Adestella
Investment Management

December 2024

Dear Fellow Investors,

Adestella gained 1.4% in the third quarter. Long positions returned 2.3%, offset by a 0.2% loss on shorts. Domestic stocks contributed 3.2% while international positions fell 1.1%. Currency fluctuations were a relatively big headwind in the period, costing us approximately 71 basis points as the dollar fell nearly 5% in the period. Net and gross exposure levels remained around 90% and 120%, respectively.

Markets advanced 5-7% over the period as the Federal Reserve commenced its rate-cutting cycle. The S&P advanced for the fourth straight quarter, with rate-sensitive sectors leading the way. This was not to our benefit given our relative overweight in energy and minimal exposure to real estate and utility companies, and as a result, we ended up lagging benchmarks by several percentage points for the quarter.

An Edgy Discussion, Part II

I think it's worth spending a bit more time on the edge in our investment process. While it is true that many market participants do very little fundamental analysis, either due to a passive mandate or a casino mentality, simply doing basic research is still not sufficient to generate excess returns. Even in-depth research has its limits; I am a bit skeptical of nearly anyone claims to outperform solely based on "out-analyzing" the same information everyone else has. Most are being fooled by randomness. In any contest with thousands of participants and limited sample sizes, there will be a fortunate few that post top-percentile results yet produce no signal that suggests they will be able to continue doing so in the future. There is a large amount of selection bias in reported investment results – generally it is only those doing well, the right-tail of the distribution, that we hear about, while those that didn't keep quiet or turn to other pursuits.

Directing analysis toward some advantaged area – your potential edge – is a more promising route. Yet as time goes on, even those "advanced" strategies that once generated superior returns become commoditized. The earliest example is net-nets, which for a time produced consistent, low-risk profits but are now virtually extinct. The latest is probably the wave of general AI models that can be further trained to produce domain-specific insights. I have a hard time believing that if such models can already outperform physicians in diagnosing illnesses, they won't soon also be able to mimic sophisticated qualitative investors too. I think Adestella's processes for finding and researching stocks are pretty good, but going up against a 1.76 trillion parameter algorithm tuned for discretionary investment analysis would perhaps not be the best battle for us to pick.

Instead, structural factors such as size and time horizon must also enter the equation. It is well known that the smaller and nimbler you are, the larger and more lucrative your potential opportunity set. This of course is a bit inconvenient to investment managers trying to grow their businesses, as it implies asset growth tends to correlate inversely with IRRs. But it is consistent with the empirical results we've seen time and again, and it is as close to a law of gravity as exists in the investment world. The good news for us is that we are currently at a size at which liquidity is rarely problematic, and we have like-minded clients that think longer-term and can tolerate benchmark deviation. In short, Adestella has the ingredients required to generate attractive returns for the foreseeable future. A few other structural advantages we currently hold over bigger firms, along with examples of how we're exploiting them in the current portfolio, are as follows:

We can target under-the-radar opportunities. Yes, this has not actually been much of an advantage to date, as large-cap stocks have trounced their small-cap counterparts for almost two decades and posted a record-setting performance spread earlier this year. However, in the very long term, cheaper valuations and longer compounding runways historically led smaller-cap firms to produce superior performance (see table below).

	Annualized Return		Premium		
	Small Cap	Micro Cap	Micro - Small	Small - Big	Micro - Big
Jul 1926 - Jun 2007	12.6%	13.3%	0.7%	2.5%	3.2%
Jul 2007 - Jun 2024	7.1%	4.6%	-2.5%	-3.4%	-5.9%

We believe these factors that led to overperformance in the more than 80 years prior to 2007 are still valid, and their merit will resurface again (hopefully soon!). Our current portfolio has no shortage of candidates; one recent example is a small investment we made in an engine and power systems firm called Power Solutions International (PSIX). You won't find companies with huge secular tailwinds, ongoing margin expansion, and solid balance sheets trading at 7x trailing earnings when you scan through the S&P 500 components, but if you expand your horizons to sub-$500 M companies (especially ones trading over-the-counter), you can.

