Adestella
Investment Management

November 30, 2020

Dear Fellow Investors,

Adestella gained 19.5% in the third quarter of the year, taking our year-to-date return to 55%. Our long positions returned 19.1%, our (much smaller) short book lost 0.5%, and the remainder was attributable to currency fluctuations. Domestic and international equities both performed strongly, with about a 50-50 split in net contribution.

After enormous volatility in the first half of the year, relative tranquility prevailed in Q3. Markets continued marching higher throughout the summer and into fall, and we were fortunate that our portfolio did as well. The S&P 500 returned to positive territory for the year and completed history's fastest recovery from a bear market – two developments which would have been unthinkable just a few months earlier when it had suffered its fastest fall into one. The speed of these moves underscores the difficulty of dancing between the proverbial raindrops, and highlights the fact that, cliché as it is, time in the market is better than timing the market when it comes to building long-term wealth.

An updated performance summary is included at the end of this letter.

News Deluge

The election is now behind us, and it looks like we will have our 46th president. Stocks have historically gained no matter which party is in power, and the intrinsic value of the companies we own is only moderately affected by their cash flows over the next four years. Nonetheless, it's my job as an investor to consider how the potential policy changes attached to various results are likely to affect the market environment and our portfolio. This pre-election primer from BlackRock did a good job in spelling out the likely ramifications of each outcome.

A Democratic sweep likely to spur biggest policy changes
U.S. election scenarios and potential market implications, October 2020

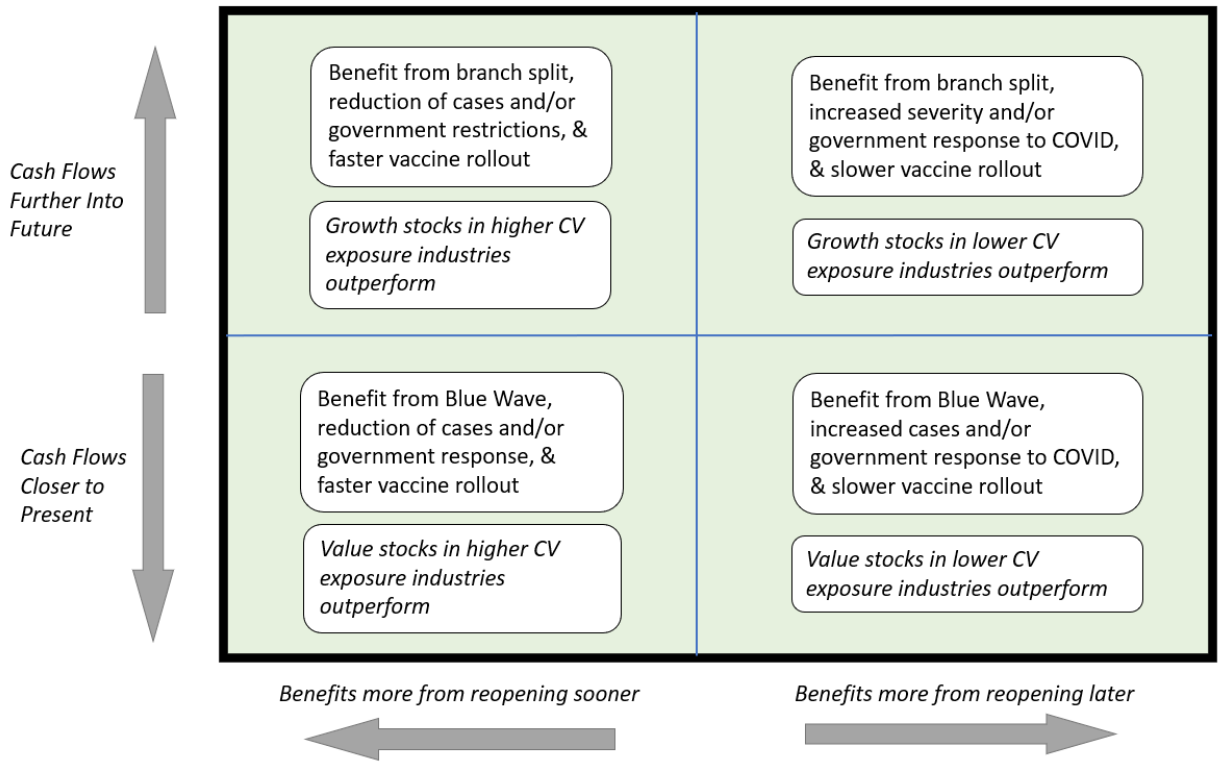
	Fiscal stimulus	Public investment	Taxation	Regulation	Foreign & trade policy	Potential market implications
Biden (unified Democratic control)	++	++	−−	−	+	Global cyclicals and domestic small-caps could benefit from U.S. stimulus plans. Sustainable assets may get a boost. The yield curve could steepen and breakeven rates rise as inflation expectations ratchet higher.
Biden (divided government)	−	−	No change	−	+	Quality may perform strongly; tech may face regulation and anti-trust measures. More predictable trade policy could help EMs. More modest fiscal stimulus may cap gains in yields and inflation expectations.
Trump (divided government)	+	No change	No change	No change	−	Tech and quality may keep performing strongly; EM and Europe likely underperform. Lack of a reflationary impulse may cap breakevens and any steepening of the yield curve.

