Adestella
Investment Management

September 7, 2022

Dear Fellow Investors,

Adestella lost 20% in the second quarter. Long positions declined just under 26%, offset by 5% gains from the short book. Foreign exchange impact netted to a 30 basis point drag as the US dollar continued to strengthen in anticipation of further interest rate hikes. International stocks were responsible for two-thirds of the NAV decline, though this is perhaps not surprising given the great majority of our short positions are in US-based companies. Once again, our long-short portfolios outperformed long-only accounts, which fell about 23%.

Markets were generally negative worldwide over the period, extending Q1 losses to post the worst first-half performance since 1970. With even traditional safe havens like bonds and real estate posting declines, there was nowhere to hide, particularly on a real return basis. The apparent culprits remained the same – rampant inflation, fallout from the Russian invasion, and ongoing COVID disruptions, particularly in China – while optimism about the ultimate length and severity of their impact waned considerably.

As always, an updated performance summary is provided at the end of the letter.

Paradigm Shifts and Power Surges

There are two truths that guide how I try to run Adestella's portfolio. Neither are groundbreaking by any means, but are helpful (at least for me) in piloting through particularly turbulent times such as these.

1.) Price is the bedrock of security investing, and opportunity cost is the bedrock of portfolio management.
2.) Discretionary active management requires opportunistic action, and many such opportunities appear only in infinite games, making them largely inaccessible to computers and strict rule-followers.

Truth #1 indicates that risk-adjusted returns are the north star for portfolio construction, while Truth #2 suggests that there will not be an intertemporally optimal way to design a portfolio. This suits me, as I have always been curious and dislike being pigeon-holed into certain sectors or set-ups. We have made highly profitable investments in everything from lumber distributors to automobile manufacturers to online furniture retailers. There have been times when I have viewed the risk-adjusted IRRs of compounders as superior to those of other opportunity types. Other times, special situations or event-driven trades were the standouts within the investment universe.

For us, such portfolio composition changes tend to manifest themselves incrementally, rather than via wholesale overhauls, as this is an inexact science and one that will quickly humble you when you're wrong. We will not get all such movements correct, but if we can tilt our holdings toward the most

compelling opportunity types available at any given time, we increase our odds of outperformance. I think we have done well over the years in terms of leaning into opportunities when they present themselves, while not overextending to the point where any singular misjudgment would be fatal to performance. Straddling the line between discipline and flexibility is the perhaps the hardest trade-off this job requires, but our track record suggests we've done a reasonably good job of it.

I generally prefer to write about the details of individual positions, and we still own all of the stocks discussed in recent quarters. However, the reality is the most important performance drivers of recent additions are more macro in nature. A few quarters ago, I talked about the addition of several commodity positions to the portfolio. These have generally performed well, and all of the factors discussed then (utility as an inflation hedge, historically cheap valuations, etc.) still apply. However, recent developments that I believe remain significantly underappreciated have led me to add several more such positions in recent months.

In my view, the sharp increases in energy costs for several prominent western European nations, and the consequences thereof, remain significantly underappreciated by market participants today. Below is a chart showing the benchmark prices in the region in recent months:

While prices are well off their peaks from recent weeks, they remain multiples above their long-term averages. I agree with the original poster that this should be front-page news all over the West. Energy bills increasing 5-10x, in such a short period of time, in prominent G7 countries, has enormous ramifications across several aspects of GDP. We are already seeing large companies starting to pause

operations due to these elevated input costs, and it appears the impact is beginning to trickle down to small businesses and individuals as well.

Now, commodity price spikes are nothing new. The difference is that the size, origin, and timing of the problem has left Europe with no readily-available solution. New power generation facilities cannot come online immediately. Many old ones were put out of service in the name of ESG in recent years and are now either completely unusable or in need of significant maintenance/repairs before reopening. Conclusion of war in Ukraine does not appear imminent; both sides have dug in and minimal territorial gains have been made in the past few months. To break the stalemate, Russia may further reduce natural gas supplies[1] to cause further pain and reduce popular support for Ukrainian aid funding. Finally, demand will only increase in the months ahead as temperatures cool down and homes need to be heated.[2]

While these problems are a huge issue for governments and citizens, they're also a huge opportunity for some companies. One example is Vermilion Energy (VET), a $5 B Canadian company that also trades in the US. Thanks to VET's significant European gas operations, the company is guiding to over $11 CAD per share in FCF this year vs. a current stock price of $33.50 CAD. For next year, the company is trading at a 40% free cash flow yield assuming a €26.25 gas benchmark price; the current price almost three times that level and projected to average €65 this winter (with spikes to over twice that possible if it's a particularly cold one). Meanwhile, the stock has only appreciated about 5% since the guidance date, meaning the expected FCF yields from today are very likely even higher. And this is hardly a dying business: VET has decades of core inventory remaining, and EIA forecasts predict increased demand for natural gas until at least 2050. There's not much leverage, and a multi-faceted capital return policy is being executed. The company won't make any "world's best businesses" lists, but even granting that, I find it nearly impossible to believe 2.5x next year's free cash flow is the right multiple here.

