Meditation Capital – Launch Letter

Dear Partners,

My goal is simple: to compound our money at high rates of return while making my best efforts to continually maintain safety of principal. Asymmetry, in both our individual investments as well as the overall fund, is extremely important.

Below I lay out some thoughts on how I plan to invest to achieve that goal.

Investing in great products

I believe strongly in investing in companies with great products. Building a great product requires enormous effort and is the strongest signal of a business's customer obsession. If building great products were easy, we would be surrounded by them; instead, they are rare. Only the products of a few companies make us marvel at their quality and the depth of thought encapsulated.

As part of my study of the best businesses globally, I've observed that the best Chinese businessmen focus obsessively on product. This is because in almost any industry in China, competition is brutal. An industry-leading company that goes public has survived a culling process that eliminated dozens or literally hundreds of their competitors. The only way to survive in such an environment is to listen closely to the customer and constantly iterate the product. Whoever serves the customer's needs best wins.

As a result of this awareness, when they look to invest outside their own businesses, these Chinese businessmen focus to a surprising degree on product in selecting companies. For example, some top Chinese investors (Tencent among them) took stakes in Tesla and Snapchat, despite significant difficulties faced by those companies in other areas. But what was key was that they had amazing products, and with hindsight, that was the correct starting point for analysis.

This focus on product is also an approach taken by American startup founders and VC investors. Product-market fit for a new business is painfully difficult to find; the only way to do is to *really* understand the customer and build a product that fulfills their needs.

In Jeff Bezos's accumulated letters to shareholders, the word "customer" shows up 506 times. Bezos explains clearly why a business should focus on the customer: because it's the best way to drive long-term shareholder value! *"If we do our jobs right, today's customers will buy more tomorrow, we'll add more customers in the process, and it will all add up to more cash flow and more long-term value for our shareholders."* (2001)

VCs understand this, and accordingly they focus on customer engagement with the product as a key signal for future financial performance. "Traction" is quickly rewarded even if many other pieces of the puzzle, e.g. profitability or competitive dominance, are not yet there. VCs are willing to bet on a company having a "product moat."

Strangely, this is an approach that has not quite filtered through to public market investing. Once a company is public, investors bring a whole group of other considerations into play. And trading is also influenced heavily by a subset of public investors that obsessively focus on changes in guidance, acceleration/deceleration, margin expansion/contraction, and relative valuation (not to say that those aren't important – if read correctly, they can be timely signals of deeper things going right or wrong in the business).

Most American public market investors look at product as just one key element of a broader mosaic, and generally not as a screening tool. If the product is great and loved by customers, that's great and is a mark in its favor, but other economic factors (moat, margins, pricing power, multiple, etc.) also receive high weightings and research time. I don't think that's at all the wrong approach. But consequently, by focusing on product first and foremost and using it as a screener rather than as just one point to be analyzed, we can find opportunities that others miss.

What I find really interesting is that some companies with great products can look like bad investments from a traditional lens (losing money, high levels of competition, questionable industry dynamics, failings in some areas outside product, etc.) – but their amazing product (driven by a culture of customer obsession) is a hidden asset that more than compensates for all of that – and will over time lead to continued share gain, better economics with scale, and with luck, even dominance in its industry.

A focus on product-led companies also helps with maintaining conviction in drawdowns. The most dangerous type of individual stock drawdown is when you lose confidence in the terminal value at the same time. The stock is cheaper, reaching levels you previously would have thought would be an incredible buying opportunity…but recent developments now bring you more doubts about its terminal value. Maybe it is more threatened by competition than we thought; maybe the market potential is not as big as we thought; maybe it was over-charging and needs to reset pricing to a lower level than we thought. Investing in customer obsessed companies gives me more confidence in their terminal value – in their ability to adapt, gain share, and beat out competitors over time.

If we extend this product-led philosophy, then it follows that venture-backed companies, globally, are a great area to hunt for product-led companies. This is a subset of the public markets that has expanded rapidly over the past several years and is poised to continue to accelerate given the explosion of private market VC funding. For reasons I describe later below, I see an air pocket in the post-public shareholder base for smaller venture-backed companies, and as a result I believe our fund can take advantage of that to be a natural home for them.

Gaps in the hedge fund model

Some of the sharpest, hardest working investors I know work at hedge funds. There are a number of amazing funds that I think very highly of and track closely.

In most industries, scale beats lack of scale, hands down. As Munger said in his 1994 USC speech, "*in terms of which businesses succeed and which businesses fail, advantages of scale are ungodly important.*"

So why am I starting this venture, in an industry that is already mature and where the top players have seemingly consolidated large scale advantages?

My answer is that like all entrepreneurs, I see a gap in the market - in how existing hedge funds work - that I want to exploit. And the investment industry is a rare industry where scale brings advantages but also material disadvantages.

Below I lay out a few categories where I plan to do things differently.

