Today, the company trades with an enterprise value of around $14 billion for over 25 million square foot of the best office and retail space in Manhattan, implying a per-square-foot price of $540. This is incredibly low compared to replacement cost, which we estimate at $1500-2000 psf. Versus second-hand market transactions (~$800 psf), this is also a substantial discount. In fact, they [recently sold four] of their lower quality assets with high vacancies at $813 psf. When you further consider that Vornado assets are in the top 10-20% of Manhattan real estate, it would not be a stretch to apply a valuation north of $1000 per-square-foot. We are still valuing the underlying assets at a more granular level but our initial analysis suggests there is at least 100% upside from Vornado's current share price.

	Per-square-foot	Notes
Vornado Implied	~$ 540	$14b EV; 25-27million square foot
Second-Hand	~$ 800	Recent sales range $400 – 2000 psf
New Build	~$ 1500 - 2000	Land: $600-800; Construction: $800; Soft costs: +20%

Finally, even though Vornado has a balance sheet that appears quite levered ($10bn liabilities vs $18bn assets), over $7bn of liabilities are non-recourse debt, encumbering $10bn of assets. In a worst-case scenario, Vornado could theoretically just hand in the keys on all the non-recourse debt and end up with a balance sheet with something like $3bn of debt against $8bn of assets. The company owns a lot of optionality and management knows it – that is why earlier this year they suspended dividends for 2023 in order to do share buybacks when the stock was trading in the teens. While we suspect there will be more pain ahead, we are keeping a close watch as Vornado is well positioned to survive and at some point could offer extremely compelling risk-reward to investors.

US Residential Real Estate

Summary

The US Agency Mortgage-Backed Securities (MBS) market is suffering from a buyer's strike – agency MBS spreads are trading at prices not seen since the global financial crisis (GFC) 15 years ago. The key reason why, yet again, is the Fed rate hikes. This has led to an inverted yield curve and higher interest rate volatility, both of which are negatives for owning MBS. This is exacerbated by increased MBS supply, mainly due to quantitative tightening and to a lesser extent the liquidation of MBS by the FDIC after the bank failures in March this year. The last two times that MBS spreads traded to these stressed levels (2008 and 2020), one would have doubled your money in less than a year by investing in agency mortgage REITs.

Background

The US Agency MBS market is one of the largest fixed income markets in the world, with outstanding issuance totaling over $9 trillion. This market consists of securities backed by pools of residential mortgages that benefit from guarantees provided by Fannie Mae, Freddie Mac and Ginnie Mae, government agencies (hence the name) that were created to [promote home ownership](). Since these bonds are principal-and-interest guaranteed and bear no default risk, investors treat them as an alternative to US Treasury bonds with a higher yield, albeit with prepayment risk and slightly poorer liquidity. Given this, MBS has historically traded at a spread (MBS yield – Treasury yield) to their equivalent-duration Treasuries; this spread has typically ranged between 50-100 basis points.

Chart 4: This is a proxy for the spread that agency mortgage-backed securities trade compared to Treasuries. In the chart above, we show the yield for a par-priced Fannie Mae-backed 30-year MBS, deducting the yield for the-then current 10-Year Treasury note.

This spread has more than doubled over the past two years to levels associated with severe stress, eg during the 2000 tech bust, the 2008 GFC and 2020 Covid. The main causes of this spread widening are:

1) Higher Interest Rate Volatility Interest rate volatility has moved higher due to sharp shifts in the Fed's rate outlook since the hiking cycle began. This challenges MBS performance in three ways. First, mortgagors own the option to prepay; MBS holders therefore are short this prepayment option and hence suffer when volatility rises. Second, higher volatility raises hedging costs, deteriorating the economics of investing in agency MBS. Third, higher volatility also weighs on demand from banks and other holders.

2) Inverted Yield Curve Rate hikes caused the flattening of the yield curve, which negatively impacts the carry for MBS holders. MBS holders implicitly have a yield-curve steepener trade on since they typically own longer duration MBS which they finance in the short term "repo" markets. When the yield curve inverts or flattens, this directly diminishes the profitability of their MBS holdings; it is therefore quite natural for investors to require a wider mortgage spread to make up for this.

