KP7

October 10, 2022
Letter #7

Dear Investors:

Our portfolio was up 0.7% in the third quarter of 2022. The S&P 500 declined 4.9% (including dividends) over the same period. After our dreadful second quarter, that brings us to -27.7% for the year versus -23.9% for the S&P 500.

One thing I'll highlight here is the inevitability of large drawdowns in all great investment track records. KP7 is in the midst of one.

Warren Buffett, Charlie Munger, and John Maynard Keynes are among the great investors of all time. Each put fantastic records together. Each had large and substantial drawdowns on more than one occasion.

Buffett's Berkshire Hathaway has compounded at 20% annually for 56 years, versus a 10% annual compound for the S&P 500 over the same period. He had drawdowns of 20% or more on four separate occasions, including a decline of nearly 50% in 1974. He underperformed the S&P 500 by 40.9 percentage points in 1999: the market was up 21.0% that year while Berkshire declined 19.9%.

Munger compounded his partnership 19.8% annually from 1962 through 1975 versus the S&P 500's annual compound of 5.2% over the same period. Munger's fund declined over 30 percent in two of those fourteen years and underperformed the market by 17.6 percentage points in 1973.

For the record, I'm not a big fan of the economic policies of Keynes. He was, however, a remarkable investor. He compounded his fund 13.2% annually from 1928 through 1945. The market in the United Kingdom compounded at -0.5% over the same period. That seventeen-year run contained three drawdowns of 25% or more and a fourth year where the fund declined 15%. In 1938, his fund lost 40% of its value and underperformed the market by 24 percentage points.

The point here is simple: great investors suffer drawdowns, some of them prolonged and many of them substantial. To be clear, I'm not comparing KP7 with these great investors. I'd be thrilled if we put together a record anywhere close to the ones just described. I'm just pointing out that drawdowns happen. They happen routinely. They happen to the best.

We believe a concentrated portfolio is the best way to generate good long-term returns. Drawdowns come with the territory.

Our two winners for the second quarter included Stone (+24%) and Nu Holdings (+18%), two companies we highlighted in Letter #5. Stone is a merchant acquirer in Brazil. Merchant acquirers offer software, point-of-sale hardware, and processing that enable merchants to accept credit cards in exchange for goods and services. Brazil is still largely a cash-based economy, but credit card transactions are gaining share as more and more citizens obtain cards and more and more merchants accept them. We expect Stone to benefit as credit cards continue to penetrate Brazilian commerce.

Stone's market share is about 11%. That is, about 11% of credit card purchases in Brazil by value run through the Stone system. That is up from essentially zero in 2016. Stone targets small to medium merchants with affordable products and personal high-touch service. Market share gains for Stone have come largely at the expense of three big incumbents, which we believe have largely ignored the small-to-medium merchant segment. We believe Stone has a better product and offers better customer service than the incumbents, which still have a combined market share of 65%. Stone will benefit, in our view, from continued market share gains relative to the three incumbents.

Nu Holdings is likely the largest online bank in the world. It now has 70 million accounts, up from 60 million when we highlighted it in Letter #5 and up from essentially zero in 2016. Most of Nu Holdings' accounts are in Brazil. Nu Holdings is entirely online with no branches and no bricks-and-mortar locations. We believe Nu Holdings' cost to acquire and serve customers is about one tenth that of the big traditional Brazilian banks. We believe the scale of Nu Holding's platform, its 70 million existing customers, and its low-cost-to-serve business model combine to give it an enormous advantage, not just with respect to the incumbent banks but also with respect to other online banks. The costs required to add incremental customers and incremental products to its platform are tiny compared with the competition.

Financial institutions in Brazil are big and bureaucratic while the per capita income for most Brazilians is quite low. The incumbent financial institutions, as a result, cannot profitably serve much of the Brazilian population: their cost structures are too high and revenue per customer too low. Many millions of Brazilians simply do without financial services for the simple reason that they are not profitable to serve under the traditional structure of Brazil's financial services industry.

We believe that dynamic is changing. The growth of the internet and availability of smart phones and other smart devices have combined to enable companies like Stone and Nu

Holdings to enter the market with products and services specifically designed for low revenue-per-customer clients. The cost structures of the disruptors allow them to serve those customers profitably. The incumbents, importantly, have been slow to respond to the disruption.

We now have about 20% of the portfolio exposed to Brazil. That number will likely grow; we are actively looking for other Brazilian companies that meet our investment criteria. As a reminder, in addition to liking the company-specific fundamentals of Stone and Nu Holdings, we also like the macro-economic backdrop of Brazil, as we described in *Three Things We Like About Brazil.*

We made no major changes to the portfolio in the second quarter.

All the best to you and your families,