September 10, 2021

Dear Fellow Investors,

Adestella gained less than 1% in the second quarter. Although there was no meaningful reduction to either our gross or net exposure levels, performance was muted across different cross-sections of the portfolio. Long positions gained 1.4%, while shorts and foreign exchange rates were 42 and 45 basis point drags, respectively. Both domestic and international holdings posted net returns between 0-1%. Further underscoring the lack of sizable movements, only three positions had a net return contribution above 1% on an absolute basis, and in aggregate, they almost exactly offset each other. As a result, after several straight quarters of relatively large portfolio swings, Q2 was unusually calm for Adestella. Meanwhile, markets posted another strong quarter as economic reopening continued, with benchmark gains in the range of 4-8%.

As always, an updated performance table is included at the end of this letter.

Bend but Don't Break

Successful investing requires a balance between two countervailing forces that stand in opposition to each other. On one side is discipline – ignoring fads and trends that regularly sweep over equity markets, avoiding paying too much for shares even when they only ever seem to go up, and resisting the urge to hold on to underwater positions even when the thesis is completely broken. On the other is flexibility – realizing that the world is always evolving, that what worked best in the past may not work best in the future, and that once-reasonable conclusions can become unreasonable in the face of new evidence. Both sides are crucial to success, but it can also be dangerous if one gains too much of an upper hand over the other. Walking the fine line that allows them to work in tandem is vital to sustainable excess returns.

Finding the proper balance between these two forces is, to me, perhaps the hardest thing about investing. Given that markets are dynamic and ever-changing, one needs to adapt and evolve to the times at hand. However, too much change leads one toward becoming a "flavor of the month" investor that simply jumps from one hot area of the market to the next, often at the worst possible time. So how can an investor find the proper equilibrium between the two?

In the end, I believe it comes down to being disciplined on principles but flexible on how they're implemented and expressed. Estimating a business's future cash flows and only buying when its present value is comfortably below that estimate is a non-negotiable principle for a value investor. However, being willing to consider multiple methods for arriving at that estimate is, in my view, wholly reasonable, if not downright necessary. In certain situations, book value is important; in others, it's almost meaningless. In some businesses, using a sales multiple is reasonable if the company is at a certain point of its lifecycle; in others, it's absurd. An investor that can only wield one tool will either miss out on many compelling opportunities or fall victim to the law of the instrument. Either situation puts him at risk of underperforming over time.

The concept also applies on a portfolio management level. Our north star is to deliver a better return than the broader market indices over time, but the best way to achieve that isn't set in stone. In deciding where to allocate capital, an investor must have a view on the competitive positioning of a company and on the industry and/or geography in which it operates, all of which can change on very short notice. Staying on top of such changes is difficult enough, but it becomes even more so if you're also battling confirmation bias. A great concept to combat these challenges is "strong views loosely held" – arrive at a preliminary conclusion based on your intuition and the information available, but be willing to prove yourself wrong. As explained by the original author, Paul Saffo:

> "This process is equally useful for evaluating an already-final forecast in the face of new information. It sensitizes one to the weak signals of changes coming over the horizon and keeps the hapless forecaster from becoming so attached to their model that reality intrudes too late to make a difference."

As just one example, in the past, one way we pursued our outperformance goal was by including multiple Chinese internet stocks in our portfolio, on the basis of long runways for robust growth at attractive valuations. Our thinking was that as trade war and tariff concerns abated under the new administration, and as Hong Kong dual listings spurred investment demand from those that know the companies best, multiples would start to trend toward American peers. However, as evidence accumulated that regulatory risks were perhaps higher than originally expected, that no company could be considered completely safe from potential governmental intervention, and that the impact of said intervention on foreign investors was of no concern to party leaders, we scaled it back. A similar process takes place all across the portfolio with every earnings release, news article, or anything else that reveals new information pertaining to a position. We cannot be wedded to the idea that Chinese tech, American online gaming, or anything else in particular will be the vehicle to reach our return goal. And rather than lowering our return standards or increasing our risk tolerance – i.e. compromising on principles – the superior course of action is to redouble our efforts to find something new that lets us keep heading north.

To Infinity and Beyond

Games often have connotations of leisure, something done in one's free time as opposed to work. In reality, it can be any activity "involving skill, knowledge, or chance, in which you… try to win against an opponent or to solve a puzzle." If we take the market indices to be the opponent that we attempt to outperform and thus "win" against, active investing clearly qualifies as such.

There remains an important distinction to be made, however, one that was first proposed by James Carse in 1986. The first category of game, a finite game, is the kind that most of us consider as the archetype. It's characterized by a resolution within the context of its rules and played for the purpose of winning. Almost any sporting event falls in this category; for example, a football game is 60 minutes long, between two teams of eleven players, contested within a 120 x 53.3-

yard field. Two important points to note are, first, that none of these regulations are inherently better than alternatives. The game could be 7 vs. 7 on a 50-yard field for 10 minutes if that was the standard agreed upon. However, once a standard is set, that status quo generally remains in place to facilitate learning, teaching, and the ability to identify and correct errors. Second, there is a definite beginning and end, and it's clear at any given point who is winning and who is losing. While there are many other statistics kept, they are all of secondary importance to the score, as that is what determines who is declared the winner of the contest.

