PhestosCapital

February 27, 2024

Dear Partners,

I hope the new year is off to a great start for everyone. As we are around the mid-point of the first quarter of the year, I wanted to share some thoughts on last year's performance and provide some updates on our portfolio.

Q4 2023 Performance Recap

Our fund had another strong quarter in Q4 2023, retuning 11.2% net.[1] After a rocky start to the year, our portfolio fully recovered and finished the year strong, ending on a streak of eight consecutive positive months.[2] For a second year in a row our portfolio was uncorrelated with the overall market (using the S&P 500 as a proxy)[3] – in fact, beta with the SPY was negative.[4] And yet, in a year that was very good for equity markets, our fund had a higher return than that of the SPY.[5]

A good year despite a wrong call

2023 ended with the Fed being very close to completing its coveted "soft landing." During the past year the U.S. economy experienced strong growth, very low unemployment, and a sharp decline in inflation – the dream scenario, in other words. And now the Fed has signaled that its next move will most likely be a rate *cut*, concluding a very aggressive hiking cycle while having seemingly avoided a recession. At a personal level, I am very happy with this outcome: it's the best outcome for the economy and for society as a whole. At a professional level, I am less happy that throughout the past year I assessed it as the *least possible* outcome. If you've been reading these updates, then you'll know that a soft landing was not my expectation.[6] It was of course always a possibility, but in my mind a small

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[1] Return for investors who subscribed at inception. Individual returns will vary depending on the timing of the subscription.

[2] January 2024 was positive as well, extending our streak to nine consecutive positive months, and as of writing February is positive as well. Hopefully the streak will continue.

[3] For the remainder of this note I will use the S&P 500 as a proxy for the "overall market." The qualitative conclusions are the same whether we use the S&P 500, the Russell 2000, or a global stock market index.

[4] Beta with the SPY was -0.22 based on daily returns and -0.42 based on monthly returns.

[5] I have discussed briefly in previous updates what the drivers of the low correlation have been in my view: obviously, our short exposure at times; a bit less obviously, our almost zero exposure to tech; and finally, our exposure to factors (oil, commodities in general) that over the past couple of years have had negative correlation with the market.

[6] To be clear, the "soft landing" has *not* been achieved yet. But at the end of 2023 the probabilities of it happening were vastly greater than when the year started.

one – which led to some tactical positions in our portfolio that effectively were a bet against a soft landing taking place. Nevertheless, in the immortal words of George Soros, "it's not whether you're right or wrong that's important, but how much money you make when you're right and how much money you lose when you're wrong."[7] While we did lose money being wrong about the soft landing likelihood, it was not enough to detract us from an otherwise great year. Our long positions, and particularly our highest conviction trades (uranium-related positions and Petrobras), performed exceptionally well. Overall, the combination of high absolute return and no correlation with the market makes me think that 2023 was a good year for our fund.[8]

Market Commentary

Looking back in 2023, I'd say that two themes dominated the market. The first had to do with rates and the Fed's moves: how much will they raise, and when will they "pivot." The Fed ended up raising short-term rates four times in 2023, for a total of 100 basis points. And despite fluctuations during the year, market rates (for example, treasury bond yields) ended 2023 almost unchanged. The second theme had to do, of course, with AI (a bit more on that below). Notably, there was little discussion about federal fiscal policy, in a year when the U.S. federal government ran one of the largest fiscal deficits in its history. Adjusted for the impact of student loan forgiveness, the deficit in 2023 was a whopping *7.5% of GDP*.[9] To put this into perspective, the only times when the deficit as a % of GDP was higher were: during WWII, in the wake of the Great Financial Crisis (2009-2011), and during the Covid

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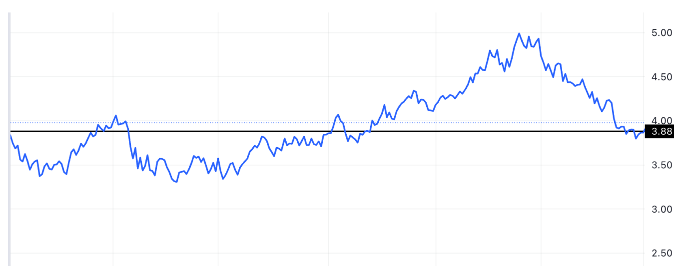
[7] This quote is attributed to Soros, but as I was writing this note I couldn't find a primary source. I didn't find the quote in The Alchemy of Finance (Soros' book); the quote is also included (as a Soros quote) in Morgan Housel's book "The Psychology of Money" but without a citation. If anyone reading this by any chance knows the primary source (most likely a Soros interview?), please let me know. From what I've seen so far I think it is actually a Stanley Druckenmiller quote, which *he* attributes to Soros. Full quote: "What I learned [from Soros] is that position sizing is 70%-80% of the equation. It's not whether you're right or wrong, is how much money you make when you're right and how much money you lose when you're wrong." He's used variations of that quote in multiple interviews, see for example here: https://youtu.be/-7sWLIybWnQ?t=1916 .

