KMF INVESTMENTS

"A PURE PAY-FOR-PERFORMANCE PRIVATE INVESTMENT PARTNERSHIP"

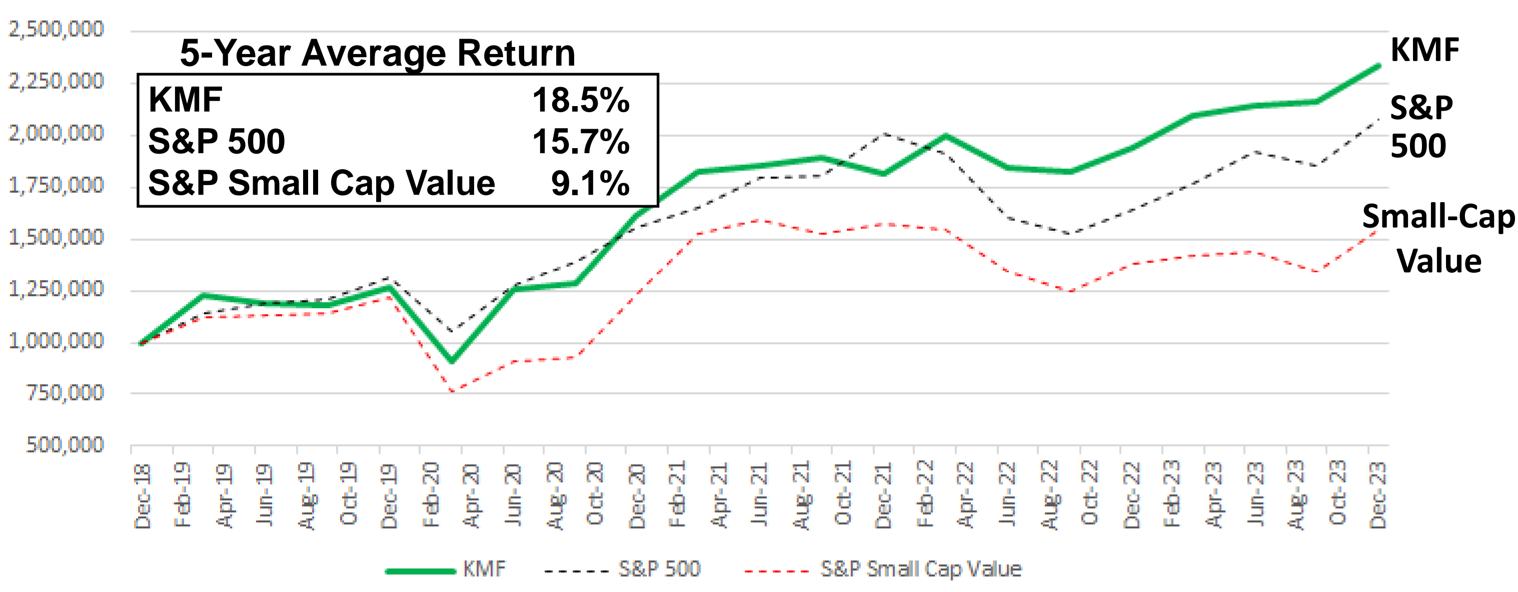
2023 Annual Partner Letter

Arvind and Jonathon are beginning their 17th year as business partners, their 25th year as friends and colleagues.

This "business marriage" was formed during late hours as strategy consultants at Accenture, was tested as new fund managers by the 2008-09 Financial Crisis, and was strengthened by the personal pain of loss and recovery during COVID.

The best investment partnerships in the world are co-led by two partners, supported by like-minded investors. We are humbled by your trust, thankful for your friendships, and look forward with gratitude to the multi-decade runway KMF Investments has to grow our Partners' wealth.

5-Year Returns



KMF returns net of performance fees. S&P 500 index returns includes reinvested dividends. S&P 600 Small Cap Value index represented by the SLYV ETF

$1 Million grows to more than $2.3 Million

The last five years spanned a frothy pre-Covid period, a pandemic panic, the meme-stock mania, the worst inflation in 50 years, bonds and stocks crashing at the same time, and an "artificial intelligence" hype cycle.

Through it all, KMF grew our Partners' wealth ahead of the S&P 500 and the S&P 600 small-cap value indices.

$1 million invested with KMF at the end 2018 compounded more than 18% a year, growing to more than $2.3 million by the end of 2023.

Infinite Games

While most value managers pay homage to Benjamin Graham and Warren Buffett, Charlie Munger also deserves much respect.

His essays on the impact of human biases on business, politics and personal affairs should be required readings for all undergraduates. Buffett used to call Munger the "Abominable 'No' Man" since he killed so many deals based on clear flaws in logic others failed to see.

There are many lessons to glean from Mungers wisdom over the years. One of the most impactful for Arvind and Jonathon is the moral duty we have as fiduciaries and advisors.

The financial industry is rife with folks who do little and charge a lot. We believe our pure pay-for-performance culture stands in contrasts to the typical advisor business model. This extends to the investments we make.

There are many traders and financiers who look for win-lose opportunities. There are some investment bankers known as "great vampire squids" who "rip the face" off their clients. As long as they are on the winning side, they don't really care about the effects on the other. If you are short-term focused, you can play these win-lose games. Eventually, they are not very fun – there may come a day when people don't want to play with you.

Instead, we prefer to play what Munger calls "infinite games". We hope to enter relationships with Partners not for a few quarters, or a few years, but for decades. We enjoy investing in companies run by management teams we trust and admire. This helps instill a long-term mindset in everything we do, even as we try to be nimble in whatever operating environment we find ourselves in.

We are grateful for each of our Partners and look forward to what the next several decades have in store for KMF Investments.

We Have a Moral Duty

Our Strategy

Value & Inflation Minded

Our strategy is to find good businesses whose stock prices are trading below our view of fair value. Value investing has proven to be the best long-term investment strategy because purchases at such discounts create strong upside potential and provide a margin of safety.

We also seek to protect our Partners from the negative effects of inflation.

We believe these two focal points are still the right ones for our long-term success.

Core Principle

Pure Pay-for-Performance

KMF charges Partners no asset fees whatsoever.
Other funds charge fees of 1-5% of assets every year.

We only earn performance fees based purely on the gains achieved by our Partners.

We only make money when you do. We believe this is still highly unique in the investment world.

Operating Principle #1:

Investing Style

Long-term, Value-investing Approach

We will continue to invest with the same approach of Warren Buffett's early partnership – searching for those rare companies with intrinsic value significantly higher than the market price.

We are not momentum chasers who care about transient fads.

Operating Principle #2:

Aligned Incentives

Skin in the Game

Arvind and Jonathon are required to hold ALL of our personal equity securities in KMF. We cannot trade one way with your money and another way with ours.

In fact, the vast majority of both of our families' wealth is in the fund. Because of this, we are not incented to take on too much risk; we seldom employ leverage to juice returns.

We have lots of skin in the game – what happens to our investors' money, happens to our money.

Operating Principle #3:

Transparency

"A-B-C" Portfolio Grades, Clear Disclosures

Each quarter, Arvind and Jonathon provide our Partners a portfolio score summarizing the attractiveness of our portfolio holdings (see page 19 for our current portfolio grade). We believe this transparency helps each partner exploit opportunities within KMF to the fullest.

Additionally, our third-party accountants provide our partners with a summary of the fund's performance and your personal account statements. The fund's results are audited at the end of the year by RSM (one of the top 10 global accounting firms).

Operating Principle #4:

Fair Structure

High Water Marks

If the fund is down in a given year, performance fees are only applied once the downside is recouped and our Partners' account balances are back above their high-water marks.

For example: Let's say a new investor starts a $1 million account and is down 10% in the first year. We don't get paid that year.

If the account grows back to $1 million in year two – we still don't get paid; while the account grew that year, the investor is not above their high water mark.

If the account grows 50% in year three to $1.5 million, the $500k above the high water mark is subject to a performance fee, and a new high water mark is set. The account must be above that level before we get paid again.

Operating Principle #5:

Risk Management

Cash and Hedges

When we are not seeing many opportunities in the market, we are happy to build up cash and wait.

When we are fully invested, we actively manage a hedging portfolio of position-specific and market-related options.

This portfolio insurance creates a natural performance drag in good times, but provides downside protection in the event of an extreme market or macro event.

Differentiation

1. KMF Positioning
2. KMF Flavors of Value
3. KMF Engagement Models
4. KMF Behavioral Edge
5. KMF Loyal Partners

What's Special About KMF?

