February 20, 2019

Dear Fellow Investors,

Adestella completed a very difficult year with a 29.3% loss in the 4th quarter, thus finishing the year with a 30.9% decline. Long positions fell in excess of 35% in the midst of a sharp market deterioration, with neither domestic nor foreign stocks proving safe havens. Meanwhile, our short book provided only minimal cushion due to our net exposure approaching 100%. Attempts to take advantage of the decline by buying into the weakness proved premature as well, compounding our problems in the short term.

An updated performance summary is below:

| | 4Q 2018 | 2018 | Since Inception |
|---|---|---|---|
| S&P 500 | -13.52% | -4.56% | 40.07% |
| Vanguard Total World Stock ETF | -13.00% | -9.76% | 16.89% |
| Russell 2000 | -20.29% | -11.11% | 20.35% |
| HFRI Equity-Hedge (Total) Index | -8.43% | -7.03% | 10.70% |
| **Adestella Investment Management** | **-29.02%** | **-30.86%** | **24.59%** |

**all index returns include reinvestment of dividends*

## Perpetual Beta and Disappeared Alpha

What a difference a year makes. Following a very strong 2017, the majority of our gains in the last 18 months were wiped out in the final portion of 2018. While the causes and drivers were varied, I believe there was one underlying element that unified them. To paraphrase a Buffett expression, we owned far too many fair businesses at great prices and not nearly enough great businesses at fair prices.

These fair businesses, while statistically cheap, tended to be exposed to more cyclical end markets and often carried a higher degree of leverage – which made them particularly hard-hit when fears of an economic slowdown caught hold of investors. Most of these companies fell between 20-50% in the quarter, and the fact that the actual macro backdrop remained quite strong was little consolation as I watched a sea of red on my screen every day and the cheap became even cheaper.

Last quarter, I discussed the idea of having a "perpetual beta" mindset and the steps that entailed: try, analyze, improve, repeat. And when you experience a drawdown to the extent that we did in the 4th quarter, one that eviscerates years of gradually developed excess returns that cycle takes on a whole new level of urgency and focus; in fact, it calls for a fundamental reexamination of your investment process. While there are a wide range of takeaways to be had, I believe they can be condensed into three overarching themes that will become more prominent for Adestella going forward:

1. Power of Compounding – The impact of compounding is often underappreciated in both directions, but the math is undeniable. There is no benefit to gaining 50% in one year if you lose 30% the next; the net result is roughly equal to owning a bond yielding 2.5% a year.
2. Importance of Downside-Focused Asymmetry – I have written about asymmetry in the past, but it tended to focus on only the risk-reward ratio (i.e. bet 1 to win 5). This led to a focus on potential upside since that portion of the equation is much more variable – downside is capped at 100%, but upside is theoretically unlimited. However, when a string of negative results comes in a row, it can ruin the compounding momentum discussed in Point #1 above. Thus, it may often be better to sacrifice some upside for lesser risk of permanent capital impairment (i.e. heads I win something, but tails I don't lose much).
3. Psychological Considerations – The impact of large portfolio swings is, at least for me, not conducive to long-term success in terms of avoiding burnout and making clear-headed decisions. Research suggests that individuals feel pain from losses 2.5x more strongly than pleasure from gains, and I am inclined to agree.

With these lessons in mind, it became quite clear what the right course of action was. The companies that best allow us to take advantage of the above factors are ones that have some sort of unique advantage (manifested through their growth, margins, and/or return on capital) and a long runway to take advantage of it. They tend to participate in industries that are less prone to large changes in supply and demand that can wreak havoc on strategic planning and financial results, and they can expand their business regardless of the broader economic environment. Of course, these companies would be more expensive because of their superior quality – but just like with one's purchases in everyday life, sometimes it makes sense to spend a bit more in order to purchase a more sturdy, reliable item, rather than one whose usefulness erodes rapidly. Adestella will be spending much more time and energy identifying these sorts of companies going forward.

I want to emphasize that this is not a wholesale change of strategy – our portfolio has always held a combination of compounder-type businesses and ones that tend to be statistically cheaper and offer potentially higher upside. I am simply shifting the ratio of these two segments more in the direction of the higher-quality businesses. I expect we will continue to own some companies in less attractive industries with multi-bagger upside, but the threshold for such situations is now significantly higher.

