KIG INVESTMENT MANAGEMENT, L.L.C.

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**KIG Investment Partnership, L.P.**
**2013 Letter**

| Trailing | KIG Investment Partnership | MSCI ACWI IMI Index |
|---|---|---|
| Since February 1st, 2013 | 49.9% | 15.7% |

The figure above is unaudited and net of fees. We had an excellent first eleven months from a performance point of view. We do not think much about it and neither should you. In our view, short term performance is irrelevant.

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**What we did well**

We focused on the long term. We achieved this by having the discipline to quickly say no to all those "urgent" matters that are nothing but distractions and by continuously ensuring we had plenty of time at our discretion. This open schedule approach gave us the flexibility we needed to pursue exceptional opportunities: one day we might have sourced nonstop by reading a number of annual reports; the next four days we might have travelled more than 10,000 miles for a two hour, in person meeting with a great CEO. Just as often, however, we took advantage of this privilege to read and ponder different topics. Today we probably know a tiny bit more about psychology, marketing, banking, energy, geography, logistics, history, retail, manufacturing, insurance, and leadership than we knew a year ago. None of these seemingly insignificant improvements might mean much on their own, but at KIG we have a strong conviction that by accumulating and compounding them over the years we have a significantly better chance at generating higher returns.

We had an active year allocating capital. We developed a disciplined and repeatable process to source, underwrite, and monitor opportunities that help us discern among thousands of candidates. While the fine tuning of this process is never ending, we are encouraged by both the breadth and depth we currently cover on a weekly basis. This is not all positive (read the following section "What we could have done better") and, of course, only time will tell how well we are doing. In any case, we allocated assets at a pace unlikely to ever be repeated at KIG and finished the year with 67% of the portfolio invested in nine businesses. We sized prudently according to our assessment of our businesses' quality and valuation, with none of them surpassing 11% at cost. This level of diversification is the result of the opportunities available to us in 2013; over time we expect the portfolio to be significantly more concentrated. More importantly, we believe we accomplished this while staying well within our circle of competence and limited our investments to either exceptional businesses at attractive valuations or good businesses at extremely low valuations[1]. We are excited about the prospects of our holdings and unless Mr. Market[2] presents us with an irresistible offer, we expect to own them for many years to come.

**What we could have done better**

From a process perspective, we lacked the discipline required to be more focused. While in theory KIG has an extremely open mandate, in practice there are not that many opportunities that actually meet or come close to meeting our high bar. This is why we are able to cover so much ground; in most cases we only need to spend minutes before moving on to the next candidate. Our mistake was spending too much time on candidates that were good but clearly not exceptional. Was it because we could not distinguish this line? We do not think so. Besides, we should not come anywhere close to this line. We believe the trick is to remain open minded while being disciplined at moving on the very moment we recognize a business is not great. A company might be doing all the right things but if they are not doing anything unusual, they are probably not exceptional. It is that simple[3].

At this point we are also aware of one costly mistake of omission. This is an exceptional business we own but deserves a much larger allocation. It will go unnamed as we hope to have another shot at buying more. At the time of the opportunity we had a deep understanding of and a strong conviction on the business model, its unit economics, its competitive advantages, and its runway. We also trusted, liked, and admired the management team that founded and built it from scratch over the last ten years. Finally, it was trading at an attractive valuation. So how come we did not buy enough? At the time of our decision there was a significant amount of noise as management was undergoing a couple of important decisions. While these actions were meaningful they were not a threat to the long term soundness of the business, regardless of the outcome. We focused on these short term events rather than weighing the only variables that truly matter: the business had a well-defined process to grow its moat over time, had great management with great opportunities to reinvest capital, and was selling at an attractive valuation. It was definitively not our brightest moment.

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**Thinking aloud**

We focus on high quality businesses. What do we mean by quality? What makes for higher quality? And how high is high enough for KIG to commit for the long term? These are not easy questions and while we enjoy addressing them they certainly take time and energy. From a pragmatic point of view it is fair to wonder if they are worth it. In general, we find that confronting these types of

[1] We believe an extremely low valuation is when a good business sells at 20 cents on the dollar or less. This rare situation is often explained by irrational market participants that overweigh short term concerns instead of focusing on long term fundamentals.
[2] An imaginary investor devised by Benjamin Graham and introduced in his 1949 book "The Intelligent Investor". In the book, Mr. Market is a hypothetical investor who is driven by panic, euphoria, and apathy (on any given day), and approaches his investing as a reaction to his mood, rather than through careful analysis.
[3] On the other hand, to actually underwrite the quality of a business is a significantly more demanding task. However, why bother if there is nothing unusual to begin with? The only concession would be if such a business is trading at an extremely attractive valuation. It is worth noting that while underwriting an exceptional business before it sells at 50 cents on the dollar or less is not a bad use of our time, underwriting a good business before it sells at 20 cents on the dollar or less should never be part of our process. This has to do with prioritizing learning: even if we never get to invest in them, exceptional businesses often have great lessons to instill in us.

abstract challenges is a win-win. At best, finding partial answers help us better understand the world we live in and expand our circle of competence. At worst, trying and failing keeps us humble and aware of what we should stay away from until we fully understand it. The goal of the next few paragraphs is simply to share some of our thoughts on quality as it relates to businesses.