KMF Positioning

Since we launched KMF we have been mindful of inflationary risks. Arvind's family saw the devasting effects bad government policies and unstable regimes have on your purchasing power. In his teens, his family fled a war stricken country, their life savings stolen from them. All they had to start a new life was the gold they could wear out of the country.

Jonathon grew up in the 1970s and remembers the gas lines and escalating food costs in the U.S. Perhaps his dad's stories, being a child of the Great Depression, made a lasting impact.

Somehow, the U.S. government has convinced the world a steady 2% decline in purchasing power is fine. But people started to rebel when CPI spiked nearly 10% and key aspects of their life like rent, gas, groceries, insurance, medical costs, and tuition rose even faster.

Given many of our Partners are no longer working, ensuring their investments grow AND are protected from the long-term loss of purchasing power is a huge KMF priority. Unfortunately, in the middle part of the last decade, we became too focused on these risks and made too many one-sided inflation-minded bets. Today we strive for more balance.

While the pace of inflation is slowing from recent 50 year highs, we believe significant supply-shock risks still persist. These would restoke inflationary fires. Intentionally, large parts of the KMF portfolio would benefit from rises in prices and interest rates.

But we also have several holdings that benefit from deflationary forces unleashed by technology. We believe this "barbell" approach will serve KMF well as the U.S. and global economy sorts out the geopolitical, demographic and social challenges in the years ahead.

Inflation or Deflation, KMF Positioned for Both

KMF Flavors of Value

New investors drawn to "value investing" begin with the lessons of Benjamin Graham. The analogy of the manic-depressive Mr. Market providing the astute analyst an opportunity to exploit discrepancies between price and value, while maintaining a margin of safety, just makes too much sense! And the formulaic approach prescribed by Graham provides an easy entry point into the discipline for those who may not have a lot of business acumen.

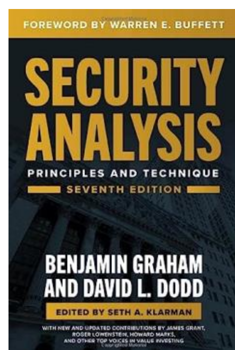
Over the years, students of Graham evolved to other corners of the market. Folks like Marty Whitman pioneered insights into asset conversions, work-outs, and liquidations.

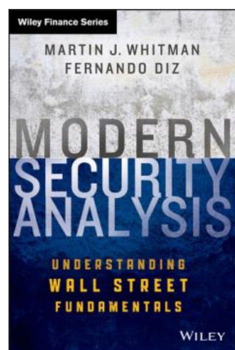
Graham's most well known disciple, Warren Buffett, took his business partner's guidance to focus on great businesses with wide economic moats. Warren owes a great debt to Charlie Munger, though Munger admits Warren would eventually have figured it out on his own.

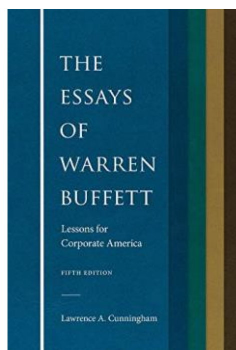
In the 90s, Joel Greenblatt stood on the shoulders of these investing giants and ventured into various special situations like spinoffs, recapitalizations, and PIPEs revealing lucrative opportunities exist in these mispriced and often misunderstood securities.

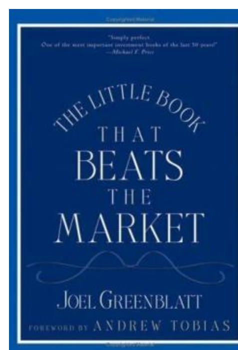
Others have focused on the worth of hard assets trading below replacement cost, asset sales, sum-of-the-parts valuations, and the effect of 20th century accounting methods on 21st century businesses. Adam Seessel's "Where the Money Is" shows how typical valuation approaches need to be adjusted to reflect the asset-light business models of today's software and technology companies.

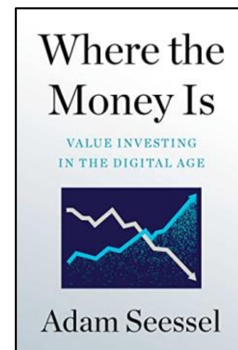
KMF is nimble enough to find opportunities across all these flavors of value.











21st Century Valuation Techniques

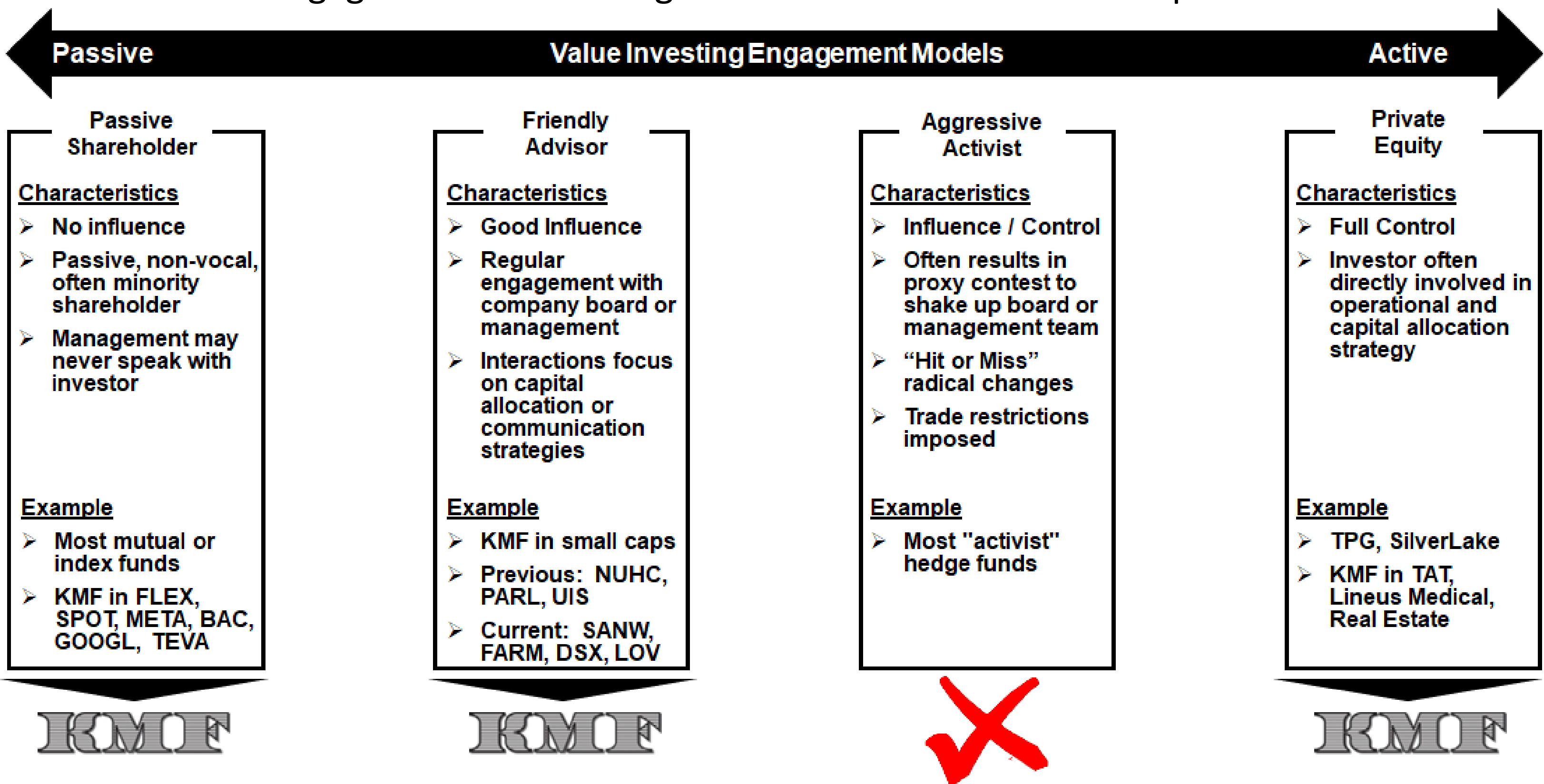
KMF Engagement Models

For many investments, company management teams have no idea who KMF is. We are pleased with their efforts and are happy to be completely passive shareholders.

Sometimes value can be extracted by engaging with company leaders, encouraging changes to communication strategies, capital allocation approaches, or deal considerations. Our Strategy Consultant background is leveraged as a "Friendly Advisor" to improve returns.

CNBC often spotlights the negative version of the this model: aggressive activists who smear management teams or embarrass them into compliance. We avoid this behavior. Instead, our engagement occasionally spills into advancing our advisor role into official governance.

