December 2023

Dear Fellow Investors,

The Fund returned 1.1% in 3Q. Long positions lost 1.2% but were offset by a positive 1.6% contribution from short positions. Interest earned on our cash balances was responsible for the remaining 0.7% net gain. Our US-based positions outperformed, which was not surprising given that virtually all our short book is in stateside names.

Markets and asset classes fell anywhere from 2-7% in Q3. It was a relatively quiet quarter in terms of economic developments, and from my perspective, not much changed in terms of the investment landscape. Those whose jobs required them to provide some sort of rationale for the pullback generally cited the usual macro concerns as the most likely cause, but I think it was simply a good example of the vagaries of Mr. Market over shorter timeframes. Our relative overweight on energy-related names and relative underweight on unprofitable technology benefitted us over the period, although that dynamic has sharply reversed in the current quarter.

Indices In-Depth

In the investment world, all performance is relative. A bond fund investor that earned 4% would probably be satisfied in recent years, but not so much in the 1980s. Someone with a box of cash under their mattress was likely thrilled with their decision in the first quarter of 2020, but regretful just six months later. This is the concept of opportunity cost in action, the value of what was forgone by choosing some other alternative.

Naturally, for these costs to be estimated accurately, there must be a fair comparison: you wouldn't judge a racehorse versus a racecar. That's where indices come into play for equity investors – averaging together a bunch of individual stock returns to get a representative sample of the performance of the broader market. While simple in theory, the devil is in the details. Over the years, various groups have attacked the problem in a variety of ways, each putting its own twist on the key structural specifics.[1]

First, how many companies should be included in the average? Different providers have settled on everything between exactly 30 and around 5,000 as being ideal. Next, how are those constituents determined? For several of the most famous indices in the US today, such as the Dow Jones and S&P 500, it is done by committees with varying levels of quantitative guideposts. Once that's decided, the final crucial distinction is whether the components are weighted evenly, weighted according to their

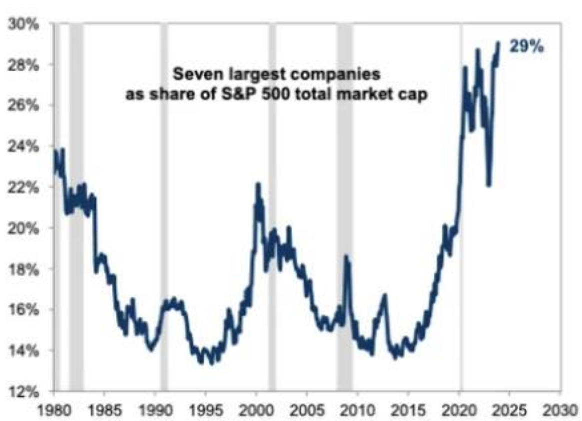
[1] This exercise focuses on broad, single-country benchmarks. Those attempting to construct things like global or sector indices have further complications with country/sub-industry weights. Rebalancing procedures can also vary, although I view this as a smaller differentiator than the others discussed.

market values, or (bizarrely) weighted according to their share prices. Further filters are then applied by ETF providers based on every imaginable aspect of a stock, and today it's possible to find some investment product attempting to gauge performance of a nearly endless list of market subsections.

The S&P 500 is the most common benchmark used today, with some $13.5 T assets tied to it. It describes itself as being "widely regarded as the best single gauge of U.S. large-cap equities." But in 2023, one could argue that it's been less representative of large-cap American stocks than ever before. A group of seven companies (dubbed "the Magnificent Seven," as commentators apparently ran out of clever backronyms) have been responsible for the large majority of the market's gains this year. While it is common for a small group of outperformers to contribute disproportionally to an index's return, what makes this year different is that A) they were already the largest companies, and thus already had the heaviest weighting in cap-weighted indices, and B) they mostly operate in the same sectors and are further connected by having the same factor drivers of quality/profitability, size, and growth.

Point A can be seen on the chart below left. The magnitude of Point B's impact is apparent in the gap between the data series below right ─ which of the lines on that chart is the truly representative one?

Exhibit 22: Share of largest seven companies' market cap in S&P 500 is at an all-time high



Source: Compustat, Goldman Sachs Global Investment Research

Exhibit 23: The Magnificent 7 have led the index higher in 2023

Source: FactSet, Goldman Sachs Global Investment Research

Other indices and their related ETFs pose similar problems. The Russell 2000 picks its constituents each June based on a snapshot of their market values in April. Thanks perhaps to the famous Morningstar mutual fund style boxes, some of its most popular products are its growth and value indices, which attempt to bifurcate those 2000 members across that classic investing dichotomy. To do this, they look at what they call three "highly representative growth and value characteristics": the price to book ratio, two-year forward earnings growth forecasts, and sales per share growth.