When we searched for quality on Dictionary.com we found multiple definitions. One of them stated "an essential or distinctive characteristic, property, or attribute." Makes sense to us; we look for businesses that are different and have a well-defined focus. Warren Buffett likens businesses to restaurants: if they want to have a loyal customer base they need a consistent menu. We found that Buffett owned businesses that catered to a specific market with "food" prepared in a differentiated way. He invested in retailers that *shared their cost advantage with customers*, franchises that *increased their share of voice*, newspapers that were the *only play* in town for local advertisers, and insurers with a *disciplined, well aligned capital allocator*. Someone who studied these businesses over the years might have had the impression they changed tremendously; however, the *essential menu* that made each of them distinct remained remarkably constant over time.

Another definition for quality is "character with respect to fineness, or grade of excellence". Three quick thoughts come to mind. The first is about management's willingness and ability to do the right thing because they want to, not because they have to. The second has to do with management's commitment towards excellence, a standard reserved for the rare souls that enjoy paying the high price of an intensely focused life. The third is geared towards understanding an entity's history. Rome was not built overnight. Moreover, exceptional cases often have a great foundation that provides them with the right focus, vision, and ideals. For instance, when it comes to countries it is not that hard to see how the United States still benefits from a thoughtful constitution first written more than two hundred years ago!

A third meaning of quality is "high grade; superiority; excellence". The new concept here is "superiority". By now this notion of quality should feel somewhat intuitive. That is because each of Buffett's *essential menus* listed above was not only constant over time but also superior to any alternative. We want to invest in companies that will take care of their customers' needs better than anyone else today, tomorrow, and ten years down the road. In addition, with the world being as dynamic as it is we certainly want to keep the "Innovator's Dilemma"[4] in mind. How is the business and its environment likely to evolve? Can we think of a potential strategic inflection point? Has the business adapted well to previous threats? <u>Most important of all, we need to understand and pinpoint the *essential, superior menu* that makes a business so hard to replicate.</u> The perfectly unique business does not exist but to quote Warren Buffett when he invested in Nebraska Furniture Mart and Mrs. B., you know you found a great one when even the best contestants in the world would rather "fight a grizzly bear than compete against it."

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[4] First published in 1997, in this book Clayton Christensen suggests that successful companies can put too much emphasis on customers' current needs and fail to adopt new technology or business models that will meet customers' unstated or future needs; he argues that such companies will eventually fall behind.

**"You get what you get and you don't get upset."**

These are the wise words my better half tells my kids whenever they complain about dinner. Regardless of their tantrum, their only choice is to eat what is served or go to bed hungry. We are quickly learning that this situation is not that different from what we go through at KIG on a daily basis. Let me explain.

While it is hard to complain about our recent returns, we would trade them in a minute for a more fully invested portfolio and higher expected returns. Since last February, when the fund first opened, we were able to deploy a significant slice of our portfolio in some exceptional opportunities. The good news is that these investments performed extremely well. The bad news is that while still attractive, the expected returns of our holdings are not as high as when we first bought them[5]. We will never stop looking for the next gem but for the most part the valuations of the great businesses we are finding today are not compelling enough.

Does this mean that we need to sell or trim our exceptional businesses? If Mr. Market presents us with an offer that is too good to refuse the answer is yes. Otherwise, selling becomes a huge mistake of omission.

This is a very common mistake. Why is it that few investors ever hold exceptional businesses for the long term? A possible guess is that people often do not understand the exceptional value of what they own and trade down for a lower quality business that looks cheaper. At the end of the day it is not easy to have a deep understanding of a business' quality, management, moat, and runway, and then figure out whether the odds implied at its current valuation represent a good investment. However it is not rocket science either and we are pretty sure that plenty of people can figure this out but still choose to sell way too early. Why? Again we can only guess, but we are suspicious this has something to do with the difficulties involved with <u>active patience</u>. People tend to sell when a stock had a good run and they predict that it will give back some of the recent gains. They might be trying to avoid the suffering involved in short term corrections. Regardless of the outcome investors rarely buy back into the business therefore missing out on massive multiyear improvements that take values multiples above where they sold.

From an institutional perspective it is even more frustrating. After all, are not professional investors paid precisely because they are good at being actively patient? As it turns out, it does not matter how good they are at it. While they might very well understand both the value of the opportunity and the pervasive incentives that affect their decisions, that rarely stops them from selling. They would rather miss these great long term opportunities than look foolish in a correction because they simply cannot afford the latter. Their omission to own these exceptional gems in a relevant size within their portfolio goes completely unregistered on their clients' statements. Imagine a line in a December 31st, 2013 fund report stating, "Cost of selling your Amazon position when stock market indices peaked in 2007: about 5x your capital or 28% per year minus the opportunity cost[6]". Keep dreaming. On the other hand, how many professional investors can withstand a 50% correction without losing their jobs?

