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KIG Investment Partnership, L.P.
2015 Letter

Trailing returns	KIG Investment Partnership, L.P.
One year	-16.9%
Two years	19.9%
Since inception (February 1st, 2013)	79.7%
Annualized since inception	22.3%

The figures above are gross results (net of management fees and costs, but before performance fees) and the 2015 results are yet to be audited. We had a poor last twelve months from a performance point of view. I do not think much about it and neither should you. As mentioned in prior years when results were strong, in my opinion short term performance is irrelevant.

What I did well

I continue holding tight to our exceptional businesses. The portfolio is almost fully invested in nine businesses with our five largest holdings representing approximately 79% of our assets as of yearend. I also developed enough conviction on two additional exceptional businesses. In one case I was fortunate enough to buy it at an attractive valuation. The other will remain in my "Monitor to Buy" folder until I manage to identify an entry point with a large enough margin of safety.

Last year I started writing annual letters to our CEOs to thank them for their amazing work and inform them about our long term commitment. This year I started to send brief letters of support whenever they are undergoing a particularly hard time. The goal is to praise their initiatives that might include some degree of "pain today, gain tomorrow", let them know we are holding tight to our shares – or buying more – and reassure them about our long term partnership. The shares we own are not going to make or break their businesses' future; however, I would not underestimate the positive effect a few words of encouragement can have – especially at a time when almost everyone else is betting against them. After all, this is precisely when good partners show up.

What I could have done better

Early in 2015 I invested in a small business in southeast Asia. I spent a significant amount of time underwriting the opportunity, including having several conversations with its CEO. I believe there is a very good chance it succeeds. However, I do not want to invest in businesses with a high probability of

success but rather in those with an extremely low probability of failure. The problem with this business was that it had a few startup characteristics – risks I do not want to take. I am attracted to exceptional businesses that are young, unknown and have a ton of low hanging fruit ahead of them. However, they should always have great competitive advantages, solid repeatable processes in place and a well aligned management team. As soon as it became evident to me that this investment was lacking on a few of these fronts, I sold it at a small profit. Needless to say, I never should have invested in it to begin with.

While mistakes of omission do not get documented in track records, they have the potential to be significantly more costly than those of commission. This is because while a mistake of commission can cost us up to 100% of our investment, one of omission has the potential to cost us multiple times the capital we should have committed. The following is probably not the exception.

In late 2014 one of the few gems in my "Monitor to Buy" folder was trading at what I perceived to be an attractive valuation. Moreover, I have always had an extremely high opinion of both its competitive advantages and its CEO. Yet I did not buy it. How could I miss such an amazing opportunity? I was hurt by my strong bias against well-known businesses with a large market capitalization. This stopped me from giving up exposure to our small exceptional businesses in order to buy this gem which at that time had close to $100 billion in annual revenues. The "rationale" for this decision was that our businesses had longer runways and therefore lower reinvestment risks. While probably true, this gem has a HUGE addressable market and is still likely to compound capital at a reasonably high rate for many years to come. In any case, what really mattered – what I did not weigh appropriately – was that this gem has amazing qualities that result in an even lower probability of impairment of capital than that of our businesses. Given that my goal is not to maximize our upside but rather to compound our capital at attractive rates taking the least possible amount of risk, I should not have hesitated to make this investment. It was a BIG mistake.

My approach to valuation in five quotes from Warren Buffett (and one from Seth Klarman)

1) "In business, I look for economic castles protected by unbreachable 'moats'."

To assess competitive advantages I first need to understand a business at many different levels: its strategy, its repeatable processes, its unit economics, its culture, its management capabilities and incentives, its ability to adapt to different environments, its relationship with suppliers, its competition, its appreciation for what makes customers tick, its approach to capital allocation and so on. After developing a complete picture I can assess whether a business is truly superior or not. As important, the entire underwriting process is mostly focused on creatively thinking about ways to "destroy" the business. Only after I develop enough conviction on how incredibly difficult it is for any competitor to conquer a castle, does it make sense to move on and estimate how much the castle is worth.

2) "You don't pinpoint things. If somebody walks in this door and they weigh between 300 and 350 pounds, I don't need to say they weigh 327 to say that they're fat."

To figure out the value of an exceptional business I ask myself how much is the minimum amount of free cash flow it should produce per year and whether it has any opportunities to grow this free cash flow over time. Business cycles, unknowable variables and a dynamic world make it impossible to

get a precise answer for these questions. While many market participants shy away from this uncertainty, I embrace it. The key is to always use conservative assumptions that can only result in positive surprises. In addition, focusing on exceptional businesses also helps to have positive surprises. This is because exceptional businesses tend to surpass expectations over and over again. Finally, estimating the intrinsic value of a business should be as instinctive as it is to assessing somebody's weight. If this is not the case it is probably a sign that either I do not understand the business well enough or the business has a high degree of complexity; either way, I do not want to be involved.