On the other hand, infinite games are not subject to any of the above restrictions. They do not have a knowable beginning or ending and may be entered into involuntarily, not requiring a conscious attempt to join. In an infinite game, the only object is to keep playing. As summarized by Carse, "finite players play within boundaries; infinite players play with boundaries."

Business is an infinite game because there are both known and unknown players and variable rules. Simon Sanek, who wrote a popular book based on Carse's ideas, suggested that "there is no clear endpoint and no winners or losers – only ahead and behind." Companies are often not defined by their successes but by when they were forced to stop playing. Blockbuster, Sears, and Kodak all enjoyed periods of great prosperity, but today they are mostly remembered for their eventual demises. Even though they all won for a long time, none are considered "winners" today simply because they no longer play.

The above distinction has important ramifications for any would-be prognosticator, as the two types of games lend themselves to very different types of analysis. In my view, the superior way to forecast outcomes of finite games is generally with a quantitative methodology. Thanks to the self-imposed restrictions and limitations, the range of future states of the world is narrow enough that there will likely be close comparables from past games that hint at the eventual outcome. This data can be crunched to determine the likelihood that the current game being played will follow a similar trajectory. If we know, for example, a basketball team is up by 5 points and has the ball with a minute left, we can use past games to get a quite accurate estimate of how likely that team is to eventually win.

On the other hand, the lack of limitations to infinite games means that there are a virtually endless variables, which in turn makes it much more difficult to forecast just how similar one "game" will look to past ones. An investment can have a wide range of contemplated time frames, and investors often either find that the rules have changed on them (either by economic forces or governmental ones), or are forced to reckon with new trends or technologies that didn't exist just a few years prior. Seen in this light, it is not surprising that market pundits have found it very difficult to make accurate forecasts with any regularity. A recent study found overall accuracy was just 48% – i.e. worse than random guessing – and that two-thirds of forecasters (including many prominent ones) were wrong more than half the time. Artificially limiting games – for example, studying stock price movements over a short, fixed period – is a key strategic component of nearly all successful algorithmic traders. As time periods extend toward those of infinite games, performance tends to decline markedly, showing that relying merely on historical data in such situations can be very dangerous indeed.

What's the takeaway for a fundamental investor? Management teams matter. Incentives matter. Competitive dynamics matter. These are as unique as the people involved in them and cannot be easily or neatly segmented. A business's ability to deftly navigate shifting environments, and to continue to play as times change, often comes down to such considerations. Thinking in terms of the two game types also highlights the importance of maintaining a long-term orientation with decisions – having executives who play a finite game by focusing on meeting quarterly earnings estimates is a recipe for disaster. That's why I spend significant time trying to understand the "soft" factors alongside the model-building and valuation, and in trying to learn enough to connect them all together. Investing for the long haul is an infinite game, and on a less predictable road with more twists and turns, being able to see around the curve is a significant benefit.

Outlook and Conclusion

While we added and removed several smaller positions over the course of the summer, Adestella's core holdings did not materially change. After a lackluster period return-wise, it can be tempting to tinker with the portfolio. This is particularly true when markets are at all-time highs and, anecdotally, it seems as though many other fund managers I follow have continued to fare well in in the current market environment. However, as mentioned, our only concern is long-term results rather than short-term performance derbies, so we will stay the course – doing so gives us the best chance to extend our own game.

Our view that many of the best opportunities today are found outside of the United States also remains intact, perhaps even more so now given domestic indices' relentless upward march in recent months. At the moment, upwards of two-thirds of our portfolio, as well as the majority of our recent watchlist additions and research time, comprise international stocks. While we will always have a sizeable portion of assets in stateside equities, having a global mandate is certainly an advantage in times like these.

As we move into the back half of the year, I plan to experiment with new methods of sharing research, beyond the typical writeup on an individual stock idea. Certain ideas or research projects lend themselves to methods – especially slide decks – that more easily facilitate sharing graphics, charts, and/or financial projections. And instead of focusing only on stock-specific ideas, I also think there may be opportunities to add value through broader analyses of things like favorable hunting grounds and opportunity set-ups that can potentially increase the base rates of success in investment outcomes. I'm always trying to improve our research processes, and things that will be useful on an ongoing basis instead of just one-off projects take on heighted importance when you're a one-man shop. While there are no surefire successes, if we can find just a few ponds with a higher proportion of edible fish, I believe it will prove to be a useful exercise. Work remains ongoing, but I'm looking forward to sharing it once completed.

I hope you all had a great summer, and look forward to writing you again in several months' time.

"Life is more fun if you play games."

- Roald Dahl

Per Ardua Ad Stella,

Andrew Jakubowski

Andrew Jakubowski

Performance Summary:

	2Q 2021	YTD 2021	Since Inception
S&P 500	8.4%	15.3%	150.8%
Vanguard Total World Stock ETF	7.0%	12.8%	94.9%
Russell 2000	4.0%	17.4%	112.6%
HFRI Equity-Hedge (Total) Index	4.8%	11.9%	66.0%
Adestella Investment Management	**0.5%**	**20.2%**	**300.8%**