Natural gas is the most obvious beneficiary given its status as the key driver of power prices, but the knock-on effects are also important. Basic economics suggests there will likely be substitution, given that gas has appreciated faster than alternatives fuel sources. I believe we will see shifts to petroleum and coal-fired power generation out of pure necessity – some countries have even outlawed the export of wood due to soaring firewood prices. While it's impossible to know the ultimate impact, it should be supportive of both crude oil and coal prices. Alongside VET are plenty of other companies in these spaces with solid balance sheets and capital return programs that are trading at 30-40% free cash flow yields. Peabody Energy (for its thermal coal operations) and Antero Resources (for its peer-leading access to LNG export terminals, the gateways to European supply) are two of my other favorites.

[1] Just prior to publication of this report, Russia announced they would indeed cut off all supplies indefinitely.

[2] It is important to note that US and European natural gas prices do not move as closely in tandem as crude oil, due to the significant costs associated with liquifying the gas, shipping it across the ocean in specialized LNG tankers, and then re-gasifying it upon arrival. Furthermore, a shortage of infrastructure on both sides of the Atlantic means volumes are currently much lower than either trading partner would like. That said, the prices are indeed positively correlated, as insatiable demand from Europe for whatever they can get keeps a bid on US benchmarks. Domestic pricing will likely receive a boost when a key LNG facility that has been out of commission since a fire in June will be operational again in November, and the Biden administration has fast-tracked several LNG terminal projects that should further reduce transportation bottlenecks in the years ahead.

I'm far from a commodity expert, and I am well aware of the pitfalls generalists often fall into when playing in specialist sandboxes. You won't see us buying an obscure small-cap E&P because they have better differentials – the only metric I'm concerned with is the amount of cash piling up on the balance sheet. I'm also aware that many energy stocks have checkered histories of capital allocation; in fact, I actually believe part of the reason the opportunity exists is that they've burned many investors in the not-so-distant past. The good news is that we won't have to wait long to see whether my assessment is correct; every three months (and often even more frequently via conference presentations), we get clear evidence on whether cash generation and capital return levels are meeting expectations, and the coiled valuation springs don't have much room to compress further.

So, in terms of Truth #1 above, these stocks are about as cheap as any I've seen, especially in their size bracket. Investing is essentially the weighing of risk vs. reward, and at current prices, the imbalances I see here dwarf those available anywhere else in our opportunity set. While it is true that many high-growth/high-quality businesses have been marked down significantly (and to be clear, we still have exposure to these as well), I believe their range of future outcomes are, in general, still wider and less-positively skewed than stocks such as VET at current prices. Many such companies, and their investors, are now navigating new waters in which structurally higher interest rates/costs of capital may blow them (or at least their valuations) into a proverbial Bermuda Triangle.

In terms of Truth #2, a black swan event, such as the largest European invasion since WW2, is the type of scenario that creates opportunities for discretionary investors to add significant value if their judgments are correct. At the beginning of this year, the stocks discussed here weren't even on my radar. But then the world changed and decades of policy consensus evaporated, so I adjusted as well.

Does increasing such positions make me a "commodity tourist"? Perhaps. But traveling to new places can be highly rewarding, if you know your limits and the factors that will make or break your trip. Am I wrong that such issues are underappreciated and adding into the top? Also possible, especially in the short-term. Picking an entry point is always difficult, and doubly so when there's commodity prices involved. But as long as the supply/demand fundamentals discussed above are intact, pricing should hold at a sufficient level to make these stocks work well, even before considering the possibility of a longer-term super-cycle caused by years of ESG-driven underinvestment. To avoid an overly-extended section here, a summary of the full thesis is included as an appendix to this letter for those interested in reading further.

Outlook and Conclusion

While history doesn't repeat, it often rhymes. From where I am sitting, following Powell's Jackson Hole speech, the current verse looks like a mix between "Volcker Rerun" and "Seventies Show" scenarios discussed here. Such an environment basically entails the Federal Reserve deciding to curb inflation at any cost, even if it likely means a recession; how much 4%+ rates hurt earnings will determine where the market settles in the short term. The good news is that we own only a very small portion of the overall market, and our results can and have differed greatly from the indices. We still have enough compelling

opportunities to go around, and I think our holdings are well positioned should the market environment continue to bear resemblance to that of a few decades ago. Those that held through the volatility in the 1980s were eventually rewarded with attractive returns, and I expect that we will be as well.

