Dear JDP Partner,

Two thousand and twenty was a remarkable year for our portfolio companies and for JDP. The Partnership was up 109.4% net of fees compared to 18.4% for the S&P 500 including dividends.

Performance in 2020 was an extra-ordinary to the upside, just like 2018 was extra-ordinary to the downside. Partners should think of returns in a single year as a building block supporting the multi-decade track record that we are building.

Periods of outlier performance are inevitable with a concentrated portfolio of businesses where the future is controversial. There will be years when the market agrees with our thinking and years where it disagrees.

JDP’s goal is to generate a 100% return every 3 to 5 years or 15% to 25% annualized without leverage or excessive portfolio turnover. Since inception almost a decade ago, we have comfortably achieved this goal net of fees.

Like any long track record, ours reflects a lot of mistakes combined with getting a few things really right. At the center of our existence is a drive to find businesses with the fundamental horsepower to outperform the S&P 500 over multi-year periods.

Our approach to beating the market has always revolved around searching for unrecognized potential in a handful of stocks and then getting to know those companies as if we owned them outright.

The profile of a business with a shot at beating the S&P over a 5 or 10-year period has evolved enormously since I launched JDP in 2011. As companies modernize over the next decade, we will likely see an even faster evolution in how value is created and discovered compared to the past.

Despite such a crazy 2020, the opportunity for a patient and focused stock picker remains very exciting.

Great vs average

The greatest investors in the world are able to invest where the value proposition of a business compounds with the passing of time. The more that the value proposition of a business grows, the more it's owners can feast off the equity appreciation for years, often decades.

This Warren Buffett-approach of "buying the business" as a passive stock owner requires an obsession to keep digging deep, learning more, and distinguishing between where a company is headed vs where it has come from.

Buying-the-business requires developing insight that the market is not anticipating through a research process that supports the confidence to hold when others cannot. It requires ignoring the Talking Heads
in financial news that profit by selling fear and making peace with fact that the majority of stock investors do not use the market to make long-term investments.

Over the years we have worked hard to strengthen our own competitive advantage as a firm, think more like business owners, and stop underperforming our own best ideas due to short-signed reasons.

In fact, the total dollar value of our worst mistakes since inception pales in comparison to the amount of money we have left on the table by selling incredible businesses at [seemingly] high valuations.

To correct for past weaknesses in our process, Seth and I implemented a simple 4-part checklist we call Survivor & Thriver company criteria that focuses on areas of value that past financial statements cannot capture.

These criteria summarize the commonalities of companies that we have studied internally over the years which have returned many-many multiples on invested capital for patient investors.

The Survivor & Thriver lens is JDP’s North Star for deciding where to invest, monitoring and sizing positions, and determining why to sell.

I have written and spoken about our Survivor & Thriver framework many times for several years because it is an important part of how investors should think about JDP’s unique opportunity as a fund, and willingness to endure volatility.

JDP’s Survivor & Thriver company criteria:

1. A business model that is adaptable and relevant in tomorrow’s economy
2. Durable pricing power protected by a growing competitive advantage
3. Capital allocation and balance sheet strategy that supports the moat
4. Strong alignment of interest between management and minority owners

2020 performance

The bulk of our performance was attributed to our largest holdings: Spotify (SPOT), StoneCo (STNE) and Roku (ROKU).

Spotify and StoneCo had been core holdings since 2018 and 2019, and Roku was added in May as our “third horseman”. These three stocks were up between 375% and 470% off their 2020 lows driven by business models that are unlocking an ocean of new value within their markets.

On March 23rd I wrote a note to investors saying that it seemed like a remarkable time to buy technology businesses positioned to grow faster than the economy even if prices declined further.
The intention of the note was to communicate—to rightly nervous investors—that we would stick to our framework and not get distracted by 'whatever stock had declined the most' in the March selloff.

Initially I had been slow to come to terms with the impact that The Virus would have on the growth of our portfolio companies. Going into 2020, our portfolio was a mix of technology leaders like Spotify, StoneCo and Autodesk, combined with more mature businesses like XPO Logistics, EchoStar and two unnamed special situations.

By mid-March, Seth and I were working day and night to re-imagine each of our company’s potential to accelerate growth as the physical world melted down.

Having no clue how the world would look in 3, 6 or 12 months we felt there was a margin of safety in asset light businesses positioned to gain market share in sectors on the precipice of major change. For example, we could imagine more people streaming music on Spotify by 2025 vs tuning-in to radio, even without a vaccine.