In a few "private equity" situations, we increase our stake to the point we can take seats on the company Board of Directors to help direct strategic decisions. KMF has employed each of these three engagement models to great success for the Partnership.



Friendly Advisor Approach Leverages our Roots

KMF Behavioral Edge

The last 17 years have been hard. Very hard.

Economically, we survived the Global Financial Crisis and the Great Recession; the European Debt Crisis and the U.S. Debt Ceiling Debacle. A U.S. shale boom and a Saudi market share battle washed the world in oil only to see E.S.G. movements blackball investments in future reserves. Four rounds of quantitative easing and a few twist operations helped create $20 trillion of negative yielding debt. COVID shut down the world. It reopened to inflationary supply shocks. Cryptos, SPACs, NFTs, and MEME stocks were chased by the fastest rise in interest rates in U.S. history.

And KMF persisted.

Personally, we experienced loss. Roy was taken 18 months into this endeavor. Jeanie got sick and was lost during Covid. Parents fell ill and passed away.

And KMF persisted.

Even so, returns did not come in a straight line. Periods of strength were sometimes followed by periods of declines. It's not fun going a year or two without a pay check.

And KMF persisted.

While volatility ebbs and flows from one year to the next, Arvind and Jonathon have demonstrated a stoicism amidst it all. When things are great, we tend to get more cautious. When fears abound, we tend to get more bullish. This is one of our greatest strengths.

Why has KMF persisted, even thrived? Exceedingly rational and stoic behavior, a differentiating edge.

Strengthened by Trials and Tribulations

KMF Loyal Partners

Most funds deal with fickle investors, chasing managers who have a hot hand and bailing on them when they hit a rough patch. As a result, most value-focused funds have shut down over the last 15 years as investor redemptions came at the wrong time.

KMF has a different group of Partners. You are long-term minded. You are aligned with our pure pay-for-performance culture. This enables Arvind and Jonathon to invest with confidence even if markets are misbehaving. Our loyal partners provide a stable base of capital to invest in opportunities which may take 5 years – or longer – to work out.

As a result, we can exploit opportunities other cannot. We are thankful for each of our Partners, and would welcome introductions to additional like-minded families.

- Partner Landscape Today: 80+ Families, Would Love to Bring on 10-15 More -

Long-Term Partners = Long-Term Mindset

Letter Themes

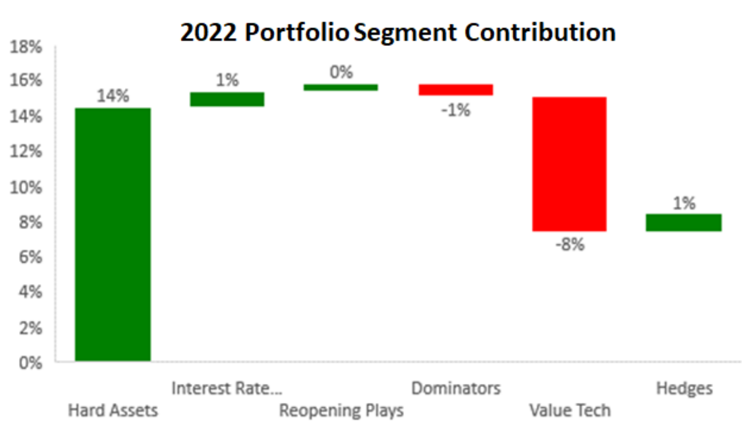
"A" Grade Returns	KMF exploited the 2022 market sell off and reported an "A" grade in December 2022. Our bullishness amidst wide pessimism proved prescient for KMF in 2023.
Rates, Banks, & Volatility	Aggressive Fed rate hikes pummeled bonds and caused a bank run in the spring. Bank failures led to a Fed pause, and KMF picked up bargains amidst the volatility.
Magnificent Seven	After crushing losses in 2022, S&P 500 returns in 2023 were dominated by the 7 largest companies. The bottom 493 stocks returned a lackluster 6% last year.
Last Decade Vs. Next	From 2011-2021, the S&P 500 returned 16% per year. Many think the next decade will look like the last. If you decompose from where returns came, that is unlikely.
Inflation & Demography	Inflation receded from 50 year highs, but history shows a second wave may come. Lack of supply investments and shrinking populations increase these risks.
Wars, What are they Good For?	Absolutely nothing. Yet, following the U.S. withdrawal from Afghanistan, enemies continue to challenge U.S. resolve. Ukraine, Gaza, the Red Sea…is Taiwan next?
Deficits and Politics	U.S. deficits grew $200 billion the first 3 weeks of 2024. Annual interest expense is greater than $1 trillion, more than our defense budget. This will impact the election.
Where are the Bargains?	Prices for "small-cap value" stocks compared to larger companies look like the late-90s. Small-cap value performed strongly the last time they were this cheap.
KMF Evolutions	Much is the same as it was when we started 17 years ago. But, we learned some things along the way. KMF portfolio evolutions have prepared us for the future.

"A" Grade Returns

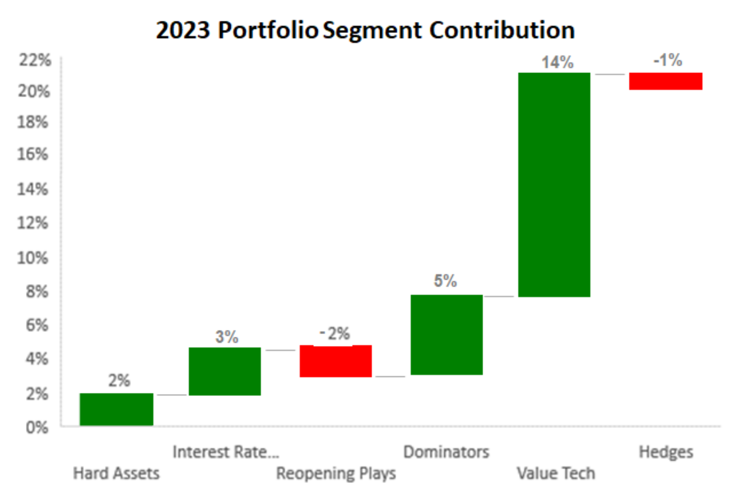
KMF exploited the 2022 market sell off and reported an "A" portfolio grade in December 2022; the opportunities in our portfolio were compelling. On cue, KMF Investments delivered another strong year of returns for the Partnership in 2023, returning more than 20% net of performance fees. This far outpaces the +12% delivered by the S&P 600 small cap value index (ETF SLYV) and compares to +26% for the S&P 500 index.

While the broader market performed well last year, the indices suffered dramatic declines in 2022 alongside the sharp rise in inflation and interest rates. Indices are just now returning to their previous high water marks, even with their strong 2023 returns.

Meanwhile, KMF continues to perform well even as we invest in a portfolio construct that is very different from "the market". Last year we wrote about 5 portfolio segments which contributed to our returns.



It is not lost on us that the portfolio segments which lagged last year contributed most to our gains this year. We picked up some compelling bargains during the 2022 market turmoil which created great entry prices for our future returns.



Our 2023 performance underscores the value of KMF's portfolio grading approach. "A" grades represent periods when the portfolio trades at more than a 50% discount to our estimate of fair value. Partners adding to their accounts during "A" grades have seen great returns.

Today KMF is at a "B" grade, a discount between 30-50%, which have been good times to dollar-cost-average into accounts. We encourage Partners to take distributions or defer capital contributions if we are ever below a "B" grade. Few investment managers ever do that.

2023 KMF Returns

+20.4%

Rates, Banks & Volatility

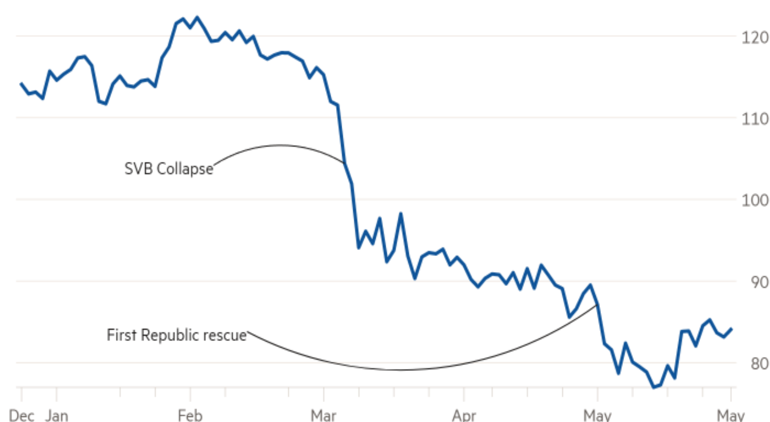
Fueled by zero and negative interest rates, the bond market became the biggest bubble in history. In 2021, we described the risk:

> *"…bond prices get battered when interest rates rise because investors sell off their low-coupon bonds in favor of bonds that give higher yields. For longer-dated bonds, prices would fall as much as 20% on just a rate 1% rise…"*

By 2021, supposedly "safe" bonds traded at unsafe high prices. The post-pandemic surge in inflation pricked the bubble. Central banks, realizing they had been too lax, sharply hiked interest rates. Bond prices collapsed, making 2022 the worst-ever year for bond returns.

