

December 16, 2022

Dear Fellow Investors,

Adestella lost 3.1% in the third quarter. Our domestic stocks gained approximately 50 basis points, driven entirely by the US-heavy short book, but we were hurt again by foreign positions both via price changes and currency movements. Exposure levels remained on the lower end of historical ranges, ending the period at 104% gross and 67% net.

Markets fell around 5% for the quarter to post their worst first-nine-month return in 20 years. Strong gains in July were cut in half in August and then completely erased in September. Again, the primary drivers were a recalibration of discount rates following [continuing large](#) inflation readings, and commitments to cool the economy to combat them. The US falling into the [technical definition](#) of the recession (despite relatively strong employment data) was likely detrimental to investor appetite for risk assets as well.

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

Newton's Fourth Law?

In [recent quarters](#), I've discussed several new portfolio additions that viewed together have tilted our portfolio away from faster-growing, higher-multiple stocks and more towards cheaper companies that can still do well in an inflationary environment. As is the case with most investment topics, Warren Buffett has a [great quote](#) to sum it up:

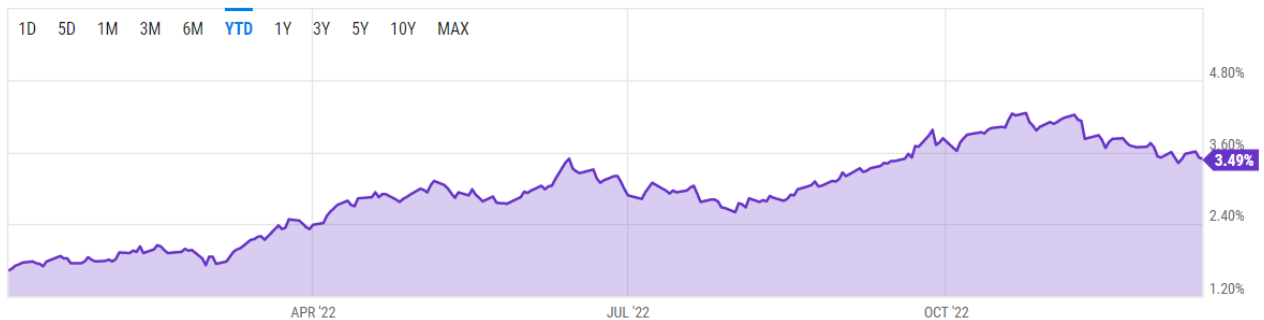
"Interest rates are to asset prices sort of like gravity to the apple. When interest rates are low there is little gravitational pull on asset prices. People make different decisions when money costs nothing vs. when Volcker was trying to stem inflation. Interest rates power everything in the economic universe."

When interest rates are low, gravity has been reduced to a minimal level. If you are is not worried about the risk to crashing back to Earth, it is quite rational to purchase the companies with the potential to fly the highest. Often these are "story" stocks with rapid growth or innovative business models but minimal near-term cash flow. We owned (and still retain) a number of these types as well,¹ and within the environment they were afforded, decisions like ramping up headcount and optimizing for sales growth were generally justifiable. It's no coincidence that

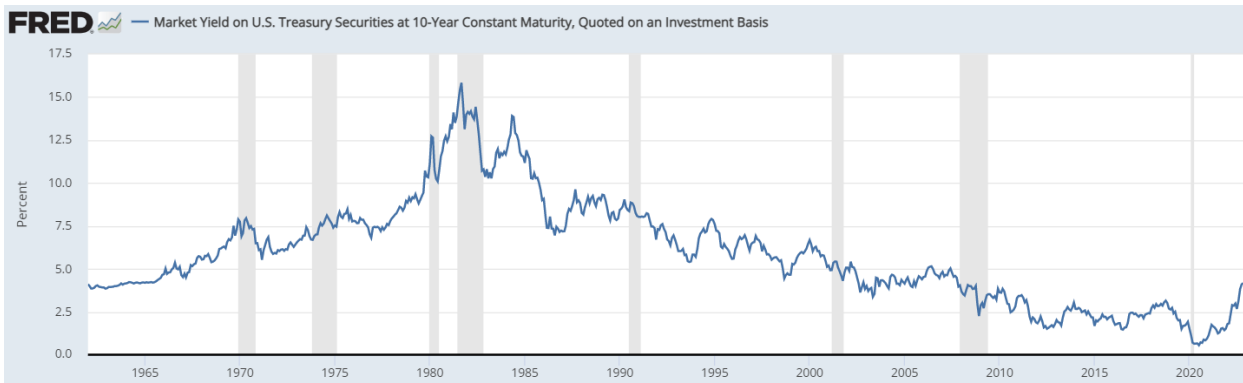
¹ Wayfair, which (at the time) was a fast-growing but unprofitable online furniture retailer, is one such example. I still believe the company will continue to take share and that its plan to reach sustainable profitability is credible, and we exited the stock at a significant profit. But there is no question that when there were rock-bottom opportunity costs for money, investors were far more willing to afford Wayfair and its peers leeway to prioritize growth over profitability.