Holdings where fundamental growth was less clear at the time were sold. We then doubled down on Spotify and StoneCo with the idea that their value propositions would accelerate, and less-focused competition would retreat.

The fund also made smaller investments in enterprise search software Elastic (ESTC), ad tech company Cardlytics (CDLX) and sports-betting app DraftKings (sold).

What doesn’t change

What doesn't change regardless of interest rates, tax policy or political party in charge, is that stocks attached to companies with sustained outsized growth vs the broader market, will perform better than the broader market.

Growth businesses of past generations like Nike, Coca-Cola, American Express, Ford, Walmart, Disney, IBM, GEICO and Johnson & Johnson were built by forward-looking visionaries who created superior products that reduced friction and pioneered new markets that were previously unimaginable.

Today it seems crazy to think about life without access to running shoes that feel weightless, driving a car safely at speeds unthinkable 50 years ago, or taking a pill to stop a headache.

It would also seem crazy to chalk up the multi-decade stock performance of Nike (+68,500% since IPO in 1982), Starbucks (+36,000% since IPO in 1992) or Amazon (+162,000% since IPO in 1997) to transient macro inputs. Nike's courage to sign unknown-Michael Jordan in 1984 and re-invent casual sport apparel over the next three decades drove the stock's market-crushing returns, not Fed policy.

Something we look for in an investment is a company's ability to consistently deliver more value to customers than the competition, while building economics that improve with scale. The longer a company retains this advantage the more powerful the long-tail compounding effect will be on shareholder value creation.
Identifying and investing based on less-obvious earning power traits is difficult when it does not match up with traditional financial metrics that define near-term value.

As an example, over the last 30 years Apple’s revenue has grown by about 5,300% while IBM’s has grown around 20%—in total. Funny enough, 30 years ago, Apple and IBM both traded for very similar multiples of just under 11x earnings, a 30% premium over the 10-year Treasury yield of 8.5% at the time (equivalent to a PE ratio of 43 today).

The valuation 30 years ago told you nothing about the future potential of either business because price alone is a poor indicator of value (Apple +38,700% versus IBM +750%).

Back in 1990 it was not obvious, or even probable that over the next 30 years Apple would drive such a massive gap in performance with IBM. There was no magical formula to make the future less murky.

But a business approach towards owning both Apple and IBM over all those years would have seen two very different stories unfold. Along the way, as Steve Jobs achieved milestones towards his vision the stock became a bet on him and his drive to succeed.

The optionality Jobs created for Apple shareholders took years to catch up with the financials and the stock became highly contentious and controversial. For many years the stock took unique insight and strength to own especially for investors tied into the financial community.

On the other hand, IBM stopped innovating and decided to live off cash streams created long ago. The prioritized large acquisitions, dividends and excessive buybacks over aggressively investing in its own human capital to compete with thriving incumbents. In the end, IBM’s attempt at engineering low-risk predictable quarterly earnings evolved into a permanent disadvantage that it could never reverse.

Looking back 30 years, the outsized opportunity in Apple vs the underperformance of IBM did not come from their valuation in 1990. Rather, Apple developed an ability to grow in a way that became more insulated, advantaged and profitable with the passing of time while IBM survived on legacy achievements.

Product history and timeline links: Apple vs IBM

****

Commentary on our largest positions

Spotify has been a top holding since 2018 and I expect our future will become even more aligned with this business as time goes on. Although the stock is up about 200%+ since our initial investment, we think founder-CEO Danel Ek is building a company that will be worth multiples more than the current $62 billion market cap.
Spotify’s start-up-like sense of urgency to deliver new products and tools that increases the value proposition to subscribers is impressive and differentiated from the "me too" music/podcast catalogues within big-tech bundles.

In 2020 Spotify executed on a laundry list of strategic investments including: high-profile original podcast content, acquisition of podcast publishing software companies and assets, signing Universal Music to the two-sided marketplace, and filing a patent for distributing music within social videos.

Strategic investments in podcast content is a way to grow and retain subscribers and increase the value proposition to anyone wanting access to the ears they control. It would also make sense for the company expand further into adjacent segments like audio books and news.

I wrote about Spotify in the 2019 Annual Letter and our excitement around the company’s transition from a music streaming app to a dynamic audio platform that also includes podcasts, a marketplace for artists to engage with fans, and a world-class advertising business.

We own Spotify because the company’s economic power as the gatekeeper between creators and consumers is growing faster than reported financial metrics suggest.

Our bet is that Spotify will be able to extract much more economic benefit from the music labels, content creators and advertisers as time goes on.