The decline continued in 2023. Banks that gorged on cheap debt during the bubble to buy low yielding mortgage bonds found themselves underwater when rates rose. One bank fell, then another, as shown by the decline in the KBW Regional Bank Index.

KBW Regional Bank Index (Spring 2023)



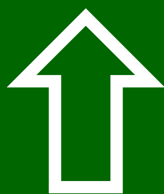
Source: Refinitiv

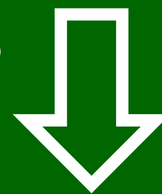
Eventually the Fed stepped in and backstopped bank deposits. The failed banks were taken over by stronger banks and a crisis was averted. Still, stocks swooned during the panic which provided KMF an opportunity to pick up bargains. By the fall, many had forgotten the spring banking crisis.

Instead, investors worried about a looming recession sure to result from the Fed's higher interest rates. But as inflation signs eased, the Fed hinted at potential rate cuts in 2024.

In December, Fed officials announced they expected to cut rates three times this year. But markets have raced farther ahead, pricing in six cuts. If these cuts do not materialize, we can expect more volatility ahead. KMF will be ready to go shopping if volatility returns.

When:

Rates Go 

Bonds Go 

The Magnificent Seven

A group of technology giants dubbed the "Magnificent Seven" was responsible for a large proportion of the S&P 500 index gains last year:

Apple:	+49%	Tesla:	+102%
Microsoft:	+58%	Meta:	+104%
Alphabet:	+58%	Nvidia:	+239%
Amazon:	+81%		

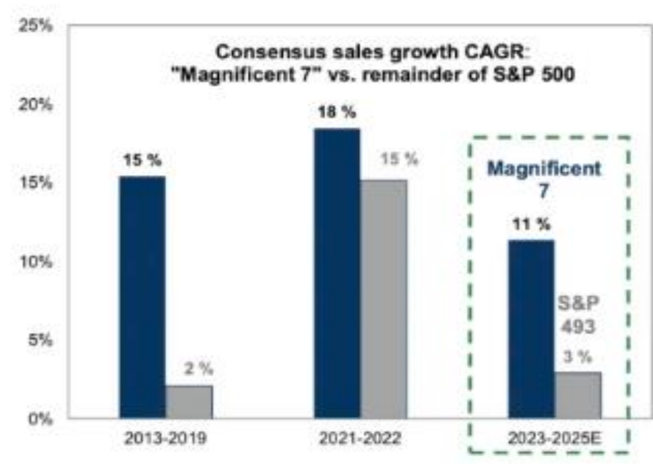
Their huge market caps also result in a 28% contribution to the index, so they have a huge influence over the direction of the broader market.

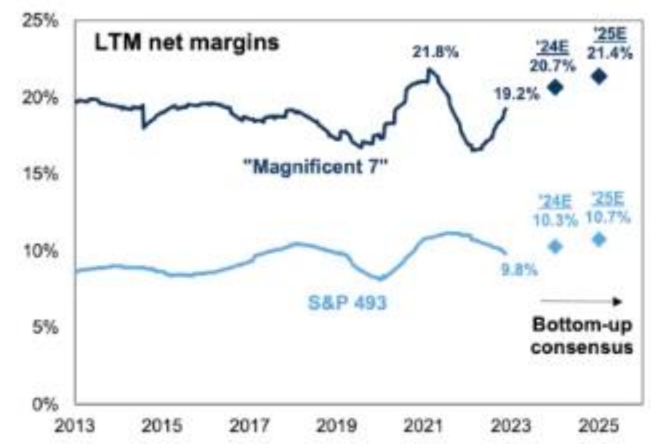
In contrast, the Equal Weight index gained just 11.5%. If you remove the Mag-7, and focused on the next 493 alone, the returns fell to just 6%.

Collectively, the Mag-7 is expected to grow earnings by +46% this quarter, while the next 493 stocks are expecting an earnings decline of -7%.

If the Mag-7's cost cutting and AI-driven growth initiatives deliver as expected, market returns should benefit. But if these companies fall short, their influence will have negative consequences for index investors.

During the tech-wreck of 2022, KMF picked up sold-off shares in both Meta and Alphabet. These, along with contributions from the rest of the portfolio, helped drive our strong performance over the past 5 years.





Source: FactSet, Goldman Sachs Global Investment Research

Last Decade vs. Next

An analysis of the S&P500 returns from 2011-2021 by Chris Bloomstran at Semper Augustus shows the index compounded at more than 16% per year - incredible returns!

Bloomstran broke down those annual returns into key 5 drivers: sales growth, dividend payouts, share repurchases, margin expansion and price-to-earnings multiple expansion.

16% Per Year

- 3% ➢ During the period, sales compounded around 3% a year, in line with GDP.
- 2% ➢ Dividends added another 2%
- 1% ➢ Stock buybacks added another 1% (rounded for simplicity).
- 4% ➢ Margins grew dramatically over the period, reaching historically high levels. This margin expansion added 4% to total index returns - boosting the compounded annual growth rate from about 6% to 10%.
- 6% ➢ Then came the big bazooka: the price-to-earnings multiple people were willing to pay for stocks grew more than 80% over the decade. This multiple expansion added more than 6% per year to the index returns!

The index saw massive capital inflows as investors chased these returns. But let's think about the next decade. We imagine sales growth, dividend payouts and buybacks could probably keep chugging along like before. This implies a 6% return from these components.

But, it's hard to imagine margins continue to improve. If anything, inflation, higher taxes, deglobalization, and increasing geopolitical conflicts might drive margins lower rather than higher. That would be a headwind for returns.

The same holds true for the average price-to-earnings multiple folks pay for stocks. With bonds offering 5-6% yields (a reasonable alternative to stocks for the first time in a decade), it seems more likely stock price multiples are flat or even fall from here, rather than increase further. If so, this could also be a drag on the index performance.

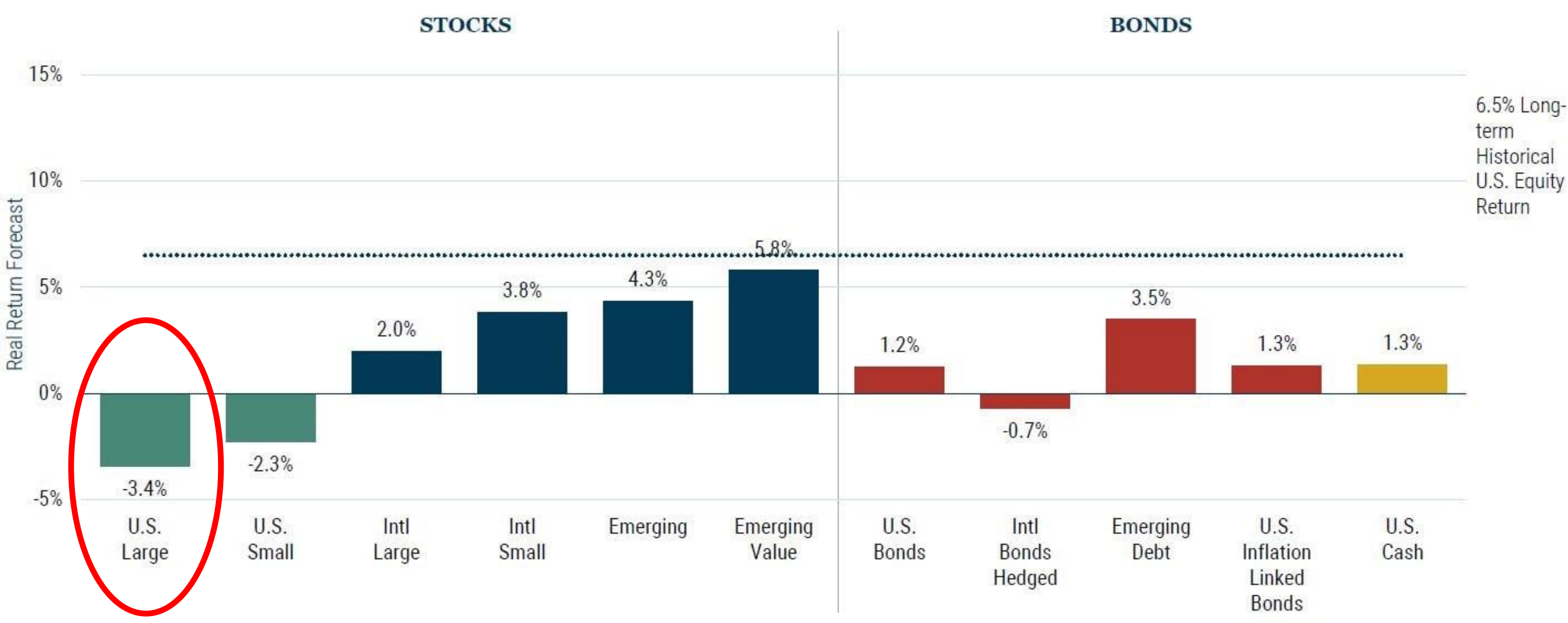
These two drags might even offset the natural gains of the first three drivers (see the next page). The combined returns from 2022-23 illustrate this point: the S&P500 is up just 3% the last two years. 16% annualized returns over the remainder of the decade seem like a high hurdle. Fortunately, KMF is not invested in "the market".