In many ways, the divided government is likely to lead to a continuation of the status quo of gridlock in Washington. While one can debate whether or not that is good for the country, the waning prospects of sweeping change have been judged positively by investors. Further drilling down on the potential portfolio implications of a Biden-led divided government, we like where we are positioned for the years ahead:

- We don't own "cigar butt" or highly leveraged stocks that would have likely seen the sharpest gains from a massive stimulus package. While we do own cyclicals and domestic small-caps, those theses are based on their through-the-cycle economics rather than on potential multiple expansion from a rotation into traditionally-defined value stocks.
- We don't own any FAANG names and are actually underweight technology on a net basis relative to market indices, making regulation or anti-trust changes less significant.
- We don't own any companies that operate in highly regulated industries or ones that count the government as a material client.
- Over half of our portfolio is in international stocks, which would likely stand to benefit, on average, from reduced trade tensions and more conventional foreign policy.

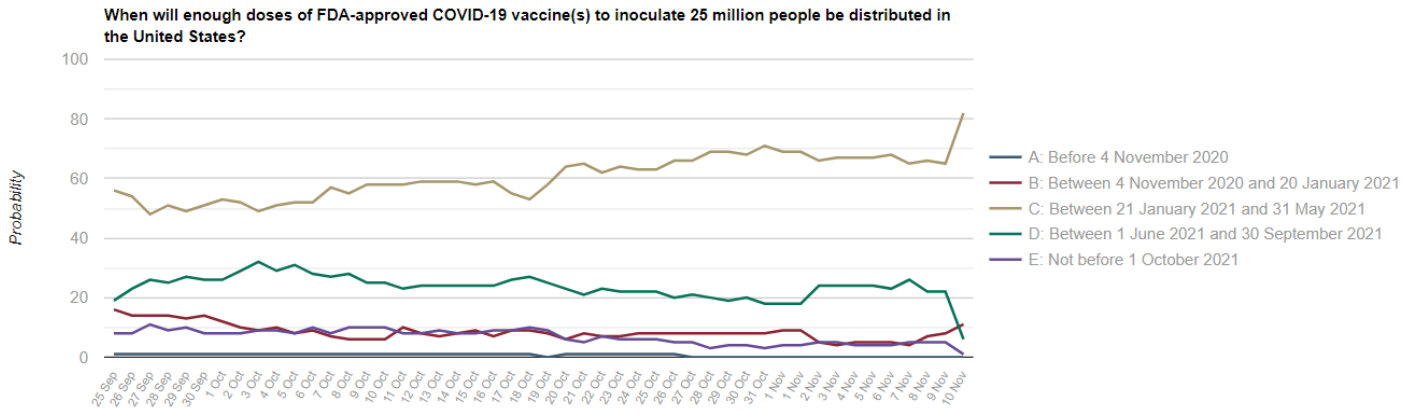
The even more recent development of substantial vaccine progress does add a wrinkle in the short term, as many of the companies perceived to be the biggest beneficiaries of a return to normal life are negatively correlated with those viewed as the biggest beneficiaries of the presidential outcome. Indeed, the size and dispersion of stock moves upon the release of Phase 3 results from Pfizer's vaccine candidate on November 9th were staggering. All that said, there remains caveats to consider – the vaccine requires extreme cold storage (-70 °C) that greatly complicates logistics (particularly in developing nations) [1], entails two doses that may hinder patient adherence, was tested on a small sample size, was not peer-reviewed, and must contend with a population in which 63% remain wary of its safety. So, while this is undoubtedly a positive development, it is not a panacea. There remain hurdles to clear, and the timing behind them is uncertain. Combining those with an highly contentious election cycle in which recounts are ongoing and an important run-off is yet to come, and you have an investment climate where in the near-term, very different groups of stocks could be the best performers (see chart below).