Perhaps these attributes were reasonable when these style indices were first created in 1987, but in my view, it's an absurd way to make a representative estimate today. But my own thoughts on the matter aren't important; the point is that there are times these metrics vary materially from our own value calculations. We're looking for discounts to intrinsic value, which may or may not be reflected in a company's price to book ratio. We're looking for growth in free cash flow per share, which may or may not come along with sales per share growth. That's why when I first decided which benchmarks to include in my letter, I simply picked the broad Russell 2000, where at least I knew the size factor would be consistently representative of my fishing ponds.

We are not going to move the goalposts by changing benchmarks; in any given period, we could find one that makes us look good, and another that makes us look bad. Ideally, there would be one that took care not only to diversify across stocks, sectors, and countries, but also across factors that can cause groups of companies sharing certain traits to move together even while operating very different businesses. However, juggling all those attributes at once is impractical, since it would likely require near-daily reconstitution. Instead, the best solution is—as is the case with many other investing conundrums—to simply zoom out a bit, as these periods of sizable deviations tend to even themselves out over time.

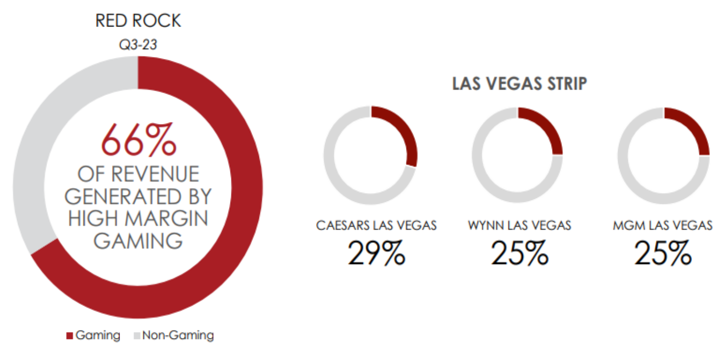
Maybe this time really will be different. Rather than turning out like the Nifty Fifty, maybe large-cap technology will always be the best place to put your money going forward. American equities have outperformed their global counterparts in 8 of the last 9 years, so maybe US-based investors are wise to eschew any international exposure in their portfolios. But both math and history suggest otherwise, and those are two of the most formidable enemies that any investor can go up against. Rather than testing them by chasing after their recent performances now, we will stick with our portfolio of names that are largely either out of favor or flying under the radar, trusting that they too will eventually get their day in the sun.

Portfolio Update

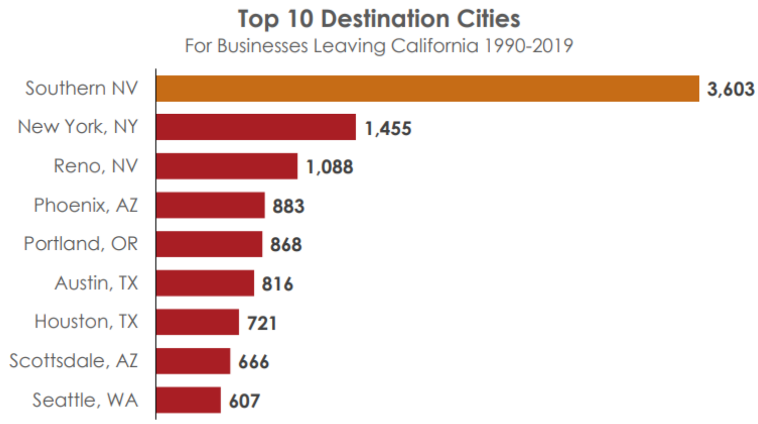
In parallel to a market that had relatively few material developments over the course of Q3, our portfolio remained largely the same as well. We did, however, find a couple new opportunities; one of them is discussed below.

Red Rock Resorts (RRR): Red Rock is a developer and operator of casino and entertainment properties, nearly all of which are in the Las Vegas metro area. RRR caters to the Vegas locals population, with 17 properties scattered across the southern Nevada region. Its two upscale properties are probably its most famous, the Green Valley Ranch and its namesake Red Rock Resort. The remainder (besides the newly-opened Durango, further discussed below), operate under the Station and Wildfire brands. The company was founded as Station Casinos in the 1970s and was publicly traded for 14 years until a terribly-timed LBO in late 2007. Following a downturn in business during the Global Financial Crisis (Vegas home prices plummeted 60%, twice the national rate), Station Casinos filed for bankruptcy in 2009. It exited two years later and returned to the public markets in 2016 as Red Rock Resorts, a holding company controlling the underlying Station Casinos operations.