The more contrarian component to our investment thesis is that we think Spotify will ultimately tilt the balance of power with the Major record labels enough to unlock gross margin potential that looks more like a technology company than it does today.

Spotify had 320 million users as of September 30, 2020 and on a trajectory to reach 1 billion users. The business model is simple: the more reasons users have to use the app, the more frequently they will engage with it. The more engagement, the higher the lifetime value of the customer base. The more engaged users become, the more artists and advertisers depend on Spotify’s toll bridge to the consumer.

An example of recent progress that we are excited about is the company’s launch of the long-discussed strategy to charge music labels and content owners for access to subscriber data.

Products like Spotify for Artists are important because they give the company leverage to monetize growing subscriber engagement driven by new celebrity podcast partnerships such as Joe Rogan or Michelle Obama.

From the Spotify Shareholder Letter, 3Q 2020:

“The number of artists and their teams utilizing our Spotify for Artists tool on a monthly basis has grown to more than 750,000 and we continue to add new features for the creator community”

“Our sponsored recommendations continue to gain traction, helping music marketers target listeners based on their streaming behavior to shift users into an active listening session of their content. During Q3, we saw a 76% increase in unique customers relative to Q2, and we retained 74% of customers from
Q2, which we believe a good sign of customer satisfaction. We saw demand from both the Major labels and Indies, with Q3 campaigns including Taylor Swift, Machine Gun Kelly, and John Legend. We continue to expand the targeting capabilities for these sponsored recommendations, allowing music marketers to segment their audience by listening behavior, data that is unique to Spotify.”

Even without a breakthrough in the variable-cost royalty structure with the Major labels, growth in products like Spotify for Artists that can grow rapidly with minimal invested capital should help drive an unexpected lift in company profitability.

Roku

Roku became a top JDP holding in April and was a large contributor to our 2020 performance. I was first introduced to the company in 2014 by a venture investor who admired its founder Andy Wood and company’s strategic move that year to partner with Chinese TV manufacturer TLC to build the first Roku TVs.

Roku went public in 2017 for $14 but I was slow to connect the dots between valuation and where the company was heading. I continued to follow along, and the stock’s 50% decline between November 2019 and March 2020, coupled with an acceleration in fundamentals, provided an excellent opportunity to build a full position around $110 per share.

As with all of our investments, we expect Roku to decline by 50% again, at least once, while we own it. Today the market is focused on the near-term transition of pay-TV ad revenue to streaming, accelerated by cord cutting and a pause in live sports during COVID.

However, looking out 5+ years we see a much bigger opportunity for Roku to leverage its global scale, world-class advertising platform, and in-app payment system to grow revenue per user far beyond the $27 per year that it earns today.

Roku is the largest aggregator of third-party streaming TV content in North America based on hours streamed (58.7 billion hours in 2020) across 50 million subscribers. There are now almost as many Roku subscribers as there are across the largest three US pay-TV providers combined.

Roku acts as a toll-bridge between the consumer and content owners that want to build streaming TV audiences and monetize across three ways: transaction video on demand (“TVOD”), subscription video on demand (“SVOD”), and advertising supported video on demand (“AVOD”).

Roku also controls the financial relationship with the consumer for subscriptions and purchases through Roku Pay where users maintain a credit card.

In addition to Roku TVs and streaming sticks, The Roku Channel is one of top streaming channels in the world with 56 million subscribers and viewable on any internet-enabled device.
Roku has the dominate market share of smart TVs in North America with 38% in the US and 31% in Canada. Roku's market share is growing as fragmented smartTV OEM operating systems consolidate and the demand for high-quality free streaming TV explodes.

Moving cable TV to the internet

Roku is doing to traditional linear TV what Amazon did to physical retail.

We think of Roku as a modern cable company without the physical boundaries and capital requirements that limit cable companies. As a consumer internet business aggregating third-party content, Roku is able to scale globally without significant marginal costs. Longer term we think there is room for two or three players in TV OS and Roku will be one of them. The global pie is big and the majority of pay-TV has still not cut the cord.

The international scale potential for Roku is overlooked because TV distribution is still viewed as country-specific and the lifetime value of non-US Roku subscribers is less proven.

Roku sells hardware (streaming sticks and TV operating systems) to facilitate customer access to their platform at prices just above breakeven, as a cost to acquire new customers. A hardware buyer becomes a Roku subscriber when she activates her account by providing an email and credit card to begin watching ad supported or subscription channels like Disney+ or The Roku Channel.

