

Columbia Heights Partners, LP

2022 Update Letter

October 24, 2022

Dear Partners,

Year to Date 2022 has been historic in terms of market performance across currencies, bonds and equities.

All are down materially.

I will try to give an update of my thoughts:

- 1) Macro Conditions
- 2) Portfolio Updates and Valuation
- 3) Thought Experiments
 - a. A Defense of Volatility
 - b. Inflation Since 1982
 - c. Supply vs. Demand
 - d. Economics of Scale

Macro Conditions

The Fed has raised interest rates substantially and created havoc in many parts of the market. Some of the risk rerating was likely fair and needed, however, certain pockets may indeed be oversold.

I remain skeptical that the Fed officials are uniquely qualified to handle a Global \$100 trillion economy and the side effects. Neel Kashkari, Bullard and few others also might be more focused on their own personal brand than the side effects of their actions. One key point seems to be that inflation data is lagged and may in fact be cooling fast. One data point is Shanghai to LA Shipping containers (arguably a large piece of global trade) have re-rated to pre Covid prices. I believe this is a huge development.

In addition, a Russian War and China Covid Zero Policy have likely helped contribute to a supply side driven inflation.

I believe inflation will cool very quickly and the market today represents a generational buying opportunity.

Portfolio Update

The portfolio has not had much turnover this year – virtually none. No trades have been done in the last 6 months. However, that hasn't prevented the market from moving like a child with too much candy in his system!

Some of the valuation metrics of specific names in the portfolio are:

- 1) a company selling at 1x EBITDA buying back 20% of its stock
- 2) a company selling below Net Cash with 1% market penetration in a large market
- 3) a 100 year monopoly business buying \$15 billion of its stock and 15% of the market cap. Its various business lines have FCF margins of 25%, 50% and 75% and 50-100%+ ROE.
- 4) another monopoly business buying back \$1 billion of stock on a \$50 million market cap. Its various business lines have 30% plus FCF margins and 50%+ ROE.
- 5) a growth business trading at a PEG ratio of 0.20 with 5-15 years of runway. I consider below 1.00 PEG cheap and below 0.50 PEG extremely cheap

The portfolio is dirt cheap. I welcome any investors and recommend that this is a good time to invest. My projection is likely a 4x over the next 2-5 years – hopefully higher.

Thought Experiments:

A Defense of Volatility

The stock market and individual stocks have been incredibly volatile. It has led me to spend some time thinking about whether volatility is good, bad, both or neither. Like a classic economist I feel the answer is: "It Depends".

Let's look at some return streams of some hypothetical \$100 investments based on NAV:

1. 100, 90, 80, 70, 60, 50, 50, 50, 50, 1000
2. 100, 101, 102, 103, 104, 1, 0.50, 0, 10, 0.01, 10, 1000
3. 100, 1, 2, 3, 4, 5, 1000
4. 100, 110, 120, 130, 140, 150, 160, 170, 180, 190, 0
5. 100, 200, 300, 400, 800, 1000
6. 100, 99, 98, 0
7. 100, 120, 140, 180
8. 1, 2, 4, 8, 0.50, 5, 0.25, 8, 100, 1000, 200, 50, 3000, 20000, 60000, 15000

Now, some questions:

- 1) Which return profile do you prefer?
- 2) Would you like the #2?
 - a. Why?
 - b. What do you like about it?
 - c. What do you not like about it?
 - d. How would you feel when it goes from 100 to 0.01?
 - e. How would you feel if you buy at 0.01 and it goes to 1000 in 2 years?
- 3) What about #4
- 4) What about #8
- 5) Which return profile is the worst?
- 6) How do you feel about upward volatility?
- 7) How do you feel about downward volatility?

There is no right answer to the questions, but what I am trying to prove is there both pros and cons to stability and tail risk.

In the context of some of the world beating companies of the last 100 years, many have had drawdowns of 50-90%. Even Warren Buffett and Jeff Bezos have had to deal with these drawdowns.

We are indeed going through such a drawdown today for many names.

One defense for volatility is that it does provide more attractive entry points for companies that are buying back stock or where you can add at lower prices. Some return streams show massive upward volatility and others show massive downward volatility or skew.

Inflation since 1982

I looked at the CPI inflation constituents since 1982 – exactly 40 years ago.

It is an interesting exercise.

All items inflated at 3x over 40 years. That is a compounded inflation rate of 2.748%.

That is actually not that bad in the context of 7% M2 Money Supply Growth.

