Adestella

Investment Management

December 10, 2021

Dear Fellow Investors,

Adestella lost 3.9% in the third quarter. A modest gain from US-based holdings (2.7%) was more than offset by losses from international stocks as American indices continued their global outperformance. Our five largest contributors were domestic, while the five largest losers were international – easily the most lopsided spread I can remember. Long positions lost 3.7% in total, due to the aforementioned foreign stock underperformance, while our US-centric short book gained 42 basis points. The reminder of the difference was attributable to currency fluctuations.

Developed markets ended the period mostly flat, with August's gains to all-time highs erased by September. Emerging markets, on the other hand, lost 9%. A government crackdown on various industries in China, combined with default fears within a prominent real estate conglomerate there, appeared to create a general risk-off sentiment across other emerging markets as well. While we have no exposure to Chinese equities, we did suffer some collateral damage from the spillover effect in other emerging markets.

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

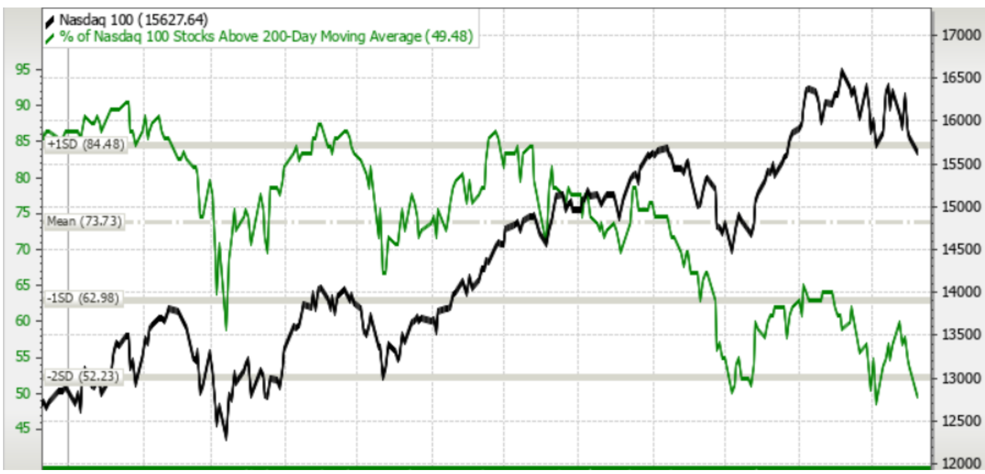
Go With the Flow

I have always been a fundamental investor and have no plans of changing that going forward. However, this year has given me a greater appreciation for the frequent non-fundamental drivers of stock returns, at least in the relative short-term. While flows on a macro level are often discussed (such as the acceleration in money supply growth and TINA), their counterparts on the micro level (such as changes in allocations to certain sectors or individual stocks) often receive less attention, though they can have dramatic effects in the marketplace.[1] Consider:

- Recently, an electric vehicle manufacturer named Rivian went public, and within a few days, it promptly reached a market capitalization of $150 B despite having never sold a single car. As a point of comparison, Dot.com era darling pets.com (which similarly IPO'd at essentially a pre-revenue stage) never attained a market value above $400 M – far less, even after accounting for inflation.
- As most already know, shares in several companies with mediocre business prospects, after years of declining sales and cash flows, saw exponential gains early this year following retail purchases coordinated largely on online message boards and targeted toward stocks with high levels of short interest.

[1] See here for a few interesting research works on the topic.

- More recently, there has been a sizable divergence between mega-cap stocks and smaller companies in the same industry. While capitalization-weighted indices such as the NASDAQ and S&P 500 are up 20%+ for the year and currently within a few percentage points of all-time highs, wide swathes of their underlying members are trading closer to their lows of the year.



I have nothing against those that were on the right side of these trades; after all, this is a bottom-line business. At the same time, to achieve such a value on potential alone shows quite clearly that many price movements one observes today are detached from fundamental reality to some extent. My job is to try to build a portfolio that outperforms, after all additional costs, what the broader market returns. And just like coaches scout an opponent's tendencies before a game, our goal should be to better understand the market and why such phenomenon can and do occur. Rather than simply dismissing it as irrational, we should try to see whether our definition of rationality may not be universal, and whether there are other factors that can influence the price movements of both individual stocks and the market as a whole. Such analyses can at least provide some insight during events such as the ones listed above.