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[5] It is worth noting that we still expect high absolute returns. As a remainder, although we target much higher returns, over the long run we will consider this partnership a clear success if we deliver mid-teen net annual returns to our investors without compromising our views on risk.
[6] As a reference of opportunity cost, the Russell 2000 Index generated about 1.4x or 5% per year since July 2007.

KIG can. This is because of our structural advantages (read the following section "Not another 'me too' fund"). By the way, a 50% drawdown was precisely the kind of correction investors had to withstand if they held Amazon throughout the last crisis. We are not implying that we are in a 2007 kind of environment and we are certainly not looking forward to a 50% correction. However, history has proven that it is only a matter of time until we are tested in a similar way. It will not be fun and KIG will probably look quite foolish. Yet other than carefully selecting exceptional businesses, buying with enough margin of safety, and selling when valuations are clearly overvalued, there is not much else we can do if we are committed to invest as business owners. Real businesses are much more volatile than most of us like to admit and while it would be great if we could earn our returns in a smooth manner on a yearly basis, that is almost never the case.

As long term investors in great businesses[7] we need to be humble enough to admit that we have no idea about or control over how these returns will arrive. Just as for my kids when it comes to dinner, our alternatives are not that many. My kids might not always be excited about their food but for the most part they will only grow strong and healthy if they eat. At KIG we might not always be excited about our expected returns but for the most part we will only compound at a healthy rate if we hold tight to our exceptional businesses[8]. "You get what you get and you don't get upset" are wise words indeed.

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**Not another "me too" fund**

A common trait of the businesses we invest in is that they have processes which include some level of "pain today, gain tomorrow". A famous example is Wal-Mart's everyday low prices strategy: the pain it takes in the short term is rewarded with customer loyalty and more business over the long term. We believe these kinds of actions speak volumes about the quality of its business model. At KIG, we think carefully about how we can create similar standards. As you read the next few examples, please think about how these processes make KIG antifragile[9].

We experienced our first test before KIG was formally created. In our initial conversations, a potential limited partner and a founder of one of the most prestigious funds in the United States suggested seeding us and creating a much larger "KIG". We knew we would probably make multiples of what we are likely to earn through the current structure. However there was an important catch: we would not have control. And that changed everything. How could we have the willingness to be misunderstood for extended periods of time if we were not absolutely sure we were going to be around in a few years? Everything from the business structure to the investment strategy would have been compromised.

[7] This is an important clarification. Investing in other types of businesses and/or with a shorter term horizon might require a different approach.
[8] While we buy at 50 cents on the dollar or less, we also hold great businesses at significantly higher valuations. In other words, we believe the range of valuations where a great business is neither cheap enough to buy it with enough margin of safety nor expensive enough to sell it without committing an important mistake of omission is much broader than what it is for a lower quality business. This is because great businesses have: a) growing moats that limit the potential downside of the business and allow for a prudent commitment of capital for the long term; and b) great management teams with plenty of compelling opportunities to reinvest capital and increase the chances of rewarding patient capital. It is worth noting that we always think about these concepts using a probabilistic framework.
[9] We borrow this term from Nassim Taleb's excellent book, "Antifragile". There he states that modern society does not have an adjective for the opposite of fragile, suggesting we suffer from an important blind spot. People often think about the adjective robust. Fragile, however, refers to negative change in a volatile environment while robust only accounts for lack of change. Taleb therefore coined the term antifragile, meaning things that actually gain from disorder.

Another example is our marketing process. Or should we call it negative marketing? "Are you ready for a 50% drawdown?" we ask every limited partner before they sign their subscription agreement. At which point we have already screened out any potential investor who showed even the slightest hint of short-termism and have had numerous conversations about our volatility and lock-up structure with the remaining ones. The 50% drawdown question is just the final step in a long process that seeks to ensure the highest possible level of quality in our investor base. Please keep in mind that we probably exaggerate if we say we spent 1% of our time on marketing. While growing slowly is painful, we are convinced that this approach is likely to provide KIG with a HUGE competitive advantage.

A third example is our process to take in committed capital. We only call it into the fund when the average valuation of the businesses in our portfolio is about fifty cents on the dollar or lower. This ensures that our new partners' capital also enjoys a prudent margin of safety. Otherwise we keep the fund temporarily closed, allowing for new limited partners to reserve capacity by signing up in our queue. As we speak, KIG has been temporarily closed for several months with multiples of the capital we actually took into the fund waiting on the sidelines. We certainly do not enjoy missing out on these economics; however, making sure that we invest our limited partners' capital the same way we invest ours will always come first.

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**Final remarks**

You should be receiving from us year-end statements and K-1s by the end of January and March, respectively. Please keep in mind that your actual performance may differ from the fund's depending on the date you became a partner. Moving forward you should expect a yearly letter and statement of your account. As you can tell, we deliberately avoid mentioning the businesses we own. If you absolutely need to know the composition of our portfolio or absolutely need quarterly statements, please give us a call.

We want to again thank all of our limited partners for your trust. As mentioned before, your long term commitment plays a critical role in KIG. We could not do it without you.

Sincerely,

Matias Sacerdote