July 2023

Q2 2023 Right Tail Capital Investor Letter

What is this letter going to be about? How can I discover the key insights in the least amount of time? These are the thoughts running through my head when I begin reading a letter or an article – maybe it's the same for you.

Well, if you're willing to be patient for just a bit, I'll share what *this* letter is all about.

Patience. I've found myself thinking a lot about patience lately. Patience is a powerful tool. It helps us to think long term and drown out the market noise. Warren Buffett says, "The stock market is a device for transferring money from the impatient to the patient." It's incredibly important to remain patient while investing.

But patience is hard to practice. After all, the stock market is open ~250 days each year with lots of news, noise, and flashing colors. You need not only discipline, but you also need "a" discipline – a method that keeps you grounded. I've written about quieting the noise in my previous letters when I talk about running in the rain and staying the long-term course[1][2]. Writing these letters is another part of my practice to do that, and to encourage you to keep enjoying the ride.

At Right Tail, we care about generating sustainable long-term returns. To us, that means being long-term holders and patient learners. We rely on our underlying investments to allocate capital wisely and create shareholder value over time. We rely on time to compound money and knowledge. Patience is key.

I expect our patience to be rewarded in several ways. First, our businesses will continue to create value with their capital allocation. This will often come in the form of reinvesting back in the business at high rates of return. Other times, management teams decide that the wisest decision is returning the capital back to shareholders rather than gambling it on mediocre opportunities.

Patience also allows compounding. I enjoy Naval Ravikant's quote, "All the returns in life whether in wealth, relationships or knowledge come from compound interest." I completely agree on all three fronts but let's focus on investment returns – wealth – for now.

Feel free to pick your own return and time frame, but let's say we generate 15% returns annually. If we do this for 3 years, we'll have done reasonably well having turned $1 million into ~$1.5M. If we can generate these excellent results over 10 years, our $1 million becomes $4M. And if we can do it over 30 years, we're really in for a treat as our $1 million turns into $66 million. The length of time matters immensely. One of the beauties of patience is how powerful the lack of action can be.

Our patience will also be rewarded as our knowledge compounds and our library of researched companies and industries grows every year. Several of my best investments have arisen not the first time

[1] https://www.righttailcapital.com/_files/ugd/9593df_644b23df34ea4112a3c03e69256f93ca.pdf
[2] https://www.righttailcapital.com/_files/ugd/9593df_6626dc082afe4f7692d1b251d77165c1.pdf

I studied a company but years later. Sometimes I have a new insight regarding past research. Other times, opportunities arise when there's a market selloff or company-specific short-term issue. I will continue to wait for those moments that allow us to meaningfully upgrade the portfolio.

It's one of the paradoxes of investing that patience is required when the market is down and when the market is up. Patience can be beneficial in remaining rational when the market is down and great long-term opportunities are presenting themselves. When these times occur, there will be very few voices and media outlets thinking long term or suggesting positive outlooks.

I also find patience helpful when the market is doing well, such as this year with the S&P 500 up mid-teens. Aren't all the factors that we've been told to worry about (inflation, interest rates, geopolitical conflicts, etc.) still present? Or maybe there are "shiny" new investments ideas that could be better than our old ones.

Let's keep in mind that our companies continue to create value. A key element of having a patient long term mindset is not being anchored to prior stock prices. Earlier in my career, I would more often sell a stock because it was up and approaching a pre-determined price target. I would want to lock in a winner and move on to the next one.

I now take a different approach. I do my best to dampen any anchoring, whether it be related to a past stock price or a past investment thesis. This is an active practice – a discipline – to view each investment with a fresh lens and let the businesses continue to create value. While each situation is different and requires judgement, I have found it helpful to be aware of those times when I feel like I "should" be making a change to the portfolio or finding a better, newer idea. I remain steadfastly focused on finding new ideas that will significantly improve the portfolio and aim to ignore ones that may only provide a slightly incremental opportunity.

Patience in managing Right Tail

Feel free to skip ahead of this operational update.

It's been a rewarding time since starting Right Tail in May 2022. Right Tail's goal is to compound wealth and generate excellent after-tax returns over multi-year periods. We'll do this through owning a concentrated portfolio of undervalued, high-quality businesses and investing with a longer-term mindset.

Right Tail is pleased to have 37 investors. I'm thankful for all of you – it's a great mix of friends, family, and other professional investors that I have been fortunate to get to know during various stages of life. We've also been fortunate to have several referrals, and I'm delighted that ~30% of our investors have added to their initial investments.

I think this speaks to the consistency of Right Tail's investment process. Several of us have multiple accounts, making it easy to meet several objectives such as taxable vs. non-taxable. My wife and I remain

Right Tail's largest investors in terms of absolute dollars and likely percentage of our net worth, the latter of which I expect to remain unchanged. Our alignment will always remain strong.

In terms of business operations, the pipes are working well. Schwab has been a great partner as a custodian, and their technology offerings will only improve as they finish integrating TD Ameritrade. Right Tail has established many repeatable processes. For example, opening new accounts for each investor is now much smoother due to having more reps. There will be fewer first-time operational decisions going forward allowing for even more time researching businesses.