Market Drivers & Headwinds This Decade:

LIKELY MARKET HEADWINDS

More on the Next Decade

In letters past, we have cited the long-term asset class forecast published semi-annually by Jeremy Grantham's GMO capital. GMO claims no special ability to predict what might happen in the markets over the next few quarters, but using basic price-to-value relationship that drive long-term returns, their 7-year asset class forecasts have an astoundingly good track record. They are noted for correctly calling major market peaks in 2000, 2007 and 2021.



The most recent forecast published this fall shows little value exists in the U.S. Large Cap space, where GMO expects the compounded annual return to be negative. The discussion we laid out on the previous page lines up with GMO's view: if you start from a high price, it is hard for prices to go up further.

Therefore, it is important for investors to hunt in the few patches of value that still exist. We believe value investing strategies in general, and KMF specifically, will continue to outperform the general market for many years to come.

GMO Market Forecast for Next 7 years

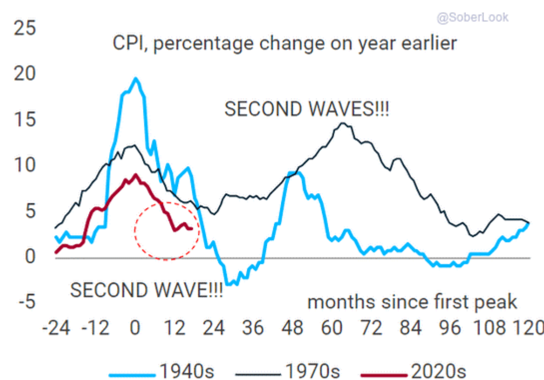
Inflation & Demography

Jonathon teaches Operations Management classes at UNT. The basic concepts – competitiveness, forecasting, lean operations, quality control – have not really changed in 70 years. But the context in which they are applied today are radically different than they were in previous decades.

After peaking in 2022 near 10%, inflation cooled this year to sub-4%. But, in previous inflationary regimes (1940's, 1970's), the first bout of inflation was followed by a second or third wave. Might we see another wave this time too?

The main drivers of inflation: fiscal deficits, demand growth and supply constraints are as common today as they were in those previous eras.

In response to COVID, the government (and its Federal Reserve proxies) printed nearly $10 trillion in stimulus. This created a massive surge in demand while supply chains were snarled, resulting in dramatic inflation. But as supply chain constraints have unwound post-COVID, economists hope inflation may be in the rear view mirror. Why might this be wishful thinking?



Significant portions of the population left the work force. Those that remain continue to ask for higher wages. *Barron's* notes 2023 saw the most union strikes since 2000, with more than 18 million workdays disrupted by strikes. Our lack of a sensible immigration policy puts further stress on labor supply. This is inflationary.

The reshoring / friend-shoring of global supply chains adds much needed resiliency, but is also inflationary.

We agree the earth needs a sustainable energy mix, but the lack of investment in copper, lithium, rare earth metal or traditional near-term energy sources may lead to inflationary supply shocks. KMF applauds lower inflation, but we are preparing for other outcomes.

Impacts of Deglobalization and Supply Constraints

The Risk of More Wars…

There is nothing worse for price stability than war. Whether we are funding them or rebuilding from them, the affects are the same: higher prices. Unfortunately, following the horrific U.S. withdrawal from Afghanistan, enemies continue to challenge U.S. resolve.

The West's NATO invitation for Ukraine crossed a real red line for Russia. Once political support was secured from China, Putin invaded Ukraine to secure a buffer on his western front. Instead of isolating two geopolitical rivals, the West drove them into each others arms, solidifying trades of Chinese tech for Russia oil.

While the U.S deploys time and treasure into the conflict, this dyad pushes diversification away from the global dollar standard. This may not be an immediate threat, but poses long-term challenges to U.S. hegemony and its ability to fund fiscal deficits on the back of a global reserve currency.

The Abraham accords began normalizing relations between Israel and the Arab world, but Iran saw this as a challenge to their regional power. Meanwhile, U.S. attempts to normalize Iranian relations provided Iran time and money to support regional proxies. The October 7 atrocities were meant to stoke international outrage to an Israeli over-response and stymie progress of the Accords. It also meant the U.S. would have to contend with a second front.

Then Yemeni Houthi's (Iran proxy) attacked key shipping lanes in the Red Sea. The U.S. responded to a third theater of war, shooting down $20,000 Houthi bomb-drones with $2 million rockets - not a great trade for U.S. taxpayers. Now 12% of the world's freight which had moved through the sea is diverting around the Cape of Good Hope. This is inflationary.

Is Taiwan next? Xi has made it clear reunification of the "wayward province" is his single biggest priority. But the Taiwanese just elected a nationalist focused on independence. The U.S. has signaled any action on the island that houses TSMC – the worlds largest manufacturer of advanced computer chips – would be defended by the U.S. But with our attention diverted elsewhere, is now the time for the Chinese to advance on Taiwan?

Markets are underpricing these risks to energy prices and supply chain costs.

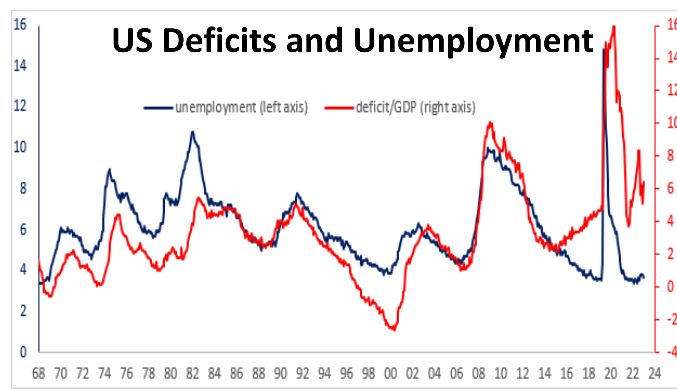
Ukraine, Gaza, Red Sea… is Taiwan next?

Deficits and Politics

In October of 2008, during the throes of the Great Financial Crisis, U.S. Treasury Secretary Hank Paulson got on his knees begging Congress to pass a $700 billon Troubled Asset Relief Program (TARP). In the six years that followed, Ben Bernanke's Federal Reserve printed another $3 trillion to fund multiple rounds of quantitative easing (bond-buying programs).

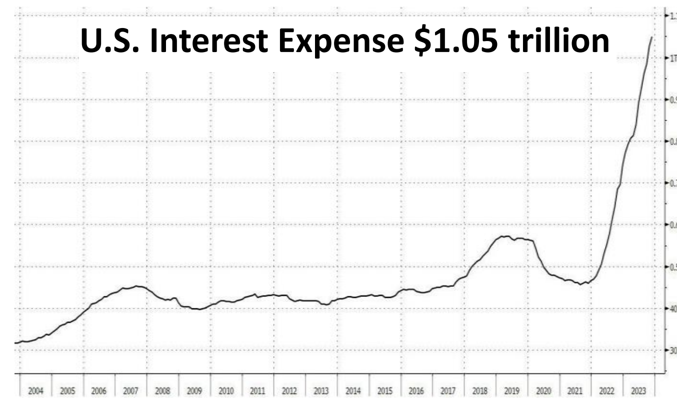
The result was the rise of the Tea Party, the 2011 debt ceiling debacle, and a downgrade of the U.S. Credit Rating. It's quaint to see what seemed so profligate just a few years ago.