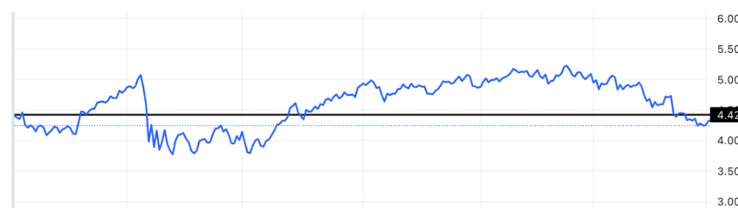
[8] Low correlation with the overall market is a desired feature, yet I'd like to emphasize again that our portfolio is not market-neutral by design (meaning, we do not apply quantitative techniques designed to minimize our beta exposure). The fact that we've had zero correlation with the market so far seems to be a side-effect of our asset selection.

[9] Student loan forgiveness was announced in FY 2022 (boosting the deficit) and ruled unconstitutional in FY 2023 (decreasing the deficit). See here for more detail: https://www.brookings.edu/articles/why-did-the-budget-deficit-grow-so-much-in-fy-2023-and-what-does-this-imply-about-the-future-debt-trajectory/.

emergency response (2020-2021).[10] There were many articles in mainstream financial media marveling at the resilience of the U.S. economy (and the heroic "American consumer"), and I was surprised that most of them did not discuss at all the stimulative impact of such expansive fiscal policy. Is this fiscal support sustainable? In the long run, probably not – although there is a number of well-respected economists arguing that the level of federal debt shouldn't be cause for worry. The economic debate however is not really relevant here; what is relevant is, does the market care about the deficit? And, for now, the answer seems to be no.



10-yr bond yields ended the year at almost the exact same level as they started…



…as did the 2-yr bond yields (charts by TradingView)

AI and the "Mag7" Continue to Dominate

In terms of the overall market picture, not much has changed since Q4 2023. The market continues to be extremely concentrated, with the top six stocks driving the performance of the entire S&P 500 Index. Concentration (measured as total market cap of the top ten stocks as % of total market cap of the S&P 500) is now at levels last seen at the peak of the dot-com bubble and right before the 1929 crash. Which naturally may prompt one to ask, *is this a problem?* Any parallel with 1929 and early 2000 will always sound ominous, but concentration by itself is not the problem, in my opinion. It does indicate that the largest corporations have done better than the smaller ones, which may raise political / societal concerns, but from a purely financial standpoint it's not *necessarily* bad or unsustainable. There is always talk about the market being in a "bubble," but in this case the outperformance of the "Mag7"[11] *is* supported by the fundamentals. These companies' contribution to the S&P 500's revenue and profit growth is commensurate with their weighting on the index. Their stock price growth has been driven primarily by revenue

[10] The large deficits in 2009-2011 and 2020-2021 were in response to large declines in GDP and large increases in employment – none of which occurred in 2023. In 2009 the unemployment rate peaked at 10.0% and in 2020 at 14.8%. Peak unemployment rate in 2023 was 3.8%.

[11] It's actually more like "Mag6" these days, as Tesla has fallen behind. Unlike the others in the group, Tesla's share price is still -54% from its all-time highs. A funny comment you may have seen online: "In the original 'Magnificent Seven' [as in, the movie – incoming spoiler alert] only three survive in the end" – let's see how many will survive in the 'stocks version.'

growth, then by improvements in operating margins, and, *lastly*, by multiple expansion: this is the opposite from what we typically observe in bubbles (when price appreciation is driven primarily by aggressive multiple expansion and secondarily by increases in net income). While valuations are certainly lofty (and may look crazy at first glance, if one focuses on just one metric – say, Nvidia's Price-to-Sales ratio), they are not unreasonable considering the growth these companies continue to have. Nvidia specifically (which is the most "richly" priced among the Mag6) just announced a 265% YoY increase on revenue(!) and a 769%(!!) YoY increase in earnings per share. With growth figures like this, its valuation at ~30 times forward earnings does not seem crazy.[12] Of course, when expectations are so high, above average future returns are less likely. For anyone buying Nvidia at these levels to make market-beating returns, the company will have to perform *even better* than what the market currently expects: a very high hurdle to clear.