3) Elevated MBS Supply MBS supply has increased because of quantitative tightening by the Fed. Thanks to QE, the Fed amassed over $2.7 trillion in MBS or nearly a third of the MBS market. Since early 2022, they have been allowing their MBS holdings to mature without reinvesting the proceeds – this

effectively amounts to MBS supply of roughly $20bn each month. FDIC liquidations of assets from SVB and Signature Bank added another $10bn in MBS supply, although these are ending.

Why This is Interesting

A bit of history – AGNC Investment Corp was a REIT set up by American Capital in 2008, precisely to take advantage of the wide MBS spreads prevailing during the GFC. By buying agency MBS and then hedging their interest rate risk, they knew they would be able to earn over 20% annual returns after leverage with absolutely no default risk, while also being long the option that MBS spreads would return to normal (which would boost MBS prices). This was exactly what happened in 2009. In fact, in the two recent episodes when MBS spreads widened substantially (2008 and 2020), AGNC shareholders made very large gains (2008 to 2009: +150%; 2020 to 2021: +120%) thanks to the large positive carry and eventual MBS spread compression. AGNC shareholders face the same set of circumstances today. AGNC's portfolio of MBS securities yield around 3.2% after financing costs; with 7x leverage, the carry component from owning AGNC is 23% per annum, of which investors receive 15% in dividends and the rest in principal accrual.

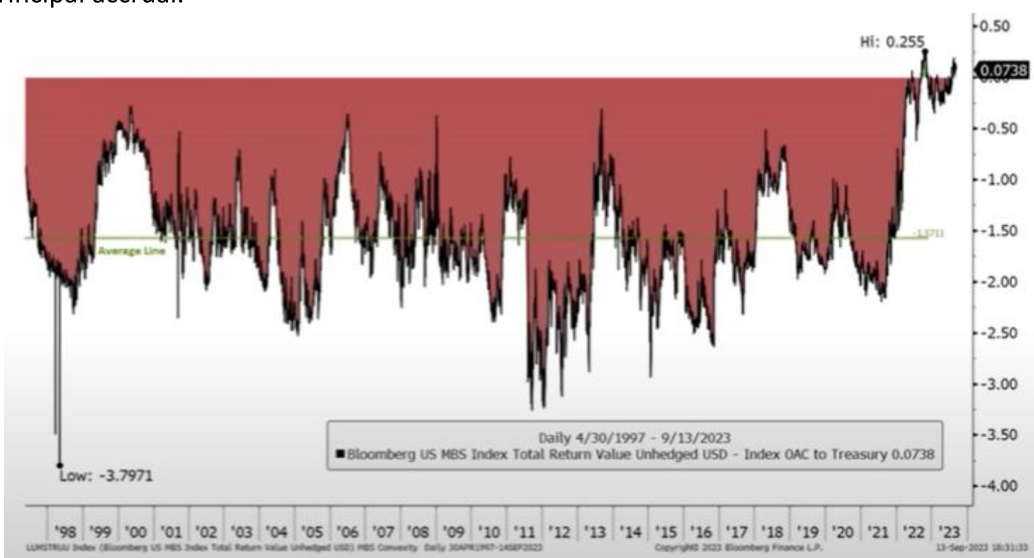


Chart 5: Bloomberg MBS Index Option-Adjusted Convexity (OAC). Mortgages typically trade with some negative convexity versus Treasuries; this effect is mitigated by discount prices of large swathes of MBS. Chart courtesy of Doubleline.

What makes MBS even more attractive today versus any other time in history is that they show no negative convexity for the first time ever. Because mortgagors' have the right to prepay their mortgages, MBS exhibit what is known as negative convexity, ie holders make less money when interest rates fall and prepayments rise while losing more money when interest rates rise and bonds extend (see appendix for details). However, since most outstanding MBS bonds are trading at discounts to par (rates have risen since they were issued), prepayments do not hurt holders as much as they normally would.