This change will also take some time to play out; it is not in our best interest to dump our cyclical holdings at fire sale prices just to speed up the transition if they remain fundamentally solid but simply out of favor (a homebuilder we own comes to mind). I have found that selling losers due to fatigue or impatience generally tends to be a mistake, and in any case, I don't feel as though I have enough good compounder ideas yet to fill a portfolio. But over time, as the theses on these cyclical names is either proven or broken, I would expect the cash generated to be redeployed into better-quality names. Thus, as the portfolio gradually turns over, our split between the two categories will shift as well.

## Mondo Mishap

While there were many negative contributors in the quarter, one merits special discussion. Earlier this year, I was excited by the prospects of a small-cap Italian company called Mondo TV. I believed I had uncovered a gem – an under-the-radar play on the explosive growth of OTT video services (such as Netflix and Hulu) and the original content arms race they were undertaking to differentiate their offerings. Moreover, it appeared to be available from Mr. Market at an extremely low price relative to its business quality and growth outlook. Furthermore, I thought that the reasons the opportunity existed seemed reasonable – a small-cap Italian company with very little analyst coverage or investor outreach, plus a terribly outdated website and relatively tightly controlled float due to 40%+ insider ownership.

The chief concerns that popped up in my research and discussions of the investment were twofold. First, the company had routinely diluted shareholders by way of convertible debt. However, I was willing to accept this given that the conversion prices were well above the prices the stock then traded at, and because their explanation – that they needed to create their content and make it available while the providers were still in their "land-grab" phase – seemed reasonable. Second, in recent years the company had reported persistently negative working capital changes chiefly due to large growth in its receivables. After a good deal of work on the topic, I became comfortable with this risk for a couple of reasons. First, the receivables balance as a percentage of sales was in line with historical norms for the company. Second, management told me personally that the shift was solely due to a larger mix of Asian customers, which tend to expect longer payables terms. Third, insiders were by far the largest shareholders – if there really were cash collection issues, I assumed they would be top of mind for the management team. Finally, it didn't seem to pass a common-sense test – the company produces children's cartoons, not massive infrastructure projects with multi-year lead times, so the fixed/sunk costs and counterparty risk are relatively minimal. If customers weren't paying, it seemed a simple fix: stop working on that project or sell the rights to it somewhere else.

Finally, the actions of the management team were extremely misleading on a number of occasions. One thing I always pay attention to is the incentives of the people in charge, as I assume they will act in their own self-interest. I cannot think of another situation in which insiders committed financial suicide to the extent that they did here. First, they put out aggressive guidance targets (and then reconfirmed them following the 2nd quarter despite already being behind pace). Then, knowing that they weren't tracking anywhere close to them for Q3, they bought a significant amount of stock despite already owning a bunch. Following the market's negative reaction to the Q3 release, they tried to quell fears by putting out a press release stating that payment flows had been "substantially constant." At this point I was considering selling, but upon seeing that multiple insiders were again buying shares, I wrongly assumed that there was no way they could be making the same mistake twice and decided to hold on. But then, less than a month after their "substantially constant" comment, they announced that they would instead be writing off 75% of these receivables, and the stock was crushed again.

In the US, such disingenuous statements would likely constitute fraud with serious consequences (as Elon Musk recently found out), but it appears as though in Italy one can get away with it. I don't recall any other situation in which I've witnessed such self-destructive behavior – snapping up shares right before announcing a massive accounting bath seems a pretty obvious way to lose money – but the fact that management compounded its losses didn't make ours any easier to take, particularly since our portfolio concentration meant we had a relatively large amount of exposure to it.

