

April 26, 2017

Dear Fellow Investors,

The Fund advanced 13% in the first quarter of 2017. Gains were broad-based, as no single position was responsible for more than 12% of the total NAV/share increase. Our long portfolio returned 13.9%, while the short book lost 1.6%. The rest of the change in value was due to currency fluctuations, which should roughly even out over time. At the end of the quarter, the Fund had gross exposure of 155% and net exposure of 78%.

A Word on Performance Measurement

While the composition of our portfolio is vastly different from any market index, most indices (including all the major US ones) offer other benefits including ease of access, liquidity, and tax efficiency. These benefits, along with the indices' tendency to outperform many money managers over time, make these indices a worthy alternative for those deciding where to allocate their capital. Thus, because of the significant opportunity cost associated with the decision to invest in an active firm like Adestella rather than a passive index, I believe it makes sense to use these indices as benchmarks even though there is little overlap in our underlying holdings.

With this rationale in mind, the indices I've selected for benchmarking purposes are the S&P 500 (which is the most readily available alternative for most of our investors), the Vanguard Total World Stock Index (which more closely matches the Fund's geographical exposure), and the Russell 2000 Index (which more closely matches the median size of the Fund's holdings). I will also include the HFRI Equity Hedge Index as a point of reference for hedge funds following a similar strategy to our own.

	<u>1Q 2017</u>	<u>Since Inception¹</u>
S&P 500	6.07%	27.73%
Vanguard Total World Stock ETF	7.33%	11.64%
Russell 2000	2.24%	20.82%
HFRI Equity-Hedge (Total) Index	3.82%	6.91%
Adestella Investment Management²	12.97%	34.65%

**all index returns include reinvestment of dividends*

¹ Adestella began operations in the third quarter of 2014.

² Time weighted returns on a net basis

Exploiting Our Advantages

Given the aforementioned point that low-cost index funds tend to outperform most investment managers over time, it's fair for you to wonder why Adestella should reasonably expect to achieve its objective of beating the indices on a net basis over time. I believe we possess several structural advantages that either cannot or will not be capitalized on by most other investment firms and passive indices, advantages that I intend to exploit to accomplish our goal:

- **Relatively small size.** This greatly expands our investible universe, allowing us to pursue opportunities well off the beaten path. Because smaller companies won't move the needle in the performance of larger funds and don't generate enough interest (i.e. commissions) to receive coverage from sell-side research firms, these stocks tend to fly under the radar, increasing the chances of a mispricing. It also makes us more agile, allowing the Fund to enter and exit positions as circumstances dictate in a relatively short period of time without affecting the price of the stock.
- **Willingness to concentrate portfolio on best ideas.** This advantage has two elements:
 - o Even in the more obscure areas of the market, substantial mispricings tend to be relatively rare. Thus, it's imperative that when one is found, the investor is willing to make a sizable bet to take full advantage, even if this produces above-average volatility. Managers at large firms are often wary of "career risk": if they underperform the indices by too much, they may be fired or else lose clients (thus reducing their juicy management fees). Accordingly, many opt to maintain a very diversified portfolio in order to reduce volatility and thus protect against deviation from the benchmark. The drawback of insuring against underperformance, however, is that it also insures against outperformance, particularly after the drag from fees.
 - o Holding fewer positions also allows me to have a deeper understanding of each company we invest in. This is very useful in situations where a stock declines and I have to decide whether it's an opportunity to add more at a better price, or whether I made a mistake. I believe active management can add significant value in situations like these, but that requires thorough knowledge of the company.
- **Intense focus on research.** Many active managers juggle their research work with frequent client-facing obligations. In a very competitive investment world where the stream of new information and opportunities is virtually endless, being able to "turn over more rocks" for new ideas and focus solely on portfolio management is a small advantage we have that will compound itself over time.
- **Long-term investment horizon.** The short-term myopia of Wall Street is frequently seen through its focus on quarterly earnings, the widespread use of trend-following strategies, and the ever-shortening average holding period for stocks by retail investors and mutual funds alike. A fund benefits significantly from the ability to turn short-term issues in stocks it owns

(or would like to own) into opportunities by adding shares at more attractive prices, but this can only occur if it has long-term minded investors. Thankfully, Adestella does, so we're able to use volatility to our advantage instead of shying away from it.

