KP7

October 16, 2024
Letter #15

Dear Investors:

KP7 was up 20.1% in the third quarter of 2024 after all fees and expenses. The S&P 500 was up 5.9%, including dividends. For the year, KP7 is now up 15.7% and the S&P 500 is up 22.1%.

We are pleased with our year-to-date absolute performance. A 15% return after all fees and expenses over nine months is in line with our goal of delivering net returns of 15% to 20% through multiple stock market cycles. Our relative return, however, remains disappointing. We have struggled to keep up with the ripping S&P 500. Not owning the mega-caps has hurt our relative performance.

At our core, we are fundamental investors. We value businesses. We buy stocks only when our estimate of business value is substantially higher than the price of the stock. As we look at today's mega-caps, we struggle to find the relationship between price and value that would make us buyers. Valuation discipline has saved us in the past. We think it will save us here too. We continue to steer clear of the mega-caps.

We see several hidden risks in the U.S. economy. Debt at the U.S. government is dangerously high, unsustainable, and continues to grow. Inflation is far from tamed. We now see an emerging bubble in the U.S. stock market associated with artificial intelligence.

To be clear, we believe artificial intelligence will change our lives in fundamental ways in the coming years and decades. We aren't so sure, however, that the winning business models are all that obvious today. We'll make money in artificial intelligence someday, but not today. We remain on the sidelines.

We've written before about the importance of finding hidden risk while it is still hidden. Risk is a funny thing. It grows and festers long before it is broadly recognized as risk. Once risk becomes obvious to the masses, the masses take action, and the actions of the masses destroy capital very quickly.

Risk didn't magically appear the day Lehman Brothers or Enron went bust, for instance. It existed long before those companies blew up. Risk grew largely undetected. One day the risk became obvious. The masses took action. The stocks went to zero.

While we never know exactly when hidden risk will become obvious to the masses, we do know when it does lots of investment value will be destroyed. The time to protect portfolios from risk is when it is still hidden. We believe hidden risk exists today with the

U.S. government (too much debt), with the U.S. consumer (inflation), and with the U.S. stock market (bubble).

Our portfolio consists of ten to thirty investments exposed to a handful of big global long-term investment themes. We like to cluster our investments around long-term themes because, if we are right about the theme, our investments are subject to multi-year tailwinds.

The largest investment theme in the portfolio over the last few years has been a cluster of investments that would benefit from the effects of the global expansion of central bank balance sheets. That cluster of investments has been a homerun for us recently. Gold producers, gold developers, and gold royalties have been among our best performers. Orogen Royalties was up 35% in 3Q and is now up 145% year-to-date, New Gold was up 48% in 3Q and is now up 127% year-to-date, and Osisko Mining was up 79% in 3Q and is now up 88% year-to-date. Victoria Gold was the one offset in this cluster. We are now paring our investments exposed to this theme.

Just as word processing software replaced the typewriter and fundamentally changed the way we create and share documents, software is replacing manpower-intensive physical processes with streamlined digital processes and fundamentally changing the way business gets done in many industries today. The old processes are expensive, inefficient, and prone to errors. The new software-enabled processes are cheaper, faster, and more accurate. We have found several compelling investment opportunities in this theme with wonderful unit economics, high value propositions for clients, and tremendous free cash flow characteristics. Our software cluster now represents the largest theme in the portfolio.

Our principle competitive advantage remains the same. Our broad investment mandate gives us an opportunity set of over 14,000 publicly-traded equities, which is orders of magnitude greater than our competitors. If we don’t like the mega-caps, for instance, we can invest elsewhere. That is exactly what we are doing today.

We work every day to gain and keep your trust. All the best to you and your families,