So for 40 years, cost of items across the economy (defined by the CPI basket) have gone up at 2.748% per year.

The individual constituents are even more interesting.

Apparel goes from an Index of 100 to 120
Energy goes from 100 to 300
Cars have gone from 100 to 300
Shelter went from 100 to 300
Medical goes from 100 to 600
Tobacco went from 100 to 1200
Plasma Screen TVs likely went from 100 to 1
Many other technology innovations likely went from 100 to 1.

Even though we all think or feel like Shelter went from a base of 100 to 1000 or 5000, across the whole economy it only went from 100 to 300. Maybe New York City, Beverly Hills, Beachfront property or Aspen property inflated at higher rates, but the average was actually quite low – only near 2-3%. All of a sudden, the 2-6% mortgage interest rate no longer looks like as good of a deal as it used to?

I will provide a screen shot in the appendix, but it is important to think about inflation in a historical perspective.

My sense is as excess margin comes to various sectors, supply will be added via technology innovation and capitalists looking to capture the margin.

With used cars and new cars, the 2021-2022 inflation has been extreme. I believe we will go back to trend here both with regards to making new cars and demand and supply rebalancing as people move back to alternatives, public transport, and other options. The same may likely happen for housing and labor as people shift where they choose to live and as free markets adjust. It could be a bumpy few years, but I believe that price signals do work as long as the government does not distort things too much.

I have addressed this issue in previous letters.

It is fascinating side note that tobacco is almost a 12x and Altria/Philip Morris was likely the best performing stock in the last 50-100 years.

Economies Of Scale

Next, I will discuss Economies of Scale.

I remember one of the first lessons of my 12th grade high school economics class at the Oklahoma School of Science and Mathematics had to do with Economies of Scale.

One of our companies is on the verge of taking its revenue from 100 to 200.

Opex is currently 3 and at 200 or revenue, Opex may remain at 3-4.

That incremental revenue and gross profit will fall to the bottom line.

We saw the same thing happen with Ford in the 1900's with mass production and with Apple in the 2010's with mass adoption of the iPhone. Economics of Scale is not a new economic concept, but luckily some companies in the portfolio are hitting an inflection point to benefit.

An Age of Abundance

Continuing from the early point on Inflation and Technology effects on Inflation and Deflation, another factor I am thinking about is the theory that we are living in an age of abundance.

I am firmly in the camp that the real growth of GDP in human civilization over the last 500 years has been nothing short of extraordinary, and it is in fact accelerating. Position your portfolios accordingly.

- 1) Do we live an Age of Abundance?
 - a. Have you been to a Costco or Wall Mart or a Western Shopping Mall?
 - b. Do we work 100 hours a week or 40 hours a week or 20 hours a week?
 - i. How do you work hours compare to 1 generation ago, 2 generations ago, and 5-20 generations ago?
- 2) What will be the effects of Robots and AI

My view is that we are moving towards a world where technology may accelerate with AI and Robots and certain stocks will be beneficiaries. These changes will not happen overnight, but we are headed in that direction. Examples include AI, Tesla, Solar Energy (free energy), Software, Economics of Scale, Agriculture Technology.

I listened to a talk recently that talked about 'Economic Surplus' when societies in Iraq, India and China thousands of years ago were able to harness rivers and agriculture to produce more output than the society needed. I believe we are headed to a similar inflection point. That was an early age of abundance.

For those interested, I recommend you watch the Tesla AI day. I believe the presentation was a Tour De Force and provides a preview to an exciting next 5-25 years. I am particularly excited by the developments of the Dojo Chip among other things.

Fund Is Open

The fund is open to new Limited Partners and I believe today represents an attractive entry point for like minded partners.

As always, please reach out with questions. I appreciate your reading my letter and indulging in my thought experiments.

Gorav Khanna
Managing Partner
Columbia Heights Partners, LP

Appendix:

Table 1. Consumer Price Index for All Urban Consumers (CPI-U): U.S. city average, by expenditure category, September 2022

[1982-84=100, unless otherwise noted]

