DAVIDSON KAHN
CAPITAL MANAGEMENT

2020 Annual Letter

Dear Clients,

This letter marks the start of a new tradition: an annual note. Many of my favorite companies (companies we own) write excellent shareholder letters each year: sharing business updates, distilling investment principles, and offering the occasional life lesson.

I have decided to copy these great leaders and write a letter of my own. In this letter, I will share my philosophy on building wealth, the types of businesses we look for, and how I run Davidson Kahn.

This letter does not, and will never, serve as a venue for market predictions. Where the overall market goes from here in the next day, month, or year, I have no idea. We are not market timers and never will be. There is certainly euphoria in parts of the market. The avalanche of SPACs and IPOs that are minting millionaires overnight doesn't seem to bode well for prospective future returns. Neither does the fact that "first level thinking" is ruling the world. However, this atmosphere could persist for years. Or the market could crash tomorrow. It is impossible to know.

I can tell you that we are well positioned as stewards of your capital in any scenario. We make purchases when we find we are getting excellent value for the price we are paying. There were many moments in 2020 when this was the case and I believe that will continue to ring true in the future. We do not buy companies looking to sell them in six months or a year, so annual predictions don't do us much good anyways. As Warren Buffett wrote in 1996, "If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes." That is the approach we take at Davidson Kahn. While tomorrow is uncertain, I do believe that over the long term, the engines of innovation and ingenuity will continue to power American prosperity and growth.

My Philosophy on Building Wealth

Our job, and our sole focus, is to build, grow, and ultimately maintain your wealth. The philosophy that underpins that effort can be summarized succinctly: **snowballs and singles.**

First, the **snowball**. Building wealth is fairly simple over the long run. You live below your means, you invest your excess cash flow in high quality assets at good prices, and you let compound interest take care of the rest. The problem is that humans are not always rational,

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and greed and fear drive many of our decisions. If patience and discipline were easy traits to practice, there would be a lot more wealth in the world.

I take the concept of the snowball from Warren Buffett. When I was 13, I read "The Snowball: Warren Buffett and the Business of Life." The title comes from Buffett's quote "Life is like a snowball. The important thing is finding wet snow and a really long hill." My Zayde (the Yiddish word for grandfather) gave me that book around my Bar Mitzvah. Much more exciting to me than learning the tropes of the Torah was learning about the rule of 72 and the 8th wonder of the world: compound interest.

To me, every client has a snowball, which is the money they have to invest. It grows two ways: through periodic contributions of more money and through the growth of existing investments. The longer money has to roll down the hill and the more wet snow one can add (good investments and increasing contributions), the bigger the snowball gets.

Our job is to lay out a really long hill. This means making sure clients don't overreact to wild swings in the market. It means making sure clients have enough emergency cash to cover the unexpected expenses that will invariably pop up. It also means making sure clients create sensible financial plans that allow them to continue to systemically add to the snowball.

The other key to is to avoid letting sunlight melt the snowball, which, to keep this metaphor rolling, is permanent impairment of capital (losing money). Buffett (you might be able to tell I am a bit of a fan) says there are two rules of investing. Rule number one: don't lose money. Rule number two: don't forget rule number one.

This doesn't mean our investments will always go up: I can assure you they will not. It does mean we are driven by the desire to always protect the snowball and vigilantly guard against permanent losses.

I believe you can impair capital in two distinct ways.

First, you can either buy a subpar company that has too much debt, too much competition, or inept management. Over the long term, this type of investment generally loses money.

Second, you can buy a very good company at an exceptionally unreasonable price. The classic example of this is buying Cisco Systems in March of 2000. Even though the company has produced tens of billions of dollars in cash flow since 2000, ignoring dividends, you still would not have broken even on the purchase as of December 2020. Until they repeal the fundamental laws of economics, price still matters.

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Between the two, I would rather make the mistake of slightly overpaying for a great company than finding a bargain on a clunker, but as stewards of your capital, it is our job to avoid both of these money losing propositions.

Second, **singles.** In baseball, you can reach the hall of fame if you hit .300 for a long career. This basically means that for every ten times you come to the plate, you only need to hit it on three occasions. These could all be singles and one day, you'll be known as one of the greatest players in baseball history, enshrined forever in Cooperstown.