there were [record levels](#) of VC funding during these times; when the gravitational constant is lower, a larger number of companies/objects are able to reach escape velocity if they find the capital to achieve liftoff.

However, when rates rise and the gravitational attraction increases again, such high-flyers are dangerous. The same factors that make them sleek and glamorous compromise their durability, and a rough landing can be fatal. Without the cash flow and valuation support to serve as a parachute, these stocks can lose altitude very quickly. As the 10-year Treasury yield has marched relentlessly higher in recent months, several former market darlings – including those of retail traders and hedge funds alike – have fallen 70% or more as investors bail on what they now perceive to be a vehicle returning to earth. Indeed, the 2-3x rise in borrowing costs this year shown in the chart below is quite close to an inverse of the IWO growth index, which has fallen 26% YTD with its minor rallies in the summer and fall coinciding with rate pullbacks.



More important for the investor today is whether these recent increases will revert anytime soon. It is not clear to me that the 2.5% and below we have seen in the last decade (much less the sub-1.5% last year) is a level we should expect to quickly return to going forward – it is well below the median of the past half-century, as shown in the chart below.²



² For a great memo that discusses this subject in more detail, [see here](#).

Indeed, [recent](#) Fed President [commentary](#) suggests that we will see further increases even under dovish policy assumptions, and that there's a reasonable chance we may be only slightly more than halfway to the end of the tightening path. I believe it's unlikely that rate increases are paused until the effective rate is comfortably in real positive territory (it's currently around -2%), and given the magnitude of the [Fed's error](#) in assuming the [inflation would be transitory](#) (recall that a year ago, their [YE 2022 forecast](#) was 0.9%), they will likely prioritize maintaining/bolstering their credibility above all else. Accordingly, I think they will be quite conservative (more so than [current market expectations](#)) when it comes to finally cutting again.

So while the pace will certainly slow (a fact [well cheered](#) by investors in recent weeks³), the direction will remain the same. In my view, this will continue to serve as a material headwind for higher multiple stocks. Now, to be clear, we still want companies that are growing! It is simply a matter of narrowing our search to the ones that have the earnings and cash flow support to match their growth. I am wary of being overly exposed to any commodity, so even though I think material and energy stocks are likely to do well on a relative basis in this environment, I would be uncomfortable adding incremental exposure beyond what we currently have. Thus, unlike the portfolio changes of the previous quarters, recent movements have been more geared toward companies with minimal reliance on external inputs.

Ideas Roundup, New and Old

Voyager Digital (VOYG)/Tremor International (TRMR): Our Q1 2021 letter discussed several "orphan" positions that thus far have been about as pleasant as Oliver Twist's workhouse. To put it bluntly, our investment in Voyager Digital was a mistake. In hindsight, I misjudged the durability of potential use cases for the latest generation of cryptocurrency applications, as well as the stickiness of customers following the rationalization of staking awards, which in turn led me to extrapolate account growth too far into the future. The good news is that the position was structured as a pair trade with Coinbase, which also fell precipitously and thus mitigated the damage incurred. Nonetheless, we would have been better off having not ventured into this space at all, and [recent developments](#) make it highly unlikely we will return again.

Tremor International also proved to be an unsuccessful investment, with its far cheaper valuation relative to peers Trade Desk (TTD) and Magnite (MGNI) being offset by far worse operating performance. I find management's excuses for poor recent revenue trends unconvincing given the [secular growth](#) of connected TVs and decent financial performance of competitors over the period, and reported profitability is becoming increasingly overstated by ballooning stock-based compensation. The company is also trying to digest a sizable [new acquisition](#) that I view to be a

³ I found the investor reaction to a [recent inflation report](#) to be a particularly notable example of how expectations drive everything in markets – 7% inflation was viewed as a great result despite being over 3x higher than the Fed's [long-standing goal](#).

suboptimal use of capital. While stocks across the entire space are down, I no longer have the same level of confidence in TRMR's execution or valuation support, and opportunity costs rose as new opportunities presented themselves. Accordingly, we opted to sell the position at a loss as part of our tax-loss harvesting efforts heading into year-end.

