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January 26th, 2018

KIG Investment Partnership, L.P. 2017 Letter

<u>Trailing returns</u>	<u>KIG Investment Partnership, L.P.</u>
One year	27.7%
Two years	22.0%
Three years	1.4%
Four years	46.2%
Since inception (February 1 st , 2013)	119.3%
Annualized since inception	17.3%

The figures above are net of all costs and fees under the founding partners' terms and 2017 figures are yet to be audited.

This year I sold our entire holdings in two businesses we held since 2013 that together represented about 16% of our total assets when we first bought them. One of them I sold after it reached an irrationally high valuation. The other one after I reached the conclusion that the prospects of the business were not anywhere as attractive as the other businesses in our portfolio. In both cases, the returns were very rewarding. I reinvested this capital into a couple of our existing companies, so our portfolio remains close to being fully invested with 70% of our assets in our five largest holdings.

This year I have not found any unforced errors worth reporting. This is not to say that there were not any. Only time will tell. There was certainly one mistake of omission that was extremely costly. This, however, I keep to myself as I look forward to the day that I will get another chance at buying it.

In Search of The Hidden Talent

“What are you doing that your competitors aren't doing yet?” was one of Phillip Fisher's favorite questions to ask prospective companies¹. I recently came across a similar, updated version of this question in an interview lead by Y Combinator²: “What do you understand about your business that other companies in it just don't get?” These are excellent questions that also play an essential role in KIG. They attempt to uncover a differentiated focus and a hidden talent.

¹ Phillip Fisher was an influential investor, active for more than fifty years during the last century. He authored a number of books including *Common Stocks and Uncommon Returns* and according to himself started his business in “growth stocks” before the term “growth stock” was thought of. The other great question Phillip Fisher asked prospective companies was “If you had one silver bullet to shoot a competitor, which competitor would you shoot?”

² Y Combinator is considered by some people as one of the world's most powerful start-up incubators. It was founded in 2005 by Paul Graham, Jessica Livingston, Trevor Blackwell and Robert Tappan Morris.

What you are about to read is a description of the ongoing journey I am traveling to internalize these concepts, a journey that I feel is just starting. But before we go any further, please read the following quotes from two legendary businessmen. They will help us set the right tone for our own little trip.

“Pouring espresso is an art, one that requires the barista to care about the quality of the beverage. If the barista only goes through the motions, if he or she does not care and produces an inferior espresso that is too weak or too bitter, then Starbucks has lost the essence of what we set out to do 40 years ago: inspire the human spirit. I realize this is a lofty mission for a cup of coffee, but this is what merchants do. We take the ordinary –a shoe, a knife– and give it new life, believing that what we create has the potential to touch others’ lives because it touched ours.”

– Onward by Howard Schultz and Joanne Gordon

“Lab managers face a real challenge in dealing with the enthusiastic inventor who presents a very creative and innovative idea –an idea that after careful and objective analysis by others is turned down. How do managers provide encouragement and help the inventor retain enthusiasm in the face of such disappointment?”

Many HP managers over the years have expressed admiration for the way Bill Hewlett handled these situations. One manager has called it Bill’s ‘hat-wearing process’. Upon first being approached by the inventor with unbridled enthusiasm for a new idea, Bill immediately put on a hat called ‘enthusiasm’. He would listen, express excitement where appropriate and appreciation in general, while asking a few rather gentle and not too pointed questions. A few days later, he would get back to the inventor wearing a hat called ‘inquisition’. This was the time for very pointed questions, a thorough probing of the idea, lots of give-and-take. Without a final decision, the session was adjourned. Shortly thereafter, Bill would put on his ‘decision’ hat and meet once again with the inventor. With appropriate logic and sensitivity, judgment was rendered and a decision made about the idea. This process provided the inventor with a sense of satisfaction, even when the decision went against the project –a vitally important outcome for engendering continued enthusiasm and creativity.”

