KP7

January 16, 2024
Letter #12

Dear Investors:

KP7 was up 9.1% in the fourth quarter of 2023. The S&P 500 was up 11.7%. For the year, KP7 was up 29.2% versus a return of 26.2% for the S&P 500.

As always, KP7 returns are net of all fees and expenses. The S&P 500 returns include dividends, which creates a higher hurdle.

The distinguishing feature of 2023 from an investing perspective was the performance of the broader equity indices. Not many believed at the outset of the year that the S&P 500 would deliver returns of 26%. The NASDAQ was up 44%. These are far in excess of both their long-term averages and the performances of the underlying businesses that make up the indices. The markets, in short, got more expensive in 2023.

Seven big mega caps drove the performance of the market. An index consisting of Apple, Microsoft, Meta, Google, NVIDIA, Amazon, and Tesla weighted in the same proportion that they represent in the S&P 500 would have been up 90% in 2023. An index of the other 493 stocks in the S&P 500 was down 2%. Since the S&P 500 is a capitalization-weighted index, the seven mega caps (that is, 1.4% of the members) now represent about 30% of the index.

Not all the mega caps had good years in terms of their underlying businesses. Apple, for instance, reported four consecutive quarters of declining revenues and still added nearly one trillion dollars to its market cap.

Given our positioning heading into the year with almost no direct exposure to the U.S. economy, a hefty allocation to precious metals, zero exposure to any of the mega caps, and a fair amount of cash at times, we feel fortunate to have kept up with the ripping equity markets in 2023. We didn't have one dime invested in any of the mega caps that drove the market.

The undeniable champions in our portfolio for the year were our investments in Brazil: XP was up 68% for the year, StoneCo was up 92%, and Nu Bank was up 108%. These digital disruptors in the Brazilian financial services industry offer digital financial services products mostly over the internet. Their cost structures are lower, their value propositions higher, their products more compelling, and their management teams more "owner-oriented" than those of the big bureaucratic incumbent banks with which they compete.

Recall that we identified Brazil several years ago as an opportunity-rich environment. As global inflation started picking up in 2021, we noticed the central bank in Brazil got a massive head start versus other countries implementing tough anti-inflation measures. While other countries twiddled their thumbs and ignored inflationary signals, Brazil was aggressively jacking up its policy interest rate. By early 2022, Brazil was the only country of size in the world with positive real short-term rates. That is, inflation was higher than nominal interest rates in nearly every country on the planet, except for Brazil.

We figured that macroeconomic backdrop gave Brazil two advantages from the standpoint of a foreign investor like KP7.

First, an island of positive real rates in a world otherwise engulfed in negative rates would attract capital to that island. Capital tends to migrate from low returns to high returns. With high real returns relative to the rest of the world, we figured Brazil would attract capital. When a country like Brazil receives capital, its currency tends to appreciate as capital allocators sell foreign currency and buy local currency.

Remember, when KP7 invests outside of the United States, our Unites States Dollar (USD) returns depend not only on the performance of the investment in its local economy, but also on the movement of the currency exchange rate during the investment period. A strengthening local currency relative to the USD during the investment period adds to the local return of the investment. A weakening local currency during the investment period detracts from the local returns of the investment.

When we scan the world for investment ideas, we look for situations with attractive local investments in countries whose currency is likely to appreciate relative to the USD during the time of investment. If we are right, our USD returns get a double boost: one from the investment appreciating in its local economy and another from the strengthening of the local currency relative to the USD.

Second, we figured that Brazil's early and aggressive attack on inflation would put Brazil in a position to begin lowering interest rates before the thumb twiddlers. Declining interest rates stimulate many sectors of a local economy. We suspected that if Brazil's early attack on inflation was successful, the stimulus from a declining interest rate would not only benefit our companies in the local economy, but would also help strengthen the Real. Another double boost.

Our investment thesis for Brazil turned out to be correct. The Real was one of the few currencies globally (perhaps the only) that strengthened versus the USD in both 2022 and 2023. Brazil's central bank began lowering rates late in the summer of 2023, at least six and probably twelve to eighteen months before other countries will be in a position to do so. With Brazilian inflation trending down, the central bank has been able to reduce rates and still maintain healthy positive real interest rates. KP7 and its investors benefited from the double boost. XP, StoneCo, and Nu Holdings have been competing and winning in the local Brazilian economy. The Real has strengthened versus the USD.

Let us step back and indulge ourselves here for a moment. The double boost our investors received in Brazil in 2023 was neither an accident nor was it luck. It was part of our investment thesis when we initiated the trade. We saw it coming. Not always do events unfold according to plan. This time they did.

Our successful investments in Brazil represent our multi-disciplinary approach to investing in action. Our research process involves both top-down macroeconomic work and bottom-up company-specific work. Typically, we use the former to identify areas with high-concentrations of great investments. We use the latter to find compelling investments within those areas. Our top-down work led us to Brazil in 2022. Our bottom-up work within Brazil led us to StoneCo, XP, and Nu Bank.

We think our multidisciplinary approach is a gamechanger that our investors will benefit from for years to come. Many asset managers, perhaps most, ignore huge swaths of data and information in making investment decisions. Macro investors ignore the fundamentals. Value investors ignore the macro. Growth investors ignore the value. That baffles us. Why would a performance-oriented asset manager ignore key pieces of information that have material effects on stock performance? We look at it all.

One other winner of note in the portfolio in 2023 was Palantir (+180%). Wow. We really like this company. Palantir sells software that integrates data from disparate sources so people can make better decisions. The world is being flooded with data at the moment, far too much for anyone to effectively organize, especially when time is short and decisions are time-sensitive. Palantir software helps organize data in real time and present it in a way that facilitates effective decision-making. That might sound like hog wash, but we believe the software works. The software has both military and commercial applications.