- **A global mandate.** A great deal of research in the field of cognitive psychology documents the variety of mental heuristics individuals utilize that often lead to biases in the way they process information and make decisions. One of these is the familiarity bias, which is the tendency for individuals to be more comfortable with what's already familiar to them. While this has many applications to investing, one particularly interesting consequence is that most investors, even those attempting to create highly diversified portfolios, tend to allocate far more of their money in their home country than would be expected by that country's weight in a global index. One recent study found US investors tend to have 79% of their portfolios in American equities (vs. a 51% global index weight).³ The US and UK (whose investors tend to overweight domestic equities by 19%) account for nearly 90% of total institutional AUM; applying this total to the home bias amounts and index weights, I estimate that 70% of professionally managed money is chasing 40% of the global opportunity set. The flip side, of course, is that the remaining 60% is underfollowed, which leads to increased odds of finding equities that are significantly mispriced. Free to invest in any geography, the Fund can go where the value is at any given time. As an extra benefit, the limited correlations between stock market performances in international markets also provide a bit of added diversification at the portfolio level.

Heads I Win, Tails I Don't Lose Much

Each quarter, I intend to do a deep dive into one of the Fund's current holdings. This will give you a better understanding of my investment process and portfolio management decisions; it should also benefit me by prompting me to crystalize my thinking before putting the thesis down onto paper.

One of the most important concepts in value investing is ascertaining whether a given security provides the investor with a "margin of safety" that protects him against permanent capital loss even if things don't go as planned with the investment. This margin of safety provides some sort of downside protection, often in the form of a hidden asset or a cheap valuation, which for a patient holder may offer some sort of floor that reduces their downside risk. In even the best of cases, the unpredictability of the future means things won't go exactly to plan – hence the need for a margin of safety with every investment.

It's often said that if you take care of the downside, the upside will work out for itself. But I think we can do one better: take care of the downside, and then work on figuring out the probability-weighted upside potential of a stock as well. Thus we have the second step, which is trying to determine what

³ See <https://personal.vanguard.com/pdf/ISGGAA.pdf> for more information on the subject

one might reasonably expect to earn on his investment across a variety of scenarios, including both punitive and optimistic ones.

The Fund's capital is limited (as is my personal mental bandwidth), so I believe it makes sense to focus on these criteria in conjunction; plenty of companies fulfill one requirement or the other, but few manage to create a compelling combination of the two. When you do find one though, you have an attractive investment proposition on your hands – one akin to a situation where “heads I win, tails I don't lose much.” If your judgements are correct, this asymmetry should provide a positive expectation over time and in aggregate.

Advanced Emissions Solutions (ADES) is one stock that I believe meets these requirements near current prices. ADES has contracted cash flows which, discounted back to the present value, fully cover the current market capitalization (providing the downside protection discussed above). Meanwhile, the company has several other valuable assets, such as a fast-growing chemicals division, that are essentially free options on significant additional upside. It also just initiated a dividend (12% yield at current price) that provides a catalyst yet to appear on the radar screens of most investors.

I've included as an Appendix to this letter a thorough explanation of the ADES thesis for those interested in more detail.

Outlook

I don't have a strong view on which way the market is headed over the next few months. Reasonable arguments can be made for either side, with plenty of data points available to support whichever particular view one holds. However, as Peter Lynch once said, “Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves.” Given the dismal record of market forecasting (by amateurs and professionals alike), I'm inclined to agree with him.

