Dear fellow investor,

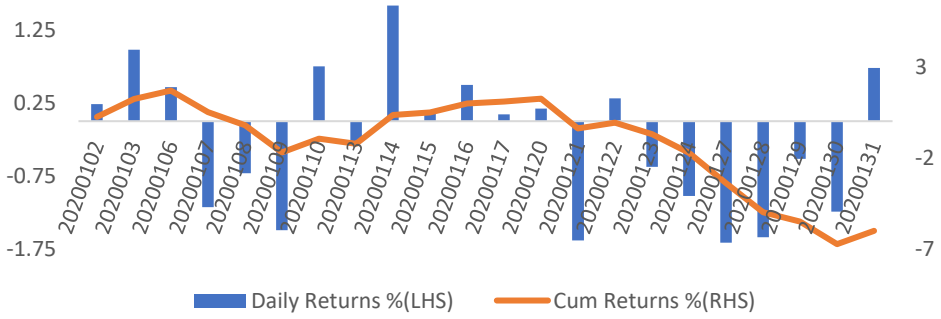
We are sharing this interim update in light of the novel coronavirus outbreak in China, a situation that still seems to be deteriorating, at least when judging by the number of confirmed infections and the continued uptick in fatalities. We are not epidemiologists, and so will limit our comments to the outbreak's impact on your portfolio, in addition to elaborating on some of the adjustments we are making given the fluid environment.

Weak January, Exacerbated by Novel Coronavirus

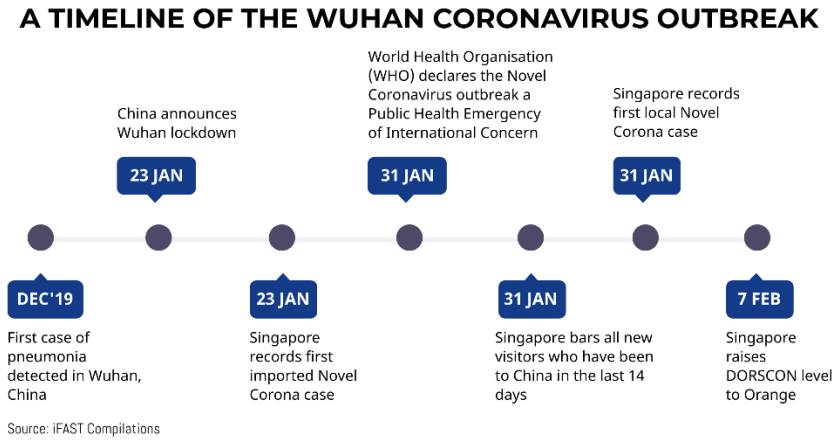
For the month of Jan 2020, your portfolio generated a return of -5.94%, a disappointing outcome given that equity markets held up relatively well despite virus scares (S&P500 -0.16%, MSCI World -0.68%).

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2019			0.2%	0.5%	5.5%	-4.0%	0.2%	0.0%	0.1%	-3.9%	7.5%	7.4%	14.4%
2020	-5.9%												-5.9%

After a strong end to 2019 with both November and December returning in excess of 7%, we had expected to give back some of our profits. Not surprisingly, your portfolio treaded water for the first three weeks of the year, rising +1.68% in the first few days, before giving up the gains and then some in the following week (-1.23%), and then rounding up the first 15 trading days basically flat at -0.08% on January 22nd, the Wednesday right before the Lunar New Year weekend.



While there had already been chatters about the Wuhan Flu (as it was then referred) from early January, the situation in China escalated in the early morning of Thursday 23rd January when Chinese state media announced what amounted effectively to a quarantine of 11 million people in Wuhan, beginning at 10am via the cancellation of all public and outbound transport. At that time, China had admitted to only 481 confirmed cases and 9 deaths. Later that same day, the quarantine was expanded to 23 million people in 7 cities; in addition, Beijing, Wuhan, Zhejiang and Macau announced that Lunar New Year celebrations and other large public gatherings had been cancelled. Equity markets opened weak on the 23rd, but actually ended roughly flat on the day, after the World Health Organization issued a statement that the virus is *not* a Public Health Emergency of International Concern or PHEIC.



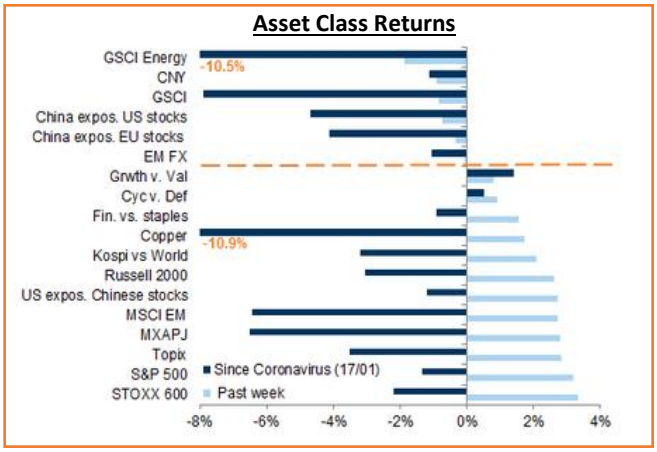
The good news did not last. Confirmed infections and deaths escalated in China and the first few cases were announced overseas. Over the holiday weekend and into the following week, a continued drumbeat of bad news hit risk assets hard – by January 31st, S&P 500 was down 3%, crude oil was down 8% and Vix had rallied nearly 50%. Your portfolio was similarly drubbed, dropping between 0.5 to 1.5% a day for 6 days consecutively, before staging a small rally on the last day of the month. A flat month was now down almost 6% in little over a week.