I hope everyone had a great summer and look forward to writing you again in a few months' time.

"Let the dataset change your mindset"

- Hans Rosling

Per Ardua Ad Stella,

Andrew Jakubowski

Performance Summary:

	2Q 2022	2022	Since Inception
S&P 500	-16.1%	-20.0%	124.2%
Vanguard Total World Stock ETF	-15.2%	-19.8%	63.9%
Russell 2000	-17.3%	-23.5%	56.0%
HFRI Equity-Hedge (Total) Index	-7.7%	-11.7%	46.2%
Adestella Investment Management	**-20.5%**	**-21.0%**	**186.4%**

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Appendix: Energy Equities Thesis Summary

The Bet/Variant View: While the causes and effects discussed in the main letter body are complicated, the bet is simple – the massive amounts of cash currently being generated by many energy companies will persist for longer and end up being higher than the current consensus expectation, leading to an almost mechanical re-rating as enterprise values fall 30-40% per year from unaffected current prices.

Margin of Safety: At current quotes, many holdings will be trading below cash value within just three years; any proven reserves or ongoing operations beyond that are pure optionality. For what it is worth, 2030 VET bonds trade near par, implying creditors don't seem to be worried about a sudden collapse. While it's possible, and perhaps even likely, that in the short-term energy prices will continue to retrace some of the parabolic gains of the past month as countries approach stockpile targets and thus slow the pace of their purchases, the fundamental supply-demand imbalance remains, and the current cocktail of factors should keep them at still-elevated levels for several years at least. So, while far from risk-free, there are few things that can make the expectations baked in here any lower, and many that can make them go higher, perhaps significantly so.

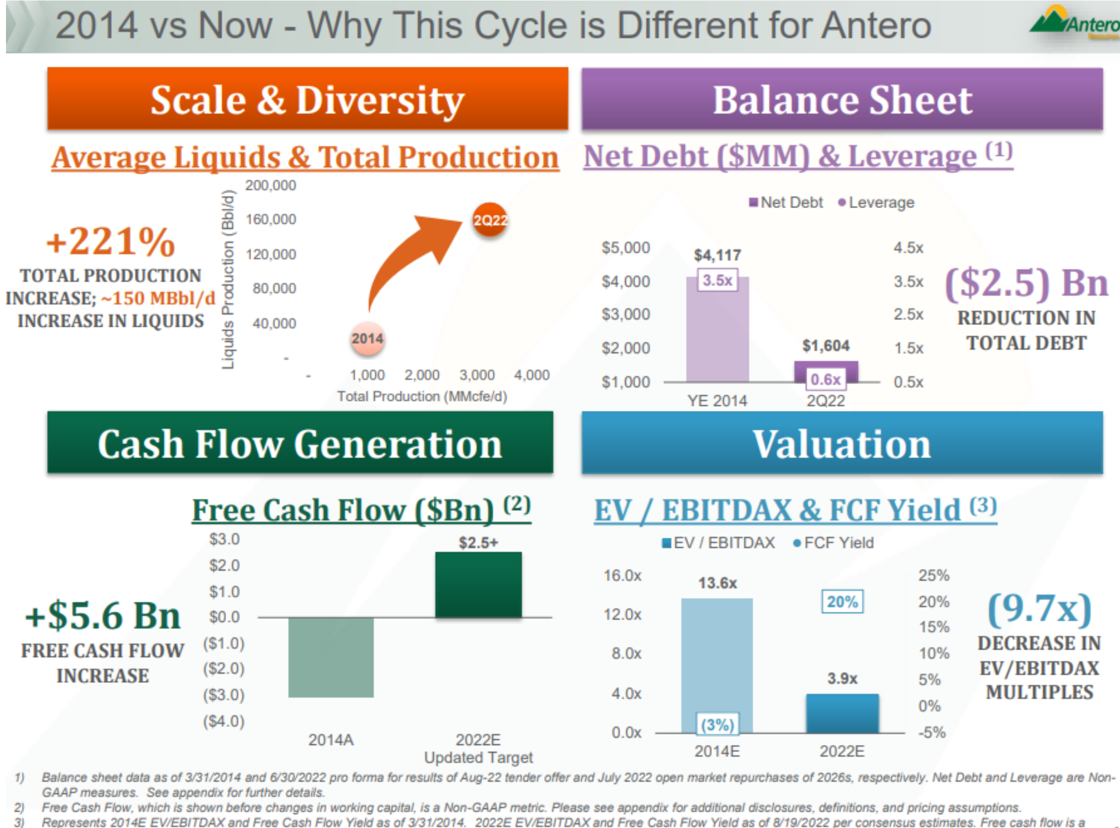
Catalyst: Simply put, the current situation in Europe is not tenable. There was already tension in the region as global inflation exploded throughout the world this spring, and adding another basic necessity to this cost-of-living crisis will only further recent social unrest. As it does, public attention will follow, and given that these are globally-traded commodities, the dots will be connected soon enough. Having followed the situation closely in recent months, I can also say anecdotally that it's being covered much more broadly in recent weeks, which seems to also be reflected on Google Trends.