Expenditure category	Relative importance Aug. 2022	Unadjusted indexes			Unadjusted percent change		Seasonally adjusted percent change		
		Sep. 2021	Aug. 2022	Sep. 2022	Sep. 2021-Sep. 2022	Aug. 2022-Sep. 2022	Jun. 2022-Jul. 2022	Jul. 2022-Aug. 2022	Aug. 2022-Sep. 2022
All items.....	100.000	274.310	296.171	296.808	8.2	0.2	0.0	0.1	0.4
Food.....	13.635	281.506	310.875	313.142	11.2	0.7	1.1	0.8	0.8
Food at home.....	8.475	262.695	295.007	296.771	13.0	0.6	1.3	0.7	0.7
Cereals and bakery products.....	1.098	292.069	336.399	339.336	16.2	0.9	1.8	1.2	0.9
Meats, poultry, fish, and eggs.....	1.905	293.217	318.867	319.486	9.0	0.2	0.5	0.5	0.4
Dairy and related products.....	0.804	231.973	267.461	268.793	15.9	0.5	1.7	0.3	0.3
Fruits and vegetables.....	1.413	315.428	343.221	348.173	10.4	1.4	0.5	0.5	1.6
Nonalcoholic beverages and beverage materials.....	0.973	184.490	206.693	208.332	12.9	0.8	2.3	0.5	0.6
Other food at home.....	2.283	225.141	259.976	260.580	15.7	0.2	1.8	1.1	0.5
Food away from home ¹	5.160	310.996	334.212	337.369	8.5	0.9	0.7	0.9	0.9
Energy.....	8.244	248.228	305.372	297.343	19.8	-2.6	-4.6	-5.0	-2.1
Energy commodities.....	4.565	283.095	358.038	338.768	19.7	-5.4	-7.6	-10.1	-4.7
Fuel oil ¹	0.156	287.325	466.755	454.177	58.1	-2.7	-11.0	-5.9	-2.7
Motor fuel.....	4.336	279.367	351.315	331.772	18.8	-5.6	-7.6	-10.5	-4.8
Gasoline (all types).....	4.238	278.338	348.593	328.918	18.2	-5.6	-7.7	-10.6	-4.9
Energy services.....	3.679	225.160	267.564	269.667	19.8	0.8	0.1	2.1	1.1
Electricity.....	2.688	229.831	265.191	265.487	15.5	0.1	1.6	1.5	0.4
Utility (piped) gas service.....	0.992	207.290	268.866	275.894	33.1	2.6	-3.6	3.5	2.9
All items less food and energy.....	78.121	279.884	297.178	298.442	6.6	0.4	0.3	0.6	0.6
Commodities less food and energy commodities.....	21.288	156.720	167.637	167.104	6.6	-0.3	0.2	0.5	0.0
Apparel.....	2.433	123.406	127.328	130.143	5.5	2.2	-0.1	0.2	-0.3
New vehicles.....	4.049	160.244	174.598	175.312	9.4	0.4	0.6	0.8	0.7
Used cars and trucks.....	4.008	190.207	212.895	203.867	7.2	-4.2	-0.4	-0.1	-1.1
Medical care commodities ¹	1.478	376.842	391.032	390.677	3.7	-0.1	0.6	0.2	-0.1
Alcoholic beverages.....	0.869	264.980	275.627	275.810	4.1	0.1	0.5	0.4	0.0
Tobacco and smoking products ¹	0.517	1,263.542	1,364.765	1,367.458	8.2	0.2	0.3	1.1	0.2
Services less energy services.....	56.833	355.962	376.980	379.634	6.7	0.7	0.4	0.6	0.8
Shelter.....	32.470	337.451	357.264	359.704	6.6	0.7	0.5	0.7	0.7
Rent of primary residence.....	7.304	351.255	373.283	376.569	7.2	0.9	0.7	0.7	0.8
Owners' equivalent rent of residences ²	23.837	345.824	365.993	368.932	6.7	0.8	0.6	0.7	0.8
Medical care services.....	6.864	572.559	605.883	609.852	6.5	0.7	0.4	0.8	1.0
Physicians' services ¹	1.807	407.266	412.828	414.767	1.8	0.5	0.3	0.2	0.5
Hospital services ³	2.146	366.394	380.339	380.465	3.8	0.0	0.5	0.7	0.1
Transportation services.....	5.860	321.673	362.511	368.643	14.6	1.7	-0.5	0.5	1.9
Motor vehicle maintenance and repair ¹	1.052	320.446	349.539	356.076	11.1	1.9	1.1	1.7	1.9
Motor vehicle insurance.....	2.431	566.211	615.559	624.558	10.3	1.5	1.3	1.3	1.6
Airline fares.....	0.615	198.975	283.911	284.313	42.9	0.1	-7.8	-4.6	0.8

¹ Not seasonally adjusted.

² Indexes on a December 1982=100 base.

³ Indexes on a December 1996=100 base.