January 16, 2023
Letter #8

Dear Investors:

One year ago, we pointed out the great bifurcation that was creating some distortions in the market. One group of stocks was receiving persistent bids from the so-called passive investment funds, bloating market capitalizations and driving their valuations ever higher. A second group of stocks was largely ignored as investors yanked capital from actively-managed funds in order to invest in those passive investment vehicles.

We noted at the time that the reallocation of capital from active funds to passive funds that created the distortions in the first place would likely have the opposite effect as the passive investment craze slowed or reversed.

We started seeing cracks in the facade of that first group in 2022. Tesla's stock price declined 68% for the year, Amazon was down 50%, Meta (aka Facebook) down 64%, Apple down 27%, Google down 39%, and Microsoft down 28%. All of these mega-cap companies declined far more then the S&P 500, which was down 18% for the year.

At some point, we will sift through the wreckage of that first group in search of good value, but not now. We suspect we have yet to see the point of maximum pessimism in U.S. equity markets. The point of maximum pessimism is our favorite entry point.

Champion Iron was our posterchild for the neglected second group a year ago. It was up 40% in 2022. In our letter last year, we noted how Champion could generate free cash flow equal to about a third of its market capitalization each and every year for years to come. We easily placed a value on Champion of several times its market capitalization. We still do despite a 40% increase in its market capitalization.

Valuation discipline saved us from the trillion-dollar meltdown of the mega caps in 2022. Yes, valuation matters. We take it seriously.

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Our portfolio consists of twenty to thirty investments exposed to a handful of long-term trends. We like to cluster investments around long-term trends because, if we are right about the long-term trend, the investment begins life subject to multi-year tailwinds.

One investment cluster in the portfolio today lies at the intersection of the green energy movement and the general disdain for natural resources that exists in the markets today. The world is in the midst of a global effort to reduce greenhouse-gas emissions on one hand and is totally neglecting the natural resources required to get there on the other.

As the green energy movement progresses, we believe constraints in the supply of some vital raw materials will begin to emerge. What we have seen in the lithium markets (prices up 6x in the last 24 months) is just the beginning.

We've seen these little pinch points develop in other rapidly-expanding value chains and have witnessed an enormous amount of value accrue to the pinch point owners. We have six stocks in the portfolio today, representing about 23% of the portfolio overall, that are positioned to benefit if and when these pinch points emerge. We call it our green industrial metals cluster.

Our green industrial metals cluster has exposure to copper (Copper Mountain Mining), iron ore (Champion Iron, Labrador Iron Ore Royalty Corp), tin, and graphite. Each are industrial metals vital to the green movement. Each could become supply-constrained pinch points as participants in the green energy movement all lurch in unison to implement their green-energy projects.

The portfolio also contains clusters of investments around our Brazilian financial technology thesis (three stocks representing about 20% of the portfolio) and around our precious metals thesis (four stocks representing about 30% of the portfolio). With the former, we like companies with compelling value propositions, large addressable markets, and low costs to acquire and serve customers. With the latter, our investments fall in two categories: low-cost producers with long runways of profitable expansion opportunities (Alamos Gold, Osisko Mining) and royalties on gold and silver mines (Orogen Royalties, Osisko Gold Royalties).

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The signature feature of our portfolio at the moment is not what it contains, but what it does not contain. We have very little direct exposure to the U.S. economy, to the U.S. consumer, or to the U.S. government. To be clear, we love the U.S. both as citizens and as a place to invest. We prefer to wait for a more attractive entry point, however, before we dedicate large amounts of capital to the United States. We are still concerned with the inflation situation in the U.S. as well as the levels of debt at the U.S. government. We also have a lingering concern with valuations in the U.S. equity markets in general: despite fairly major declines across most U.S. equity markets in 2022, valuations based on most metrics are still somewhat higher today than they were prior to the dot-com bust of 2000. The U.S. equity markets, in other words, are still not cheap.

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Last quarter was the best quarter in our brief history. KP7 was up 18.5% in the quarter, net of all fees and expenses. The S&P 500 (including dividends) was up 7.5%.

Our biggest winner for the quarter was Champion Iron (+ 54%). Our precious metals cluster also did well with Alamos Gold (our biggest position at the moment) up 37%, Orogen Gold Royalties up 28%, and Osisko Gold Royalties up 18%.

We had no major offsets to our winners during the quarter.

After that strong fourth quarter we were still -14.4% for the year (again, net of all fees and expenses) versus the index return for the year of -18.1% (including dividends).

Remember, our goal is to outperform the S&P 500 Index (including dividends for the index and after all fees and expenses for our fund) over rolling three-year periods. After 18 months of operation - halfway into our initial 3-year period - we trail the index by 464 basis points. We have our work cut out for us.

As always, we appreciate the confidence you have in us. We work every day to gain your trust. All the best to you and your families,