[1] As I write this, Moderna and AstraZeneca have recently announced successful trials of their own vaccines which need only standard freezer temperatures for safe storage, so this may soon be a moot point.



Note: see this graphic for approximate industry CV exposures

This cross-current of developments leaves investors at high risk of being too clever by half, so rather than risking whiplash by pivoting upon the release of every piece of news, we prefer to stay the course. Much like we didn't change our portfolio leading up to the election in anticipation of a certain outcome, we don't own any stocks solely on the basis of their perceived exposure to the "work from home" or "reopening" trades. While some may have exposure to secular themes that stood to benefit from behavioral changes during the pandemic, we believe a.) the ones we are exposed to (like increased eCommerce penetration) are structural shifts that were accelerated rather than temporarily anomalies that will revert, and b.) those positions are offset by others (like travel stocks) for whom an end to lockdowns will be highly positive. Moreover, the eventual development of an effective vaccine was always in the cards, and a widespread rollout in the first half of 2021 was already the consensus view (see chart below). In our experience, trying to time the market – particularly by reacting to an already-expected development – is very difficult to get right.



Thus, the extent of our activity in recent weeks has been a small amount of selective hedging (using index ETFs) to ensure our net exposure is not too concentrated in any of the quadrants above. But whether the vaccine is distributed in early 2021, late 2021, or tomorrow, and regardless of the volatility that creates, I'm confident Adestella is well positioned for the long term.

Checking it Twice

Last month, I did an interview with Seeking Alpha. One of their questions related to my investment process, which of course is a query fielded quite frequently by any professional investor. I crafted an answer to match the typical length and likely reader base of the piece, but subsequently realized that current and prospective investors alike might benefit from an expanded discussion of the points discussed therein. This quarterly letter provides an excellent opportunity to do so.

Several years ago, I read the book The Checklist Manifesto by Atul Gawande. The central theme of the book is that one of the best tools we can use to handle complex situations is actually a very simple one – the checklist. Given the author's medical background, most of the examples were healthcare related, but the underlying precepts – protecting against serious oversights and establishing higher baseline performance standards – were widely applicable. Upon completion of the book, I browsed for investment-focused checklist examples available on the internet, but found none to my satisfaction;[2] most were either too prescriptive (i.e. is the ROE over 10%?) or overly broad and simplistic (i.e. does the business have favorable long-term prospects?).

This inspired me to codify my own process by compiling a list of key considerations by category. An overview (with descriptions added) of some of the due-diligence sections of my list is included below; I've omitted portions related to position sizing and buy/sell discipline, which I plan to discuss at a later

[2] One exception was *The Investment Checklist* by Michael Shearn, but it is a full-length book and thus not well suited to everyday usage.

date. All the standard forewarnings apply – not every item will apply to every company, and I've probably overlooked something that could or should have been included. Certain factors are more important than others; some can be done instantly in one's head, others require focused analysis. Most importantly, completing such a list certainly does not guarantee a positive outcome. That said, I do find it helpful in facilitating multifaceted thinking about the key drivers of an investment as well as its potential pitfalls. Investing is a numbers game, and anything that can help us make correct decisions even slightly more often is worth the effort.

In the coming days, we will release a case study of sorts that goes through the checklist with one of our multi-year holdings that we've recently been adding to, Genomma Lab. I hope readers will find it helpful in understanding how we evaluate companies, and maybe even be inspired to put together a list of their own.