We made Palantir one of our largest positions as its stock slid to all-time lows late in 2022. We started trimming last summer as the artificial intelligence wave dominating the market at the time created some valuation fluff in the stock. We sold out entirely in December.

We don’t believe we have seen the last of Palantir in our portfolio. We’ve done the work. We know the management team. We love the business model. Don’t be surprised if it reemerges in the portfolio a time or two down the road. Valuation is the key thing we are monitoring.

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KP7 delivered 29% returns for our clients in 2023 with almost no taxable gains. Some investors received short-term capital losses and others very minor long-term capital gains, depending on the timing of their investment with KP7.

We have a philosophy with respect to taxes. We do our best to push the recognition of capital gains off for as long as possible, but we will never keep an over-valued stock in the portfolio solely for tax purposes. We've tried that a time or two and it didn't end well. We sell over-valued stocks as soon as we determine they are over-valued, regardless of the tax consequences. We didn't expect Palantir to increase 180% last year, but when it did and we became concerned with valuation, we sold it despite generating short-term taxable capital gains. In the case of Palantir in 2023, the gains were offset with recognized losses, but the existence of losses had no bearing on our decision to sell Palantir.

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KP7 is now GIPS compliant and GIPS verified. The CFA Institute developed the Global Investment Performance Standards (GIPS) in 1987 to create ethical industrywide standards for asset managers to calculate and report performance. Prior to GIPS, the industry had no standard. Asset managers calculated and reported investment performance however they thought appropriate. Some took advantage of the lack of standards.

The Beardstown Ladies was an investment club that generated returns of 23% compounded annually over 12 years in the 1980s and 1990s. The S&P 500 compounded at 15% over the same period. Members were mostly grandmothers. They met weekly in the basement of their church in Beardstown, Illinois. This investment group of little old ladies from the Midwest so trounced the market and so thoroughly outperformed sophisticated professionals that it became a national story. The morning shows interviewed them. The afternoon talk shows had them as guests. They wrote books about their stock selection process, which included cookie recipes sprinkled across the pages.

The problem with the Beardstown Ladies was they weren't calculating their performance properly. That sad disclosure came out years after their books were sold and their investment record became memorialized. Members of the club made monthly contributions to the investment pool the club managed. In calculating returns, the ladies included those contributions as investment returns. Oops. Treating contributions as contributions rather than investment returns reduced their investment track record from 23% to just 9%, again versus the S&P 500 of 15%. At the time the error was discovered, *The Motley Fool* claimed a monkey throwing darts would have had a better return.

Let's give the Beardstown Ladies the benefit of the doubt and say they were clueless, not malicious. Bernie Madoff was the opposite. He was malicious, not clueless. People trusted and respected him, yet he succumbed to the temptation to deceive. He's the extreme example, but he's hardly alone. Asset managers have been deceiving clients about performance for centuries. Not all asset managers deceive, but many of them do. Trust us. We've been in the business for decades. We see it practically every day.

If an asset manager claims "GIPS compliance", it means it is following the GIPS standards set by the CFA Institute when it calculates and reports performance. When a firm becomes "GIPS verified" it means the asset manager has hired a third-party independent company to review its books, records, and history of performance reporting to verify the asset manager is in fact following GIPS. KP7 is both GIPS compliant and GIPS verified. That means we have had a third-party examine our books and records to verify that we are following GIPS in our performance reporting.

Surprisingly, GIPS compliance and GIPS verification are still voluntary for asset managers. No one asked us to be GIPS verified. We just did it. If roles were reversed and you managed our money, we would expect no less.

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Positioning heading into 2024 is largely the same as a year ago. Our largest single position by far is a software and payments company that facilitates cross-border ecommerce in emerging economies. dLocal's software is massively underpriced relative to its value proposition. Its management team is one of the best we've seen for some time and the incremental unit economics of growth are attractive. We like its valuation too. dLocal is a little gem with massive potential.

We added three investments during the year. Vermillion Energy is a global oil and gas company. We estimate it will generate more than 30% of its market cap in free cash flow in 2024. This is our first foray into the oil and gas industry after having gotten smoked in the sector from 2014 to 2020. Green Dot is a white label debit card provider that is creating a full-service online banking platform. We've seen the wonderful things online banking can do through our work on Nu Holdings (Brazil). We like the management team and think the business model makes sense. Tecsys Inc provides software to hospitals and other organizations that helps organize procurement. Tecsys has an outsized value proposition, a sticky product once implemented, and an underappreciated opportunity to grow margins. As of the time of this writing, Vermillion, Green Dot, and Tecsys each represented about 4% of the portfolio.

Lastly, we still have a large allocation to precious metals. Gold is the largest single exposure (across multiple positions) in the portfolio. We love the set up for gold at the moment. We believe the downside risk is low and the ceiling high. We own gold developers, gold miners, and gold royalty companies.

We suspect the funding of the U.S. government will increasingly be an issue in the coming 12 to 24 months, yet the deficit and spending programs continue to reproduce like rabbits. We think the U.S. government is in a dangerous and unsustainable place with its debt.

Meanwhile, the sentiment among Western investors is that inflation is contained and the Fed is nearing the end of its credit-tightening cycle. We have a different view. We're not sure what the Fed will end up doing (we don't play that game), but we are pretty sure inflation will be with us for a while. Inflation is a funny thing. It comes in fits and starts depending on what else is going on in the economy. U.S. inflation is in a temporary lull at the moment. We don't believe the Fed can increase the size of its balance sheet 7x (as it has done since the Global Financial Crisis, even after shrinking it recently) and get away with ten percent inflation for a few months. The ramifications of pumping so much money into the system will be far greater, in our view.

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

Sincerely,