I believe the best explanation of these occurrences comes from the idea of "liquidity flywheels," a concept I was first introduced to in [this quite excellent blog](). As the author describes:

> *"A liquidity flywheel is a situation where inflows into an asset class lead to buying pressure that pushes up prices, leading to favourable apparent return and volatility characteristics in the said asset class. This favourable outcome then attracts yet more inflows, leading to yet more buying, etc. Conversely, poorly performing asset classes with significant downside volatility can lead to investor redemptions, leading to forced selling that contributes to yet further price declines, yielding even worse returns and even greater redemptions, and so on."*

With this view in mind, let's take another look at the market events described above:

- Bubble in EV – In recent years, there have been significant net inflows into ESG funds that need to allocate capital. While their mandates are often nebulous, electric vehicles are certainly an area that has been deemed a social/environmental good, and given the 10x (or more) returns seen in stocks like Tesla and Nio in the last 24 months, it's also an area that's generated attractive investment returns.
- Meme stocks – Following the spectacular returns generated by a few early speculators, many rushed to make their own fortunes. While a desire for fast returns from volatile stocks is nothing new, the speed and ease of target coordination and FOMO are now greater than ever. This demand-side boom was further exacerbated by the reverse flywheel effects on the other side of the trade. Short sellers faced mounting losses (and potential career risk in many cases), forcing many to cover at the same time and pushing up prices as they raced each other to the exits.
- Mega caps – AUM growth in passive ETFs has no doubt provided support for the index constituents that such funds track, and such purchases are made independent of any valuation or price discovery considerations. Active allocation decisions have contributed as well; in a world with negative real risk-free rate, buying shares in the largest and most prominent enterprises may be considered a new "flight to safety" option and appealing alternative to government bonds. This may even be particularly attractive because such a maneuver has paid off lately, and going with what has recently worked is a more comfortable way to allocate capital. Just like IT professionals in the 80s and 90s were never fired for buying IBM equipment, RIAs today aren't fired for making large allocations to Apple and Microsoft. As a result, index bellwethers may feel less selling pressure as they are either mandated to be included or the easiest to justify holding, whereas many stocks outside such indices have no such support behind them. This can create a "big get bigger" dynamic that contributes to the anomalies discussed above.

Each of the situations above relied on turbo-charged liquidity flywheels to move prices in certain groups of stocks in ways that would not have been predicted by financial fundamentals alone. While I am skeptical that anticipating such flywheels will prove to be an effective strategy in the long haul, it does provide useful context on why we cannot expect a value-driven portfolio to move in lockstep with the broader market all of the time.

Selected Portfolio Holdings

A summary of a few Adestella positions, one new and one simply not covered in detail before, is provided below.

Alsea (MX: ALSEA): Alsea is a restaurant operator that serves as the master franchise licensee for several globally successful brands in a range of Latin American and European countries. The company operates over 1,500 Starbucks, 1,000 Domino's, and 400 Burger Kings, alongside a smaller number of casual dining stalwarts and regional concepts:

Alsea is headquartered in Mexico and began building its restaurant portfolio in 1990 with the acquisition of Mexican Domino's franchises. For the next decade or so, the company focused on expanding into new concepts in its home country, gaining domestic rights to both of its other two flagship brands over that period. Then, from 2006 to 2016, it extended its footprint into several South American countries while also adding multiple casual dining chains to its Mexican portfolio. In 2018, following a small trial in Spain, Alsea expanded into Europe first with the acquisition of the license for Vips (described by some as a "Mexican Denny's") in Portugal and Spain in 2018, and then for Starbucks in the Benelux region in 2019.

Like every other restaurant operator, Alsea's business (and stock) was devasted by the impact of the pandemic in 2020. However, while many other operators have seen their equity make a full recovery, if not new all-time highs, Alsea remains down nearly 20% from its 2019 pre-COVID levels, despite having reported positive same-store sales and net income growth on a two-year stack in its most recent quarter.

Much like our successful investment in Canada's MTY Group (which is actually how we found Alsea), the simple thesis here is that we're buying a good quality business at a discount relative to its normalized earnings power, that those earnings are very likely to normalize in the near future, and that when they do, the stock could more than double if it were to trade at the same multiples as it did prior to the pandemic onset. What makes Alsea potentially even more interesting, however, is that those prior trading multiples are significantly below that of franchisee peers, despite having arguably the best brand portfolio of the group. This was not always the case; in the years prior to 2020, Alsea often traded at or above peer valuations due to its superior growth.

Some discount is warranted as Alsea trades in an emerging market and is denominated in pesos, but we think much of the discrepancy should dissipate as more investors catch on to the story and foreign stocks eventually move back into favor. Another positive aspect here is that this is not just a "reversion to the mean" on an out-of-favor asset – prior to 2020, the company grew sales and operating profit at a ten-year CAGR of 21% and 30%, respectively. Once earnings normalize next year, further unit acquisitions are likely on the table as well. Thus, while most of the re-opening trades have already largely played out, Alsea presents another opportunity to buy a good asset at a discount due to short-term issues that have now largely dissipated. As the company regains and eventually surpasses its 2019 financial metrics, strong stock performance should ensue.