AIM Checklist – Key Considerations Overview

Portfolio

- Overall net exposure – will we still be in an appropriate net exposure range after making the investment?
- Industry/geography concentration – would this investment keep our exposure to a given industry or geography at a level we're comfortable with?
- Investment Theme/Type – would this would this investment keep our exposure to a given theme (i.e. aging of populace) or type (such as turnaround situations) at a level we're comfortable with?
- Opportunity cost – in light of our current opportunity set, is this the best use of our time and capital?

Industry

- Porter's 5 Forces – how much of a threat is there of new entrants or substitutes, how much bargaining power do the company's customers and suppliers have, and how much do the players compete against each other?
- How technical/complicated is the industry? How much time and effort will be required to get up to speed on the industry and to then keep up with developments that could potentially impact the target company?
- Where does the company sit on the industry value chain?
- Industry Stability – what are the approximate market shares of the various competitors, and how have they changed over time? What are the average annual prices changes in the key input cost(s) and/or the output product?
- Industry fragmentation – What is the HHI score for the industry? How does that impact or influence the target company's stated strategy (such as rolling up an industry)?
- Expected industry growth rate & its drivers – will the company have the tailwind of a growing pie, or will it have to fight for a piece of a shrinking one? Is the growth secular or cyclical, and what are the economic forces that govern it?

Company

- Background
    - Every 10-K and most annual reports begin with a broad overview of the business – read them carefully.
    - Founders – their previous work experience and where the idea came from (along with its initial funding)
    - History and Development – product line or business model focus over time, growth rates of key financial items, and material corporate events both financial (i.e. a share issuance) and operational (i.e. a divestiture)

- Business Quality
    - Competitive advantages – what does the company do both better and differently than others?
    - Ability to raise prices – customer retention/repurchase rates, price sensitivity (percent of customer budget), typical customer's profitability (B2B) or disposable income (B2C), network effect or value proposition reputation that drives repeat usage
    - Historical value creation – long-term stock price chart, or past private funding rounds if available/applicable
    - Reliance on external inputs – are there factors outside the company's control (oil prices, interest rates, etc.) that can have a material impact on financial performance?
    - Operating leverage – fixed vs. variable cost breakdown, scalability and asset intensity
    - Cyclicality and seasonality – has the company experienced large swings in operating results over time, and do certain times of year (i.e. back-to-school season) have a disproportionate impact on annual results?
- Customers
    - Customer concentration – largest customer and largest ten customers as a percent of sales/profit (disclosure required if any customer is greater than 10% of sales)
    - Customer satisfaction – customer reviews or testimonials can be found for nearly any consumer-facing company/brand, and several sites offer them for various B2B industries as well
    - Employee satisfaction – how do employees rate their work experience? What are their most/least favorite aspects, and what would they change if they could?

Liquidity/Solvency/Earnings Quality

- Leverage
    - Net debt/EBITDA – absolute level and relative to industry peers
    - Coverage of interest and principal from FCF generation – can company comfortably meet obligations even under adverse conditions, or might capital raise be required?

    - Covenant requirements – will company be able to remain in compliance even under an adverse scenario?
- Liquidity
    - Cash conversion and its components – historical trends and relative to peers
    - Changes and trends in accounts receivable/working capital over time
- Earnings Quality
    - Changes in adjusted GAAP definitions over time – has company moved the goalposts for key metrics, and if so, was there a reasonable rationale?
    - Changes in R&D/software capex spend as percentage of sales – has company been underinvesting? Has there been any significant change over time in the percent being capitalized vs. expensed?
    - Changes in deferred revenue/RPO balances – how will this affect future reported profitability?
    - Frequency and reasonability of restructuring expenses being added back – consider whether these may actually be ongoing costs rather than one-time items.