– The HP Way by David Packard

A couple of years ago I wrote in KIG’s annual letter about the importance of looking into inputs rather than outputs. Whether assessing the quality of a business or other realities of life, it is always tempting to reach quick conclusions by only looking at results. Please do not misunderstand me; I believe results often provide valuable information, especially when the sample is large enough. The problem is that without a deep understanding of what is causing these results, how do we know if a change in circumstances should warrant a change of mind? Rules of thumb are great for making quick decisions in cases where the worst that could actually happen is wasting too much time in the decision-making process – i.e. shall I wear my white or blue shirt? On the other hand, they are extremely dangerous when dealing with decisions that might have a significant impact in our lives. In these instances, we are way better off learning more about the variables in consideration.

One of the reasons we often ignore inputs is that going deeper requires an extra effort. For instance, most people think that the quality of the ingredients are key inputs to a great meal. Chef Dan

Barber certainly believes so. However, Mr. Barber takes this idea a few steps further by focusing on the processes behind the ingredients. He does this by owning a farm and implementing sustainable practices. For instance, he pays special attention to how his land and soil is treated over the years and raises calves by exclusively feeding them cow milk –both expensive and rare practices. The results are vegetables and meat with an incredible taste that essentially can't be found anywhere else. This helped Mr. Barber's Blue Hill at Stone Barns earn numerous awards and be ranked by critics among the very best restaurants in the world. Mr. Barber's arduous approach and exceptional result show us the value of digging deeper.

About seven years ago a wise man sent me a great gift, a book called *Zen and The Art of Motorcycle Maintenance* written by Robert Pirsig. In this book Mr. Pirsig explores his philosophy through a number of conversations and thoughts during a motorcycle trip. The following is one of his many wonderful insights:

“Peace of mind isn't at all superficial, really,” I expound. ‘It's the whole thing. That which produces it is good maintenance; that which disturbs it is poor maintenance. What we call workability of the machine is just an objectification of this peace of mind. The ultimate test's always your own serenity. If you don't have this when you start and maintain it while you're working you're likely to build your personal problems right into the machine itself.’”

Peace of mind, our own serenity, might very well be the deepest we can go –the ultimate input. In fact, Mr. Pirsig states that is much more than that. *“It's the whole thing. That which produces it is good maintenance; that which disturbs it is poor maintenance”*, implies that peace of mind is not only the input but also the goal. This insight feels so right, so powerful. But what produces peace of mind? How do I take this into practice? And does this mean we want an enlightened monk to run our companies? Of course not; even if a CEO is extremely enlightened she or he is not necessarily fit to run all types of businesses. Know-how is also critical. Like two smart investors who work together recently told me: *“A CEO might say all the right things and be great in so many ways, but we always ask ourselves, will she or he catch the ball?”*

Early 2017 I was fortunate to receive an invitation from a friend to spend an entire day with a particularly accomplished and insightful CEO who walked us through his privately-owned company and shared with us his business philosophy. He believes companies should aim for sustainable growth and argues they can only achieve this by engaging with all of their constituents in win-win relationships. Win-win relationships with employees, win-win relationships with suppliers, win-win relationships with customers, win-win relationships with community members, and win-win relationships with shareholders. If everybody is winning, there is a very good chance growth will continue. If any party in this ecosystem is consistently losing, sooner or later growth will stop. We spent the entire day discussing the details entailed in each of these win-win relationships. For instance, the best way to have a win-win relationship with employees is to create a special culture with *“an environment so rich in trust, reciprocation and abundant incentives, it encourages employees to go ‘all-in’ –thinking like owners, putting forth optimal energy, productivity, cooperation, ingenuity, etc.”* Our guide backed his ideas using valuable lessons learned over decades of successfully running his own business, studying multiple disciplines, and reading about the life and work of great leaders from a variety of competitive fields including business, military, sports and the arts. Needless to say, we had a fabulous time and left with a lot of food for thought.