Century Communities (CCS): Century is a long-time holding, and despite recent gains, the stock's outlook is as favorable as it has been during our holding period. We remain constructive (no pun intended) on the housing market, particularly on the single-family segment, which has both a lack of resale inventory and strong consumer demand supporting prices. Tailwinds from the growing popularity of hybrid or remote work arrangements should remain in place for the foreseeable future. Meanwhile, builder confidence and current sales conditions indices have also remained strong despite ongoing labor and supply-side issues, which should be at least partially eased as ports are unclogged and PUA recipients re-enter the workforce. Recent earnings reports across the industry confirm the breadth of this trend: Lowe's and Home Depot both recently reported two-year stacked comparable store sales above 30%, while Williams Sonoma called out the lasting impact of the stay-at-home dynamic of the pandemic as it raised guidance for a third straight time.

CCS is particularly well-positioned for these developments, as many of its communities are in parts of the country that are experiencing net talent inflows from higher-cost cities following the increase in location-agnostic jobs. And the right team is in place to capitalize on it – we think CCS's management is among the best in the industry, having grown shareholder value at a nearly 25% CAGR since its 2015 IPO. And with the founders and co-CEOs owning about 10% of the equity, their interests remain closely aligned with those of other shareholders. Yet despite its favorable positioning and strong leadership, Century trades at a discount to peers that have generally inferior growth profiles.

Comp set is US homebuilders with MC > $30 M & positive LTM sales growth

Symbol	Name	MV (USD)	EV (USD)	LTM P/E	NTM P/E	LTM EV/EBITDA	NTM EV/EBITDA	LTM P/CF	LTM P/FCF	LTM EV/S	LTM EV/GP	Gross Margin	EBITDA Margin	Net Debt / EBITDA	Avg. ROIC	1 Yr. Sales Growth
MTH	Meritage Homes Corporation	4,244	4,865	10.3	6.2	8.8	4.6	6.0	6.2	.96	3.7	26.0%	17.3%	.49	22.4%	22.8%
SKY	Skyline Champion Corp.	4,160	3,893	73.1	23.5	30.5	14.5	22.8	18.5	2.09	9.6	21.8%	11.8%	-1.55	27.3%	3.7%
TMHC	Taylor Morrison Home Corpor	4,069	7,057	18.1	6.6	13.9	6.9	6.6	2.9	1.08	5.5	19.7%	10.6%	4.70	8.8%	28.7%
MDC	M.D.C. Holdings, Inc.	3,670	4,664	10.1	6.6	11.9	5.8	5.9	-	.95	4.2	22.4%	13.2%	1.90	18.6%	17.5%
LGIH	LGI Homes, Inc.	3,665	4,289	11.8	9.1	11.7	7.3	7.9	13.5	1.36	5.0	27.0%	18.2%	1.38	30.5%	28.8%
TPH	Tri Pointe Homes, Inc.	2,947	3,760	12.1	6.8	9.3	5.0	6.8	4.0	.98	4.0	24.7%	15.7%	1.78	13.8%	5.8%
CVCO	Cavco Industries, Inc.	2,757	2,528	44.0	21.6	27.7	14.2	29.4	24.4	1.97	8.7	22.7%	10.5%	-3.80	15.8%	4.0%
PATK	Patrick Industries, Inc.	1,779	2,964	17.9	8.5	11.9	6.8	5.0	12.3	.80	4.5	17.9%	11.3%	3.11	19.9%	6.4%
MHO	M/I Homes, Inc.	1,715	2,469	7.2	4.7	7.2	4.5	5.7	8.2	.69	2.8	24.5%	14.0%	1.80	20.1%	21.9%
GRBK	Green Brick Partners, Inc.	1,473	1,817	13.0	8.2	14.4	7.8	8.8	36.2	1.51	5.8	25.9%	15.8%	1.48	20.5%	23.3%
HOV	Hovnanian Enterprises, Inc. C	745	2,100	1.4	-	7.8	-	1.3	-	.76	3.9	19.3%	9.4%	4.15	16.0%	18.9%
BZH	Beazer Homes USA, Inc.	696	1,490	10.8	4.6	9.3	4.7	3.9	32.6	.70	3.7	18.6%	7.5%	4.85	7.7%	.6%
LEGH	Legacy Housing Corporation	609	616	16.0	12.9	12.6	10.2	12.5	-	3.18	8.2	38.9%	29.8%	.73	16.4%	4.6%
Average		**7,617**	**8,540**	**17.9**	**9.8**	**13.2**	**7.4**	**9.3**	**20.8**	**1.35**	**5.6**	**24.0%**	**14.7%**	**1.20**	**19.9%**	**15.3%**
Median		**3,665**	**3,893**	**13.0**	**7.5**	**11.8**	**5.8**	**6.8**	**12.3**	**1.17**	**5.0**	**22.7%**	**14.1%**	**1.43**	**19.9%**	**17.5%**
CCS	Century Communities, Inc.	2,606	3,315	12.6	5.7	11.6	4.7	5.7	4.6	.84	3.7	22.5%	12.9%	2.58	20.9%	24.7%