Profitability

- Margins
    - Gross, operating, EBITDA, & FCF margins – how have they trended in recent years? If there's been any deviation between them, why? How does current profitability compare to both the company's historical levels and its peers, and if there's a difference, what accounts for it?
    - Impact of growth investments on short-term profitability – what is the approximate margin impact of discretionary growth investments relative to what they would be if company pursued short-term profit maximization or were content to grow in line with the industry?
- Capital Efficiency
    - Returns on equity and assets – how do they compare both to the company's own historical levels and to peers?
    - Piotroski F-Score components – what is the company's score on both a fiscal year and LTM basis?
    - ROIC – for numerator, calculate using both operating profit and normalized free cash flow; for denominator, estimate using several methods as well.[3] Think about whether it makes sense to include goodwill/intangibles in denominator and consider calculating it both ways.
    - Incremental ROICs over last 2-5 years – how much additional capital was invested into the business, and what additional cash flow did it bring?
    - Reinvestment opportunities and their prospective returns – does company have the attractive projects to finance, or would it be better served simply returning the money to shareholders?

[3] [Total assets – current liabilities – ST debt/capital leases – excess cash] and [NWC + net PP&E + other investments in operations/associates/equity – excess cash are two common methods

    - Annual intrinsic value growth – can be estimated by multiplying reinvestment rate by ROIC
- Economic Return
    - Production or consumer advantage – does the company have a high CFROI (generally implying a large spread between perceived customer benefit and cost to produce) or high asset turnover (generally implying a cost advantage)
    - Economic Value Added – how does the CFROI compare to the industry's estimated discount rate?

Valuation

- Consolidated or SOTP valuation – if two or more material business segments differ greatly in terms of their product focus, margin structure, lifecycle stage, etc., it is generally better to evaluate each unit separately.
- Multiples
    - What are the metrics that seem to drive the industry valuations, if any?
    - How do the current trading multiples (including both MC & EV-based ones) compare to company's historical levels and relative to peers? If there's a discrepancy, what is the perceived difference(s) driving it, and is that justified?
    - For growing businesses trading above historical multiples or shrinking ones trading below, what is the implied waiting time for it to return that historical median if the price stays the same? For others, if the business were to re-rate back to its historical median, how would that impact your fair value estimate?
    - How much of a premium are you paying, or how large of a discount are you receiving, when you consider these multiples in the context of expected growth rates & business quality?
- Range of Outcomes
    - How sensitive are your key assumptions to industry or capital structure changes?
    - Is there any downside protection to your value estimate in the form of real estate, cash balances, hidden assets, etc.?
    - Asymmetry – do your assumptions leave a margin of safety, and are your expectations sufficiently conservative so as to make upside surprises more likely than downside ones?

Management

- What is the CEO's career history? How much experience does he/she have in the industry?
- Relationship of key management and board members to the founders/owners – if any, is it based on competence or on family ties?
- C-Suite priorities – what info or developments tend to be highlighted or focused upon in press releases and investor presentations? What KPIs do they highlight?

- Track record of value creation – how have the business and stock performed during the CEO's tenure?
- Track record of strategic planning – If guidance is provided, review the metrics chosen, level of detail in projections/forecasts, their historical accuracy, and the apparent importance to management of meeting Street expectations
- CEO interview video (if available) – what is his/her demeanor and mannerisms? Very basic typing – are they an excitable salesman type, reserved data-driven type, etc.
- Review earnings call transcripts – is management using vague/obfuscatory language or buzzwords? Also note any change in their tone over time.
- Insider ownership – how much of the equity do they own? If it's low, do they have any other incentives that would be aligned with common shareholders?
- Board of Directors – what is the structure of the Board, and are the directors independent? Any questionable corporate governance episodes?

Risks

- Does the company have exposure to a legal/regulatory event that could materially change its business and outlook? Is it a black swan or something many market participants are already aware of?
- Pre-mortem – how could you be wrong? If the thesis is derailed, what are the most likely culprits, both operationally and financially?
- Is there anything that might not affect the business itself but might impact us as shareholders (i.e. a severe currency deprecation in an EM stock)?

Miscellaneous

- Second-level thinking – Why does this opportunity exist? What is the source of our variant view?
- Catalyst type – are you expecting a particular event, a business inflection, or a multiple re-rating, or will gains come from gradual intrinsic value growth over time?
- Security type for position – if there's a choice, is it better to put on the position via equity or options/warrants? For common stock, consider the listing exchange and currency of listing; for derivatives, do the strike, expiration date, and implied volatility (relative to historical levels) create a risk-reward profile that is materially superior to the equity? Is the option chain sufficiently liquid?