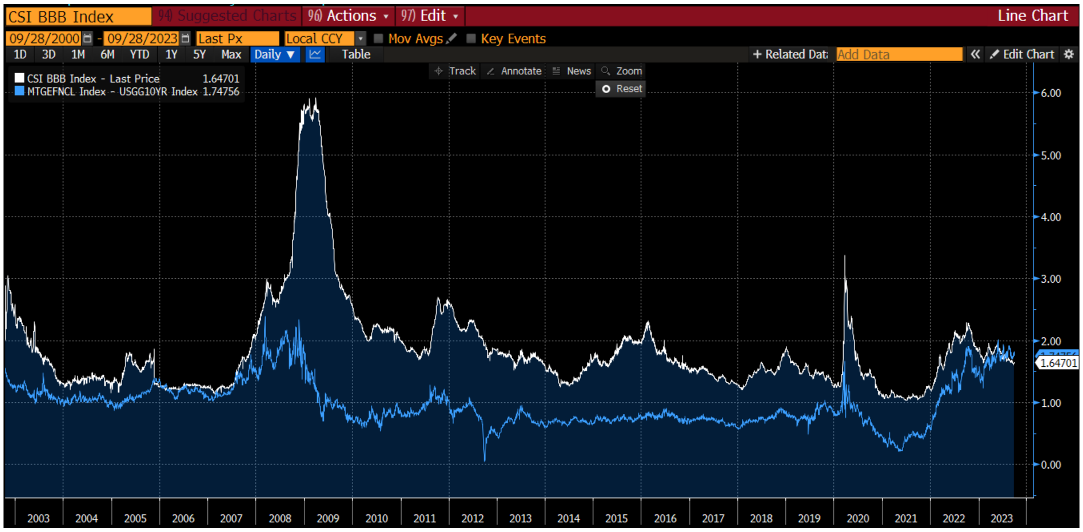
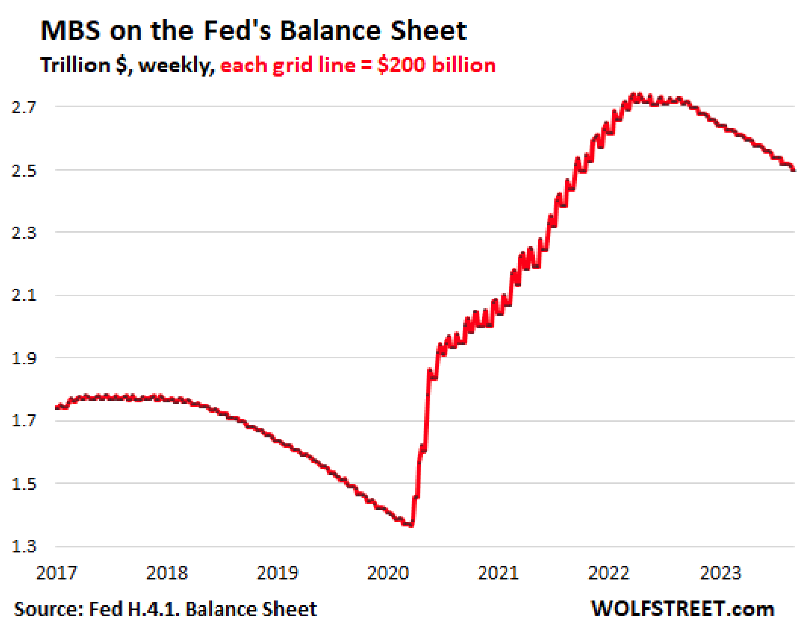


Chart 6: White – US Corporate BBB Spread to Treasuries; Blue – MBS Current Coupon Spread to Treasuries. Corporates should trade wide to MBS given risk of defaults.

