KINSALE CAPITAL MANAGEMENT

The Kinsale Compass Fund:

An Owner's Manual

Kinsale Compass Fund – Owner's Manual

Dear Partners,

I have written the following owner's manual to provide you with the information necessary to understand our ongoing relationship, my investment philosophy, and my investment process. I must stress that the Kinsale Compass Fund is solely focused on long-term performance and every aspect of the fund has been structured to achieve this goal.

You will notice that I addressed this letter 'Dear Partners'; while the structure of the fund is not a partnership, I run the fund as a long-term value based partnership (and hence think of you as partners). This mentality allows me to work on your behalf and avoid conflicts of interests and poor business practices which plague many traditional "fund managers". Given that I manage the Kinsale Compass Fund as a partnership, I would like to take the opportunity to share with you how I view our relationship:

- You provide the capital and I provide the investment advice. There are expenses, which are covered by the management fee, and we split any profits that we have at the end of the year. My fee can only be earned if you profit from your investment in our partnership.

- I think of you as a partner, not a client. I have no interest in marketing and thus spend the majority of my time finding great investment opportunities for us.

- I will be straightforward with you and provide you with the information you need to make an informed decision regarding your investment in my partnership.

- In a partnership all partners benefit from and are affected by each other partner; investors in "funds" do not typically think of themselves in this way and thus trade in and out of the fund. As a partner, I ask that you understand that your behaviour not only impacts your returns but those of other partners as well.

- I ask you to be cognizant of your fellow partners. I treat the fund as a long-term investment. Its long-term performance is dependent on your support of my stock picks even when the market seems bleak. If your view and commitment are short-term, you will not benefit from one of my key strengths - which is, the ability to buy stocks when other money managers are selling them irrationally.

- I manage the fund. I am responsible for the returns and most of all I understand that I act as your fiduciary.

- I welcome your calls and am more than happy to explain what I am doing (but be prepared to be bored about the minutiae of the fund's holdings).

As partners I believe it is important for you to have the necessary information to assess the job I do. As such, you should have full transparency into how returns are achieved. There are too many investment funds that believe the opaqueness of a portfolio adds a certain cachet. In my opinion for funds of a modest size where liquidity is of minor importance, such secrecy can lead to the abuses that the investment management industry has been embroiled in lately.

Providing you with transparency also minimizes one of the greatest risks I face when running a pooled investment fund, the risk of having the wrong investors. This risk hinders my ability to invest when markets become irrational. Uninformed investors (typically only attracted by past performance) will be tempted to withdraw capital from the fund at the wrong moment (when markets are falling), leading to further losses as we are forced to sell stocks for redemption purposes (when in fact we should be buying stocks). Your actions at the wrong time can negatively impact the ability of the fund to earn outsize returns that come from periods of distress. It is for this very reason that Gearoid, Seán and I have gone to great lengths to attract a base of investors who understand what I do, and I have done my best to discourage potential investors who I internally classify as renters rather than owners. When the inevitable bout of underperformance hits the fund and stocks I previously purchased (at attractive prices) are under water I expect our partners to commit additional capital.

Finally, because I think of myself as running a partnership, there are a number of activities I avoid. I do not actively seek new investors and avoid gathering assets as size is the enemy of superior investment returns. I accept meetings with prospective partners, but do not have PowerPoint presentations or slick (or any) marketing brochures. We are very conscious of having the right investors and only accept referrals from investors and friends that understand our investment philosophy and process.

My Investment Philosophy

The Fund's goal is to find and invest in a collection of great businesses at great prices that can compound at high rates of return over a very long period of time. In order to accomplish this goal, I always focus on the 3 cornerstones of value investing, each is described below.