The value proposition for the consumer to move from cable TV to streaming is compelling and only limited to the speed of a WiFi connection. The consumer experience is meaningfully better because content is on-demand vs forced time-slots and free content supported by ad loads that are often 75% less than cable TV and more relevant to the viewer.

Lower ad loads, higher ROI for advertisers

Lower ad loads are possible within Roku’s closed platform because the identity of the user is known with certainty and responses to advertising can be measured. There is no guessing who is watching, what her interests are and how she responds to specific advertising.

Advertising on Roku is different from traditional digital advertising that relies on stringing together probabilistic (unknown) data about a buyer. Cable TV produces minimal information about who is watching or when, so tiny conversation ratios require bombarding viewers with repeating ads often 16 minutes per hour (26% of an hour).

The ability to pinpoint individual identities allows Roku to reduce the number ads per hour because buyers pay a higher price for targeting that can be measured.

Over time Roku should be able to reduce ad loads even further, to improve user experience, while still increasing ad revenue. The more time a consumer spends watching Roku the better the company’s algorithms can serve hyper-targeted, high-value ads in timely window to known buyers (20% off Domino’s Pizza at halftime anyone?).
The rise of T-commerce

One exciting opportunity Roku has is expanding its advertising offering by building a marketplace to sell products and services on the platform (t-commerce) and charge a fee for doing so.

The next advancement in connected TV advertising could be for advertisers to sell products within interactive video ads in a similar vein to social-commerce selling in Asia. Merchants could also offer products seen in movies, shows (clothing, cars, food, furniture, etc.) within a dedicated area of the Roku channel or smartTV.

Roku Pay already manages a subscriber’s credit card payments of content subscriptions and on-demand content transactions; the "buy-now" feature on the Roku remote could also include Nike shoes someday.

Under-monetized TV content

Roku could unlock new value for TV content owners as ad buyers re-define what a viewer's attention is worth based on who they are and how much they spend, not what they are watching.

Advertising slots on cable TV are partly priced against the perceived popularity of the content. Old re-runs of MASH or The Brady Bunch might have a lower value compared to slots on prime content like a new episode of The Bachelorette. If Roku knows who is watching and what products she is interested in, the content value gets re-rated simply as a vessel to deliver relevant advertising.

The win for Roku is that the company gets access to third-party content in exchange for sharing the revenue that drives the new value for content owners. This means Roku can expand the content on its platform beyond what traditional cable TV could offer without needing to own or license the content.

As Roku achieves global scale, its financial flywheel has the potential to spin much faster and more efficiently than current valuation is anticipating.

Stone has been a core holding since early 2019 when we bought the stock at a 20% discount to the 2018 IPO price. The stock is up 220% from our initial investment and 370% since we doubled down on the position in April 2020. I wrote my research trip to Brazil in the 2019 Annual Letter and the insightful ground-level access the company gave me to a sales "Hub" operation in Sao Paolo.

Despite the recent run in the stock price, we think the company's earning power is more attractive than when we first invested. Management has exceeded our expectations on how quickly they can layer on new, ultra-high ROI financial products to their customer base of small, medium and micro merchants.

Stone’s mission is to replace traditional bank relationships with its own platform which was purposely built for the country’s ~11 million SMBs (small, medium businesses). The majority of Brazil’s economy is driven by small businesses and many are grossly underserved by traditional banks.
In the past year, and in the face of COVID, Stone grew its SMB client base by 42% to 583,000, or about 5% of the market. The market is fragmented, competitors are a combination of one other major Fintech giant and financial service resellers linked to big-bank products.

Stone started its business by offering card processing terminals and credit card receivables factoring with white-glove-like customer service which was unheard of among payment processors.

Today Stone offers a suite of back-office software for accounting/inventory/payroll to make their clients more efficient and transparent, including enabling brick and mortar sellers to move online. The company also offers digital bank accounts, vendor payment services and working capital loans. Stone has built a pipeline to continue laying on new products such as insurance, stock brokerage and payday loans.

Stone’s unique window into the day-to-day profitability of its merchants allows it to underwrite risk on a merchant-specific basis in a way that traditional banks cannot. The company’s scale and reputation allow it to use third-party capital to fund risk products without taking much balance sheet exposure.

A classic Fintech flywheel just starting to spin:

(1) Customer service and attractive financial products are driving 40%+ SMB growth annually (583,000 SMBs + 66,000 micro merchants as of September 30, 2020).

(2) Stone’s back offer software package (inventory management, payroll, etc.) and digital banking drives customer stickiness. Merchants use Stone’s software/banking/card processing to build a credit score to then access higher value products such as working capital loans.