3) "The three most important words in all of investing: margin of safety."

Margin of safety is another term used for "cushion for error". A great opportunity to use this concept is when thinking about the qualities of the opportunity. For instance, everything else equal, an investment in a business that has the ability to increase prices or has a brilliant CEO with the ability to adapt to unexpected challenges has a larger cushion for error. Another important angle to consider is the price I end up paying. When considering a business I always assign a probability to all sorts of potential outcomes and take into consideration extreme scenarios. I want to make sure I always get our money back and therefore never pay more than 50% of what I think that business should be worth today. In fact, I often end up paying significantly less. As long as I select good businesses, this guarantees we get our capital back even if my conservative estimate ends up being off by as much as 100%.

4) "I will tell you the secret for getting rich. Close the doors. Be fearful when others are greedy and greedy when others are fearful."

How is it possible to buy an exceptional business at 50 cents on the dollar? Is the market that inefficient? Most times it is not. Every once in a long while, however, Mr. Market gets scared about the future of a business and gives it away at a ridiculously low valuation. These scares come in different shapes and forms. My favorite is when an exceptional business reinvests appropriately to expand their competitive advantages. While Mr. Market might get scared by the negative impact this action has on earnings over the short term and sells, I might become confident on the long term benefits this investment has on the "moat" and become convinced to buy. To do this effectively I need to have fully underwritten the business before others become fearful – preparation, preparation, preparation. I then need to be patient and willing to wait indefinitely for the fear to arrive – it often takes years. Finally, I need to make sure the event triggering the fear does not impair the long term quality of the business. The key is to only buy from a seller that is acting irrationally. As Seth Klarman said, *"If you are at a poker table and can't figure out who the patsy is, it's you."*

5) "To suggest that this investor should sell off portions of his most successful investments simply because they have come to dominate his portfolio is akin to suggesting that the Bulls trade Michael Jordan because he has become so important to the Bulls."

When an investment in a business performs extremely well in a relatively short period of time three things are likely to increase: its valuation, its size relative to the entire portfolio and the probability of a sharp correction in both its own market capitalization and the value of the entire portfolio. When this kind of performance takes place most money managers trim or sell their "Michael Jordan" hoping they can buy it back at a lower price at some point later in time – something they rarely manage to do. They often give up on tremendous long term potential sometimes because they cannot appreciate what they

own but more often because the "career risk" they are subject to forbids them from taking too much volatility. On the other hand, KIG's manager, structure and partners are all aligned to avoid these important mistakes of omission. I hold tight to our "Michael Jordan" even if it becomes uncomfortably large as a percentage of our portfolio or it becomes relatively expensive[1].

Let's talk about risk

In his Pulitzer Prize winner *The Beak of the Finch* Jonathan Weiner tells the fascinating story of Peter and Rosemary Grant who dedicated a large part of their careers to proving the concept of evolution by researching finches in the Galapagos Islands. Among many other brilliant insights, they learned that even a half a millimeter difference in the size or shape of these finches' beak – a measure practically invisible to the human eye – played a critical role in the type and amount of seeds these birds could eat. In normal times these tiny differences were almost irrelevant as there was plenty of food for all finches to share. On the other hand when a particularly extended drought took place, the only finches that survived were those with beaks capable of accessing seeds that others could not. During these rare crises the natural selection process became increasingly evident, eventually killing as many as six out of every seven finches.

Whether it is a finch finding a seed to eat, a business acquiring a profitable customer or an investor underwriting a rewarding opportunity, we are all subject to the brutally competitive nature of this world. What are the droughts I should be watching out for? Are there any invisible qualities that might help us survive?

An obvious analogy for a drought would be a severe market dislocation such as the one we had during the great recession. If a similar scenario were to arise my conviction is that while in the short term our investments are likely to endure a significant amount of volatility, in the long term they would still fair quite well. The vast majorities of our businesses sell non-discretionary or affordable goods / services, have practically no debt and are the low cost providers within their industries – three characteristics that make them antifragile. In a bad economy, when consumers become more price sensitive, their value proposition becomes even more relevant. In addition, they have market shares ranging somewhere between less than 1% and 5% of their total addressable market[2]. This means that even in an extremely pessimistic scenario where economies or markets where they compete shrink by a significant amount, they would still have plenty of room to grow. Again, it would likely be a hell of a roller coaster ride but in the long term I am confident both our businesses and capital have an excellent chance of producing superior returns.

While I do not perceive volatility as risk, I do not want to take someone with a heart disease for a roller coaster ride. I want partners that are strong and healthy. In a crisis the quality of the investor base will define the extent to which I will be scrambling to sell in order to meet redemptions or keep my eyes on the ball to be greedy when everyone else is fearful. The impact on long term returns is tremendous.