XPO Logistics (XPO): Last month, legacy XPO Logistics, an existing holding for the Fund, [completed its spinoff](#). Our position now comprises a stake in two companies, an [LTL](#) provider and truckload broker operation (see below), both of which we have retained in full. The valuation is not demanding on either side, and the differing asset intensity and competitive positioning of the two entities sets this up as a textbook value-creating spin as investors can now more easily evaluate the entities with true comparables and appropriate valuation metrics. And while the two companies approach their operations in different ways, both have proven to be good businesses, with mid-30% ROICs for XPO and 40%+ for RXO.

Separation will create two high-ROIC transportation leaders with vast potential

XPO

One of the largest LTL providers in North America

- \$51 billion industry with stable landscape and few large players
- Asset-based model with coast-to-coast footprint
- ~1,300 bps of adjusted operating ratio improvement since 2015 acquisition¹
- XPO-specific tech initiatives to drive hundreds more bps of margin improvement

\$7.5 billion²
LTM REVENUE

RXO

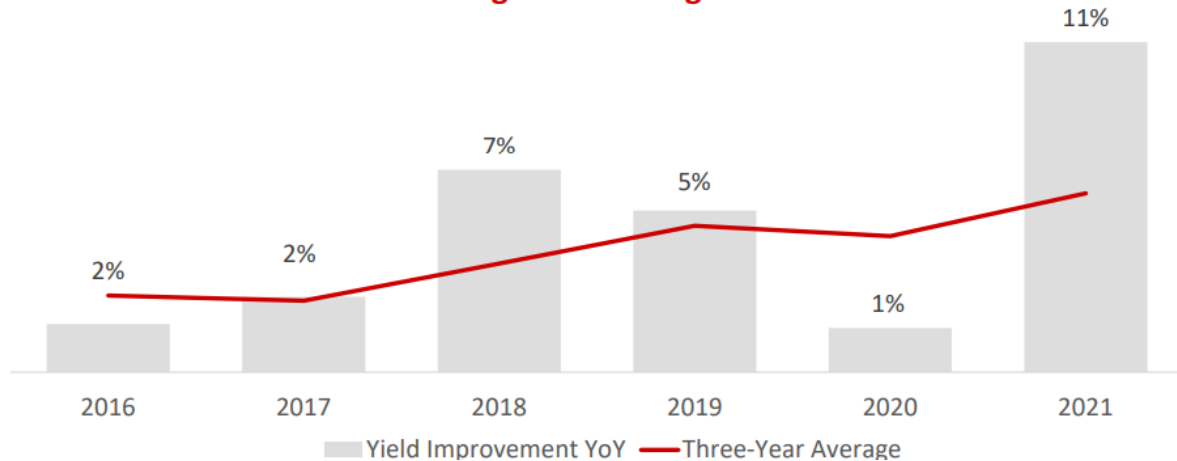
4th largest US full truckload broker

- \$750+ billion addressable market for service offerings
- Nimble, asset-light model with access to massive capacity
- A best-in-class truck brokerage provider with track record of outperforming the industry
- Highly variable cost structure provides operating flexibility to manage effectively through cycles

\$5.1 billion
LTM REVENUE

On the surface, XPO's LTL business may seem somewhat staid with its GDP-plus growth outlook, but the underlying setup is attractive. The major capital investment required to build scaled network coverage and enter an industry growing mid-single digits is not a particularly attractive proposition to an outsider, and as a result, nine of the top 10 largest carriers today are the same as they were a decade ago. With this rather relaxed competitive profile, there has been limited growth investment from incumbents, and today there are actually 3% fewer LTL terminals than there were in 2012. This combination of demand growth and capacity limitations has pushed up pricing, with yields increasing by an average of 5% a year (and continuing to rise through the pandemic).

Continued growth through COVID-19



While not immune to the impact from a potential recession, the industry dynamics discussed above combined with cost-saving projects such as linehaul insourcing should allow the company to drive solid financial performance in any macro climate. Based on pure-play peer multiples (which are not only currently depressed, but generally come from less profitable firms), we think fair value is at least \$48 per share, representing over 30% upside from here.