We have an almost unlimited investible universe across geographies and asset classes. This is a somewhat parallel concept, as "under the radar" tends to apply on a relative basis to international stocks, something I've discussed in the past. As with small caps, non-US equities have lagged badly over the past 15 years, and to date have been largely a headwind for the entire life of the firm (see chart below). But such companies, often with superior valuations or growth prospects – or at least somewhat-uncorrelated ones – have historically been a source of attractive investment opportunities and a worthy complement to American stocks. Maybe this time truly is different, but the odds would suggest that, at some point, valuation discrepancies and sentiment changes will eventually propel foreign firms to a run of relative outperformance.

One such candidate is long-time holding Evolution Gaming (ST:EVO). EVO is a very high-quality business with a great operating track record, and it has good prospects for the years ahead as well. Yet it has declined significantly in 2024 and currently trades at multiples below the broader US market, much less its highly-profitable peers. Meanwhile, US firms in similar industries meeting the lower thresholds of 10%+ sales growth at 20%+ EBIT margins have continued to be bid up and enjoyed another solid year of performance. Sooner or later though, the pendulum will once again swing, and we will be waiting when it does.

Chart 6: US stocks very "exceptional" relative to European equities
US vs Europe equities price relative (US dollar-terms)

Source: BofA Global Investment Strategy, GFD Finaeon

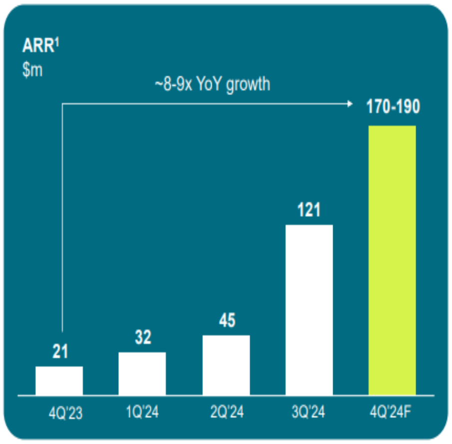
BofA GLOBAL RESEARCH

	EVO	US Comp Median*	Difference
YoY Sales Growth	15.6%	14.9%	0.7%
EBIT Margin	63.1%	28.7%	34.4%
NTM P/E	13.4	33.1	(19.7)
NTM EV/EBITDA	10.0	24.5	(14.5)
YTD Performance	-24%	18%	-42%

**US comps screened by size, industry, growth, and margin parameters*

We can invest in new, immature equities. Often when a new company is formed via corporate action, such as a spinoff or restructuring, it takes a little while for such companies to get picked up by the financial data providers. Institutional processes like investment committee meetings at large firms can also delay any action on such stocks. This gives nimble firms a window of advantage and potential opportunity before such issues go mainstream.

We benefitted from this dynamic recently with the debut of Nebius Group (NBIS), an AI-infrastructure company comprised of the international assets from a Russian company we used to own called Yandex. The setup here had many of the hallmarks of a misunderstood situation, and our misfortune of being stuck with sanctioned, untradeable stock for several years following the Russian invasion of Ukraine at least had the silver lining of making us among the first to know about the NBIS debut. Upon digging in, we saw that the new firm had a core business growing rapidly (see table below) yet trading at a significant discount to comps and several promising secondary divisions that provided future optionality.



Current trading and 2024 guidance

	Q3'2024[3]	2024
ARR[1]	**$121m**	**$170 – 190m**
Revenue	**$27m**	**$70 – 80m**
Adj. EBITDA[2] **Cash Opex of $15-17m / month** expected to be fully covered by revenue by the end of 2024 or early 2025	**($7m)**	**($60 – 70m)**
Capex	**$164m**	**$0.9 – 1.0bn**

2025 Outlook

Depending on the amount of capital available in 2025 to cover the company's investment program we intend to:

- spend between **$600m and $1.5bn on CAPEX** (most of it will be invested in NVIDIA GB200 GPUs, as well as expansion of our DC capacity)
- generate **$500-1,000m ARR** by the end of 2025 and corresponding $400-600mn revenue for the full year based on assumed capacity expansion
- become **Adj EBITDA positive for the full year 2025**

Just as importantly, Nebius had shed the "ick" factor from any Russian exposure. It was a high-quality asset that would undoubtedly benefit from the insatiable demand for AI stories at reasonable prices, but it wasn't in any indices and barely showed up in any screeners. Moreover, it had an odd origin story and its divisions remain in various stages of their financial lifecycles, further adding to the barriers and delays many firms faced in taking advantage of the opportunity. All these factors allowed us to accumulate shares at attractive prices before many had even heard of the company. We think in recent weeks investors are finally arriving to the same conclusions as we did, which has helped NBIS appreciate into one of our largest positions.