No one can consistently anticipate market corrections or predict the short-term performance of either the stock market broadly or an individual stock particularly. Given this reality, I believe the prudent approach is to focus instead on the underlying fundamentals of our portfolio holdings. While markets tend to be governed by sentiment in the short term, they're ruled by fundamentals in the long term. Thus, accurately estimating the intrinsic values of the companies we own will drive our performance in the long term – which is the time period we are ultimately concerned with. And that is what I intend to do.

Conclusion

This is the first quarterly letter Adestella Investment Management has sent out. My goal in doing so is to facilitate a more frequent flow of information to all fellow investors – both in terms of our performance and in terms of our strategy. Our interests remain fully aligned, as the great majority of my net worth is invested in the Fund and I maintain no personal account outside of it.

At the present moment, I believe our stocks continue to trade at substantial discounts to fair value, which makes me optimistic about the Fund going forward. There will be bumps in the road along the way, but I expect it will be a rewarding journey for all of us. Given the ancient Roman phrase from which the company takes its name, *Per Ardua Ad Stella* or "Through Struggle to the Stars," it seems like the only appropriate path.

I look forward to writing to you again at the conclusion of the second quarter.

"An investment in knowledge always pays the best interest."

- Benjamin Franklin

Best Regards,



Andrew Jakubowski

Appendix A: Advanced Emissions Solutions (ADES) Investment Thesis

Advanced Emissions Solutions (NASDAQ:[ADES](#)) has declined around 30% in the last few months, and I believe the stock is now highly compelling around current prices. As it has drifted downward on basically no news, I've continued to accumulate shares, taking it from one of the smaller holdings in my portfolio to one of the five largest. I believe its combination of downside protection and upside potential, along with the presence of a strong catalyst make it one of the best opportunities available in the market today.

Introduction and Company Background

ADES is a unique company that has had a bit of a tumultuous history. It was founded as ADA-ES Inc. in 1997 with a focus on providing technologies and equipment for emissions regulations, but it reorganized as Advanced Emissions Solutions in 2011. At around this time, it [expanded a JV arrangement](#) to take advantage of an IRS tax credit (more on this below). But then in 2015, the firm became embroiled in an expensive [accounting restatement](#) that also prevented it from filing financials with the SEC or doing any earnings calls. Shortly thereafter, the [CEO was replaced](#), and it wasn't until summer of last year that ADES regained compliance and relisted on the NASDAQ.

However, in the 1.5 years or so since [present management](#) took over and the stock was relisted, the company's prospects have improved materially as it has shifted towards an asset-light business model generating positive free cash flow. The company's [latest earnings release presentation](#) does a good job depicting the considerable progress it's made, but the improvement has been quiet and I believe the market has yet to fully appreciate it.

ADES's main source of value comes from its 42.5% ownership in a JV called Tinum (Goldman Sachs and Nexgen Refined Coal are the other owners) that is awarded tax credits when it generates refined coal (RC), an IRS-defined low-emission variety. In 2004, the [IRS developed a tax credit](#) (not a deduction – these credits decrease tax expense dollar for dollar) in an attempt to incentivize the creation of these cleaner RC facilities. A total of four companies took up this offer and built facilities, with the Tinum Group being the second largest with a total of 28. The window to build them closed in 2011, and the credits expire in 2021 (except for two facilities placed into service in 2009, for which the credits expire in 2019).

The mechanics of the JV's cash flow generation is a bit complicated, so walking through the steps of the process may be instructive:

1. Tinum finds a firm (the operator) looking to reduce its tax liability.
2. The operator runs at the facility at a cost of around \$7.50/ton. (This credit increases a bit every year; around half is the cost of operations and half is a payment to Tinum).
3. For each ton generated, the IRS provides a tax credit worth about \$7.50/ton (hence, running these facilities is cash flow neutral for the operator).

4. Though net cash flow is \$0 for the operator, the operator is allowed to deduct the cost of running these facilities on its own financials. Thus, each ton of RC produced creates around \$2.75 in tax credits (assuming a 38% tax rate).