Century has also posted increases in ROE each of the last 10 quarters, which is particularly impressive given it has simultaneously reduced net debt as a percentage of net capital from 54% to 23%. This is important because homebuilder ROEs have historically been closely correlated to the book value multiple that investors ascribe to the business. A simple regression suggests that even if CCS is only able to maintain its current annualized ROE of 30.5%, the stock could plausibly trade at 2.5x book, which would represent around 50% upside from here. Further ROE improvements, driven by increased leverage of SG&A costs and purchasing contracts across a now national footprint, are not out of the question either.

In summary, CCS is a best-in-class operator with an asymmetric return profile. If the stock sees a bit of multiple expansion, we win, and if lasting value is ascribed to the current ROE levels, we win even more. And while homebuilding is certainly a cyclical industry, CCS's 10-year streak of uninterrupted revenue growth suggests that strong localized sub-markets combined with measured new community growth can go a long way to mitigating its effects. And in any case, broader market fundamentals suggest an environment that will remain solid, if not outright favorable. As a result, though it has already been in the Adestella portfolio for several years, I expect CCS will remain there for some time to come.

Short Positions: I have historically not written much in the way of short position theses. This is attributable to several factors, many of which I have written about in past letters, including negative asymmetry, mistake magnification, and inferior return on time spent. However, we have been slightly more active in this portion of our book recently, and now own more single-stock shorts than at any time since 2019. It remains a relatively small part of what we do, but as aggregate risk-rewards continue to become more favorable alongside rising valuations, it is a recent area of interest for us.

I have also attempted to protect the portfolio against left-tail risk. Is it possible that the market may eventually be spooked by 5-6% inflation? Is it possible the Fed might do an about-face about said inflation being transitory,[2] and look to hike rates or wind down its easy-money policies? Is it possible that record high long-term growth expectations (see below) may not prove feasible or sustainable?

Exhibit 2: Consensus LTG is at a record high, well above the Tech Bubble peak
S&P 500 consensus long-term growth forecast (1986-10/21)

Source: FactSet, BofA US Equity & Quant Strategy
BofA GLOBAL RESEARCH

While I have no insight on the precise likelihood of the above (hence why we don't make macro predictions), I also I don't find any of it unfathomable. In order to hedge against this scenario, we have purchased inexpensive protection in the form of out-of-the-money puts on several high-flying indices. If complacency continues, we'll lose a small amount of option premium paid – such options are comparatively cheap near all-time highs; much like umbrellas are on a sunny day. If it

[2] During editing, this already became a reality.

doesn't, we are much better insulated against a potential fall and will be better positioned to capitalize on opportunities that are likely to arise at that time. At the very least, it frees my mind to worry about our individual holdings rather than spending time on macro factors; sometimes, optimizing for return on time is just as important as for ROIC.

Outlook & Conclusion

The companies we own should do well no matter what transpires in the broader economy. In general, they have pricing power, favorable industry tailwinds, and limited reliance on external inputs. If our judgments on that front prove correct, satisfactory stock performance is in turn a matter of when, not if. It's also worth repeating that we own individual enterprises, not the whole market, and that the performance of our portfolio can and does vary greatly from it. Recent weeks have been an acute reminder of this, as we don't currently own any of the mega-caps that have generated half of market's 2021 return. But a portfolio cannot beat the market if it is the same as the market, and such deviations are simply a short-term cost any active fundamental investor must bear to have any chance of outperforming over time. Given our stated goal of generating a net return above that of the indices in the long-term, it's one we willingly take on.

I hope everyone enjoys the upcoming holiday season, and I look forward to writing you again early next year.

"Arguing with a fool proves there are two."

- Doris M. Smith

Per Ardua Ad Stella,

Andrew Jakubowski

Andrew Jakubowski

Performance Summary:

	3Q 2021	YTD 2021	Since Inception
S&P 500	0.6%	15.9%	152.3%
Vanguard Total World Stock ETF	-1.3%	11.3%	92.3%
Russell 2000	-4.3%	12.3%	103.4%
HFRI Equity-Hedge (Total) Index	-0.9%	10.9%	64.6%
Adestella Investment Management	**-3.9%**	**15.6%**	**285.3%**