The research process is also going well. I have continued to broaden our circle of competence by studying many new companies and becoming more knowledgeable about auto dealerships, contract research organizations, and railroads. Hard work has also led to "scrappy serendipity." I have built great relationships with several companies and service providers, relationships which are now "compounding."

I'll sometimes invite other investors to my company calls which creates opportunity and learning for all parties involved. Investor letters and other communication efforts such as podcasts have led to awesome relationships and better research opportunities, often connecting with people who work in specific industries or other knowledgeable investors. I'm grateful for all of you.

In May, I attended the Berkshire Hathaway meeting in Omaha for the first time. As a big fan of both Buffett and Munger, I was elated to attend. I was blown away by their ability to recall events and stories from 50 years ago or 50 days ago. They are also fantastic examples of how patience pays off in their investment careers and lives. It was great to reunite with old friends and make new friends from near and far. I found everyone to be so kind and inclusive, focused on the joys of investing and learning. I also recorded a podcast[3] with friends from Australia. We'd originally connected through a mutual admiration of Buffett's long-term approach. Two huge takeaways from the event were the importance of remaining patient and having simple investment theses.

Investment Spotlight: NVR Corp (NVR)

One investment where I've been a patient long term holder over much of the past 5 years has been NVR.

NVR is one of the largest homebuilders in the US, operating in over 30 markets. There are several attributes that are underappreciated about NVR. First and foremost, it's not your normal land-owning homebuilder: NVR options their land which leads to outsized returns and less risk by having less capital tied up in land. Many homebuilders cite the positives of owning land such as more control over the entire building process and higher margins.

NVR mitigates the lack of control inherent in their option strategy by working extremely closely with local land developers. These partners appreciate NVR's trustworthiness, pristine balance sheet and quick

[3] https://open.spotify.com/episode/3Ynbsho8b8mEqWQ5FoJcQd

turnarounds. As one developer tells me, "They do what they say they'll do and they honor their commitments to buy a set number of lots." While owning land may lead to higher margins during most economic times, it takes up much capital and is incredibly illiquid. It's also likely worth much less during tougher economic times…exactly when you might want to have more cash on hand.

NVR is so focused on not owning the land that they even refuse to own the model homes for each community – instead, they'd rather free up the capital and pay an above market rent to a local resident who's willing to own it. The model homeowner also may receive the benefit of that home's price rising as NVR further builds out the community, creating a win-win for all parties.

Another underappreciated advantage is having a dominating presence in select markets. NVR has a huge share (>20% in largest markets) in some of its largest markets which leads to local economies of scale. Through their market share concentration, vertical integration, and tight SG&A control, NVR is often the low-cost producer in their markets.

I often find myself thinking about this quote from one of investor Josh Tarasoff's essays[4]:

> *"I think of the highest quality companies as being in a class of their own: the 99th percentile is not 10% better than the 90th percentile but 10x better. Linear thinking and analysis—though they play an important role in building a full understanding—are insufficient for revealing superlative quality…Because the best companies are so good, are so rare, and defy standardized methods of analysis, I suspect they remain undervalued for a long time."*

In NVR's case, the most often cited advantage they possess is not owning their land. This seems like a simple and easy to replicate advantage. However, it's hard for larger homebuilders to clone when a part of their culture and profitability is tied to land ownership. A new company can organize this way but will not only struggle to access capital, they'll face NVR's less visible moats, such as its network of partners who can help with issues like local permitting. Of course, NVR's success is much more than any one factor and is due to doing several little things well. For example, their excellent balance sheet and long-term approach allow NVR to keep investing and opportunistically enter new markets during more difficult economic environments.

NVR's returns on incremental capital have been fantastic. Over multi-year time periods, they have averaged well north of 30%...not surprising, given that the business requires little capital and turns its inventory so quickly (4-5x per year). NVR also scores well on Buffett's retained earnings test. Since 2010, its market cap has grown greater than $16B while retained earnings have grown ~$400M. This indicates that the earnings reinvested in the business are creating significant value for shareholders. Not

[4] https://www.greenlealane.com/_files/ugd/25304a_7f4600d601f843e09e5cc1851207cef6.pdf

surprisingly, this has shown through in the stock's return over the last 10 years with NVR rising >6x or ~21% CAGR.

I remain confident that over long periods of time NVR will remain well run and continue to gain market share. It's not hard for me to pencil out a mid-teens IRR from today's prices. While the housing market seems to be under-supplied, anything can happen in the short term with the economy and housing market. I consider position-sizing more so with NVR than other companies, and it's an investment that is less likely to be Right Tail's largest position after a longer period of company fundamental and stock price outperformance.

As an aside, if you'd told me that a homebuilder would be one of our best investments since Right Tail's inception, I would not have guessed it. It speaks to the importance of partnering with a diverse set of great companies, even within a concentrated portfolio, and not trying too hard to predict macro events and stock market movements. It also speaks to the importance of dampening the noise of stock market news as most housing-related news has been negative.

Thank you for your partnership and continued interest in Right Tail. Your long-term mindset - and patience - are two of our greatest advantages.

Best wishes for continued happiness and success,

Jeremy Kokemor
Right Tail Capital

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