The completion of this process is known as monetization, and each one completed produces a reliable stream of income to Tinnium (of which ADES gets 42.5%). Even better, there's very little cost associated with these cash flows because most of the capital investment was incurred in the outfitting of the facilities during the 2009-2011 period. In the past, ADES also retained some of these facilities to run itself, but it (wisely) moved toward the asset-light model of monetization-only under the new management team and finally ceased production at its last retained facility in Q1 of 2016.

Operating Tons: Invested vs. Retained



Three Months Ended December 31, 2016	Invested	Retained	QTD - Total	Year ended December 31, 2016	Invested	Retained	YTD - Total
Tonnage (M)	10,068	15	10,083	Tonnage (M)	41,828	890	42,518
Count (#)	13	—	13	Count (#)	13	—	13

Source: Q4 earnings call presentation

So ADES basically receives ongoing tax credits for having built refined coal facilities before the 2011 deadline, then monetizes them by finding an investor that can use the tax credits in full. It also operates several other businesses that are not being ascribed any value at the current price. Here are the two key reasons why I think the stock is very compelling at current levels, which I believe creates a situation akin to "heads I win a little, tails I win a lot."

Key Thesis Points

ADES has strong downside protection at current prices via contracted cash flows from facilities it's already monetized. From now until 2021, ADES should receive around \$251M from the 14 facilities it has already monetized, the PV of which (at a 15% discount rate) is now well above the company's current market cap and EV. This chart from its [latest investor presentation](#) depicts this cash flow stream; the company presents it on an undiscounted basis, but to provide a more conservative estimate I've discounted it to the present value, which works out to about \$10/share in value.



Source: ADES presentation at Sidoti Spring 2017 Emerging Growth Convention

Multiple free options create the potential for significant additional upside. While the aforementioned cash flow stream protects the downside, the company also has several promising growth levers to pull. These include:

1. The ability to monetize its remaining 14 facilities in the future. ADES has currently monetized only half of its facilities, with the most recent one added in the first quarter of 2017. Other firms offering RC tax credits have [managed to lease over 80% of their facilities](#), and there's no reason ADES can't do the same. Management believes there's the potential for several more deals to go through later this year, although I only model one more in my valuation below.
2. A fast-growing chemicals division. A few years ago, ADES commercialized a line of chemicals designed to reduce coal emissions. Since beginning from a standing start in 2014, the division has grown from \$391k sales in 2014 to \$3M in 2016, a CAGR of 178%. Even after this growth, it still has penetrated only a small portion of its TAM. Management is targeting \$20-40 M in sales from this division within the next few years, implying at least a few more years of parabolic growth. EBITDA will grow even faster as operating leverage kicks in, a trend that already started to occur in 2016 when segment EBITDA margins [went from 31.3% to 42.8%](#).

3. A declining equipment and consulting business. All legacy contracts will run off by 2018, at which time I assume the division will be shuttered, but until then, this segment also produces positive segment-level EBITDA and is probably worth something.
4. An intellectual property portfolio. The company has 57 patents either confirmed or pending, mostly in the US, but until recently had never really attempted to monetize them. This is now changing under the new management team, which is actively looking to unlock some of their value. As stated by CEO Heath Sampson in the [2016 Q3 earnings call](#):

"...the right way to think about the patents around our portfolio and we have patents across the entire business, the big value are all centered around the M-Prove technology and there's other chemical type patents that would complement that and support that. So, we're currently talking with customers on how we could use some of these other chemicals that would complement the M-Prove technology... So, encouraged about our patent portfolio and we'll see how we monetize that. Either that's through - potentially, people are evaluating us whether or not they want to buy those or how we can sell those current products that are tied to those patents to our current customers. So, early on, but that's how we are evaluating using the necessary experts and the market and our customers to help us value those."

In my SOTP below, I don't ascribe any value to the portfolio yet, but it's another free option that could potentially be very lucrative.