This concept holds immense appeal to me. In investing, if you can consistently be above average for decades on end, the ultimate results will be stupendous. As Charlie Munger said, "it is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent."

We are not trying to outsmart the competition on a daily basis by determining which stock will double in the next month. We are looking for high quality businesses with good management that are well priced and have ample reinvestment opportunities. These don't come around that often, but by just buying these companies and holding them (being consistently not stupid), and avoiding trying to double our money in six months (trying to be very intelligent), I like our chances over the long term.

Morgan Housel, an excellent author, recently wrote, "the most important question to answer as an investor is not, '"How can I earn the highest returns?"' It's, '"What are the best returns I can sustain for the longest period of time?"' That is the concept of singles in a nutshell.

The idea of doubling your money in a month is always more attractive than holding for the long term. However, as my Zayde told me when I was young, the only way to guarantee doubling your money is to fold it in half. Trying to hit home runs every time up to bat would risk melting the snowball, and we plan to hit singles while avoiding frequent strike outs. **Singles and snowballs are the sustainable path to wealth for all of us.**

Businesses We Invest In

Based on my frequent quotes of Warren Buffett and Charlie Munger, you might think I am a card-carrying member of the Value Investment Club. However, I think the concept of value investing compared to growth investing has gotten skewed by academic writing and factor based quantitative investing. The definition of "value" as measured by cheapness or a higher earnings yield is not the type of investing we engage in.

Price absolutely matters, but it is only one of the characteristics we look at. Amazon is a large position of ours. True cigar butt value investors would laugh us out of the room for that holding. However, when we bought the company, I thought we were paying a fair price for their

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future stream of (rapidly) growing cash flows. That does not mean they are fairly priced now or we will sell them every time they get expensive. As long as they stay a great company with excellent business fundamentals, we will be proud owners.

Munger's approach to investing serves as our north star. He has said that a great business at a fair price is far superior to a fair business at a great price. This line of thinking was so persuasive that it changed the way Buffett invested, moving him away from his previous "cigar butt" investing style. Finding high quality companies at good prices has been the true Buffett/Munger approach for the majority of their illustrious partnership.

To me this is true value investing: getting great value for high quality companies, while being conscious of price. There is no growth vs value battle. Growth is an important characteristic of any great business, and it must be considered when determining the value of a company. The key is to avoid overpaying for growth.

In the 2014 Markel shareholder letter, Markel management expertly conveyed how they invest in detail. They wrote:

Our investment record has not and will not be based on our ability to forecast the future of geopolitical changes, interest rates, currency moves, technological change or any other factor that occupies the minds and hours of countless investment professionals. We simply accept that all of those things will continue to fluctuate and change, and that our four part process does the best job we know of finding people and financial circumstances who will make the best of whatever happens

1. **Profitable business with good returns on capital and modest leverage**
2. **Management teams with equal measures of talent and integrity**
3. **Businesses with reinvestment opportunities and or capital discipline**
4. **Reasonable valuations**

For the most part, Markel summarizes the characteristics I look for as well. While they are less concentrated in their portfolio than we are, the capital allocators at Markel are stupendous investors. We only buy individual businesses that I can envision owning for a decade or longer.

From a financial point of view, we look for fairly priced companies that have a high rate of return on invested capital, the ability to generate large amounts of free cash flow, strong gross and net margins, and low levels of debt. Every company needs to have clear growth prospects, excellent management with significant ownership in the business, defensible competitive advantages, and respect from customers, vendors, and employees.

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While the list is fairly straightforward, finding companies that fit these criteria is not nearly as simple. We only purchased a handful of new companies this year. I looked at over 140 companies in detail this year, and we only found a handful of new ones that were worthy of purchasing at existing prices. It was harder to find a new company that met all of our criteria and was fairly priced than it was to get into Harvard last year!

We are attracted to managers who have large ownership in the companies they run and who have consistently demonstrated an ability to reinvest in new opportunities at exceptionally high rates. We buy companies that don't care about quarter to quarter results but set out ambitious long-term growth strategies and actually convert on said plans.

When I find great companies, I feel invigorated, almost as happy as I will be when USC wins a national title in football or championship in basketball (at this rate it could be a while). Many of our companies have had strong share price performance this year. However, they could have all dropped precipitously (as every company we own did in March), and I would have felt just as good about them. If anything, I would be happier because we could have bought more. Share price doesn't matter to me on any given day (unless we are buying). The underlying business operations are all I think about.