Any discussion of edges should consider not only a comparison to the broad investing public but also to other professional managers. There are a lot of discretionary funds out there, almost all of which pursue value investing in one shape or another. The majority also recognize the competitive advantages that stem from fishing in smaller ponds or from not needing to have their results judged on a quarterly basis. From my experience, most would point to a combination of their pattern recognition, patience/volatility tolerance, and/or willingness to turn over a lot of rocks. While certainly useful, such traits are sufficiently nebulous to make it difficult for one to determine the degree to which they are truly differentiated relative to anyone else. So below, I wanted to highlight a few things we do that we think many other discretionary investment funds don't that can potentially be a source of advantage, or at least differentiation. Again, I'll also provide a few examples of how they've worked to our benefit in current or recent portfolio positions.

> **We use tools that allow us to better understand the complete range of potential outcomes.** I doubt there are many discretionary managers writing Python code to make customized Monte Carlo valuation simulations. When used in conjunction with thoughtful assumptions, this is a more robust procedure than the typical bear/base/bull case analysis often seen in

investment memos. The reality is that there is a very wide range of potential results for any company based on the future states of the world, so the best one can do is aggregate a great many combinations to determine a true median "base case" as opposed to arbitrarily picking a few variable combinations. Such tools are especially valuable in situations where operating and/or financial leverage means the range of potential outcomes is skewed. Current holdings United Parks & Resorts (with its high fixed costs) and Shift4 Payments (with its frequent M&A usage) are two recent examples for which our final fair valuation estimates, and thus subsequent decisions on whether they should be added to the portfolio and in what size, benefitted substantially from these exercises.

We lean into the scientific method. Academic research often gets a bad name in fundamental investing circles as the fallacy of modern portfolio theory and of strong forms of the efficient market hypothesis have been discussed at length, for many decades, by some of the world's most famous investors. But there are plenty of other studies that have produced useful and relevant information to today's investor, including rigorous testing of the valuation metrics that produce the highest quality signals and empirical results quantifying the impact of the many behavioral biases investors fall prey to. The base rates such papers report are useful to crafting a better-calibrated expectation of the future and are a worthy addition to any investor's process. We have incorporated their insights both when searching for new positions (leading to several valuable finds such as UFPT) as well as for managing existing positions (cutting losers where the thesis was broken, like Mondo TV). Having the data-driven underpinnings to our portfolio management decisions not only improves outcomes, but it also produces the conviction to stay the course knowing that the odds are in our favor.

Of course, such tactics don't guarantee success or outperformance, and I am sure other managers are also doing certain things that we are not in pursuit of their own advantages. But having followed a decent number of other practitioners over the years, the above processes don't seem to be commonly pursued, which means they have the capacity to produce the differentiated insights that are the key component of an edge.

Outlook & Conclusion

With the election now in the rear-view mirror and the uncertainty in Washington cleared to some degree, markets have further rallied in recent weeks. Valuations remain on the higher end of historical ranges, but economic data has remained strong and optimism abounds for the year ahead. I often mention such developments in order to include the "news" in my newsletter, but the truth is that the long-term success of the portfolio will still mostly depend on the performance of the underlying companies. We've managed to do well over time in a range of environments, and that should continue regardless of the factor and macro trends discussed here.

I'm also happy to report our investment adviser registration is now complete, and we look forward to the additional growth opportunities it provides. There may be some modest changes in the year ahead to better align our communications and investor base, but nothing has been finalized yet and of course, investors will be promptly apprised of all developments.

Hope everyone has a Merry Christmas, and I look forward to writing you again in the new year.

"Be patient. Watched stock never boils."

- Peter Lynch

Per Ardua Ad Stella,

Andrew Jakubowski

Performance Summary:

	3Q 2024	YTD	Since Inception
S&P 500	5.8%	21.9%	252.6%
Vanguard Total World Stock ETF	6.7%	17.8%	141.0%
Russell 2000	9.3%	11.0%	110.6%
HFRI Equity-Hedge (Total) Index	3.9%	10.4%	83.0%
Adestella Investment Management	**1.4%**	**9.3%**	**297.7%**

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