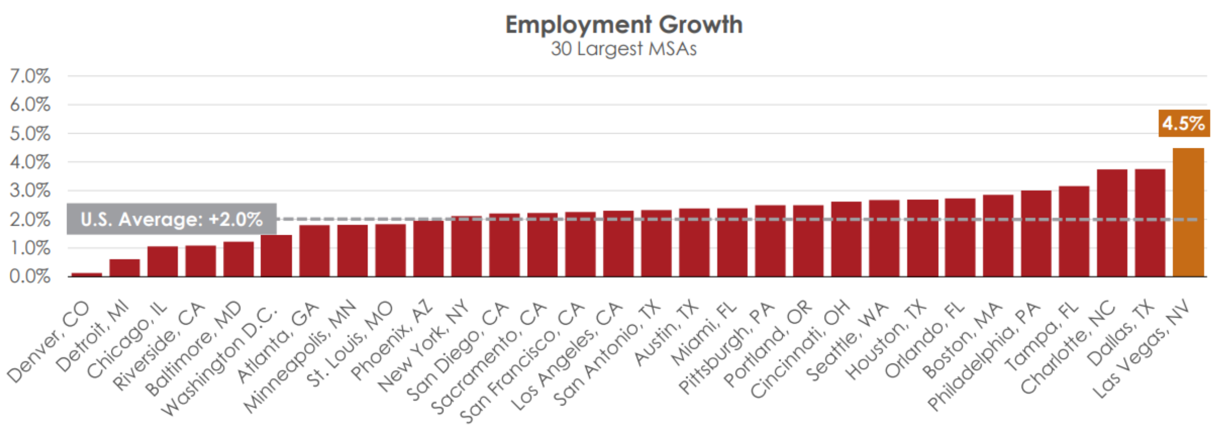
While the Strip garners most of the glamour and attention as the hub of American commercial gaming, the Las Vegas Locals gaming market is actually right behind, having surpassed Atlantic City as the second largest sometime around 2017-2018. The locals market also has several structural advantages that make it perhaps even more attractive than that of Las Vegas Boulevard. First, competition is not quite as cutthroat as on the Strip, where there are 30 casinos within walking distance to each other; second, a higher proportion of revenues come from gaming, which tends to be higher margin than other categories such as food & beverage.



Las Vegas's long-standing reputation as a place for a short vacation or weekend getaway belies the fact that the city is actually one of the most rapidly expanding metro areas nationwide. With no state income taxes, mild weather, and relatively affordable cost-of-living, Nevada has been the fastest growing state in the nation over the last two decades. Business owners, looking to take advantage of the lack of a state corporate income or franchise tax, continue to relocate in droves and bring their jobs to the area. Nevada is also fortunate to be in close geographic proximity to California. High taxes and housing costs have driven many Californians to migrate; today, about a third of new Nevadan residents are California transplants, a 6x greater total than any other state. The same has applied to businesses—many Californian enterprises, from professional sports teams to small LLCs, are leaving the state, and they relocate to southern Nevada at a rate 2.5x greater than any other region.



Naturally, many of those new Nevada residents have ended up in the state's largest city; since the 1990s, the Las Vegas Valley metro area population has tripled. During a trip to the region's suburbs a few years ago, I remember marveling at the number of new housing developments under construction, and since then they still have not slowed down. Unsurprisingly, the economically symbiotic result of having both more jobs available and more individuals looking to fill them has been a labor market growing 2.3x faster than the US average, best among any of the top 30 MSAs.



If you put together this growing population and its rising level of disposable income, you have an ideal combination for an operator of gambling and entertainment venues focused on residents. Given this setup, one would not be surprised to see competition trying to move in to get their piece of the pie, as has happened elsewhere even in less attractive locales. But Nevada law SB 208, passed in 1997 to curtail neighborhood casinos, greatly restricts the development of off-Strip gaming properties. While currently both Red Rock and Boyd Gaming have a range of locals properties operating throughout the area, RRR retains most of the remaining licenses for future gaming development sites. With a stable regulatory environment and significant sway over future gaming capacity expansion, the returns to Red Rock's various capital projects are unlikely to be competed away.