It is great to own companies with world class managers like Jay Adair at Copart, Willy Walker at Walker Dunlop, Gary Friedman at RH, and Tim Cook at Apple. I don't know if these companies' stock prices will go up or down next month, next quarter or next year. I also don't know if the other companies we own will experience appreciation in their share price in 2021. I do know that each company should meaningfully grow their intrinsic value next year and should for the foreseeable future as well. I feel very comfortable owning each of these companies, and our other companies, for the next decade. We also follow all the businesses exceptionally closely, so if the facts and circumstances change, we will not be caught asleep at the wheel.

Benjamin Graham said, "in the short run, the market is a voting machine, but in the long run, it is a weighing machine." We own high quality companies, and we only care about the weighing machine. I believe we will be richly rewarded for this discipline and patience for decades to come.

Our Business

2020 was a big year for Davidson Kahn Capital Management. We changed our name, started to take on outside capital and set in motion the plans to grow for much of the 21st century.

When thinking about how to run Davidson Kahn, I aim to build a business that I would love to buy. We want to embody many of the extraordinary characteristics of the companies we own. I know it is audacious, but I plan on building a business that resembles Brookfield Asset Management. I try to emulate some of the best managers and capital allocators in the world

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when making decisions: Bruce Flatt at Brookfield, Jeff Bezos at Amazon, Bobby Kotick at Activision, Tom Gayner and Richie Whitt at Markel, Mark Leonard at Constellation Software and of course Charlie Munger and Warren Buffett at Berkshire Hathaway.

Taking a page from Munger and inverting, I should set out what we do not do. We do not trade or market time. We are not simply asset gatherers. We do not attract clients and partners who are in it for the short term. We do not, and will never, have fancy offices, lavish expense accounts, or high-pressure salespeople.

We will never measure ourselves by how many newspaper articles are written about us, the amount of revenue we generate (free cash flow and net profit are the only things that matter to me!), or the number of employees we have.

What we do have is a relentless focus on pleasing clients and operating with a low-cost structure. We invest tremendously in research, we outwork other investors, we focus on the long term, we are not swayed by market trends, and we are not trying to get rich quickly.

I treat every clients' money like I treat my own, or my parents, or my grandparents (depending on the age). Health and money are two of the most important things in anyone's life and it is an immense privilege and responsibility to be an effective steward of capital. We charge a straight management fee that declines as assets increase and that is it. There are no hidden expenses or commissions. Our goal is to help clients build wealth and we want the incentives to be clearly aligned.

As you all know, we pair our hand-picked companies with carefully selected index funds to create a broad-based diversified portfolio with international exposure. I believe a portfolio that combines well-researched individual equities with specific index funds is the best way to build wealth over the long term.

Client First: Amazon has been extraordinarily successful because they always focus on the customer. Our clients are our business. Doing well by them and helping them build wealth is why our business exists and that is all I am focused on. If it doesn't help our clients, we don't engage in the behavior.

We don't have a fancy website, nice marketing materials, or a plush office. None of these things make us better investors nor do they help us put together more effective financial plans. Helping clients build wealth is what matters. Clients don't care if we are in the news. They care about having enough money to send their kids to college, to buy a second home, or to travel whenever and wherever they want. I am confident word of mouth will bring us plenty of clients as treating clients right will pay way more in dividends than any advertisement ever could.

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Low Cost Operators: Jeff Bezos is famous for saying that customers wanting low prices will never change. Just like we want to pay a fair price for companies, clients want to pay a fair price for our services. This doesn't mean we are going to be the cheapest in the world, because often what you pay for is what you get. However, we provide so much more in service, diligence, and planning than anyone else for anywhere near our fees. We are able to do this because we are low-cost operators.

Andrew Carnegie and Cornelius Vanderbilt are two of the most successful capitalists of all time. Both were low cost operators in commodity industries (steel for Carnegie and boats and railroads for Vanderbilt). They had lower levels of expenses than other bloated competitors and were able to charge less. This led to a virtuous cycle where they captured more of the market, enabling them to spread their fixed costs over a wider pool of customers, and ultimately charge even less. At a basic level, Amazon does something similar in contemporary times (although it is a bit more complicated than that).

