KP7

July 24, 2024
Letter #14

Dear Investors:

KP7 was down 8.0% in the second quarter of 2024 after all fees and expenses. The S&P 500 was up 4.3%, including dividends. For the year, KP7 is down 3.6%; the S&P 500 is up 15.3%.

We had a lousy second quarter. There is no other way to describe it. Two stocks in particular created our dreadful results: dLocal (DLO) declined 45% in the quarter and Victoria Gold declined 84%. Ouch.

Of the two, Victoria Gold was the most painful. Victoria Gold suffered a breach in a heap leach pad dam that served its mine in the Yukon. We don't know the extent of the damage (economically or environmentally), but we do know substantial damage occurred and the mine was shut down. We suspect significant capital and a great deal of time will be required to get the mine back up and running. We believe the break in the dam, in other words, created a permanent loss of substantial value. We sold our position in the company on the day the news broke. Our investment in Victoria Gold cost our portfolios about 3 points of performance relative to our purchase price.

DLO is a different story in the sense that we do not believe the decline in DLO's price in the quarter reflects a reduction in the underlying value of the company. Our investment thesis, in fact, has only gotten stronger. We added materially to our position in DLO during the quarter as its stock price plummeted. It is now the largest position in the portfolio by far.

DLO provides payment solutions in emerging markets for international merchants. Paying for online goods and services in emerging markets can sometimes be tricky. Turning a customer with an intent to buy into an actual purchaser of the product frequently fails because of either extremely limited payment options or glitches in the payment infrastructure. We believe DLO has the best emerging market payment platform in the industry. Its value proposition for international merchants wanting to sell goods and services into emerging markets is a simple one: its platform increases the conversion rate from a potential purchaser with an intent to buy to an actual purchaser. In some emerging markets, conversion rates increase from 50% to 80% with the use of the DLO payments platform. That is a huge tangible value proposition.

DLO has virtually no competition, its CEO (Pedro Arnt) is one of the most talented managers we've seen in many years, and it has cash on its balance sheet equal to 30% of its market capitalization with no debt. We see little downside and a large upside. It is trading today for a fraction of our estimate of long-term value. We suspect DLO will be a core holding in our portfolio for years to come.

Our gold thesis is beginning to play out. Our bullish thesis on gold is as follows. The U.S. Federal Reserve has increased the size of its balance sheet 7-fold since the Global Financial Crisis. Every dollar of increase in the Fed's balance sheet is a dollar of liquidity injected into the U.S. economy. Injecting more and more USDs into the U.S. economy reduces the value of the USD. A lower USD value will cause the holders of USDs to reallocate a portion of their wealth away from USDs and towards assets that more effectively retain their value. A portion of that reallocation, we believe, will be directed to gold. The gold market is infinitesimal compared to the size of the market for USDs, so any reallocation will have an outsized effect on the price of gold. That is our thesis.

We believe our thesis is beginning to play out because we see a reallocation beginning to take place in Asia. Asian central banks have been very large buyers of gold. Many of them, including China, are reducing their holdings of U.S. Treasuries and increasing their position in gold. We think that reallocation is largely responsible for the 17% rise in the price of gold in the first half of the year.

We believe we are in the early innings of the reallocation. Investors in the U.S. and Canada and most investors in Europe have either no allocation to gold in their portfolios or very tiny allocations. If our thesis plays out, the awareness of a devalued USD will begin to spread among Western investors. They will begin to reallocate wealth. Gold will get a portion of that reallocation.

Our gold holdings have been our biggest winners so far this year. Wesdome Gold was up 43% in the first half of the year, New Gold was up 54%, and Orogen Royalties (royalties on gold and silver mines) was up 82%. We are pleased that our gold equities, with the notable exception of Victoria Gold, have outperformed the price of gold.

The S&P 500 keeps surging forward. The six largest companies by market capitalization (not including Tesla) generated 113% of the returns in the S&P 500 in the second quarter. Nvidia by itself generated 43% of the second quarter gain and Apple accounted for another 31%. Nearly 75% of the gains in the S&P 500 in the second quarter, in other words, came from just two stocks.

Last year was a similar story with the mega-cap stocks driving more than 100% of the 26% gain in the index. We managed to deliver 29% gains after fees due largely to our investments in Brazil. So far in 2024, however, we are struggling to keep up with the surging S&P 500. Not owning the mega-cap stocks has cost us dearly on a relative basis while the decline in DLO (which we think is temporary) and Victoria Gold (which unfortunately is permanent) has affected our relative and absolute performance.

Hang in there with us. Our portfolio has very little overlap with the S&P 500. When the S&P 500 surges and we have a setback or two, we are bound to underperform for certain stretches of time. We are just as likely to surge when the S&P 500 has setbacks. Over time, we believe our combination of fundamental, environmental, and tactical research will generate returns in excess to the S&P 500. That is our long-term goal.

All the best to you and your families,