I don't mean to fully disclaim responsibility for this outcome – I made mistakes as well. When I learned the investment business, I was taught to use measure free cash flow by looking at it on a normalized basis using the following equation: Net Income + D&A – Capital Expenditure. The implicit assumption in this formula is that changes in working capital swing both ways and normalize over time. In the great majority of cases, this is a valid assumption, but it was not for Mondo – working capital was a cash outflow every year as accounts receivable (money yet to be collected from customers) increased every year. Thus, while the stock looked very cheap on my normalized calculation basis, it was much less so after applying a true economic free cash flow number that accounted for the persistent working capital hole. Also, I should have been more skeptical of the massive valuation discrepancy between Mondo and its peers on both trailing and forward bases, and I should have realized it was unlikely such a discrepancy could be fully attributed to a lack of investor awareness. This was a painful reminder of an old adage that can be applied to most aspects of life: if something seems too good to be true, it probably is.

A few years ago, I followed the Valeant Pharmaceuticals saga with great interest as many famous and celebrated investors suffered huge losses due to aggressive accounting and a lack of real cash flow. At the time, I wondered how such diligent and sophisticated market participants could get caught owning a large position with issues severe enough to cause it to drop by 95%. Unfortunately, I had to find out the answer the hard way. Following its price collapse, Mondo remains very cheap relative to its new (much more conservative) guidance, but if there's a profit to be made going forward here, it won't be us that collects it. I no longer trust this management team and cut a large portion of the position at the end of the year for tax purposes; the rest is being gradually phased out as well. It goes without saying that I am extremely disappointed with this outcome, but "the return on brain damage" will never be sufficient here and the trust never regained, so I believe it is better to simply move on.

An Appendix Removal Procedure: Short(er) Discussion of New Positions

Speaking of moving on – rather than presenting an in-depth thesis in a post-letter appendix this quarter, I'd like to share a few new additions to the portfolio, each of which exemplifies our shift toward owning more great businesses. In the future, I plan to continue writing a bit about several companies instead of writing a lot about one. The original idea behind those appendices was to better share my investment thought process, but by now everyone should be familiar with some of the key focuses of my research process after going through the seven ideas posted to date. Switching to shorter summaries of positions allows me to cover more ground and to be more transparent about our portfolio, which I think will be beneficial overall.

**Alphabet (GOOG)**: I first looked at investing in Google in 2011 (which became Alphabet after a 2015 corporate restructuring), right when I started paying close attention to stocks. At the time the it was trading at about $300 on a split-adjusted basis. However, I ended up not buying it, because the relatively high per-share price combined with my very small personal account meant that buying even one share would result in a larger position size than I wanted. This proved to be a missed opportunity - the stock more than doubled over the next few years. Then in 2015, I read an interesting thesis on the company on an online value investing forum that I follow – and again passed, telling myself that I had "missed it" and that it was too expensive now. But again, it was a lost opportunity – the stock rose 46% in the next year. Almost the same thing happened in 2016 – I looked into it but didn't end up buying any – and the stock has risen another 40%+ since, producing yet another error of omission.

I (finally) began to recognize this pattern, and it occurred to me that it was quite likely that the next time I had the chance to buy the stock and passed, it would be a mistake as well. Thus, with GOOG having fallen around 20% from its summer highs in the fourth quarter, I finally purchased shares for the first time.

Alphabet's ubiquitous search engine (with a bit of help from its related properties) generate 85% of the company's revenues via ad sales, and its moat is unassailable. Microsoft's Bing will literally pay people to search on their engine (which has a similar layout and generally produces very similar results), yet they have still lost market share to Google in recent years. The point was further reinforced when a foreign company I was researching announced that its results had suffered materially recently as a result of unexpected Google algorithm changes. How many companies in the world have that kind of power? While core search growth has (and will continue) to slow due to the law of large numbers, the persistent shift from offline to digital advertising coupled with the company's pricing power has allowed Google to post consistent ~20% growth while throwing off a lot of cash flow in the meantime. This cash is then deployed into the wide variety of other projects Google works on – everything from balloons delivering internet service to rural areas to delivery drones. Many of these projects have great potential, but there are a few that I am particularly excited about:

- Waymo: it appears that self-driving cars are now inevitable, and Waymo has carved out a clear leadership position in the space. The company has more than twice as many self-driven miles than any other competitor and the most robust patent portfolio. Given that its data collection and improvement have accelerated greatly, there is a good chance that lead continues to grow every day. Of course, we are still in the very early days of autonomous vehicles, and the way things play out from here remains very unclear. However, even using some conservative estimations for market share and revenue per mile suggests a revenue opportunity of up to $50 B over the next decade. Even with a high discount rate to account for large degree of uncertainty here, these future cash flows are worth up to $75 B today and potentially much more should the company decide to license the technology.
- YouTube: the video-sharing site purchased in 2006 has become the 2nd most visited website in the world (behind only Google itself) with about 5 B video views per day, and it has a long runway of monetization ahead of it as its ad targeting continues to improve. Now, in addition to its traditional business of user-uploaded recorded videos, YouTube offers a paid music streaming service, as well as a live TV service that many believe is the best among the various OTT TV providers' alternatives to cable. TV is a massive market, and the superior value propositions offered by OTT offerings like YouTube make me confident that there is significant room for market share gains (currently around 12%). I believe this business is worth more than $100 B now, and could perhaps be closer to $200 B if YouTube manages to convert some fraction of its free users to paying live TV customers.
- DeepMind: purchased in 2014, Google's DeepMind and its flagship AlphaZero program are on the cutting edge of artificial intelligence and machine learning. Its accomplishments to date, such as learning chess by itself in four hours and then proceeding to dominate the best chess engine ever created while analyzing 99.9% fewer moves, are nothing short of extraordinary. In the years ahead, this technology will likely be applied to even more productive purposes, healthcare and energy efficiency being among the early applications for which there's a huge market. I don't have any idea what the ultimate commercial worth of this unit will be, but I'm willing to bet it will prove quite valuable.

On top of these, Google owns the globally dominant mobile operating system, operates highly popular mapping/email/productivity platforms, and is a quickly growing player in the burgeoning cloud computing market – not a bad list of afterthoughts!

While not cheap on a traditional valuation basis, there really is no reason a business of this quality should be. 17x this year's expected earnings (net of cash) following its winter pullback strikes me as a fair price for a company that is likely to grow those earnings relentlessly for a very long time to come. Or, looked at another way – backing out estimated valuations for Waymo, YouTube, and the cloud business (the three largest non-core pieces for which I can make a rough triangulation) would imply we paid about 12x core earnings for what is arguably the best business in the world. Thus, Adestella now owns shares in Alphabet, and I hopefully have learned my lesson once and for all.

**Majestic Wine (LON:WINE):** a small-cap based in the UK, Majestic Wine's traditional business is operating a chain of wine retail stores, which is a fairly stable but wholly unexciting operation. What is compelling, though, is the company's direct-to-consumer business, which after finding success in the UK expanded into the much larger US market a few years ago.

This division, named Naked Wines (the inspiration for which was drawn from the founder's former boss, Richard Branson), is essentially a crowdsourcing model for funding independent winemakers. WINE collects subscription fees from its members (they refer to them as "Angels") and then forwards the majority of that money to small, independent winemakers so that they can make wines under their own name or label. In return, Angels receive access to these exclusive wines at insider prices (generally 40-60% below retail). The business capitalizes on several cultural trends, including wine's increasing share of alcohol consumption and millennial desire for artisanal/craft products. To date, the value proposition has been well-received – the company has seen 4x ratio of customer lifetime value to the cost to acquire that consumer (LTV/CAC) with full payback with two years.

Based on the success of this growth algorithm, WINE has encountered an issue that can be viewed either positively or negatively depending upon your time horizon. The good news is that the strong returns they were seeing on the average customer meant that by spending more they could greatly increase their ultimate payback; the bad news is that the investment required to accomplish this would reduce near-term profitability. In an April capital markets day, management stated its intention to accelerate growth by making these investments. For the months following the announcement the shares traded flat, but investors seemed to lose patience following the release of half-year results in November indicating that they were planning to increase investment even more than previously anticipated, that the retail business was struggling more than anticipated in a tough consumer environment, and that they would be stocking extra inventory in preparation for potential Brexit disruptions. Following the release, shares dropped more than 40% over the next month or so as the combination of the news and general Brexit fears weighed heavily.