Reducing Risk in A Volatile Environment

In order to protect your portfolio, we began layering into broad index hedges in the final week of January; we also reduced long exposures over the course of the following weeks. Coming into 2020, we had a net long exposure of around 80% of NAV; as of today, that is reduced to approximately 40%.

While the Cypress Fund's strategy is not predicated on short-term trading, we resolutely believe that proper risk mitigation is fundamental to long-term investing success. Given the still unknown but potentially wide-ranging impact of the virus, the one-way rally in risk assets in the fourth quarter of 2019 going into early January, and the sharp sell-offs after the holiday weekend, it seemed to us that risk was asymmetrically skewed to the downside. So while a quick recovery is always possible, this would likely be capped at recent highs; on the other hand, there was still a trapdoor underneath us that may or may not open, but if it did we were likely in for a painful drop. Accordingly, we felt the prudent decision was to put on broad market hedges for your portfolio.

Beyond the immediate P&L impact, hedging also provides added psychological reinforcement in an obviously stressful period. Essentially, it gives us the confidence to be more patient and deliberate should we decide to reduce our equity exposures, as opposed to feeling like we have to sell at any price. While we will forgo some gains in a rally, we believe this puts us in a better state of mind to manage the portfolio (both in reducing *and* adding risk).



It is interesting to observe that since the sell-off started in late January, a number of asset classes have recovered a substantial percentage of their losses. In fact, the S&P 500 has gone on to make new highs (invalidating our thesis above that any gains would be capped) and is up nearly 5% from recent lows. However, the energy sector is a clear laggard. Your portfolio owns shares in a number of energy-related businesses (we have ~30% correlation to crude oil as of end 2019) and so have not rebounded as strongly. As of February 14th, our month-to-date return stands at 0.41%.

Adjusting Weights Between Various Investment Themes

At the end of the day, we are fundamental investors with a medium to long time horizon. As such, we do not expect the current situation to materially impact some of our favoured themes. For example, our companies in the Nuclear Energy/Uranium space will be driven much more by a cyclical, structural supply deficit, and are less likely to be materially affected in the near term even should the situation deteriorate. On the other hand, we own companies, including in Canadian Oil & Gas and Shipping, that are quite exposed to the global economy, which almost certainly will be negatively affected as a result of the near-shutdown in China and its attendant impact on broad-based demand (see charts from Capital Economics and Bloomberg below). In particular, we own a couple of conventional oil and gas producers (Kelt Exploration and PetroTal) where revenue is directly tied to crude oil prices. We have merely trimmed risk in the sectors we perceive to be less affected by the virus, but more aggressively reduced risk in those companies that are more exposed.

Chart 5: Average Road Congestion across 100 Cities in China

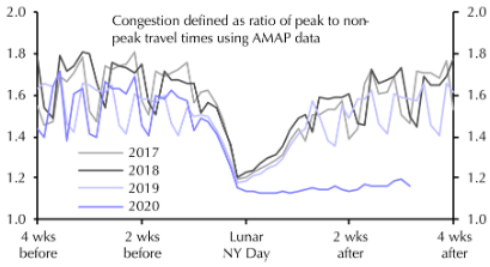
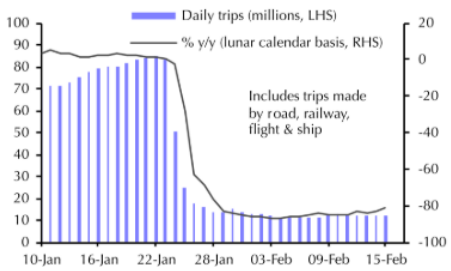
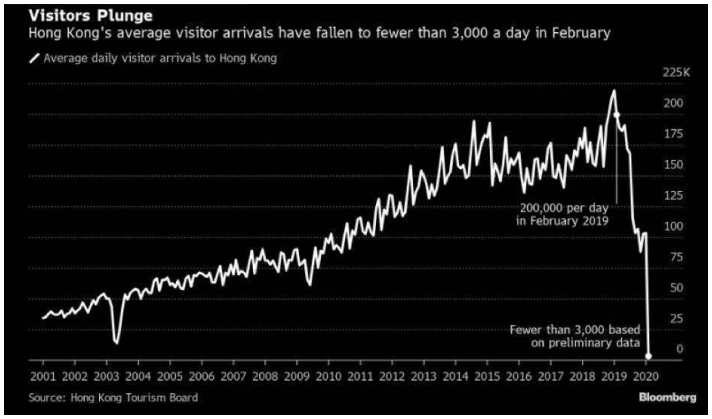


Chart 6: Daily Passenger Traffic





Balancing the negative real-world impact, we already have looser monetary policy in China and may see continued expansion of the Fed balance sheet, and possibly even rate cuts. These could keep investors in risk-on mode. Combining still substantial fundamental headwinds with monetary and fiscal tailwinds, we end up with the conclusion that volatility should re-rate higher, since large moves in either direction are quite plausible, and even likely. All things equal, this implies smaller position sizing for the time being.

In closing, we will continue to re-weight your portfolio towards longer-term, structural themes, and away from those with a higher beta to the global economy. Again, while this focus on risk mitigation may mean forgoing some upside in the event of a sharp rebound, we prefer to err on the side of caution in these uncertain times. That said, we stay alert for opportunities to add risk. Some of our investee companies like Adriatic Metals and Golden Ocean have held up well despite overall weakness; we are watching closely and may provide updates in a future letter.

The world has become a more dangerous place over the past month; we are staying vigilant. We hope that this interim update has been useful. Thank you and take care.

Sincerely,

Yongchuan Pan
17 February 2020