(3) The lifetime value per client should grow exponentially as high-value products are layered on to legacy card processing services with minimal costs or balance sheet risk.

**New product example - working capital loans**

Stone is turning on a working capital loan program that had been in pilot mode for the past two years. The company developed a credit-scoring system and pay-as-you-sell model by making $3,500, 7-month loans for selected SMB clients. Stone used its own balance sheet for the pilot program and earned an unleveraged return of 2.7% per month.

Last week Stone announced it had raised R$490 million ($92 million) in outside capital to deploy into the lending product without taking material balance sheet risk. Pooling and securitizing the loans allow institutional buyers to lend based on an implied credit rating of the larger pool vs the merchant itself.

Stone will pay between ~7% and ~10% (secured and unsecured tranches) for the money and with a limited first-loss position in the pool.

Although the company has not discussed profitability expectations yet, we know that it is common for small businesses to pay 30% to 60%+ annualized for working capital loans, sometimes higher. Stone will earn the difference between the interest paid to the third-party pool and the retail loan price.
Our back-of-the-envelope math using pilot program numbers implies that when a client takes a loan, Stone could double the average annual fees it earns from that client per year.

We are excited about the ramp-up of the working capital loan program across the national client base once the model is fine-tuned and the impact of COVID is better understood on a per-SMB basis. Next, we expect to see products like brokerage and insurance offered with a similar third-party risk model.

Stone probably has the most asymmetric business optionality of all our holdings today. The company has the scale, brand equity, talent, and capital to execute on its long-term vision, or a version of it.

Despite 31% after-tax profit margins, Stone is, in many ways, still a start-up. The C-Suite is comprised of an unusually young, smart and highly motivated group, including founder and controlling shareholder Andre Street, that is willing to take risk and dream big.

Our approach to owning STNE has been to manage the position size as it appreciates while keeping in mind the bigger opportunity as the company executes. We are looking forward to returning to Brazil when possible and seeing the company’s progress first-hand.

****

**JDP’s future is bright**

Digitalization is smashing old barriers and enabling economic progress in a way that was unimaginable when I launched JDP in 2011.

Our investment framework has evolved over the years with lessons learned the hard way and a drive to generate top-tier performance by capturing the long-tail upside of our best ideas.

Today our portfolio’s growth runway is longer and produces more optionality than at any time in our history. A differentiated process provides the conviction to think differently, and our investors allow us to play the long game.

Someday it will be normal for a family in rural Brazil to order food from an interactive ad seen on their Roku TV, or an undiscovered rapper in Kyiv to build a fan base in Mexico City using Spotify’s two-sided marketplace.

All of our holdings have the luxury of reinvesting 100% of their gross margin back into their businesses to support a vision that is different from the past. We want to own Apple in 1990, not IBM. The opportunity to plow every penny into high-value human capital investments in engineering, design and sales drives innovation and distance between less-focused competitors.

All of our holdings are run by leaders with all-in mindset that puts product quality and customer experience over short-term financials.

Our founder-controlled or founder-backed CEOs like Daniel Ek (Spotify), Thiago Piau (StoneCo) and Andy Wood (Roku) encourage their teams to take risk that might not pay off financially for years. This is the
opposite profile of a mature business that has reached its potential and where the Board’s vision is limited to returning capital to shareholders.

****

2021

Heading into 2021 we are excited to watch our companies pick the fruit from strategic and financial advantages gained in 2020.

This does not mean it will continue to feel this easy.

It is normal for a company's stock price to drift in and out of fair value, but the market’s run in 2020 was exceptional. The feeling of uncertainty is the most consistent part of investing and it is okay to be skeptical when prices go up this fast.

That said, it is easy to get wrapped up in the ongoing debate around stock prices vs "value". Our response is that JDP is focused on a handful of businesses we think trade for substantially less than the present value of their future cash flows. Volatility is not just a part of investing but an unavoidable emotional tax on excellent unleveraged returns.

We are excited and fortunate to be in a position to capture the future value creation of our best ideas.

Adding capital

The subscription process for adding capital to the fund has been greatly simplified. New and existing investors wishing to add capital can now do so by answering a questionnaire hosted in the Investor Portal area of our website using a mobile phone or desktop.

JDP’s YouTube channel

Quarterly fund Q&A sessions with Seth and myself are available on JDP’s YouTube channel along with past video podcasts on a variety of investment-related topics. In 2020 I had the honor of participating in several interviews that touched on JDP’s process and sectors like ad tech where we are invested.

Thank you for your continued support.

Sincerely,

Jeremy Deal