Another metric that supports the idea that MBS are cheap is the fact that MBS spreads are trading wider than corporate spreads. Corporate bonds usually trade to a wider spread than MBS – this makes sense since corporate bonds are exposed to default risk while MBS have none. Incredibly, one can now earn more owning government-guaranteed MBS than corporates, just when the corporate default cycle is picking up. Either investors are too negative on MBS or too optimistic on corporates and the economy, likely both. All of which is to say, this is arguably one of the best times to own MBS, an exposure that can be replicated by investing in AGNC, with the potential for a quick doubling of our investment.



There is however one big elephant in the room – the Fed is a long way from finishing QT. This does not mean that they are selling MBS; rather they are just no longer re-investing proceeds from the MBS that are maturing. Regardless, this means they are absorbing less supply from the MBS market compared to a couple of years ago. For now, we like the set-up for MBS and AGNC, although we acknowledge potential headwinds from the supply side. We will keep you posted as our thinking evolves.

Offshore Wind

Summary

After enjoying more than a decade of growth (offshore wind capacity grew from 3 GW to 65 GW today or 25% CAGR), offshore wind players are now suffering from lower profitability due to cost inflation, higher interest rates and supply chain issues. Orsted, the world's largest owner and operator of wind farms, saw its share price fall 40% just this year, and is down over 70% from its 2021 highs, shedding nearly $60bn in market cap. Its net income has also fallen a staggering 96%. Wind turbine manufacturers, such as Vestas and Siemens Gamesa, are down similarly, suffering from pricing pressure from Chinese competition. As cost rationalizations continue to play out in the coming quarters, we expect all players in the value chain to suffer. We are looking at a number of unique companies in the ecosystem that will better weather the storm and that are most likely to benefit from a recovery.

Background

Over the past 20 years, renewable energy has seen remarkable growth. Solar PV capacity, which was under 1 GW at the start of the 2000s surged to over 1 TW by the end of 2022. Wind energy also experienced similar growth, rising from around 17 GW in 2000 to 900 GW in 2022. Over this period, it is estimated that nearly $3 trillion dollars has been invested into this space.

Offshore wind, while still a small percentage of total renewable capacity, enjoyed particularly high growth rates in recent years. Firstly, offshore wind sites typically experience stronger and more consistent wind speeds, meaning turbines can produce power more consistently and at higher outputs over time compared to onshore. The absence of land-based constraints also allows offshore wind farms to install larger wind turbines (that generate more power) over a vaster expanse of space. These benefits mean that unit costs for offshore wind may eventually approach that of their onshore cousin.

As is often the case, the market got ahead of itself. Capital rushed into the space not just from specialized renewables players but also from traditional oil and gas majors looking to diversify away from fossil fuels. Aided by a combination of supportive government policies, easy money from QE and worries about climate change, money rushed in, resulting in project equity IRR falling as low as 4-8%! With such thin margins for error, it is not surprising to hear of projects being cancelled as developers abandon loss-making projects. Just this year, at least 3.5 GW of projects have been scuttled in US and Europe, with another 9 GW at risk in the US alone.

Why This is Interesting

While it appears that we are likely in the early innings of the downturn in offshore wind, we want to start doing our homework to identify the winners that could emerge from this crisis. Critically, given the urgent need to diversify the sources of energy supply (as has been made clear by the war in Ukraine) and to reverse or at least slow down climate change, the growth of offshore wind will not be derailed, merely delayed. Below, we briefly share some of the areas that we are watching for potential investments.