Ever since our meeting I have been examining these leaders –in fact, he pointed to enough new material to keep me busy for quite some time. They seem to have a few things in common including their relentless focus on both people’s character and the fundamentals of their activity. One of them, football coach Pete Carroll, is a huge fan of Timothy Gallwey’s *The Inner Game of Tennis*, a little book that aims to help us reach our peak performance by mastering the art of playing with a “quiet mind”. The book is so insightful it has transcended into other sports –i.e. into professional football– and other disciplines.

Mr. Gallwey’s message is simple, and quite liberating I should add. He explains that in order to reach our peak performance, once we know the fundamentals, we need to trust ourselves and act instinctively. As long as we are fully focused on the task at hand and do not judge ourselves when we make a mistake (we must acknowledge the mistake in order to do better but should avoid judging ourselves) our mind and body will naturally adjust to perform at our peak. In other words, we must let go and stop pretending we control things we do not actually control –a much humbler and realistic approach. How does he suggest we do this? Instead of focusing on complex techniques that need to take place in fractions of a second –which of course makes thinking about them an extremely counterproductive effort– we should focus entirely on the one and only thing we actually control: watching the ball³. To be precise, he suggests we note the exact pattern made by the seams of the ball as it spins.

By focusing on the pattern made by the seams of the ball as it spins from the moment our opponent hits it, our mind improves at processing the ball’s trajectory. This processed information is then used by our body which adapts intuitively to the challenge. I have been playing tennis for thirty years at a reasonably good level and have never heard anyone articulate the challenge this way. While everyone works on the mental aspect of the game and/or the technical aspect of the game, Mr. Gallwey focuses on the specific action that connects these two. How well we focus on the ball is the output of our inner peace. At the same time, watching the ball is the very first action that is specific to the activity. Watching the ball is, therefore, the cornerstone skill. Great footwork, great strokes and great shot selection –in other words, great tennis– is only possible to the extent we become great at watching the ball.

Watching the ball does not receive the immense credit it deserves because the task is extremely simple –which does not mean easy⁴– and therefore is hard to believe it can have such a significant impact on one’s performance. It also does not help that watching the ball to the best of one’s ability requires us to surrender and let go all efforts to judge or modify the situation at hand –something with which most of us struggle. Only by letting go we allow our mind to get better and better at processing the input from watching the ball. Only by letting go we give ourselves an opportunity for a peak experience⁵. It is important to note that processing this input is not a conscious effort on our part. The only conscious

³ This is when the ball is in play. When it is not, he suggests we focus on our breathing.

⁴ Mr. Gallwey wrote, “*It’s easy to see the ball, but not so easy to notice the exact pattern made by its seams as it spins.*”

⁵ Mr. Gallwey wrote, “*We have arrived to a key point, it is the constant ‘thinking’ activity of Self 1, the ego-mind, which causes interference with the natural capabilities of Self 2. Harmony between the two selves exists when this mind is quiet and focused. Only then can peak experience be reached. When a tennis player is ‘in the zone’, he is not thinking about how, when or even where to hit the ball. He is not trying to hit the ball, and after the shot he doesn’t think about how badly or how well he made contact. The ball seems to get hit through a process that does not require thought. There might be an awareness of the sight, sound and feel of the ball, and even of the tactical situation, but the player just seems to know without thinking what to do.*”

Coach Pete Carroll regularly asks his players: “*Do you realize that every time you take the field you have an opportunity for a peak experience?*”

effort on our part is focusing on watching the ball. Processing the information is an invisible ability that happens subconsciously, without our full awareness. We might be able to help trigger it but, other than that, it is out of our control. Could this be the hidden talent?

“What do you think is the hidden talent in what we do? What is the hidden talent in business? What should we be constantly focusing on?” asked my friend who earlier in the year invited me to spend a day with the insightful CEO. We quickly started going back and forth trying to find the best answer. *“We should always focus on the customer’s needs, how they evolve,”* we both agreed.