In my opinion, this drop has produced a very interesting opportunity for an investor with a multi-year time horizon. While WINE's new customer investments will hurt reported earnings in the next few years, they will increase the company's ultimate value so long as churn and margins don't drop off sharply. Given these metrics are currently very strong (more than a 4x ratio of customer lifetime value to the cost to acquire that consumer) and trending higher, this seems unlikely. In the current LTV/CAC range, I believe these investments are solidly NPV-positive. Given that insiders own about a quarter of the equity, they are likely to be judicious about making sure this continues.

At our cost basis, we paid about 8x for the wine retail segment and in-place subscription base, with the with any potential sub growth (as well as two small divisions that don't make a material financial impact) thrown in for free. While Naked Wines will likely post flat profits over the next few years as it ramps up investment in new customer acquisitions, I believe it will ultimately be much more valuable than the retailing segment. If I'm wrong, valuing the segment at 10x the EBIT it generated before it started accelerating investment (about 9 M GBP on a smaller customer base) plus 10x retail EBIT gets you back to the current price, so I view the downside as limited.

**Alibaba (BABA)**: like Google, the Chinese Internet giant Alibaba earns me no points for creativity. However, returns aren't awarded on the basis of uniqueness – ultimately it comes down to business performance, and on this front, I think the company will earn many points. I believe Alibaba is a prime example of an "inevitable", positioned squarely in the middle of several irreversible secular trends in the world's largest market, which is itself also benefitting from unstoppable secular trends.

Alibaba's main businesses are two e-commerce sites called Taobao and Tmall. The scale of these is hard to wrap your head around – on a popular shopping holiday in China a few months ago, BABA recorded $30.8 B USD in merchandise sales, which would be around 15x more than the busiest day in Amazon history and imply that they had passed Amazon's full-day total within 10 minutes. While it is important to note that this is not exactly an apples-to-apples comparison – BABA's figure reflects gross merchandise value, a metric Amazon does not disclose, which inflates the 15x figure to some extent – the sheer size remains impressive. But perhaps this shouldn't come as a surprise considering that China has more than three times as many internet users as the US. And yet, internet penetration is only 55% in China (developed peers are in the 85-90% range), and GDP per capita is $8.8k USD (vs. an OECD average of $39k USD) which means there remains a long runway for further increases both from usage and buying power gains.

Alibaba is also a major player in two other large, attractive, secularly growing markets. The company's AliCloud is the dominant cloud player in the Chinese market with nearly a 50% share, and the company seems intent on expanding into new geographies as well. BABA also owns a 33% stake in Ant Financial (recently valued at $150 B USD, making it the most valuable start-up in the world), which controls half of a mobile payments duopoly that is also growing rapidly. In the last few years, users have gone from 50 M to over 450 M, while transactions have increased from 4 B to over 97 B. Another few hundred million users are expected by 2021, along with a tripling of total payment volume from the current rate.

Like Alphabet, Alibaba is not cheap on traditional metrics. But again, there is no reason it should be – I believe it may have the longest runway of 20%+ sales and earnings growth of any company that I know of. On a sum of the parts basis, I think the stock will be worth around $250 by the end of fiscal year 2020, with intrinsic value continuing to increase each year. Thus, following a nearly 40% decline on general Chinese stock weakness due to trade war fears, Adestella has made Alibaba a core position.

## Conclusion

It goes without saying that I am not happy with the Fund's performance in 2018. The declines were significant, and since the vast majority of my liquid net worth is invested in the fund, I felt the losses as acutely as anyone. But for those unaware, the name "Adestella" comes from the Latin phrase *per ardua ad stella*, which translates to "through struggle to the stars." So it was perhaps fitting that we would experience a very challenging period at some point; I would say the fourth quarter certainly qualifies. Our ability to progress to the second part of that phrase will depend on our response to the last three months. If the lessons that were learned and the strategy adjustments that resulted from them improve our net after-tax returns in the long run, perhaps it will prove to be a blessing in disguise that it occurred relatively early in my investing career. As with most other things in investing, only time will tell whether that is the case. While the first quarter has progressed well to date, there remains a long way to go. But by learning from the past year and recalibrating our approach for the way ahead, I believe we are in a strong position to resume progress toward our long-term goals in 2019.

*"I never lose. I either win or I learn."*

- Nelson Mandela

Per Ardua Ad Stella,

Andrew Jakubowski

Andrew Jakubowski

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