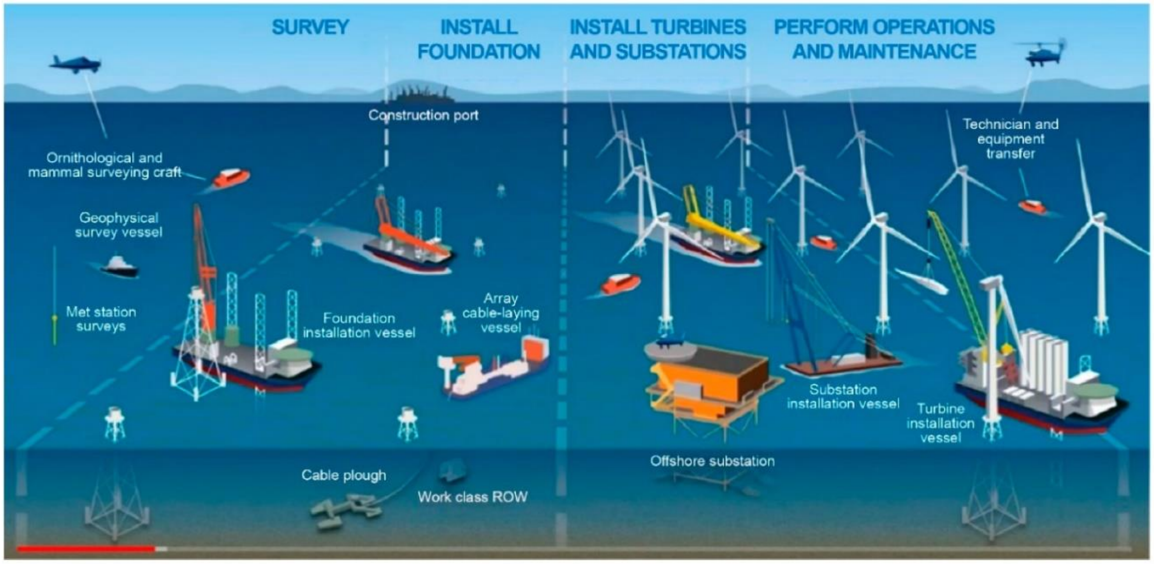
1) Developers The most obvious way to invest in this space is via developers like Orsted. The company recently announced $2bn write-offs in their US offshore projects, which caused their stock to drop 20%. Our estimate of intrinsic value actually suggests that the company is now fairly reasonably priced. This by itself is obviously not enough to justify investing; but it is worth keeping the company on our watchlist. At some point, it could even become attractive for the oil and gas majors to acquire Orsted and its extensive portfolio of assets versus growing their renewables business organically.

		Orsted Enterprise Value in USD Billions		
	Capacity (MW)	**Base Case**	**Low Case**	**High Case**
Offshore Wind	6492	27.7bn	23.9bn	31.4bn
Onshore Wind	3162	5.1bn	5.0bn	5.3bn
Onshore Solar	681	1.6bn	1.5bn	1.6bn
Others	NA	6.1bn	-	10.8bn
Enterprise Value		**40.5bn**	**30.3bn**	**49.2bn**
NAV/Share		**$63**	**$39**	**$86**
Current Price		**$57**		

2) Foundation Providers Offshore wind technology has rapidly matured in the last decade, allowing developers to chase economies of scale to improve returns. Today, Chinese manufacturers are leading the way in producing 15-18MW turbines which are more than twice the height of the Statue of Liberty. This means that the foundations used to support turbines in the sea will also need to be scaled up appropriately, yet there are few manufacturers that can meet this upcoming demand. Even after accounting for expansion plans, a shortage of these critical components is expected in the next decade. We see opportunities to invest in established manufacturers which have fully contracted their capacity until 2025 and have strong risk controls against further cost inflation and potential project cancellations.

3) Vessel Owners The installation and operation of offshore wind farms requires the use of many vessels which in the past have been borrowed from the offshore oil & gas industry. As supply continues to be drawn back to offshore oil and gas work and new wind projects demand specialized vessels, vessels will be a critical bottleneck in the roll-out of wind farms. According to Clarksons, $20bn in vessel investment is needed to meet demand across different vessel types such as wind turbine installation vessels, cable-laying vessels, and service operation vessels. However global shipyard capacity remains constrained, setting existing owners up for prolonged periods of strong earnings even if demand falters. There are

only a few players in this space and current valuations imply substantial discounts to NAV, offering additional margin of safety.



We are long term bulls on renewables in general and offshore wind in particular. The developing downturn will offer the opportunity to invest in this long term trend via some of the most critical participants in the value chain, most importantly without having to pay up for it.