Valuation

First, I'll show all the components to my SOTP valuation. For Tinuum, I assume the company manages to monetize one additional facility a year (it has already completed one for this year, hence the two for 2017), which would still put its overall utilization upon the credit expiry in 2021 below peers. I assume the chemicals division continues to gain market share and increase operating leverage, and that sales hit management targets of \$20-40M. Finally, I assume that the E&C segment completes its legacy contracts and then is shut down in 2018.

Adestella

Investment Management

CSS (Tinum)	Time Until		0	1	2	3	4	5		
	2015	2016	2017	2018	2019	2020	2021			
Remaining CSS Payments	32.2	108.7	116.0	130.0	134.0	123.0	87.0		590	total
									15%	discount rate
NTM PV to ADES	13.7	46.2	49.3	48.0	43.1	34.4	21.1		42.5%	ADES share
Cumulative Remaining	255.8	242.1	195.9	146.6	98.6	55.5	21.1			
New Facilities Investors	-	-	2	1	1	1	1		<--	monetization closer to A/G percent of total
x PV to ADES per Facility	16.0	16.0	10.7	16.0	16.0	16.0	16.0		16.0	full yr. PV per facility
Marginal Value	-	-	21.4	16.0	16.0	16.0	16.0		67.9%	of facilities operating by 2021
									33%	complete of current yr.
NTM Present Value	-	-	9.1	5.9	5.1	4.5	3.9			
Cumulative Remaining	-	-	28.5	19.4	13.5	8.4	3.9			
Total CCS Value	255.8	242.1	224.4	166.0	112.1	63.9	25.0			
per share	11.75	10.89	10.09	7.47	5.04	2.87	1.13			
Chemicals										
	2015	2016	2017	2018	2019	2020	2021			
TAM	350.0	350.0	350.0	350.0	350.0	350.0	350.0		350	TAM (sales)
x Penetration	0.3%	0.9%	2.4%	7.5%	8.5%	9.5%	10.5%			
Sales	0.9	3.0	8.4	26.3	29.8	33.3	36.8		<--	targeting \$20-40M in sales next few years
x Seg. EBITDA Margin	31.3%	43.8%	46.0%	55.0%	50.5%	51.0%	51.5%			
Segment EBITDA	0.3	1.3	3.9	14.4	15.0	17.0	18.9			
x Multiple	11.0	11.0	11.0	11.0	11.0	11.0	11.0		11.0	EV/EBITDA
Segment Value	3.1	14.6	42.5	158.8	165.3	186.5	208.2			
Equipment & Consulting										
	2015	2016	2017	2018	2019	2020	2021			
Sales	61.9	47.6	37.1	12.4	-	-	-			*legacy contracts all run off by mid-2018
- Opex	47.0	38.1	31.6	11.1	-	-	-		-38.1%	CAGR
Segment EBITDA	14.9	9.5	5.6	1.2	-	-	-			
x Multiple	3.5	3.5	3.5	3.5	3.5	3.5	3.5		3.5	EV/EBITDA
Segment Value	52.2	33.2	19.5	4.3	-	-	-			

Next is the consolidated totals. I assume, in line with management guidance, that ADES continues to receive around \$11M in distributions per quarter, which I apply first toward funding the dividend and then to reducing the net debt. I also apply a conglomerate discount for conservatism.

	2015	2016	2017	2018		
Total Value	311.0	289.9	286.4	329.2		
- ND	16.9	(13.2)	(40.3)	(97.6)	11.0	avg. quarterly distribution
MC	294.1	303.1	326.7	426.8		
x SOTP Discount	85.0%	85.0%	85.0%	85.0%	15%	discount
Adj. MC	250.0	257.6	277.7	362.8		
\$/ Shares	21.7	22.2	22.7	23.1	2%	annual dilution
Value	11.53	11.59	12.25	15.68		
by 2021						
Upside	40.8%	41.5%	49.5%	91.5%		
IRR	40.8%	41.5%	49.5%	38.4%		
	2015	2016	2017	2018		
EBITDA	(39.8)	(34.4)	(6.6)	(0.3)		
- D&A	2.0	1.0	1.3	1.8		
EBIT	(41.8)	(35.4)	(7.8)	(2.1)		
- Interest	8.4	4.8	-	-	<--	no debt remaining
- Tax	0.0	0.3	0.4	0.4	<--	AMT due to NOLs
Operating NI	(50.2)	(40.5)	(8.2)	(2.5)		
+ Equity Method NI	8.9	45.6	44.0	44.0	11.0	avg. quarterly distribution
Total NI	(41.3)	5.1	35.8	41.5		
+ D&A	2.0	1.0	1.3	1.8		
- Capex	0.5	0.3	0.6	0.6		
FCF	(39.8)	5.7	36.5	42.7		
Dividend Cost	-	-	22.7	23.1		
Dividend Yield	0.0%	0.0%	12.2%	12.2%	\$ 1.00	annual dividend