Avoid Losing Money: One of the most important and often ignored concepts in investing is the concept of not losing money. It is against human nature to take action expecting to be wrong. However, this can be a very useful way of thinking when it comes to investing. With this in mind, the foundation of my philosophy begins with a focus on "not losing money" and "eliminating" losers. How do most investors lose money? By failing to understand the business models, management teams, and valuations of the companies they invest in. The Compass Fund strives to avoid losing money by doing the exact opposite, that is: avoiding poor businesses, becoming a world expert in the companies the Fund owns (through extensive due diligence), constantly searching for factors that can kill my investment performance and candidly admitting and fixing my mistakes. Another equally important discipline is a willingness to sit pat and hold cash in the portfolio until I find outstanding investment opportunities.

Think of Investing In Stocks as Owning Businesses: I approach the buying of an individual stock as if I was buying the entire company. This keeps me focused on the long-term value of the company. I ask myself, "Would I be happy to buy the company today at current prices and not be able to sell it for 3-5 years?" To be able to do this with confidence, I want to buy great operating assets (that is, assets that will produce excess cash either now or in the near future, as opposed to dead assets which may be valuable but are not growing in value) that have critical mass and have definable barriers to entry. Such companies will typically have value to other buyers and will tend to emerge from industry-specific, economic slumps or other unforeseen problems in better shape than their competitors.

Pay attention to the Margin of Safety (i.e. Don't Over Pay): The price I pay for a company is one of the few things I can control as a minority shareholder. I tend to become more excited as the companies I want to buy get cheaper. This is a situation that is unusual in the investment industry, for a reason I have never understood. Mr. Market (as Ben Graham called the collective investment community) becomes more excited the more he is asked to pay for a company and more despondent when that same company goes on sale. I treat this unique aspect of the investment business as an opportunity. You can use these temporary periods of fear and greed to buy companies selling at discounts to their intrinsic value and sell them at premiums. There is a wide body of academic evidence that will tell you the more volatile the market is, the riskier the market becomes. However, common sense will tell you: the cheaper an individual stock is, the less likely it will decline further. I require at least a 50% discount to what I ascertain to be a company's intrinsic value to a sensible buyer. This margin of safety is very important in a concentrated portfolio and plays the risk reduction role that diversification plays for other investment styles.

My Investment Principles:

Below are my core investment principles that have long guided the individual makeup of the portfolio. They are certainly not unique but are the foundation of my investment success.

Invest in businesses: Investing is not about ticks on a screen. It's about buying a slice of a company, and the investment process should reflect the work you would do if you were to buy the whole company.

Invest for the long-term: I feel you can get a true advantage by bucking the investment industry's short-term focus and by being willing and able to look past short-term fixable problems to the long-term value of your chosen company. This time arbitrage is especially valuable in periods of great uncertainty.

Quality management teams matter: Management teams that come into the office every day asking how they can best allocate new capital to provide the best returns to all stakeholders are the people I want running the companies we own. They are invariably the teams who have great balance sheets that can take advantage of competitor's weaknesses in tough times.

Quality wins out: As a value investor, I struggle with the "everything has a price" mantra. However, the fact is that companies with true franchise qualities such as leading brands, low cost structures and strong balance sheets perform better over a cycle than their lesser competitors.

Go global: If you invest globally, you increase the probability that you will find higher quality companies at cheaper prices than if you just looked domestically.

Intrinsic value should grow over time: Do not invest in static assets, and make sure time is on your side. If you invest in an asset that is at 50% of intrinsic value but grows at 10% a year versus an asset that is static and both take 3 years to close the gap, you will have a total return of 166% versus 100%. Tailwinds are preferable.

Absolute value counts: What counts are real after-tax returns achieved without undue risk. The investment management industry is flawed: for many you are a hero and get paid a big bonus if you lose less money than the next guy. You can't live on relative returns.

Volatility is your friend: The long-term informed investor should welcome the opportunity to buy more of a company when it sells at an increasingly large discount. The investment management industry is one of the few industries where people get despondent when prices go down. This makes no sense.