What's in a Name? Part II: Putting the Envy in Nvidia

We started this investor letter by exploring the significance of names, so it seemed fitting to end on the same note. Readers may think we are picking on Nvidia after having just recently written about them in our [last investor letter](). We are not; we merely found this somewhat amusing and symbolic of the times we live in.

NVIDIA®

I happened to be watching an interview with Javier Milei, potentially the next president of Argentina, when it struck me (as it must have some of you) that Nvidia looks and sounds remarkably similar to the Spanish word for envy, *Envidia*. A quick googling suggests that the founders of the firm were inspired by the Latin equivalent or *Invidia*. Close enough. Whatever the inspiration, there is no doubt that the company has certainly generated a great deal of envy amongst those who missed out – it is the top performing name this year in the S&P 500 (+200%) and the second best in absolute terms, only after Apple. Personally, it would never cross our mind to name our company after any of the seven deadly sins, but I guess we are all different. On this curious trivia, let us leave you with a parting thought from Charlie Munger: *"Envy is a really stupid sin because it's the only one you could never possibly have any fun at. There's a lot of pain and no fun. Why would you want to get on that trolley?"*

Conclusion

We set up the Cypress fund with the goal of delivering very attractive risk-adjusted returns to our investors. The core of our strategy is to look for asset-backed companies amidst distressed sectors – the assets offer downside protection while distress skew the risk-rewards in our favour (since prices get so beaten down). It is fairly clear to us that we must own real assets in the coming decade; it appears that a great opportunity to scoop up some of these assets at very appealing prices may be just ahead. Once again, thank you for your support and we look forward to connecting again soon.

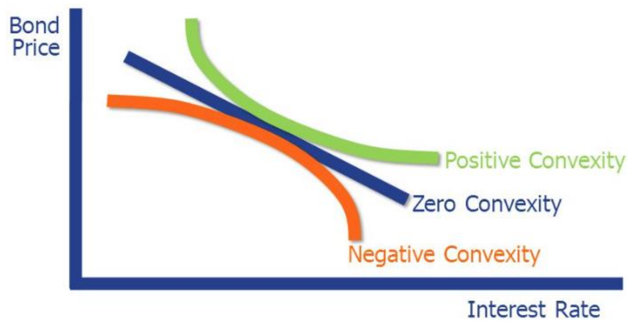
Sincerely,

Yongchuan Pan
2 October 2023

Appendix

Negative convexity in the context of Mortgage-Backed Securities (MBS)

Convexity:
Convexity measures how the duration of a bond changes as interest rates change. A positively convex bond will see its price rise at an increasing rate as interest rates fall and fall at a decreasing rate as interest rates rise. Negative convexity, on the other hand, implies that as interest rates fall, the bond's price rises at a decreasing rate, and as interest rates rise, the price falls at an increasing rate.



Negative Convexity in MBS:
MBS exhibit negative convexity primarily because of prepayment risk:

When interest rates fall, some homeowners will refinance their mortgages at lower rates by exercising their prepayment option. This is detrimental for MBS investors as they get their principal returned when rates are low and have to reinvest at these lower rates. Mathematically, since the MBS contract in duration, and the rise in MBS price from the falling yield is less than it would have been without the prepayments.

When interest rates rise, homeowners are less likely to refinance, meaning MBS investors are left holding lower-yielding bonds in a higher interest rate environment. Mathematically, the MBS extend in duration, and the fall in MBS price from the rising yield is greater than it would have been without the prepayments.

Because of the embedded prepayment optionality, MBS underperform in both higher and lower rate environments, hence they are described as exhibiting negative convexity.

Better Convexity with Discount MBS:
MBS that trade at a discount to par suffer less from negative convexity. The risk of prepayment due to falling interest rates is less because there is lower refinancing incentive since their original mortgage rates were already low, which is often the case for MBS trading at a discount. On top of that, any prepayment result in principal being repaid earlier, speeding up the realization of the discount as a gain. The reverse is true for MBS that trade at premiums to par.