Finally, here's a breakdown of value by segment. Over time, Tinum's value falls as the total amount of cash flows remaining drops, but it's offset by growth in the other business segments (primarily chemicals).

	2015	2016	2017	2018		
CCS Value	255.8	242.1	224.4	166.0		
+ Chg. in net cash	-	-	21.3	42.2	11	avg. quarterly distribution
Steady State	255.8	242.1	245.8	208.2		
Value of Other Ops	55.2	47.8	62.0	163.1	<-- assumes no value to patent portfolio	
Shares Out.	21.8	22.2	22.7	23.1	2%	annual dilution
CCS Value/share	11.75	10.89	10.84	9.00		
+ Other Biz/share	2.54	2.15	2.73	7.05		
Total per Share	14.28	13.04	13.57	16.05		
x SOTP discount	85.0%	85.0%	85.0%	85.0%		
Adj. Value/Share	12.14	11.08	11.53	13.65		
Upside	48.2%	35.3%	40.8%	66.6%		
IRR	48.2%	35.3%	40.8%	29.1%		

Catalyst: New Dividend Announced With 12% Yield at Current Price!

The cherry on top of all this is that investors will be paid to wait for the market price to come closer in line with the SOTP value. [In the first quarter, ADES announced](#) it would begin paying a \$0.25 quarterly dividend, or \$1/year, which is above a 12% yield at the current price. How many asset-light, recurring cash flow-generating firms with material upside potential offer anything close to that yield? Because the first dividend won't be paid until Q2, it won't show up on any screens yet, and because this is a small-cap company with very little Wall Street coverage, I doubt many people are aware of it yet, but when they are I'd expect the shares to rerate materially.

The company has also stated it would consider expanding its capital return program through a buyback, and at current prices, I wouldn't be at all surprised to see that initiated as well. That or the announcement of another facility monetization (each one is worth about a \$1/share to ADES) are also potential catalysts here.

Why Does This Opportunity Exist?

I think the opportunity today has been created by multiple factors, including:

- Messy historical financials, particularly prior to the past year and a half when ADES was not just monetizing its facilities for the tax credits, but also attempting to run some of them (known as retained facilities). This was a far more capital intensive and unattractive business that some people may still incorrectly associate with the company.

- Legacy issues associated with prior management team. ADES is now free from an accounting misstatement and attendant litigation that plagued it a few years ago, but investors who were burned may not have forgotten.
- Much of the company's earnings are ascribed via the equity method (for Tinuum), which means ADES often doesn't screen well.
- Perceived risks from association to the coal industry. While ADES facilities are indeed connected to coal production, the company itself has no exposure to commodity prices and the stock is much more of a tax credit play than any sort of bet on the outlook for coal.
- No sell-side coverage and small market cap mean the stock is well off the radar of most investors.
- Unique business model means it's not a stock many people would stumble upon accidentally while researching a peer or the like.