In response to COVID, Congress and the Fed tripled the GFC response. But instead of taking 6 years, this cash flooded into the system in a matter of months. Deficits exploded, and they have stayed large even as unemployment stays low (see chart).



As we kick off 2024, the U.S. added another $200 billion in Federal debt in just 3 weeks. Interest expense will grow to more than $1.05 trillion this year, larger than our national defense budget.

We are on track to spend nearly $1.4 trillion per year to service $40 trillion in debt by end of 2025. By 2033 interest costs will be twice the amount spent on income security programs.



What happens if we do have a recession?

Typically, tax receipts fall, stimulus increases and deficits grow. But how will we continue to fund social security, wars in Ukraine, Israel, the Red Sea, and maybe China, while maintaining peace and stability at home?

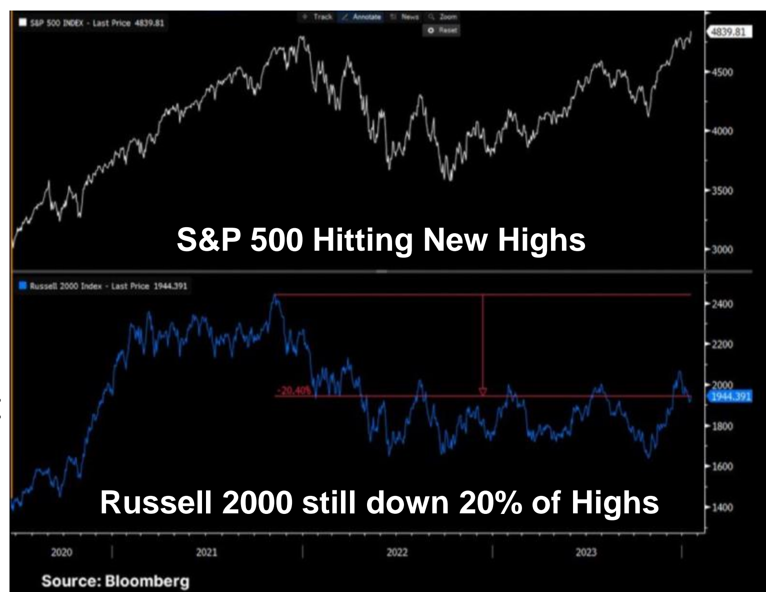
We suspect this will become a major topic over the next 5-10 years with potentially dramatic consequences on the political front. Markets do not like uncertainty. Our fiscal predicament seems to guarantee more uncertainly not less. Volatility will likely increase.

What happens to the deficit if unemployment rises?

Where are the Bargains?

With the S&P 500 index (and KMF) hitting all time highs, one might ask, "where are the bargains"? An analysis by Jason Goepfert, founder of Sundial Capital Research, shows value still may be found outside the mega-cap companies. The Russell 2000 index is comprised of small-cap U.S. stocks, and is still in a bear market (more than 20% off its highs).

So what is a small cap stock?



Folks have different definitions of small-, mid-, and large-cap stocks, but typically small-cap stocks are those whose total market value, or market capitalization, is between $250 million to $2 billion.

As noted earlier, the largest stocks in the market dominate the index and capture most of the headlines. But in this small-cap universe lots of opportunities still abound.

In fact, the combination of large cap stocks hitting new highs while small cap stocks remain in a bear market has never happened before. Since markets are mean-reverting, this extreme scenario should normalize over time, driving small-cap stocks higher.

If wars, demographics, and deficits lead to sustained inflation, where should you invest? An analysis by Bank of America showed that during the stagflationary 1970s, Small Cap Stocks and Value stocks excelled. Energy, banks, and industrials outpaced tech.

The pages that follow delve into KMF's portfolio positioning. While we have some large-cap exposure, we also have significant allocations to small-cap value stocks in the energy, banking and industrial sectors. These holdings are trading at some of the largest discounts to our estimate of intrinsic value we have ever seen.

Logic dictates discounts between price and value should close over time. This would provide significant upside for KMF Partners.

Value Still in Small Caps!

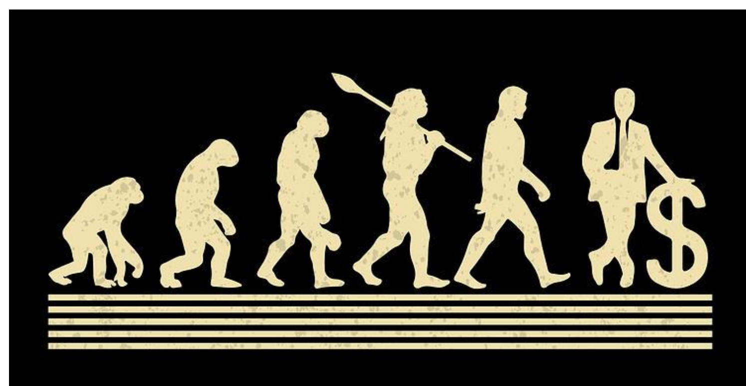
KMF Portfolio Evolutions

Each year a couple of Partners ask, “What’s different today compared to when you started?

Our core strategy and operating principles are much the same. See pages 5-11 for details. But there are some evolutions to our portfolio management approach worth mentioning.

The first is scaling, into and out of positions. We used to find a bargain, wait for it to get “half-off” and then put 5% of the fund into the stock. When it doubled, we sold.

Today, there is more nuance. Bargain stocks can get cheaper, so we may start a 1% position at a 40% discount and scale into the stock as the price falls. We try to couple our buys alongside periods of market fear because we find more indiscriminate sellers who are liquidating positions for reasons that have nothing to do with business fundamentals.



Conversely, we tend not to exit all at once either. We typically trim positions as they near our estimate of intrinsic value, but also provide time for more information to come it so we can determine if that value estimate should be revised higher. We are also more thoughtful today about overall position sizing.

We used to avoid hedges, thinking they were a waste and a long-term performance drag. Today we use hedges to mitigate impacts of extreme events.

Tactically we are more nimble. In late 2019 we built cash which was used to go shopping in 2020 during COVID. We avoided the 2021 SPAC bubble. Our energy holdings combined with a willingness to ignore the FOMO in MEME stocks helped deliver solid returns in 2022. In 2023 we exploited both the bank-crisis and October recession-fear selloffs. Today we are getting more defensive as rate cut expectations may be getting ahead of themselves.

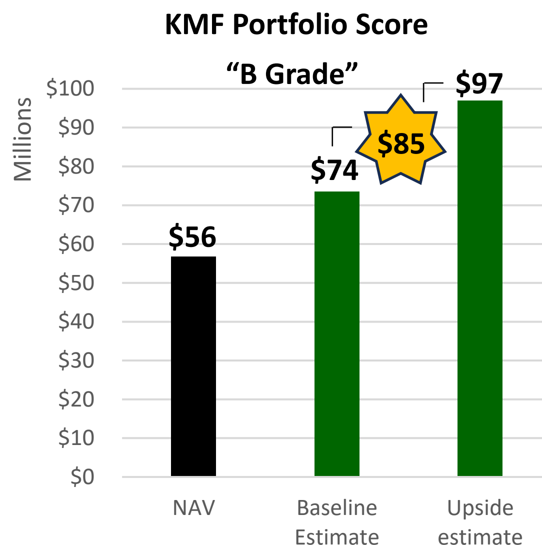
Overall, this nimbleness and portfolio management evolution helped drive our strong returns the last 5 years. We believe this evolved approach will also help KMF in the years ahead.

✓ **Scaling** ✓ **Sizing**

✓ **Hedging** ✓ **Nimble**

KMF Portfolio Segments

KMF enters 2024 with 5 key portfolio segments which were constructed to help achieve that balanced portfolio positioning discussed earlier:



- Dominators - companies whose business model and competitive advantages will help them thrive for years to come
- Hard Assets - businesses that benefit from rising prices, including commodity prices like oil, natural gas or gold, real estate prices and shipping rates.
- Interest Rate Plays - businesses that have specific operational catalysts that will materially improve earnings while also benefiting if interest rates rise
- Value Priced Tech - asset light technology business previously considered too expensive even in light of their growth that became bargains in the 2022 selloff
- Other Opportunities – businesses that have benefited from the post-COVID reopenings and other private investments

We will review the holdings within each category in the pages that follow. It is important to note KMF added two new positions to the fund in 2023:

- CVS, the largest pharmacy in the United States, and
- MODG, the merged entity of Top Golf and Callaway Golf Brands.

We will review the background and opportunity for each in the dominators and reopening play segment discussion. In addition, KMF exited three positions last year: IBM, LOV and FTAI, an error in judgement for all three. We held IBM and LOV too long. We may have sold FTAI too soon. All together, the portfolio in mid-February is a "B" grade opportunity.