Size and liquidity constraints

This is the most obvious. We've all heard Buffett yearn for the days when he had less money. *"Size is the anchor of performance. There is no question about it."* (The Superinvestors of Graham-and-Doddsville, 1984)

It's ironic because I never was (and still am not) a big fan of small caps, as traditionally understood. In the past, the small caps I've looked at have tended to be a bit sleepy, run by OK to good but not great managers, arguably overlooked by investors but not overwhelmingly cheap. Most importantly, they lack scale – the essential business ingredient discussed in the Munger speech quoted above – in an increasingly consolidating world.

<u>But a lot has changed in literally the last four years</u>. Seeing what's changed and the opportunities now available is a big part of what led me to start this fund now rather than later.

In short, over the past half-decade, venture capital funding has exploded – in the US, in China, in Europe, and elsewhere. Global venture capital dollar volume has increased from $70 billion in 2012 to $230 billion in 2017 to $640 billion in 2021. This funding, stories of enormous success, and the generally greater opportunities enabled by technology has encouraged some of most talented people in the world to start businesses. A disproportionate number of those people in turn create customer-obsessed companies with amazing products – exactly what we're looking for in investments. And as they mature and go public, I see an incredible opportunity to back them on the public side.

This may seem counterintuitive – why is this an incredible opportunity? Aren't there a large number of funds that own public venture-backed companies, which often trade at very high valuations?

I don't think it's widely recognized yet that the market has bifurcated. The top, biggest companies IPO to great fanfare and become staples of the hedge fund community and its associated sector coverage lists. They go to all the sell-side conferences, are covered by every bank, pod analysts memorize their guidance and pepper them with extremely detailed questions, every earnings report makes the news, etc. They tend to trade for high valuations; and some of them despite the attention and high valuations still turn out to be great investments.

But there's a second category of post-IPO venture-backed companies: the ones who don't hit the liquidity threshold to be investable by medium-to-big funds. This could be because their market cap is just a bit too small; but it could also be because of high insider and VC ownership, listing venue (Europe and Hong Kong are notoriously illiquid), or just general lack of investor interest.

Companies themselves don't necessarily realize that there's a magic liquidity threshold of ~$30 million per day. Below that, it's just not worth it as a big-fund analyst to spend time doing research. Sell side will cover the company as a favor but won't market it heavily to their clients; the company presents at conferences but investor attendance is sparse; the stock doesn't make it onto pod sector coverage lists. The company somewhat falls off the map.

Just to lay out some numbers on liquidity thresholds: let's say you're a $2 billion fund and have an average position size of 5% (thus, average position size of $100 million); as a risk management measure, you have a rule that you have to be able to exit the position in 15 trading days (thus, trading $7 million per day); and you trade up to 20% of daily volume when buying a position to avoid moving the market (a common rule of thumb). Those constraints lead to a minimum average daily liquidity of $33 million. For a $10 billion fund, scale that up by 5x to $165 million, and so on. For exceptional opportunities, funds may make exceptions in position size and days to exit; but there's still some minimum close to the $30 million per day liquidity mark.

But now there are a lot of respectably sized, excellent companies that trade nowhere near $30 million per day. Just to give two examples: Deliveroo trades $7 million and Aramis $1 million (despite a $500 million market cap). For even medium-sized funds, these are practically uninvestable.

It's ironic – as private companies with zero daily liquidity, they received lots of high-profile suitors. But once public, these high-profile institutions will be selling, not buying; and despite falling valuations, due to low liquidity not many other institutions of similar size will be taking their place.

Thus, as one part of the overall strategy, my vision is of our fund being a natural buyer of high-quality, smaller/less liquid venture-backed companies in a later stage of their life cycle, as public companies.

These characteristics are illustrated by our portfolio. Of the 15 companies I've picked for day 1, 11 of them went public within the last four years. 10 of the 15 trade for less than $30 million per day, but only 2 of the 15 have a market cap smaller than $1 billion.

There're a lot more venture-backed companies that are coming. We've all seen the frequency of announced private rounds over the past two years. I'm super excited, both intellectually and commercially, to study these companies as they mature and eventually come to market.

Shorts detracting time and focus from longs

Hedge fund analysts are generally very good long analysts – when they have the time for it. But in long/short funds, there are structural constraints on how much time analysts can dedicate to long investments.

It is common for hedge fund analysts to spend 60-70% of their time on shorts. (A few funds have separate short teams that handle the short book, but most don't.) This time allocation mix naturally proceeds from the nature and requirements of short selling: smaller positions (so more needed); more frequent turnover (more replacement needed); more intensive initial research (it's hard to gain conviction to bet against the management narrative); more active tracking and trading.

If 60-70% of time is spent on shorts, then only 30-40% of time is available for longs. To make the time allocation work, many funds take an approach of finding high-quality "buy and hold" compounders for their long book while spending the majority of their time researching the short book. In this model, spending a lot of time to research one-off idiosyncratic longs, especially less liquid/smaller ones, doesn't make that much sense.