There is also a catalyst present here, one that will play out over the next few quarters. On December 5, Red Rock welcomed its first guests to the Durango Casino and Resort. Located in the South Valley, one of the fastest-growing neighborhoods in the area, the hope is that it will become the centerpiece of the local social scene, much like Red Rock Resort has been for Summerlin. This is a property that RRR spent nearly $800 M developing, and that outlay will now finally start showing a return through the income statement. Early reviews have been favorable, and it seems primed to join Red Rock Resort and Green Valley Ranch as the company's crown jewels. Management stated on its latest earnings call that it expects Durango to quickly become one of the highest-margin properties in the system.

Beyond Durango, it's unclear what the company's next project will be, but with six sites in high net worth, high growth areas, it isn't lacking for options. Management has said it intends to double the company's presence in Southern Nevada within the next decade, so it's clear there remains a significant growth runway ahead. Just as importantly, with 20%+ IRRs on greenfield properties since 1993, they've proven they can capitalize on it. And in the interim, the area should only continue to grow and get wealthier, providing a further financial tailwind.

RRR's financials don't currently help it stand out as being particularly cheap or compelling. Its cash flow doesn't screen well given the significant pre-opening costs associated with Durango, and its trailing valuation multiples are not noticeably discounted relative to peers. Looking around the corner to next year though, both these factors will reverse as the Durango pre-opening spend rolls off and the property flips from a cost center to a profit center. To arrive at a true picture of free cash flow, one must separate the growth and maintenance portions of the spend. Ongoing maintenance spend is around $80 M with no deferred requirements that need to be caught up on. This suggests around $425 M in 2024 discretionary free cash flow, which will allow for meaningful leverage reduction with comfortable coverage of the regular quarterly dividend.

Red Rock's 522 acres of real estate, all gaming-entitled, were recently valued at $1 B in a CBRE appraisal – significant relative to a current $4.9 B market capitalization. Backing out that land value, an investor today is paying around 9x 2024 EBITDA for RRR's existing operations, assuming a conservative ramp of Durango performance. Other casino operators in the area are close to 8x on a lease-adjusted basis, but I would argue that the structural advantage of dictating the timing and location of most future capacity growth in the second largest gaming market – and fastest growing US MSA – deserves some sort of premium.

If Red Rock is simply able to roll forward its current 10.5x trailing multiple, shares would trade at about $60, about 20% higher than recent prices.[2] 20% may not seem like much of a reward for paying an above-peer multiple, but keep in mind this exercise ascribes zero value to the development pipeline – it

[2] When I started working on this piece RRR was trading around $45, but it's rallied 10%+ in its last 5 trading days, so it's now fairer to define "recent prices" as $50.

just assumes the raw land is sold off, whereas the company has already stated its goal of doubling its footprint within a decade and has generated attractive IRRs on its past projects. I could attempt to discount back the future value creation from these endeavors, but the exercise would be so imprecise as to be almost worthless, so I prefer to view it as a free option that is highly likely to expire somewhere in the money. With both long-term growth drivers and short-term catalysts for greater investor awareness, I think the risk-reward is favorable here for investors with multi-year horizons. In the meantime, free cash flow generation will transfer the value of existing assets from debt to equity holders, and thousands of new potential customers will continue moving into RRR's backyard.

Outlook & Conclusion

In recent weeks, markets have returned to all-time highs, with investors having decided it more likely than not that the Fed has now finished its rate-hiking cycle. And, while consumers seem glum about the economic climate, the underlying data on their incomes and employment levels has been quite strong: some have even described it as an ideal set-up for a Goldilocks economy. I'm not banking on any fairy tale outcomes, but one would hope that a period of solid growth without the specter of tighter financial conditions might stand to benefit the commoners of common stocks, rather than just the magnificent elites. In the meantime, we will continue to focus on sifting the investment world for the best risk-reward opportunities, regardless of their locations, industries, or index memberships. Going off the beaten investment path has not been particularly rewarding this year, but I'm confident that sticking with companies like Red Rock will deliver rewards around the bend.

I hope everyone has a great holiday season and a great start to their new year, and I look forward to writing you again in 2024.

"Energy and persistence conquer all things."

— Benjamin Franklin

Per Ardua Ad Stella,

Andrew Jakubowski

Andrew Jakubowski

Performance Summary:

	3Q 2023	2023	Since Inception
S&P 500	-3.2%	13.0%	159.2%
Vanguard Total World Stock ETF	-3.5%	9.7%	83.8%
Russell 2000	-5.2%	2.5%	66.4%
HFRI Equity-Hedge (Total) Index	-1.0%	4.7%	55.8%
Adestella Investment Management	**1.1%**	**14.0%**	**252.5%**