Prepare for the worst: Always assume the absolute worst-case scenario for the company you are trying to buy and make sure you can at least preserve capital on that basis.

Cash is not a four-letter word: If there is nothing to do, do nothing. If you cannot find the right company at the right price, resist the institutional imperative to be fully invested.

Price is paramount: No matter how much analysis I do on an individual company, I am still a minority investor. I will not know everything and I am not in control of the cash flows. To counteract this, I need a margin of safety which is supplied by the price I pay. I never compromise on price.

Have partners, not clients: No matter how good my investment process is, even the best investors go through periods of underperformance. If my partners leave me when stocks are the cheapest, not only will they be doing themselves a disservice but they will make me a forced seller when I want to be a greedy buyer. This is a disaster scenario for the professional value investor.

My Investment Criteria

Before we invest in any business it must meet three factors a company must have: a high quality business model, a great management team, and selling for less than its worth (ideally a 50% discount to intrinsic value).

Great Business- I search for high-quality businesses that have the following traits:

- Simple & Understandable Business Model
- Competitive Advantages
- Pricing Power
- Ability to Generate Free Cash Flow (which will grow over time)
- High Returns on Capital
- Strong Balance Sheet

I find one of the most important questions to ask before a company gets included in the portfolio is "does it deserve to exist?" Is it a company that provides a service or product that will be genuinely missed if the company ceases to exist?

Using this criteria and understanding that great companies at great prices are a rare commodity, my focus is to concentrate on those rare opportunities. This makes it easy to eliminate a vast swath of companies; because they mainly fall into the category of 'not being in control of their own destiny'.

I invest in companies where management actions can influence earnings more than the macroeconomic environment that they operate in. This means, I avoid commodity companies and financial companies, unless the worst-case scenario for the particular commodity has been factored into the price we are paying. I also like our portfolio companies to be in a "self-help" position, meaning there are internal actions that management is capable of making that will lead to the recognition of intrinsic value, examples of which could be cost improvements or better use of excess capital. I am less excited about managements that must achieve external improvements to realize this value, such as winning market share.

I focus on companies with a sustainable competitive advantage. That is, I seek companies that can raise prices in times of inflation and maintain prices in times of deflation. I want companies that have a light capital structure so inflation will not be a drag on returns. I favour companies that have a balance sheet that can survive the unimaginable and I avoid companies that may be terminally impaired if government policies unexpectedly change.

Great Management – A quality management team will have the following traits:

- Think Like Owners
- Focus On the Long Run
- Focus on Capital Allocation

We want managers that have incentives, whether it is via direct stock ownership or incentive pay, not just to increase earnings but to improve metrics that will lead to a stronger more competitive company. We think that management should be rewarded for measures that increase a firm's intrinsic value, regardless of share price, as in doing so the stock will look after itself over the long term. For this reason, it is critical to unearth if management incentives are aligned with the key performance indicators management believes are critical to the company's success. Disclosure of pay, incentives and stock ownership vary greatly among international markets, which is all the more reason to engage management. In short, we do not want to invest in companies where the interests of management are not aligned with the long-term success of the company.

Great Price: Price is at the core of why we are value investors. We believe that the price we pay for a company will protect us against permanent loss of value. The beauty of value investing and why it makes so much sense to us is that it is intuitive that if you can buy an asset, everything else being equal, for 50 cents on the euro, there is not only greater potential for reward but there is simultaneously less risk of loss of capital than if we paid 80 cents for that same euro. Price is our primary risk management tool. Other investors rely on painfully diversified portfolios or sophisticated hedging techniques, but we believe that if we buy right, we will reduce the risk of a permanent loss of value

Searching for Investment Candidates

In order to build a list of companies that meet our criteria, we read voraciously and our office tends to be strewn with various publications, company filings, and folders of potential investments. I am not embarrassed to mine the portfolios of other investors that I respect for investment ideas. I do not blindly follow them but use their portfolios as a starting point. All along, I am always looking for quality companies where the current news may be negative, but over time and under reasonable circumstances the problems will either lessen or be solved by management.

