KP7

July 8, 2022
Letter #5

Dear Friends and Investors:

Our portfolio lost 28% in the second quarter versus a loss of 16% for the S&P 500. We are down 28% for the year versus a loss of 20% for the S&P 500.

We are embarrassed and frustrated with our dreadful performance so far this year. It was awful. We've been in this business long enough to know, however, that drawdowns of this nature are inevitable, especially with relatively concentrated portfolios. We ask for your patience. Please hang in there with us.

It is hard to miss the narrative about a pending global recession. We do our best to disregard such hype. Recessions are difficult to predict. The track records of even the best economists and macro-investors at predicting recessions are lousy. They fail to predict the big economic events. They predict recessions that never materialize. While we don't totally ignore the health of the economy in our investment operations, we also don't alter either our investment philosophy or our portfolio based on the tea leaves of the macro-economic prognosticators. That's just not what we do. We do our best to find long-term value that is not reflected in price. Our investment horizon is three to five years. Sometimes our investment horizon includes a recession. Sometimes it doesn't. We don't spend much time trying to differentiate the two.

While the fear of a pending global recession hasn't affected which stocks we own, it has affected the market prices of many of our holdings. That portion of our portfolio with exposure to industrial metals has been hardest hit. We have exposures to both copper and iron ore. Copper Mountain Mining and Champion Iron are both among our top five holdings; the former is down over fifty percent for the year and the latter is down over forty percent from its recent high.

After carefully reexamining our investment theses on these two companies, we have added materially to both. We like the long-term fundamentals of both iron and copper. Capable managers run the two companies, managers that know how to allocate capital and create value. Valuations based on free cash flow are compelling. We believe the balance sheets of the two companies will allow them to weather a lengthy recession if the global economy does in fact get worse. We think these two companies have wonderful days ahead of them despite their recent drag on the portfolio.

Elsewhere, Brazil's financial services industry is in the early stages of a digital transformation. Digital-first new entrants are taking share from the country's three big incumbent banks by offering unique financial services products over the internet. We now hold two of those disruptors.

The first is Nubank. With sixty million retail customers, Nubank is likely the world's largest digital bank. It now has scale, a super-low cost structure, and unit economics only Mark Zuckerberg could fully appreciate. We think value will migrate from the incumbents to the disruptor as Nubank grows and expands its platform. We added Nubank to the portfolio in the second quarter.

The second is StoneCo, a company that offers payment services, point-of-sale devices, and enterprise software to small and mid-sized merchants in Brazil. StoneCo provides what they call hyper-localized customer service to clients, a level of service that we believe differentiates the company. We added StoneCo to the portfolio late last year.

StoneCo has unfortunately contributed to our losses so far this year. Like our investments in the industrial metals, we reexamined the investment thesis early in the year and decided to add materially to the position. StoneCo is today our largest position.

At KP7, we believe in the alignment of interests. We look for alignment between us and our portfolio companies. We insist on alignment between us and our investors. I am the largest investor in the fund. My portfolio is invested exactly like yours. When I decide to add to a position like Champion Iron or Copper Mountain or StoneCo, I am investing my money right alongside yours. We wouldn't have it any other way.

I have also invested additional capital into my KP7 account this week. Valuations, after all, are more compelling today in most cases then they were six months ago. This might sound self-serving, but I would encourage you to follow suit. As difficult as it might sound, making incremental investments after a drawdown like this leads to better dollar-weighted returns than doing so after we have had a decent run. If you trust us and believe in our investment philosophy, now is the time to invest more capital. We are open for business.

We appreciate your patience and confidence now more than ever. All the best to you and your families,