[1] This does not mean I will not sell our "Michael Jordan" if it becomes clearly overvalued – a rare instance indeed.

[2] One might wonder how our businesses can be dominant enough with such low market shares. The answer is that they are disrupting large industries with an improved value proposition and have a dominant position among those competitors embracing a similar approach. As important, I believe the large incumbents in these markets are not capable or nimble enough to adapt to the shift in paradigm presented by these new business models.

How do I make sure I only allow well-tempered partners into the fund? I underwrite them as much as they underwrite me. Additionally, the fund has a two and a half years rolling lock up and I ask new partners whether they are ready to withstand a fifty percent drawdown before they sign their subscription agreement. The message is loud and clear: KIG is not for everyone. That is also why I do not spend any time marketing and only agree to meet with those who are interested in KIG after reading these annual letters or are recommended by existing partners. I have an amazing set of partners[3] and look forward to keeping it this way.

Another danger is the risk of impairment of capital in one of our businesses – a particularly threatening one given the high levels of concentration in our fund. The bad news is that despite the huge amounts of time, energy and thought I devote to figuring out how anyone could conceivably "destroy" our businesses, it is always possible to miss something and invest in a vulnerable proposition. The good news is that as painful as a negative setback could be, it should not come anywhere close to being deadly. As an example, a highly concentrated portfolio held over ten years where a 25% position goes to zero, two other 25% positions return 20% per year each and one last 25% position returns 5% per year, results in an average return of 13.4% per year. The meaningful risk for KIG's long term survival is not whether we will endure big mistakes or not – let's face it, if Warren Buffet made them, what are the chances I will not make any? – but rather how will I react when it happens. As long as I learn the right lessons, we should be ok. Needless to say, if we suffer too many zeros both you and I will need to find a new money manager.

Not that I expect one of our investments going to zero anytime soon. After all, I research, think, and size businesses weighing their potential weaknesses – rather than focusing on their strengths – and am only willing to allocate a large percentage of our assets in a given business if I can underwrite a particularly low probability of impairment of capital. For instance, I am extra cautious about opportunities in countries where rule of law is not respected, even more averse to any meaningful amount of debt and directly avoid any business model where I can identify a potential disruption. My focus on the downside is also why I end up emphasizing simple businesses, robust "moats", and brilliant CEOs with high ethical standards and the majority of their wealth invested along us. In case you are wondering, I also placed the majority of my personal capital in KIG.

Having so much skin in the game could also backfire and make me too risk averse. At the end of day, investing in exceptional businesses is easier said than done. Our CEOs reinvest continuously into their businesses in order to capture the great opportunities they have ahead of them. This often results in volatile earnings that make Mr. Market quite uncomfortable. To give you an idea, five out of nine of our holdings suffered a correction in their stock price of at least 50% while we owned them. So far these corrections took place at different points in time but that might not always be the case.

As mentioned earlier I do not perceive price volatility as risk. How about volatility of earnings? Would it not be safer to diversify and invest at least part of our capital in businesses with more "stable" earnings? The key is to internalize that in the long term such "stability" is often an illusion and it is precisely next to the prudent and smart risk taker that one is truly safe. Like Jeff Bezos – who several

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[3] They are incredibly supportive. Also, the vast majority of my partners are principals. This is an important advantage because principals cannot get fired and therefore do not suffer from "career risk". This is why I pay attention to the corporate governance and reputational status of any potential limited partner acting as an agent. In good situations, agents can also behave as excellent partners. For instance, one of the few agent partners in KIG unsolicitedly committed to extending their lock up to five years.

times experienced a greater than 50% correction in his Amazon stock– explained in a recent interview: *"What really matters is that companies that don't continue to experiment – companies that don't embrace failure – they eventually get into a desperate position, where the only thing they can do is make a 'Hail Mary' bet at the very end of their corporate existence. I don't believe in bet-the-company bets."*

Final remarks

As of this date the fund remains closed. I plan to reopen it if and when our exceptional businesses trade again at valuations where I believe there is a large enough margin of safety to buy more of them. An important heads up that is worth keeping in mind: at that point, an investment in KIG is very likely to feel particularly scary – either because the business environment will feel quite uncertain and/or because our performance would have suffered in a meaningful way. One of the best things about opening in tough times is that I increase the odds of having high quality investors.

We have a new prime broker – Weeden & Co – and a new custodian – Pershing LLC. While I would have preferred to continue with our original providers, I could not justify the significantly higher fees they were starting to charge us. Weeden and Pershing offer all the services we need at a more reasonable price.

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

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

Sincerely,

Matias Sacerdote