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KIG Investment Partnership, L.P.
2014 Letter

Trailing returns	KIG Investment Partnership, L.P.
One year	44.2%
Since inception (February 1st, 2013)	116.2%
Annualized since inception	48.3%

The figures above are gross results (net of management fees and costs, but before performance fees) and the 2014 results are yet to be audited. We had an excellent first twenty three months from a performance point of view. As I said last year, I do not think much about it and neither should you. In my opinion, short term performance is irrelevant.

What I did well

I continue to focus on the long term. This year I added two exceptional businesses to our portfolio and Mr. Market was generous enough to offer a few good opportunities to buy more of the exceptional businesses we already owned at attractive valuations. This handful of decisions left us with a portfolio that is close to being fully invested in nine businesses with the largest four holdings representing 79%. From a process point of view, this year's best new practice was writing letters to the CEOs of our businesses to communicate my admiration for their work, my long term commitment as an investor in their companies, and my gratefulness for sharing their journeys with us. While today our investments represent a tiny percentage of their businesses' capital, I hope one day our growing commitments might further strengthen their ability to think and act long term.

Perhaps more important is what I had an opportunity to do but did not do. This year I could have sold a couple of businesses we owned at valuations that were becoming somewhat elevated in order to avoid a likely – but far from certain – correction. Similarly, I could have passed on buying an exceptional business at an attractive valuation hoping its valuation became even more attractive and potentially – but again, far from certainly – capture a higher expected return. Finally, I could have lowered my bar on exceptional businesses for the sake of further diversification. While these actions were likely to improve our short term performance and/or mitigate our portfolio's volatility, they also would have compromised what KIG is all about: owning exceptional businesses for the long term.

What I could have done better

Reporting mistakes

The cases you are about to read in this section might feel a world apart from my focus on exceptional businesses. This is because: 1) these businesses belonged to our secondary effort of investing in good businesses at extremely attractive prices and 2) they were a mistake.

Would KIG be better off focusing exclusively on exceptional businesses? For what is worth, I went back and looked into my short track record of investments in business that were not exceptional but were trading at exceptionally attractive valuations. In twenty three months I made a total of three investments within this category (including one with a disastrous outcome that you are going to read about) that had a weighted average return on investment of 26%. More important, I will never "compete" capital away from our exceptional businesses and will only consider investing outside our main strategy if there is a significant amount of cash in our portfolio.

I also acknowledge that by providing details on mistakes and not discussing any positive cases I might be scaring limited partners away and effectively doubling up on KIG's negative marketing efforts. I am more than comfortable with this. I see it as a long term positive for the partnership as it should help self-select limited partners that have the ability to trust me even when I am at my worse. As Ed Catmul, co-founder of Pixar and current president of Pixar and Disney Animation wrote in his excellent book, *Creativity*: *"Trust doesn't mean that you trust someone won't screw up – it means you trust them even when they do screw up."*

As much as I believe in negative marketing, this is not the main reason I go about revealing our holdings in this manner. Discussing exceptional businesses I own or I am willing to own in the future can have a number of negative consequences such as affecting my psychological ability to change my mind. On the other hand, disclosing bad investment decisions increases the odds of learning from them and keeping me humble. I want to fully embrace these poor decisions and draw from them lessons that have the potential to add significant value over time. As a result, KIG's transparency will be second to none when it comes to mistakes.

My latest round of self-inflected pain

In 2013 I invested about two percent of our assets in Corinthians Colleges, a for profit postsecondary education company in the US with more than 80,000 students and 15,000 employees. At that time, Corinthians was going through tremendous scrutiny for their prior recruiting and lending practices and the entire business was selling for approximately $200 million or less than 15% of their annual revenues. While I acknowledged that Corinthians was far from a model institution, I believed its new management team was addressing its problems and had a much better chance than expected at turning around the situation. Moreover, a good number of Corinthian's vocational schools provided a valuable service and a high return on investment to students that graduated. To make a long story short, last June the Department of Education triggered a liquidity crisis by cutting off federal student aid, which resulted in a more than 90% loss of our investment. Before moving forward, I certainly thought about the perils of having the government as the sole financial provider for these loans but attributed a small probability that this risk would actually materialize. Whether or not I assessed this probability accurately,

not even in hindsight is it possible to say; such is the nature of risk. What I do know is that there was no need to expose ourselves to such a fragile situation. I want KIG to invest in asymmetric opportunities that are "heads I win big, tails I do not lose much". Corinthians was not one of them.