"B" Grades Good for Dollar Cost Averaging

Dominators

CVS Health CVS Health is the nations largest Pharmacy that also provides Pharmacy Benefit Management services, Aetna health insurance and a variety of clinical care solutions.

Over the last year, CVS has been investing to recapture a 5-star Medicare quality rating and growing in clinical footprint. In mid-2023, the stock fell nearly 50% off its recent highs to a price that was < 8X earnings.

We felt this was too cheap for a high quality business like CVS Health. We suspect its changes to a cost-plus pricing model will resonate with consumers and investments in its clinical care programs will demonstrate value to the CVS ecosystem.

While shares have rallied, we look forward to holding for years to come.

Previously known as Flextronics, Flex is one of the world's largest contract manufacturers which historically made a modest 2-3% margin while incurring much of the inventory, manufacturing and supply chain risk for their customers. Over the past 10 years, the company has shifted to higher-value lines, improved margins and grown revenues.

We presented our investment thesis at the MOI conference last summer: watch it > here <

That thesis is working out: FLEX's spun out its stake in Nextracker (NXT) which we monetized. As the world looks to increase supply chain resiliency, Flex will continue to benefit. Flex now earns about $2.20 per share and has about $6 per share in cash.

Ex-cash, the company trades for 8X earnings. That is too cheap.

Dominators

Originally purchased in 2019, trimmed in early 2020 and then added to during the COVID panic, GOOGL remains a meaningful position for the fund.

Last year's cost cutting efforts, and abating recessionary fears, helped drive GOOGL's shares higher in 2023. It is still one of the least expense "Magnificent 7" stocks.

With adjusted operating earnings approaching $7 per share (ex-other bets and near-term losses to scale their cloud business) and about $9 per share in cash, the company trades about 20X earnings.

Accelerating revenue growth, a potential spin of YoutTube and continued share repurchases should be tailwinds for the stock. We expect this to be a core position for years to come.

Kyndryl (KD) is the spin off of IBM's managed service business. The two separated in late 2021 and most investors (including KMF) sold their shares. By 2023, the shares had fallen more than 80%. At that price, it was attractive again!

Under the IBM umbrella, the business we seen as a loss leader used to sell equipment. As a stand alone business, Kyndryl is renegotiating contracts and earning a proper margin.

They are also developing partnerships with non-IBM cloud players like Amazon Web Services, Microsoft Azure and Google Cloud. Profits are growing and the stock price is beginning to reflect the post-spin business dynamics.

While the stock has doubled off its lows, we believe there is still room to run.

Dominators

Paramount (PARA) unifies the CBS-Viacom broadcast, cable, studio and streaming assets. We bought the stock during the COVID sell-off in the $10-20 range and rode through most of the 2021 run toward $100.

At those prices, the shares were more than fully valued and we exited a large portion of our stake. Now back in the low-teens, we have rebuilt our position.

The market discounts the merits of PARA's streaming investments. Pre-COVID, PARA had $5 in earnings power; today its trades <3X that. Even Warren Buffett, who bought shares in the $20s thinks it's a bargain.

David Zaslov, the CEO of Warner Bros. Discovery and financier David Ellison have both expressed interest in buying the company. PARA's content library is a trophy asset that likely gets bought by Disney, Amazon, Apple or Netflix or another player.

A few years ago, Teva had taken on a mountain of debt to overpay for a competitor. As the revenue and cost synergies failed to materialize, earnings tanked and the management team was replaced by an industry veteran known for turn-arounds. This piqued our interest and we built a position.

Unfortunately, the turn-around progress got overshadowed by a series of lawsuits related to the opioid epidemic. These lawsuits were settled last year and Teva's earnings power and revenue growth (from branded therapies, traditional generics and complex biologics) should drive a rerating of the share price.

Teva trades at <5X earnings, continues to pay down debt and manages the business for the long-term. Teva stock could double and still be a bargain; it is one of our largest positions.

Hard Asset Plays

Over the last 10 years, we watched most companies in the dry bulk shipping sector go bankrupt, some twice. Diana was one of the few that managed the last decade nimbly, using a conservative balance sheet and allocating capital to the shareholders' benefit.

In years ahead, as supply-demand imbalances tilt more in favor of higher shipping rates, Diana's margins are poised to expand. The stock trades at a meaningful discount to liquidation value of its ships, pays a very healthy dividend and trades ~10X earnings.

When the stock rose nearly 30% last spring, we trimmed a good portion of our position.

Gold is still one of the best alternatives to monetary mayhem. Seabridge (SA) is a junior gold minor in Canada proving out one of the largest gold and copper deposits on the planet, secured in British Columbia, Canada (property-rights friendly, non-warzone locale).

Seabridge has more metal value per share than any producer - the most gold per share in the industry; more copper per share than most all copper companies. Their gold is one of our monetary mayhem hedges, but their copper is increasingly important for U.S. grid upgrades and the electric vehicle transition.

Management is willing to sell, at the right price. An acquisition by a large gold or copper miner looking to replenish their reserves makes sense. Recent deal multiples would result in an exit 2-3X Seabridge's current stock price levels.

SEABRIDGE
GOLD

Hard Asset Plays

S&W is a mid-sized agriscience business that developed a pesticide-resistant sorghum line. Over the last three years, this new seed trait has taken 10% market share and continues to grow.

S&W also has an alfalfa seed business which is struggling. Management has a turn around plan.

Interestingly, S&W also has a joint venture with Shell to monetize its Camelina grain traits to produce oil seeds for Shell's biofuel business.

S&W has burned cash over the past couple of years which has been a drag on the stock. The new CEO & CFO expect revenues to accelerate and margins to improve - generating strong cash flow. Seed companies with high value traits sell to companies like Monsanto for 3X+ revenues - implying a stock price more than 5X higher than today's levels.

TransAtlantic explores and develops oil and gas fields for production in Türkiye. Originally established as the international exploration and production arm of West Texas billionaire Malone Mitchell III, we invested in TAT nearly 10 years ago based on the prospects of bringing U.S. oil field technologies to legacy international oil fields.

Eventually we helped take the once-publicly traded company private during the throes of COVID when negative oil prices caused most investors to flee. In the years since that transaction, production has remained consistent, new gas fields have been discovered and the higher pricing environment has allowed the company to pay generous dividends.

This also provides the partnership with an embedded option on higher oil and gas prices if geopolitical chaos and inflation escalates.

Interest Rate Plays

Bank of America (BAC) is one of KMF's longest held positions. Originally built in 2011 during the U.S. Debt Ceiling Debacle and the European Debt Crisis, this once $5 stock rose nearly 10X over the past decade plus. To manage risks, we trimmed this position along the way.

But when banks sold off in 2022 on recession fears, we added back in. The regional banking crisis in 2023, and worries about market-to-market impairments on BACs bonds bought when rates were low, drove the stock even lower. We bought more at these cheaper prices.

Over the years, CEO Brian Moynihan steadily reduced costs, resolved liabilities, invested in technology solutions and prudently managed growth. BAC is a bargain trading below 10X earnings and in line with book value. With the company consistently buying back stock and generating returns on tangible equity between 15-20%, shares should easily trade 40-50% higher once recessionary fears abate.

Citibank has seen a revolving door of executives. Most recently, Jane Fraser has taken the helm and is committed to setting Citibank back on a profitable path.

As the leading bank to multinational clients, Citibank offers unique services to these massive customers, especially cross-border treasury management. Citibank also maintains a strong credit card franchise, a leading deposit banking business and strong capital markets / wealth management business.

While Fraser cleans up the global business unit sprawl her predecessors left behind, the stock trades at almost half of tangible book value and <9X earnings.

As Fraser continues to deliver, we expect the stock to trade at a more appropriate multiple of earnings and tangible book value – levels double the current price.

Interest Rate Plays

Fairfax is a Canadian property and casualty insurance business run by Prem Watsa, often labeled the Warren Buffett of Canada. This moniker provided shareholders little solace over the past several years as a series of macro-investments went the wrong way.

FAIRFAX
FINANCIAL HOLDINGS LIMITED

But more recently, Watsa has returned to his knitting: making fewer macro bets, focusing his underwriting business on selling profitable insurance and directing those insurance premiums and profits to a series of undervalued investments.

We acquired Fairfax stock during the COVID selloff and a number of tailwinds have been at our back. First, Watsa continues to harvest his investments to free up cash to repurchase his own undervalued stock. The stock trades for <8X earnings and about 1X book value. Every time he sells a business for 2X book value and buys back stock at 1X, he creates value for his shareholders.