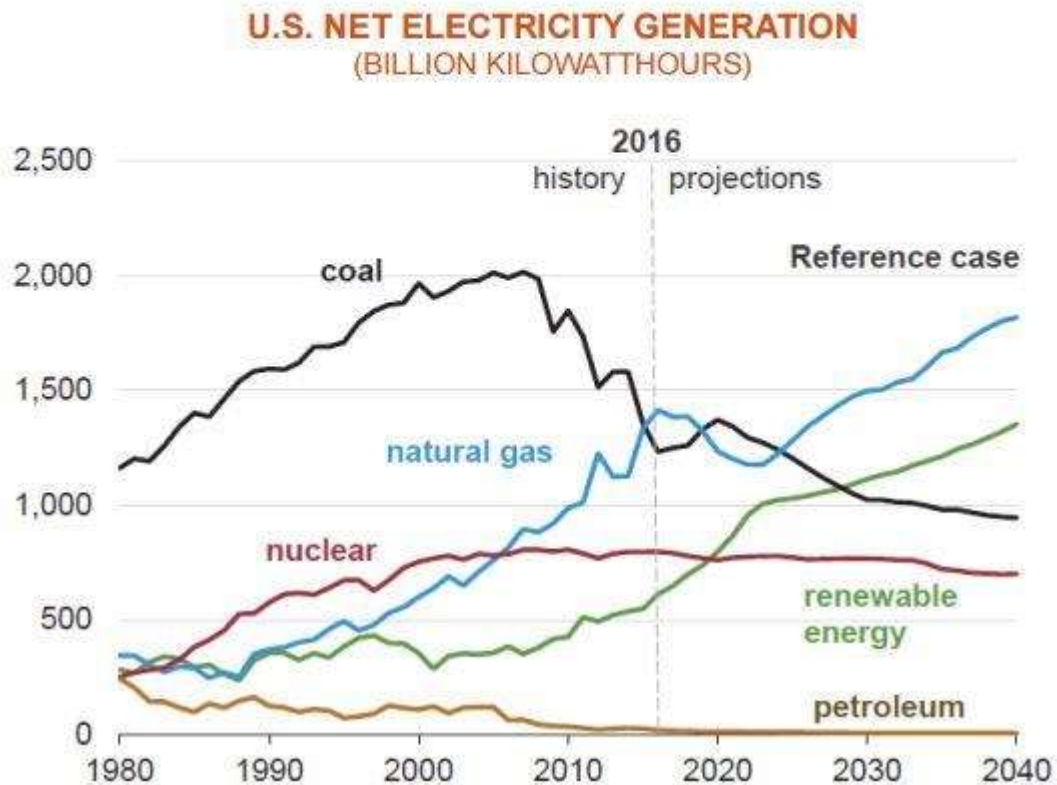
Risks

The main risk is that tax reform under the new presidential administration somehow hurts the value of the tax credits for restricted coal facilities. I'm comfortable with this risk for three reasons:

1. President Trump's comments about the coal industry have generally been favorable.
2. There's no guarantee tax reform will even go through Congress, if the problems with healthcare reform are any indication.
3. The section of the federal tax code dealing with coal tax credits is small, arcane, and unknown to most people. Since it barely impacts anyone, it is hardly something that would be prioritized by reformers, leading me to believe any amendments to it would be much more trouble than they're worth, particularly since the credits expire in just four years anyway

The second potential problem would come from a drop in coal demand so significant that there would no longer be any benefit in running the facility, even for the tax credit. However, coal power won't go away overnight and over the timeline of this investment it should be more than sufficient (see chart below), particularly given the current administration's rhetoric on the subject.

COAL USE: A REALITY MOVING FORWARD



Source: ADES presentation at Sidoti Spring 2017 Emerging Growth Convention

Concluding Summary

I think the risk-reward in ADES's stock is highly favorable at current prices, and I've attempted to take advantage of the dislocation by adding materially to my position in recent weeks. With the continuing cash flows from Tinium, the long runway for additional facility monetization and chemical segment growth, and the positive tail-risk of the patent portfolio's value, there are multiple ways to reach a favorable outcome from here. Even better, with the new 12% dividend, investors are paid (handsomely) to wait for these events to unfold.

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