KP7

January 21, 2022
Letter #3

Dear Friends and Investors:

Equities today have bifurcated into two broad categories: those that receive persistent bids from so-called passive investment strategies and those forgotten securities that don't. We naturally favor the latter.

We value equities based on free cash flow, both current and potential. We struggle to place a value on Tesla anywhere close to its market capitalization whereas we easily place a conservative value on Champion Iron that is two or three times its market capitalization. Champion can sustainably generate free cash flow equal to no less than a third of its market capitalization each and every year for many, many years. That is the kind of value we like. Tesla is catching the bid in the market today. Champion is not.

The great dichotomy in valuations fortunately creates a host of investment opportunities, despite most broader market indices trading at close to historical highs. The mega-cap companies catching the passive investment bid are driving markets higher; opportunities still exist in the forgotten cast offs.

We suspect the distortions created by the billions of dollars that have moved into passive investments in recent years – like valuations for the largest companies getting richer and richer – will have the opposite effect when the passive investing craze slows or reverses. Our portfolio is positioned to benefit when that day arrives.

Our principle advantage remains the same. We structured KP7 to maximize the opportunity set. Our opportunity set consists of *fourteen thousand* publicly-traded global equities, compared with an opportunity set of about 130 for asset managers employing a U.S. large cap value strategy. That's not really fair, but it's the way we like it.

Inflation is running six to seven percent in the U.S., yet the U.S. Federal Reserve continues to stimulate the economy. We believe the Fed and other central banks around the world would have a completely different stance with respect to inflation and interest rates if we approached current inflation levels from the other direction. That is, if inflation had *declined* to 7% from higher levels rather than *increased* to 7% from lower levels, central bankers would not be stimulating economies and interest rates would not be close to zero. The apathy with which policy makers are viewing global inflation makes us believe rising prices might actually be with us for a while, perhaps years.

While we have about twenty percent of the portfolio invested to benefit directly from the deleterious effects of the explosion in central banks' balance sheets, we currently examine every one of our investments through a lens of persistently higher inflation in the years to come. We like companies with at least one of the following features in such an environment: built in and automatic price increases with no lag or delay, exposure to rising prices but not rising costs, revenues in a jurisdiction that is not debasing its currency, or cost advantages relative to competition that increase with inflation. The vast majority of our portfolio is invested in companies with at least one of those four characteristics.

KP7 started operations in July of last year. Our portfolio was up just 1.3% (after all fees and expenses) during the last six months of 2021 versus a total return of the S&P 500 of +11.7% (including dividends). Our twin performance goals are to beat the S&P 500 Index over rolling three year periods and to deliver net returns after all fees and expenses of 15-20% through multiple stock market cycles. We have our work cut out for us on both counts.

All the best to you and your families,