I benefit from being located in Chicago in that there are a small number of local investment houses that invest globally. So when companies come into town to visit with investors, despite our small size, we are normally offered a meeting in order to fill up a day. I don't mind being an afterthought; I get to see a number of companies every week that may or may not be currently interesting but it adds to my knowledge base. I never refuse a management meeting, as an hour spent talking to an operator is better than an hour spent reading an analyst report. Of course, in addition to these meetings, I also participate in many site visits every year. This involves travelling to see management teams in their surroundings. Nothing tells you more about a company than the interior decoration of their head office.

As a global investor, there are situations regarding certain companies where the information flow is limited, normally due to language difficulties. In such a situation I enlist the help of local brokers to either have their analyst interview the company on our behalf, or submit to management a list of questions that I have prepared. These are companies which are unlikely to become core holdings for the partnership, but still merit consideration simply due to their enticing discounts to intrinsic value.

Over the years I have built up a list of companies that I think are potentially attractive or may become attractive at some stage, and continually keep my eyes open for new additions to our list. All businesses on this wish list meet my investment criteria (i.e. quality business models, and quality management teams) but have not made it into our portfolio because of price. It is not uncommon for me to follow a company for years that I like from a business standpoint, but has never been at the right price from an investment standpoint.

Portfolio Management

My goal is to build a concentrated portfolio of great franchises at great prices. I believe such a portfolio will lead to above-average absolute returns. Ideally, I would like to buy less than 20 stocks out of a universe of greater than 30,000. I will pick these stocks using a bottom-up approach and analyzing risk on the individual business level, as well as the portfolio level.

I would much rather invest in 10 companies that I know well than 100 in which I only have passing acquaintance. I would much rather have a concentrated portfolio of great investments than a diversified portfolio of mediocre ones. This approach to portfolio construction will lead to returns being lumpier in the short run but superior in the long run, which is one of the reasons I encourage you to think in terms of long holding periods.

With respect to selecting individual investments I am opportunistic and completely agnostic to location or size of each business and do not want to be restricted in any way in regards to portfolio construction, geographic exposure or industry concentration- because a dollar of cash flow is worth the same to me no matter where or how it is produced.

Because of my long-term value approach it may be years before the intrinsic value of any particular investment is realized, but on average I expect to own the companies in the portfolio for the next 3-5 years. Sometimes a security will rapidly appreciate to a point where it no longer represents good value relative to other potential purchases and will be sold. However, as long as the management and the company continue to grow the intrinsic value at a greater rate than the market recognizes, I will be more than happy to compound our returns.

My mandate is to make money at a given level of risk; if the risk is too high, so will be the cash level. Conversely, the more confidence I have that these are the right investments, the lower the cash level will be. I have no target level of cash; it all flows from the stocks available. I treat your money as if it was mine; if there is nothing sensible to do, I will do nothing.

From my vantage point, the monthly or quarterly volatility of our portfolio should not be associated with risk. On regular occasions the quoted prices of the companies in our portfolio are up or down by "Mr. Market" based on short-term factors. I do not believe that these price movements are evidence that I am taking risk. If I have done a thorough job on my initial research, and provided there aren't any fundamental changes to our investment thesis, I am of the firm opinion our portfolio risk is actually decreasing as the portfolio's quoted NAV declines. I maintain that if you care about month-to-month volatility, Sharpe ratios, betas and all the other Greek letters, you are most likely not my ideal partner.

In summary:

The money you have entrusted me with is your money, a fact that is self evident but nevertheless seems often forgotten by the vast majority of fund managers. My goal is that by treating you as partners, sharing my investment philosophy, and detailing my investment process we will have a long and fruitful partnership together in the Kinsale Compass Fund. As always I am happy to answer any questions you may have.

Best regards,

Peter

Peter Kinney