KIG INVESTMENT MANAGEMENT, L.L.C.

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KIG Investment Partnership, L.P.
2016 Letter

Trailing returns	KIG Investment Partnership, L.P.
One year	-4.5%
Two years	-20.6%
Three years	14.5%
Since inception (February 1st, 2013)	71.7%
Annualized since inception	14.8%

The figures above are gross results (net of management fees and costs, but before performance fees) and 2016 figures are yet to be audited. From a performance point of view, the last twenty-four months were poor. 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.

This year our portfolio's turnover was relatively high as I sold two of our businesses. One I sold at a loss. The other I sold at a healthy profit after its founder and CEO decided to retire. I also bought two exceptional businesses that I have been following for years. Thus, our portfolio continues to be fully invested with 84% of our assets concentrated in our six largest holdings.

What I could have done better

In 2013 I invested in B2W Digital, a leading e-commerce business in Brazil, in what became a painful unforced error. My main mistake was overestimating its management's ability to run the business. The company is controlled by the same group that acquired and successfully operates Ambev and Kraft Heinz among other businesses. However, running a business that evolves as fast as B2W requires not only efficient operators but also a leadership team with the ability to respond to challenges in an entrepreneurial way. Over time it became clear to me this is not how the business is run so I sold our position. This bad investment is my largest mistake of commission to date and cost us approximately 3.4% of our assets under management. Certainly, not your manager's brightest moment.

What I did well

"Any year that passes in which you don't destroy one of your best loved ideas is a wasted year." – Charlie Munger

Until recently I thought a business that combines strong competitive advantages with a strong management team could be considered for KIG. Not anymore. Conversations with mentors, careful study of CEOs with outstanding track records and events at two businesses we used to own[1] convinced me it was time to destroy this idea. While these types of opportunities are likely to do well, I do not want to invest in businesses that are likely to succeed but rather in those that have an extremely low probability of failing. The problem with competitive advantages is that regardless of their strength, they still need constant reinforcement by an outstanding operator who can figure out what to do next.

So where does this leave us? Not far from where we started. I always paid special attention to CEOs; I am simply raising the bar. I now believe there are only three kinds of exceptional opportunities: a business with an unregulated monopoly[2], a business with an outstanding CEO, or a specialized business focused on a niche market. In other words, if the case under consideration is not an unregulated monopoly or a niche business, then it absolutely needs to have an outstanding CEO. The difference between a strong and an outstanding CEO might seem subtle but I believe that over the long term it makes all the difference.

Is there any other way?

Warren Buffett is one of the best CEOs the world has ever seen. That is why I find it particularly interesting that Buffett himself is on record saying: "Most of what I have learned about management, I have learned from Tom Murphy. I kick myself because I should have applied it much earlier." Buffett is no stranger to praising his managers but this is not just another praise; he is telling us that Tom Murphy knew much more about an extremely important aspect of business than he himself knew. That is no small feat.

Tom Murphy was the Chairman and CEO of Capital Cities, a media company that grew from very humble beginnings in the 60s to acquiring giant ABC in 1985 and was eventually sold to Disney in 1996 for $19 billion. By the end of his tenure he compounded capital for his shareholders at an annual rate of 19.9% for twenty-nine years! Some might try to explain such impressive returns by pointing out that the industry was particularly attractive back when regulation prohibited widespread competition. This, however, would be a vast oversimplification. There were many operators at the time who had similar opportunities but no one matched Murphy's track record. What did he do different from his competitors?

One of Murphy's virtues was recognizing and understanding the business' potential. Reflecting on his career during an interview in December of 2000 Murphy explained: "Eventually, it became clear to both of us (referring to Frank Smith, Capital Cities' first CEO) that broadcasting was quite a business.

[1] I am referring to B2W and the other business I sold this year after its founder & CEO decided to retire.
[2] Different from a business with a strong competitive advantage, an unregulated monopoly has an unbreachable moat. A great way to tell them apart is by understanding whether a business can increase its prices without losing market share.

We were smart enough to figure that out and I don't think everyone else did. This was a business that began to explode, and as we grew, the margins grew. The costs are somewhat fixed so as you had greater and greater sales, the margins would just continue to grow. Other people would look at the business as it was at the time and say, 'Well, gee, there's a 25 percent margin. That's sensational.' The fact was, it could have been a 50 percent margin and Frank and I were able to see that. So just by being sensible about our business, we continued to grow the company and buy businesses from other people who didn't see the potential profitability that we saw."

Murphy could achieve such high level of profitability by developing a culture of cost control. How he addressed Capital Cities' headquarters is a great example. The building was old and needed to be re-painted, especially because prominent clients visited regularly. Murphy agreed to paint but only the sides of the building facing the road, leaving the other sides untouched! One might conclude he was a relentless cost-cutter willing to go to the bone but this was far from being the case. As a good capital allocator Murphy understood perfectly well the difference between good and bad costs. For instance, he did not hesitate for a second to hire the best people or invest in modern equipment.

In the book *Limping on Water* by Phil Beuth, one of the first hires at Capital Cities, a powerful quote by Frank Smith illustrates yet another central pillar to the business' approach to management: "Some of you fellows may think I tie you to Capital Cities by corrupting you with compensation and stock options. But I've decided the reason you are afraid to leave this company is more because our system naturally corrupts you with autonomy and authority. And I suspect that after living that way for a time, you're fearful that someplace else might not operate in the same manner."