Mental & Psychological

- Are you suffering from the sunk cost fallacy, and feeling obligated to purchase the stock because of the time already spent researching the idea?
- Anchoring bias – if you are updating your work on an existing holding, are you being unduly influenced now by the initial purchase price?

- Has the stock historically experienced volatile price movements (either based on idiosyncratic factors or broader market movements), and if so, are you mentally prepared for the possibility of a significant mark-to-market loss in the short-term without it clouding your judgment?
- What is your level of personal interest in the company and industry? Will keeping up with its developments be a chore, or would it be something that you would already be curious about or naturally inclined to do?

Other Work Required

- Financial Model – does not need to be a full three-statement one; the goal is to compare the potential upside versus the assumptions that you underwrite to get there
- Review recent SEC filings – does the story management tells in its marketing material match that in its government filings?
- Intellectual honesty safeguards – have you explicitly written down the thesis summary, key determinants of the investment's success/failure, expected upside, and contemplated timeframe so that you can compare progress against it at a later date?

Outlook and Conclusion

2020 has been full of unexpected developments. As I write this, there have now been 24 new all-time highs for the S&P 500 this year in the midst of a global pandemic that pushed GDP off a cliff and made investor fretting in years past about basis point-sized deviations from expectations look downright quaint by comparison. The rapid-fire developments in the past month or so further underscore the reality that "nobody knows nothing" when it comes to near-term forecasts. The key is to keep our eyes on the horizon and to become comfortable with the fact that there will be unexpected bumps along the way. Owning companies that are well positioned no matter what sort of near-term terrain emerges has helped us in doing that, and I intend to make sure that that remains the case.

"Never confuse movement with action."

— Ernest Hemingway

Per Ardua Ad Stella,

Andrew Jakubowski

Performance Summary:

	3Q 2020	YTD 2020	Since Inception
S&P 500	9.0%	5.6%	94.1%
Vanguard Total World Stock ETF	8.4%	1.0%	49.6%
Russell 2000	5.0%	-8.6%	38.0%
HFRI Equity-Hedge (Total) Index	6.0%	2.5%	29.0%
Adestella Investment Management	**19.5%**	**54.9%**	**167.1%**

Disclaimer:

This document is not intended for public use or distribution. While all the information prepared in this document is believed to be accurate, Adestella Investment Management, LLC makes no express warranty as to the completeness or accuracy, nor can it accept responsibility for errors appearing in the document.

An investment in the fund is speculative and involves a high degree of risk. Opportunities for withdrawal/redemption and transferability of interests are restricted, so investors may not have access to capital when it is needed. There is no secondary market for the interests and none is expected to develop. The portfolio is under the sole trading authority of the investment manager. A portion of the trades executed may take place on non-U.S. exchanges. Leverage may be employed in the portfolio, which can make investment performance volatile. The portfolio is concentrated, which leads to increased volatility. An investor should not make an investment, unless it is prepared to lose all or a substantial portion of its investment. The fees and expenses charged in connection with this investment may be higher than the fees and expenses of other investment alternatives and may offset profits.

There is no guarantee that the investment objective will be achieved. Moreover, the past performance of the investment team should not be construed as an indicator of future performance. Any projections, market outlooks or estimates in this document are forward-looking statements and are based upon certain assumptions. Other events which were not taken into account may occur and may significantly affect the returns or performance of the fund. Any projections, outlooks or assumptions should not be construed to be indicative of the actual events which will occur.

The enclosed material is confidential and not to be reproduced or redistributed in whole or in part without the prior written consent of Adestella Investment Management, LLC. The information in this material is only current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Statements concerning financial market trends are based on current market conditions, which will fluctuate. Any statements of opinion constitute only current opinions of Adestella Investment Management, LLC, which are subject to change and which Adestella Investment Management, LLC does not undertake to update. Due to, among other things, the volatile nature of the markets, an investment in the fund may only be suitable for certain investors. Parties should independently investigate any investment strategy or manager, and should consult with qualified investment, legal and tax professionals before making any investment.

The fund is not registered under the investment company act of 1940, as amended, in reliance on an exemption there under. Interests in the fund have not been registered under the securities act of 1933, as amended, or the securities laws of any state and are being offered and sold in reliance on exemptions from the registration requirements of said act and laws.