Another mistake was investing about two percent of our assets in a fast-moving consumer goods company in China that ended up costing almost 65 basis points. As I do not want to spread any false rumors I will not disclose its name. Throughout my due diligence I had a number of interactions with the company, I personally checked their products' availability, and I talked to distributors and competitors. I also had evidence that their manufacturing and marketing efforts were growing. However, after I made our investment a market participant published a report claiming the company exaggerated its numbers. I talked to the company a few more times. I also talked to a few more distributors and competitors. While I was not able to prove any wrong doing, I was not able to prove their innocence either. I was not sure what to think and that is precisely why I never should have invested in the first place. This mistake helped me to further internalize the importance of trust: no matter how great the opportunity, it is not worth a second of my time if I cannot develop enough conviction about the owners' ethical standards.

Focus

At KIG I can invest in any asset class, in any sector, in any business, in any country around the world. With such a broad investable universe, where do I start? My investment philosophy begins by humbly admitting that it is very difficult to assess the value of most businesses. This is because I view the world as an extremely competitive place, where evidence shows that most businesses do not endure the test of time. Will the business be as strong in 5 years? 10 years? How about 20 years? Without enough evidence to develop a reasonably high amount of conviction to answer this question, investing is not a prudent activity. I believe, however, there are some instances where enough evidence exists to identify greatness in foresight and become long-term owners of a share of these businesses. These instances are rare.

Why are they rare? An interesting way to think about this is by inverting the question: why are not all businesses exceptional? There are all sorts of reasons. Some lack a focused, differentiated strategy. Some lack repeatable processes. Some are not dominant enough within their markets. Some do not offer a compelling, superior value proposition. Some are not developing any exceptional skills. Some are not frugal enough. Some lack an ambitious vision that can inspire internal and external partners. Some participate in activities with bad economics. Some leverage up and might end up in a fragile situation. Some are too mature and lack reinvestment opportunities. Some provide overly generous compensation packages. Some lack a well aligned management team capable of going to the next level. Some do not understand capital allocation. Some are constrained by unfavorable regulation. Some lack shareholders with enough patience. Some are too vulnerable to new disruptions. Some are not good partners. Some fail at empowering employees. Some lack a culture of continuous learning. Some are way too concerned about improving their short term profitability at the expense of their long term

moat. Not that an exceptional businesses is created by checking all the items in this never ending list[1] but you get the point: the vast majority of businesses are far from exceptional.

How about blue chips[2]? While they might be great quality, the problem is that those ships sailed long ago. As good as the long term expected returns of investing in blue chips can be, they are nowhere as interesting as those of investing in high quality businesses that are relatively unknown[3]. Professor Richard Zeckhauser from the John F. Kennedy School of Government at Harvard University wrote an excellent paper related to this titled *Investing in the Unknown and Unknowable*. I highly recommend reading it. Among other things, Zeckhauser explains that great investments tend to have three characteristics, which he calls UUU. First, they are unknown, meaning relatively few investors are aware about the opportunity. Second, they are unique, meaning there are no similar opportunities out there from which arbitrageurs can learn. And third, they have an unknowable intrinsic factor[4] that creates uncertainty, which in itself discourages competition, but also has the potential to have a tremendously positive effect[5]. By definition, blue chips and UUU characteristics are incompatible.

Going back to the original question: with such a broad investible universe, where do I start? I start by making sure I write down every single sourcing idea I have, regardless of how good or bad it might seem at the original eureka moment. These ideas lead me to all sorts of businesses and over a year I end up reading the first few pages of hundreds and hundreds of annual reports. I then move on to underwrite the very few cases where I can identify signs of both great quality and UUU characteristics. Whenever I manage to develop enough conviction about one of these rare opportunities and I am fortunate enough to get it at a valuation with a high margin of safety, I buy it and I do it in SIZE. Then, unless I recognize a mistake on my assessment or its valuation becomes irrationally expensive, I hold it for the long term. That is it. While in theory KIG's mandate has the potential to be incredibly broad and complex, in practice it is an extremely focused and simple strategy.