Meanwhile, RXO has become a scale player (just 10 years after its creation) in an industry that continues to grow as an increasingly large percentage of freight transportation is outsourced. As one of the only companies to offer a full suite of related solutions (freight forwarding, last mile, etc.), RXO has managed to take share consistently and grow at 3x the industry rate in recent years. The predominantly variable cost structure also offers significant flexibility and adaptability as appropriate to any market environment, which may prove useful if a prolonged recession materializes next year. We conservatively estimate intrinsic value at \$22 a share (35% above today's price), with further upside possible if the market rewards RXO's materially above-industry growth rates.

Evolution Gaming (EVO): Further to our mission to find companies that are rapidly growing yet able to maintain a completely internal funding profile, we added to a small existing position in Evolution Gaming to make it into a full-sized one. Longtime readers know that [I am bullish](#) about the long-term prospects for online gambling, and EVO, a Swedish operator now focused on the huge opportunity from ongoing US legalization, is one of the best positioned firms in the space.

Evolution is a B2B operator that provides live casino games for clients in the US and Europe. With Live Casino, online players interact with a human dealer working from one of EVO's studios, rather than a computer-animation display. This model provides significant advantages to both sides. Players get an immersive, authentic experience from the comfort and convenience of their own home, and many prefer (or even have their suspicions quelled) that the results are decided

by an actual deck of cards instead of a random number generator. On the casino side, the usage of Live Casino allows for scaling – and thus profitability – that is simply not possible with traditional brick-and-mortar games. For example, at the casino, there needs to be at least one dealer for every seven blackjack players, whereas with EVO’s offerings, hundreds of players at dozens of virtual tables can all use the same one. It also allows casinos the flexibility to offer games at a wider range of stakes, including ones that would otherwise be uneconomical, and thus draw from a wider player pool. Meanwhile, EVO simply takes a roughly 10% cut of the gross revenue generated from the games it operates. Leveraging a relatively fixed cost base across more tables, games, and sales each year has allowed for meaningful and consistent margin expansion since its entry into the US market.

Evolution AB (EVO-SE)

Local | Bmrk/Ind: FactSet - Country / Technology Services -SEC

Profitability Ratios - Annual

Profitability (%)	10Y Trend	Dec '16	Dec '17	Dec '18	Dec '19	Dec '20	Dec '21
Gross Margin		29.9	37.4	36.4	43.0	56.8	61.2
Operating Margin		30.3	37.5	36.5	43.1	56.9	61.2
Pretax Margin		30.1	37.4	36.4	43.0	53.3	60.6
Net Margin		27.6	34.9	34.0	40.9	50.8	56.6

My concerns were always around valuation, as EVO historically traded at a premium multiple to match its premium growth and profitability profile. However, following a material pullback in the fall, we finally pulled the trigger. At current prices, EVO trades at 19x forward earnings, 10 turns below its five-year average, which I find acceptable in the context of what should be 20%+ earnings growth for the foreseeable future. Essentially, we paid a near-market multiple for a much, much better-than-average business that will only further consolidate its advantages in the years ahead. It is difficult to assign a precise target price as I hope we will be shareholders for a long time to come, but between earnings growth and the potential for both multiple expansion and greater returns of capital, I think a 20-30% multi-year IRR is possible as the company continues to execute across an ever-expanding US online casino market.

Outlook & Conclusion

Midterm elections are now behind us, with a divided government installed in Washington. This set-up will likely ensure minimal progress with either party’s aims, but such gridlock – via the increased predictability it provides – has [historically](#) been a good thing for markets. Given the curveballs we’ve [seen globally so far](#) this year, a period of relative quietude doesn’t sound so bad to me.

The end of the year is coming up fast. The significant financial and geopolitical changes seen in the last 12 months have meant our activity levels have been higher than usual, and returns-wise, 2022 has been challenging thus far. That said, we've been through periods like this before and come out the other end, and I expect we will again. Best wishes to all readers for the holiday season, and here's to a great start to everyone's 2023!

"The equation for ego is: One over Knowledge."

- Albert Einstein

Per Ardua Ad Stella,

Andrew Jakubowski



Performance Summary:

	<u>3Q 2022</u>	<u>2022</u>	<u>Since Inception</u>
S&P 500	-4.9%	-23.9%	113.2%
Vanguard Total World Stock ETF	-7.1%	-25.5%	52.2%
Russell 2000	-2.1%	-25.1%	52.8%
HFRI Equity-Hedge (Total) Index	-2.3%	-13.8%	42.8%
Adestella Investment Management	-3.1%	-23.4%	177.6%

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