There are plenty of anecdotes that prove Murphy's unconditional commitment to Frank Smith's system. A particularly telling example: Capital Cities was planning a Sunday edition for a newspaper they owned when Warren Buffet – a large shareholder at the time – suggested it was a bad idea. Buffet had a very negative experience implementing the same idea for another newspaper he owned – a competitor ultimately sued him. Murphy's reaction was to discontinue the plan. His team, however, had the courage to challenge his decision not once but twice and eventually convinced him of the merits of taking the risk of publishing a Sunday edition. Dale Duncan, who was part of these meetings, explained: "The message, sent to all operators (within Capital Cities), was loud and clear. While the chairman listens to everyone, he is likely to favor the men and women in the trenches. It was the bedrock of his philosophy of decentralization."

It seems so simple: understand your business, be conscious about costs, employ the best people, and stay out of the way. Yet it is anything but. We all know that management is much more an art than it is a science. Not everyone has the vision to recognize an exceptional business, the discipline to remain frugal, the humility to hire the best and listen to them, and the ability to make wise decisions.

What made Murphy such an extraordinary leader was not only having these attributes but also the ability to permeate the entire organization with his integrity. As Alan Nesbitt, who enjoyed a long career at Capital Cities, described: "We could make honest mistakes, or miss our budgets, but if we put the company, or ourselves, in disrepute, there was no second chance at Capital Cities. Do the right thing was our personal road map. We were taught to avoid the quick-fix solution and when faced with a tough decision, favor the best long-term interest of the station, person or community."

In the book *The Outsiders*, William Thorndike reveals what is likely the ultimate secret to Murphy's success: he was always ready to personally embody the company's values. "'ABC, in fact the whole broadcasting industry, was a limousine culture – one of the most cherished perks for an industry executive was the ability to take a limo for even a few blocks to lunch. Murphy, however, was a cab man and from very early on showed up to all ABC meetings in cabs. Before long, this practice rippled through the ABC executive ranks, and the broader Capital Cities ethos slowly began to permeate the ABC culture. When asked whether this was a case of leading by example, Murphy responded, 'Is there any other way?'"

Not your typical portfolio management

KIG is not your typical fund. The capital provided by limited partners is different, the kind of businesses we own are different, and the way we think and act as business owners is different. When it comes to managing the portfolio the approach is also unconventional.

One way our portfolio is atypical is in its concentration. In my opinion there are not that many exceptional businesses, so when I find one I want to own it in size. As an investor, there are few things I find more frustrating than not buying enough of a business on which I have a great deal of conviction that later goes on to do very well. Unfortunately, I have been there. Let's say I allocated three percent of our assets in a business that goes on to increase in value by a factor of four in five years. Owning some is better than nothing but such a small allocation is not going to move the needle. So how much is enough? Assuming we can own a diversified portfolio of about seven exceptional businesses – with a few of these holdings being larger than average –, I think allocating about ten percent of our assets is a prudent starting point.

I am also willing to concentrate a much larger percentage into a single business. While I have yet to encounter it, every once in a long, long while, a particularly exceptional business might become available in what could be described as an opportunity of a lifetime. It is important to note that I do not take this statement lightly. There are three crucial conditions that need to be met – more than ever. Know the business as well as anybody else, understand why this business has an extremely low probability of impairment of capital, and be able to buy such business at a very attractive valuation. When such an incredible opportunity comes up I believe the only rational thing left to do is have the courage to size it big. How big? At least twenty-five percent of our assets.

Another important difference between how most investors manage their portfolios and the way I go about it is that I do not rebalance our holdings. While I might increase or decrease the allocation to our businesses based on new evidence about their quality, I avoid doing it based on a change in valuation. This is because I do not size our businesses based on expected returns but rather on the probability of impairment of capital. For the most part, a change in valuations affects the former but has no effect on the latter. Knowing there is always a possibility I got the business completely wrong stops me from adding any more capital beyond the originally planned allocation when valuations are going down. On the other hand, knowing how easy it is to underestimate the long-term potential of an exceptional business prevents me from trimming them when valuations are going up. Of course, if a business becomes irrationally expensive or I find a better quality business, I sell.

Risk management at the portfolio level is also different. While I certainly consider variables that our businesses might have in common, they rarely constrain my decisions. In the short term, shared factors, such as currency or sector related risks, might heavily influence our returns. Over the long term, however, these risks are likely to be completely overwhelmed by each of our businesses' specific attributes. This is why I believe the best way to manage the probability of impairment of capital in our portfolio is by constantly raising the bar and never stop looking for better quality businesses in which to deploy our capital. Like one of our CEOs said: "I think the most dangerous people in the organization are not the people who are overwhelming because you are going to promote them and you love them. And are not the people who are underwhelming because they are not good and you are going to fire them. It is the people who are just whelming."

Final remarks

The fund remains closed. While many of our businesses are now trading at attractive valuations, the portfolio as a whole has yet to present the entry point I require to take in more capital.

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

Please do not hesitate to call me if you have any questions. Thank you again for your trust and patience. Your commitment plays an important role in helping me think and act long term.

Sincerely,

Matias Sacerdote