Second, the rising interest rate environment allows him to reinvest his statutory capital into bonds that finally have a meaningful yield. Zero percent interest rates (ZIRP) have been terrible for most insurance companies. Prem refused to step in front of a steamroller to pick up a few extra pennies by investing in long-term bonds at super low yields. Instead, he kept the bond duration of his investment portfolio short, and he can now roll maturing bonds into new ones at much higher yields.

Third, the excess profits from the insurance business can fund new investments will drive further value years down the road. Fairfax is the largest investor in “Fairfax India”, a holding company which owns some of the best businesses in one of the best long-term markets on the planet.

Last fall, Arvind and Jonathon recorded a video-podcast highlighting the investment thesis for both Bank of America and Fairfax. You can watch that video podcast > here <

With the shares tripling over the last three years, we began trimming our position. A recent “short-selling” report by research firm Muddy Waters sent shares lower in February. While the report created waves during the pre-earnings quiet period, our assessment is it brings up nothing that changes our overall thesis. Our preference is to hold a core stake for many years to allow Fairfax to compound over time.

Interest Rate Plays

During the tech-wreck of 2022, SOFI's stock price fell -85%! Yet, while the share price was tanking, business was getting much better. Since 2018:

- SoFi has grown revenues 8X
- SoFi has grown members 11X
- SoFi has grown product usage 16X

Management expects to grow earnings 40X over the next three years, exiting 2026 with nearly $0.80 in earnings per share and a 25% growth rate. Today, shares trade at just 10X those 2026 expectations, even as its growing deposit base provides ample runway for future growth. While most banks maintain a 10% capital ratio buffer, SoFi is above 15% - providing additional capital to fund loan growth.

While most of the U.S. banking industry is dominated by the large money center banks, SoFi received one of the few new bank charters of the last decade. This lowered its cost of capital to make customer loans. SoFi also added an array of consumer and commercial financial services to its product stack; the company expects revenues from its tech and financial services platform to grow 50% this year.

SoFi turned its first operating profit last year alongside positive GAAP earnings. When the stock nearly tripled we trimmed our stake into the rally.

Why not hold every share for the long-term ride? We admire the business and believe there is lots of runway, but it is not a 'ham-sandwich" business. SoFi requires adept management and risk controls. CEO Anthony Noto seems quite adept, but as outside investors we need to manage position sizes appropriately.

Since our summertime exits, the stock retreated, and we recently scaled back in. On the January earnings call, management forecasted 35% EBITDA growth in 2024, even assuming the U.S. economy slows dramatically (modeling >5% unemployment and 4 Fed rate cuts). Those are pretty dire assumptions and still impressive growth!

We believe the runway ahead for SoFi is tremendous. The stock could double from here and still be attractive.

Value Tech

The company better known as Facebook, Instagram and WhatsApp, has been on our radar for years. They grew revenues more than 30X and earnings more than 100X from the early 2010s. It is hard to fathom this type of growth!

Then, Apple's app tracking policy impeded Meta's target user adds (a feature advertisers prized). META also spent heavily on the "Metaverse", a virtual-reality based ecosystem, while over-hiring engineering talent.

This spending binge, alongside a drop in revenues, crushed earnings which drove the stock price down almost 80% in 2022. Meta was suddenly on sale.

In 2023, META cut its bloated engineering staff and revealed the bulk of its investments were actually building AI engines to better target adds to its nearly 4 billion monthly active people.

By Q4, revenues reaccelerated, growing nearly 25% year-on-year. But more impressively, operating margins more than doubled, growing from 19% in 2022 to 41% in Q4, driving a tripling of profits. These results, combined with a massive $50 billion stock buy plan on top of a new quarterly dividend drove the shares up more than 20% the day after earnings.

Overall, META's stock has more than quadrupled since the end of 2022. Amazingly, it may still be a bargain, but we have trimmed our stake given its massive move higher.

Value Tech

Spotify is the world's largest streaming music service, handily besting Apple Music, Prime Music and Youtube Music based on total (largely ad-supported users) and paid subscribers (monthly subscriptions).

In the summer of 2022, Arvind and Jonathon presented our investment thesis at the Manual of Ideas Wide Moat Investment Conference. You can watch our pitch > here <

Much of our thesis is playing out as expected. In 2023, management increased prices across most of its markets without meaningful subscriber loss. In fact, overall paid subscribers grew by 31 million (+15%) while total monthly active users grew by 113 million (+23%).

This helped drive a 16% increase in revenues. But these were not empty calories. Gross margins improved by 30 bps. even as the podcast business continues to be a small drag. Operating costs controls also helped double free cash flow.

CEO Daniel Ek stated that while user, subscriber and revenue growth should remain strong in 2024, management intends to better monetize the existing user base. This implies a mix of more price increases and better cost controls, alongside a move to profitability in the podcast business.

In last year's investor day, CEO Ek stated his goal to grow revenues 10X over the next decade. Similar to Meta above, it is hard for us to fathom this type of growth. But coming into 2023, we believed with Spotify's latent pricing power, earnings ramp and new business development efforts, the stock could easily double.

We were wrong – it more than tripled.

Much of our thesis is playing out as expected. If the growth Spotify expects over the next 5-10 years plays out, the stock is still a tremendous bargain. It would not surprise us if Google or Amazon tried to acquire it once a more merger-friendly administration is elected. While the opportunity is still compelling, the price is no longer the bargain it was a year ago. Spotify is still a significant holding for the fund, but we have trimmed the stock at recent levels.

Other Plays

Topgolf Callaway Brands (MODG) is a modern golf company featuring Callaway Golf, Topgolf (venues are a mix of a driving range and sports bar/night club), Toptracer technology, Ogio bags and TravisMathew clothing.

Shares of MODG fell 60% last year due to reduced forecasts for Topgolf's 2023 same-venue sales, even though 2-year stacked growth is expected to be up high-single-digits.

While year-over-year sales comps disappointed on the back of very strong numbers in 2022, venue profits grew with cash-on-cash returns now in the 50%-60% range.

We expect Callaway to provide a strong base of sales and the long term ramp for Top Golf venues to create significant value for many years to come.

Farmer Brothers (FARM) is one of largest coffee roasters and bean sellers to restaurants, hotels, and coffee shops around the U.S. These sales are supported by a direct store delivery network where sales reps visit stores on a route to replenish inventory, service equipment and cross sell complementary products and services.

Last year FARM returned to revenue growth and is passing along price increases to make up for elevated supply chain costs. Management expects revenues and margins to continue to improve even as shares trade around liquidation value, or roughly 3X their pre-COVID earnings power.

The company sold its Texas roasting facility for $100 million last summer to clean up its balance sheet and refocus on its Portland, Ore roasting operations and direct-store-delivery business.

Other Plays

Lineus Medical is an emerging device manufacturer, maker of SafeBreak which reduces the number of complications requiring IV restarts by separating when a harmful force is placed on an IV line. Check it out > here <

When SafeBreak intentionally separates, it has valves that seal both sides of the line, preventing the leaking of medication or blood from the IV tubing and reducing overall IV complication.

Sales are growing. Hospital systems are reordering. International distribution is picking up speed and product expansion into the veterinary market is underway.

KMF owns about a 5% stake in the business, retains a seat on the Board of Directors and looks to help Lineus scale sales until a strategic acquirer buys the business.

Teresa's House is a luxury assisted living facility, with campuses in McKinney and Argyle, Texas. They are designed to feel like home. Each custom, ranch style home has 16 private rooms, and features an open-concept kitchen, dining and living area. The concierge-style, homelike environment makes residents feel safe, comfortable and loved from the moment they step inside. Check it out > here <

The size allows the team to get to know each resident personally, providing individualized care plans and unparalleled support. Licensed, degreed and/or certified staff members provide a higher level of professionalism and quality, with the best staffing levels in the field (a licensed nurse and state-certified care staff on-site 24 hours a day, 7 days a week).

KMF invested in the recently opened Argyle campus, and the McKinney campus expansion.

Thank You

We send thanks to our friends and families for their continued support of KMF as we embark on our 17th year of operations. We are excited by the decades long runway we still have ahead of us.

We are grateful to have each of you as Partners – you have spread the word about KMF, and we now extend across 17 states. We are honored you who have entrusted KMF with the mission of growing your wealth.

If you know of a family who would appreciate the KMF culture, value approach and pure Pay-for-Performance credo, we would be happy for you to introduce us. We look forward to connecting with each of you this year, and wish you a very happy, healthy, and wealthy 2024.

Your Investment Managers,

- Arvind Mallik and Jonathon Fite

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KMF INVESTMENTS

"A PURE PAY-FOR-PERFORMANCE PRIVATE INVESTMENT PARTNERSHIP"

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