I later realized my friend and I were missing something. Focusing on the customer’s needs and how they evolve is the cornerstone skill. It is the first action that is specific to the activity; it is the action that we must pursue relentlessly. The hidden talent, I believe, is our ability to use the information we gather –our instinct to get businesses and people. Those who are privileged and shrewd enough to get it – like Howard Schultz and his baristas or Bill Hewlett and his inventors– will always be a step or two ahead. This is the invisible talent that we might be able to trigger but happens subconsciously, out of our control.

A few months ago, I was watching my eight-year-old son hit a tennis ball –something he does remarkably well and loves doing every single day, often for hours at a time. I thought to myself, *“I like tennis, but I do not remember ever enjoying it as much as he does. He seems to have a special connection with the ball, one that is somewhat of a mystery to me. He looks so into it, so natural.”* Then, the obvious hit me. Exercising our cornerstone skill, triggering our hidden talent, is good maintenance. It produces peace of mind.

How Many Do You Think There Are?

“How many exceptional companies do you think there are?”, asked one of KIG’s most sophisticated limited partners. If we define exceptional companies as those with an unregulated monopoly or an extraordinary operator, I think we are talking about a very small fraction of existing companies in the world. Still, it is probably a number many multiples larger than eight or nine –the typical number of holdings in KIG’s portfolio.

If the question would have been, *“how many exceptional companies do you think there are that allow you to reach a very high degree of conviction?”*, then the number is significantly smaller. To begin with, there are some companies that might be exceptional that I do not understand because their activities are outside my circle of competence. Second, although I go through hundreds of annual reports each year, it is impossible for me to learn about every single exceptional company. Third and last, there are companies that are exceptional and that I also understand but, for some reason or another, it is too hard to foresee what their businesses will look like in ten years.

Following the same train of thought, if the question would have been *“how many exceptional companies do you think there are that allow you to reach a very high degree of conviction and are not anywhere close to being recognized by the market as exceptional?”*, then again, the number is significantly smaller than the one I would use to answer the previous question. As manic-depressive as Mr. Market is, he does a reasonable job at valuing businesses. Fortunately, there are exceptions. For

instance, every once in a while, a company with an unprecedented way of doing business –with a differentiated focus, a hidden talent– comes along and raises the bar to a whole new level. As one of our CEOs likes to say, “*we spend our time doing what everybody else is unwilling or unable to do.*” And because the company reinvests a large percentage of its annual earnings to capture a larger share of its addressable market, it tends to report earnings well below its normalized levels for a good number of years. As a result, the company flies under almost everyone’s radar until it is too late for competition to do anything about it or for new investors to earn the high returns that early investors already captured.

Finally, if the question would have been “*how many exceptional companies do you think there are that allow you to reach a very high degree of conviction, are not anywhere close to being recognized by the market as exceptional, and can grow at high rates for many, many years?*”, then the number is probably quite small –a number that even my three-year-old son might be able to count up to. Take time to think about how many companies you know that ten years from now are likely to still grow at about 15% per year? I don’t know many. Not to mention that they must also fulfill the previously mentioned and indispensable conditions. If you happen to know of any company that might fit these criteria please let me know!

Final Remarks

The fund remained closed throughout the year and will remain so until further notice.

In the second half of this year I changed our prime broker and custodian to Interactive Brokers. This is the second time in only a handful of years that I had to do this after our previous prime broker raised prices due to lack of activity in our account. In both cases I warned them repeatedly before starting the relationship that KIG is not a customer that will generate much income because I do not short, do not use leverage, and have minimal turnover. Anyways, Interactive Brokers offers everything we need, both in terms of service and safety, at the right price. Equally important, they have experience working with customers that generate a relatively low amount of business so I am looking forward to a long stay at our new home.

Exceptional companies that are not recognized as such by the market, have a business that is highly predictable, and enjoy a long runway to grow, are extremely valuable. These rare opportunities exist because the vast majority of capital in the market is not capable of focusing ten years down the road. I am very grateful for partners that allow me to be bold and patient. Thank you for your exceptional capital and continuous support. They make a tremendous difference.

Sincerely,

Matias Sacerdote