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[1] Taking a check list or pattern recognition approach to sourcing opportunities is extremely dangerous as I never know in what shape or form the next gem will arrive. It is critical to always keep an open mind.

[2] According to Investopedia.com a blue chip is a nationally recognized, well-established and financially sound company. Blue chips generally sell high-quality, widely accepted products and services.

[3] Are not the risk adjusted returns comparable? Are not blue chips less risky? I do not think so as I am particularly uncomfortable with the extent to which the *institutional imperative* typically affects large organizations. The *institutional imperative* is a term coined by Warren Buffett to explain that large organizations tend to resist change in direction, make less than optimal use of corporate funds, support foolish initiatives and imitate, at times rather unwisely, the actions of peer companies.

[4] A good example of a positive unknowable is when a new product comes to market and no one, not even the company's owner or CEO, has certainty on how big it will become. One concrete example could be Coca-Cola many decades ago, before the company became a blue chip.

[5] Zeckhauser leaves an extremely important element out of the picture: the concept of quality. To his credit, he mentions the value of having complementary skills within a business, a concrete way to think about quality – but hardly the only one. In any case, I do not blame him. Quality might be one of the most difficult concepts about which to think and write. You can find a humble attempt in KIG's 2013 annual letter. The next section in this letter is also related to quality.

The essential

With my children learning how to read, this year I revisited many chapter books that include wonderful lessons for kids and grownups alike. My favorite is *The Little Prince* by Antoine de Saint-Exupéry. While the entire book is full of wisdom, I was particularly captivated when the little prince said:

"Grownups like numbers. When you tell them about a new friend, they never ask questions about ***what really matters****. They never ask: 'What does his voice sound like?' 'What games does he like best?' 'Does he collect butterflies?' They ask, 'How old is he?', 'How many brothers does he have?', 'How much does he weigh?' 'How much money does his father make?'" Only then do they think they know him. If you tell grown-ups, 'I saw a beautiful red brick house, with geraniums at the windows and doves on the roof...,' they won't be able to imagine such a house. You have to tell them, 'I saw a house worth a hundred thousand francs.' Then they exclaim, 'What a pretty house!'"*

Antoine de Saint-Exupéry picked up on a common flaw in our human nature: our tendency to overweigh tangibles that are easy to count at the expense of intangibles that are difficult to weigh. As a result, we often focus on outputs rather than inputs. This fault affects investors as much as it affects any other group of grownups. For instance, it is not rare for investors to think that the way to assess the quality of a business is by analyzing its return on invested capital over previous years. They only assess it positively if its recent profitability is high and stable as that must imply that the business has a strong competitive advantage. Of course, this does not make any more sense than it does driving while looking in the rearview mirror. Not to mention it wrongly assumes that businesses with returns on capital that are not particularly high or stable cannot have a strong competitive advantage.

What makes the issue so prevalent is the fact that, in general, investors as a breed tend to overly emphasize the left side of their brains. We tend to have quantitative, rational backgrounds that are necessary to analyze financial statements, typical business decisions, and discounted cash flows. The problem is that all these numbers and "logic" are not very useful, and could even hurt us, if we do not also use our creative skills to remain open minded and select the right mental model to understand both the risks and opportunities at hand. At the end of the day, ***what really matters*** is whether we have the ability to discern and give the appropriate weigh to the right variables. Fortunately, Antoine de Saint-Exupéry does not only criticize our human nature but also provides a critical hint on how to go about this art. In one of their conversations the fox tells the little prince:

"And now here is my secret, a very simple secret: One only sees clearly with the heart. ***What is essential*** *is invisible to the eyes."*

As cheesy as this quote might sound, it contains an important element of truth that most investors seem determined to ignore. When one of our CEOs takes the time to personally write notes by hand to answer customers' complains, when another of our CEOs gives shares of his business from his personal account away as a gift to every single one of his employees, or when another of our businesses goes the extra mile to make right by every customer even when their warehouse has literally caught on fire, I know that there is likely to be an exceptionally valuable intangible at work. A skeptic might argue it takes eyes to see these actions; I argue it takes heart to weigh them appropriately.

Final remarks

You will receive K-1s by the end of March.

I want to thank again all of our limited partners for your trust. As you know, your long term commitment plays a critical role in KIG.

Sincerely,

Matias Sacerdote