I think this is generally a good, but sub-optimal, strategy, especially in an environment where compounders are increasingly well-appreciated and it's harder to find differentiated and cheaper/better ones. If instead of 30-40% we dedicate 95% of our time to our long book (maybe 5% to hedging); then together with a bigger/different opportunity set due to our smaller size, we will find an amazing portfolio of investments. This isn't just theoretical; I'm very excited about the 15 positions we've assembled for day 1.

Not only can we find better investments, as a PM I will understand them better. Two investors owning the same stock will monetize the investment at different levels. The one with more understanding and conviction will size it bigger, know when to buy more, have the conviction to hold through a drawdown, and be able to react quicker to sell when something is going wrong. Conviction is monetizable; and I plan to spend my time developing conviction while remaining balanced about the risks and unknowns.

This comes, of course, at a cost – without a portfolio of single-name shorts, our portfolio will be more sensitive to market movements and more volatile. Some of this is unavoidable, but I plan to mitigate what I can by holding varying levels of cash (sizing down when IRRs are low, sizing up and potentially taking on leverage when IRRs are very high) and occasional hedging.

Pressure from non-investment sources

My experience is that lockups do not necessarily accomplish their intended goal of enabling a firm to think and invest long-term.

Regardless of the lockup on existing investors, funds actively marketing to new potential investors and needing more AUM will still feel the pressure to generate good returns in the short term. Managers may also be keenly aware of the lockup clock and the need to retain investors who are on pace to have their lockups expire, again via good returns in the short term.

If we look deeper, I believe barriers to thinking and acting long-term come from expectations embedded in a firm's structure. A high cost base (i.e., a lot of people) relative to AUM necessarily requires that AUM base to not decline. Also not helpful is if the investment team focuses on maximizing the income stream that comes from the business, as opposed to that from the compounding of personal capital, or simply pride in generating a high CAGR.

My goal is to create the conditions to be able to think rationally, to optimize for the long term instead of the current quarter or month. For me, the best way to do that is by having a cost structure that is always well within our means and by having a clear understanding of our values (high CAGR while minimizing drawdowns). Various elements of our structure were designed with that goal in mind; for example, no single-name shorting means a much smaller analyst team, one which we can pay exceptionally well if fund performance warrants it. Ultimately, my goal is that partners joining or leaving will not at all affect our operations or investment thinking.

The fund's terms include a two-year lockup because I want the decision to invest to be a two-year commitment. But after that commitment, I feel strongly that our investors' money belongs to them to do as they see fit, not to me to improve the short-term structure of my own business. I oppose rolling lockups or gates. Full redemption is allowed with 90 days' notice.

I am in this for the long-term; I will be managing my own money for the rest of my life. Relative to the capital I've accumulated to date and even with zero external AUM, the cost of running the fund isn't substantial. To paraphrase one of my favorite characters: I don't intend to invest in order to have clients. I intend to have clients in order to invest.

All of this is not to say that I will be tolerant of large short-term losses. I am not a strongly ideological, "long-term without caring about short-term drawdowns" investor (though I have a lot of respect for those guys too). I think minimizing drawdowns is very important. But most important is to minimize outside pressure that might cloud our thinking. Let's focus solely on the portfolio and on making the best decisions possible.

Meditation

The more I invest, the more I realize the wisdom of Munger's comment to the effect that so much of successful investing is in not doing dumb things ("*being able to tune out folly, as opposed to recognizing wisdom*"). And the temptation to do dumb things is often driven by emotion. Chasing or not trimming at highs even if you know the valuation doesn't quite work; selling at lows because you can't take it

anymore and allow your worldview to become distorted by extreme bearishness; getting caught up in charisma and narrative.

A year ago, I moved across the river to Jersey City to create more space to think. It's not quite Omaha, but it does create some distance from the buzz of the city. When you step off the PATH train in Newport, you immediately notice a different level of ambient noise and feel a different sense of calm.

Location is a helpful passive influence; I've also found that calm can be enhanced actively through meditation. When I feel agitated, I meditate, and I feel more clearheaded afterwards.

Recent events have shown us that it is extremely difficult to predict the future. What we do know about the future is that frequent, major, unexpected events are in store. Whatever comes, I hope to navigate it calmly and rationally. It's not entirely practical, but I love the idea behind this quote: *"You should sit in meditation for twenty minutes a day. Unless you're too busy; then you should sit for an hour."*

Gratitude

Investing is an incredible profession. I am immensely grateful for having discovered it. As investors we are paid to learn. Our curiosity gets monetized, which further incentivizes and gives extra pleasure to more curiosity.

Investing is fascinating in that it is both useful (growing our capital, which can then be used productively for societal benefit) and a game (get a higher number). We as humans like things that are useful, and we also really like games. Rarely do you get to do both at once. I often toggle back and forth; sometimes I think of investing as doing something useful for myself and our partners and sometimes I think of it as playing a game. It's a lollapalooza of motivation.

Every day I wake up really excited to read and talk about what's happening in the world. What I do every day is an exact fit to my personality and interests and I hope to monetize that alignment to our benefit over a long time to come.

Yours,

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