Why Does the Opportunity Exist? Aside from the lack of attention (at least stateside), I see two reasons why the opportunity in energy stocks currently exists:

1.) The perception that Europe has robust contingency plans that will make the current difficulties prove temporary. But the bloc's targets seem extremely optimistic, and measures such as voluntary reductions (based on metrics of each country's own choosing) do not inspire a lot of confidence, at least for me. Meanwhile, Germany is still going ahead with a plan to decommission its last three nuclear plants this winter, which seems imprudent in the context of potential rationings. I think many of these types of targets and initiatives will need to be reset later this year, with market expectations soon following.

2.) Many market participants seem wary of these types of owning energy companies, for a couple reasons. The simplest of these is that is a results-based business, and energy has been consistently among the worst performing sectors in the past decade. Accordingly, I think the market is slow to discount these developments based solely on backward-looking performance (pull up a 10-year chart between the energy and technology sector ETFs and you'll see what I mean). Some have also been burned by the "drill at all costs" mentality seen at some companies in recent years, and I don't blame them for any initial skepticism. That said, this chart below from Antero Resources (AR) does a good job of incapsulating how the current situation is

materially different from the last energy bull market. While meant to apply specifically to AR, each of the four points applies to all of our holdings: scaled production, minimal leverage, copious FCF generation, and bargain-basement valuations.



Range and Skew of Outcomes: Even with the caveats above, I believe the situation here is strongly skewed in our favor. The market is pricing in sharp reversals in commodity pricing; if these come to fruition, we'll own a few well-capitalized businesses at still-attractive free cash flow yields. The stocks may be dead money for a while, and our payback period timeline may be extended, but permanent capital impairment should be limited. Furthermore, there are plenty of slightly more expensive peer companies with liquid borrow should one desire to structure this as a pair trade. However, as I've tried to outline above, I tend to think prices, if anything, are biased to the upside in the medium-term. If they indeed rise farther, remain at today's elevated levels, or even fall 10-30%, many of these stocks will either re-rate sharply higher or begin approaching negative EV territory.

Signposts: Each holding has clearly and publicly outlined its capital return plans and expected free cash flow generation, making it easy to track progress each quarter. Any sudden change of heart to reallocate toward M&A, expanded exploration programs, etc., should be viewed as a thesis-breaker. Of course,

underlying commodity prices are also important, but only insofar as they make a substantial, sustained move over a multi-month period.

Risks and Counterpoints Chart: The below summarizes the main risks to the thesis, as well as why I view them as tolerable in light of the risk-rewards available at current share prices.

Thesis Risks	Counterpoints
Europe caves and lifts Russian sanctions	Recent comments indicate European leaders are not willing to do an about-face so quickly after pledging steadfast support for Ukraine; stimulus spending to offset impact seems much more likely.
Quick end to Ukraine war	As mentioned earlier, all reports indicate the conflict has turned into a war of attrition. Even if a quick resolution did materialize, I highly doubt we would go back to a "business as usual" situation for some time. Some countries, including the US, seem keen on making sure there is a punitive component that will have a lasting impact.
New LNG supply facilities come online sooner than anticipated	While it is true that the problem will eventually be solved as new capacity comes online, such projects take years to complete, and fast-tracking them can only speed the process so much. All haste is already being made, but project timelines for building massive, technologically demanding facilities like LNG terminals simply cannot be further compressed beyond a certain point.
European nations succeed in creating a material and lasting reduction in demand from their citizens	I think most would agree the ability to keep lights on and homes heated is simply non-negotiable for the vast majority of Europeans, and believe things such as rationing, blackouts, etc. will not be tolerated and would lead to unrest if implemented. While people certainly have sympathy for the plight of Ukrainians, I fear people's patience for making such sacrifices on their behalf will likely wear thin as temperatures fall. Some reduction is certainly feasible, but I think 15% will prove difficult to achieve.
European government succeed in imposing some sort of windfall tax or other measure that reduces cash flows available to shareholders	Currently such measures are only proposals, with implementation far from assured; in any case, the bloc is targeting only non-gas power generators rather than companies like VET.