Davidson Kahn will always be a low-cost operator, and we will pass on those savings to our clients. I created our website in an afternoon because we don't invest in marketing or advertising, and we will never have a big staff. Offering market commentary and predictions provides zero utility and if anything creates unnecessary activity and stress for clients.

We invest heavily in research and technology, because that ultimately helps our clients. If it doesn't improve our ability to find high quality companies or excellent index funds, we do not spend money on it and we never will. We do not hoard that surplus. We pass it on to our clients, so they have more money to add to their snowball.

I want our clients to be happy and to make money, and that is about it. This constant focus on cost and service will pay off in the long run. As Willis Johnson, the founder of Copart, wrote in his book *Junk to Gold*, "watch your pennies and the dollars will take care of themselves."

Patience: One of the key attributes that has led to Berkshire, Markel, and Brookfield's long-term success is their patient shareholder base and the allocators' patient investing approach. Most of Wall Street is focused on the next quarter or year; I am focused on the next seven decades. Buffett and Munger are investing into their nineties and with advances in healthcare, I would love to do this for the entire 21st century. Quarter to quarter results don't matter as much on that type of timeline. We are playing a different game than most other investors, and that gives us a competitive advantage.

Furthermore, we are not trying to reach a certain asset level at any specific period. We only want to work with clients who see eye to eye on long term growth. All client money is not the same; who we work with is of paramount importance. We are fine turning down investors. This year, I told seven potential clients I didn't think we were a good fit. I imagine this number will only grow over time.

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I have chosen this business because I love investing (I enjoy making money also, but it is not the main motivator). There is no magic number we are searching for. We will always build slowly and with patience. We don't ever want to feel pressured to generate a certain return or else a client will leave. That is not a sustainable business model and when you think in decades, sustainability is critical.

I also don't put pressure on clients to invest with us. If they want to, that is excellent. If they need time to think, three or six months won't make a difference in a multi decade relationship.

Skin in the Game: Just like we want the managers of the companies we own to have large ownership stakes in the businesses they run, we also eat our own cooking. The overwhelming majority of my net worth is invested in the same companies and indexes as our clients. There is not a single stock a client owns that I do not have a material ownership interest in relative to my overall net worth. The position sizing for clients varies based on age and risk tolerance, but we all own the same positions. That will never change. At the end of the day, money talks, and investors' interests must be aligned with their clients, so they all succeed or fail together.

Effort: When I was growing up, the only thing my Dad said he cared about was my effort level in school. Although when I didn't get a 5 on the AP Biology exam as a sophomore, he seemed to care about the score quite a bit. (My mom cared about my behavior in class, so I was disappointing both parents that year).

However, he was right. Effort is what is ultimately going to set Davidson Kahn apart. There are plenty of smart investors out there. There is a subset who have long term time horizons as well. However, no one is ever going to outwork us. We are always going to spend hundreds of hours analyzing and researching a business before we decide to purchase the company.

Outside of USC football or basketball games, my only hobbies are reading and investing. Investing doesn't feel like work to me, and that is tough to compete with. I love investment research. I love messaging and calling vendors, customers, employees, and competitors of every company we look into. I love poring over the annual reports, reading conference calls transcripts, and analyzing industry data not just from this year, but from many, many years prior. As we bring on employees and partners, every single person is going to have that same drive, hunger, and love for investing. Our DNA will be based on patience, discipline, and intense effort.

The Future

2020 was a year for the history books and I hope everyone is able to stay healthy and safe. I am excited to start this journey with all of you as we build an incredible company. I cannot thank

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you enough for your trust in me. It bears repeating that it is an immense privilege to manage your money and it is one I do not take lightly.

When I was at USC I met a girl who was from Omaha, Nebraska. Naturally, I asked her if she somehow knew Warren Buffett. She didn't. However, she did say he was responsible for her going to college. It turns out her grandparents bought Berkshire stock decades ago, and whenever a grandkid was ready to go to college, they sold a share or two to pay for the tuition.

That story has always stuck with me. My goal is that one day in the distant future, clients, as well as kids and grandkids of clients, will say that investing with Davidson Kahn helped pay for college, their first home, a large charitable bequest or any other meaningful item or experience. That is the type of wealth we are looking to help build, and I am confident we can do so for much of the 21st century.

Sincerely,

Jake Davidson, JD/CPA

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