Back to the discussion about market concentration: the inherent issue with high market concentration is that the market is less diversified and, therefore, more susceptible to sudden large moves. What makes the current situation even more extreme, is that the market is not just concentrated on a few mega-caps, but on a few mega-caps that are also *all* tech companies, whose future profit expectations heavily rely on the "AI" narrative. The six companies with the heaviest weight in the S&P 500 are, in order: Microsoft, Apple, Nvidia, Amazon, Alphabet (Google), and Meta. All are tech companies, and all are heavily invested in AI. Just consider for example that Nvidia's largest customers are… Microsoft, Meta, Alphabet, and Amazon. This makes the market susceptible (or at least, more susceptible than usual) to a sharp decline: we have the most concentrated market ever, among companies that are highly correlated and exposed to very similar risks; if there is a slowdown in AI-related capex, we are likely to see a large correction. For what it's worth, capital expenditures as % of GDP tends to be mean-reverting, with a long-run average around 10%. Assuming a 3% GDP growth, that equates to ~$80 billions of additional capex per year, for *all* the (non-financial) companies in the U.S.[13] How much of this will go to AI-related spending? Nvidia increased its annual revenue by $34 billion in 2023. AI spending was clearly a huge part of corporate capex in 2023; but for how long will this continue? I don't have an answer, but AI's current share of total capex already seems stretched.

U.S. and the Rest of the World

Finally, just a quick commentary on the continued outperformance of the U.S. stock market vis-à-vis (most of) the rest of the world. There have been two major global crises over the last fifteen years: the Great Financial Crisis and

[12] What's crazy here, is that a $2 trillion company posts these types of hypergrowth results that are hard to find even among startups.

[13] Rough calculations.

COVID. Following both, the U.S. economy (and the U.S. stock market) emerged much stronger than the rest of the world. As a result, the valuations of U.S. mega caps have grown to mind-blowing levels relative to other developed markets; for example, Apple and Microsoft together have approximately the same market cap as the total *combined* market cap of all German- and French-listed companies.[14]

And while following the GFC China was also a major winner (the main laggard being Europe), post-COVID China has also stayed behind. The continued underperformance of the Chinese stock market was one of the main financial stories in the beginning of 2024. To put into perspective how low valuations in China have come, or rather, how much the gap between U.S. and Chinese valuations has widened, as of early February five U.S. companies (Microsoft, Apple, Google, Amazon, and NVIDIA) were *each* worth more than the *entire* market capitalization of the Hong Kong stock exchange! Another astonishing statistic: the combined P/E ratio for the Chinese companies listed in the HK stock exchange is lower than the P/S (price to *sales*) ratio of the Nasdaq! Just a few years ago the Chinese tech giants seemed ready to overtake their American counterparts: in October 2017 Alibaba had almost the same market cap as Amazon. Today – less than six and a half years later – Amazon is worth almost *ten times* more.[15]

So, given all the above, *are there opportunities in Chinese stocks right now?* The risk with Chinese stocks is not economic; it's that the Chinese government intervenes in ways that are detrimental to "shareholder value" (especially *western* shareholder value), and totally unpredictable. That's a non-quantifiable risk. Great opportunities generally arise when there is a combination of depressed valuations *and also* some feature that offers protection on the downside (for example, due to a company's assets, or due to a company generating free cash flow while having low or no debt, etc.): that allows one to invest in size, and that is when the returns matter and the "big money" is made. Unfortunately, this is not the case here. With Chinese stocks, in the bad case scenario the outcome is **zero**; you lose everything. It would therefore be imprudent to build a sizable position in a situation like this. That said,

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[14] There are approximately 500 companies listed in the Frankfurt Stock Exchange and approximately 800 companies listed in the Paris Stock Exchange.

[15] The underperformance of the Chinese stock market is another example of how hard – borderline futile – macro is. Imagine you had a crystal ball back in March 1996, the month the MSCI Hong Kong ETF (EWH) was launched. Thanks to your crystal ball, you would have known with certainty that by 2024 China's economy will be 25(!) times larger, while the U.S. economy over the same period will have grown by "just" 3.6x (for both, that is nominal GDP, measured in USD). Given this information (one economy will grow 25-fold and the other 3.6-fold), and assuming you had an investment horizon of 28 years, where would you invest your money? In the newly launched EWH, or in the SPY? If you are honest, you will probably answer that you would invest everything in the Hong Kong index. Fast forward to 28 years later… the investment in EWH would have a total nominal return of 173.8% (equivalent to an annualized return of 3.7% - only slightly above inflation), while the investment in the SPY would have a total return of… 1,167.4% (9.5% annualized). Knowing the future is not always enough to make you rich!

Chinese valuations right now are so depressed that a small position may be warranted – especially given the Chinese government's apparent resolve to stimulate the economy and the stock market.

Portfolio Updates

Uranium-related positions

Uranium had a parabolic move up to start the year and has since had a sharp pullback. The initial move upward was triggered by Kazatomprom's announcement that due to "supply chain issues" it will likely miss this year's production target.[16] The market then cooled off following Cameco's 2023 earnings release earlier this month.
I think we are at a "junction point" in the uranium trade. I believe the "easy" part of the move is done. That said, the most lucrative part may still lie ahead. Here's how I see it: the move so far (all the way to $106/lb) made perfect sense given the fundamentals: the market is at a structural deficit, demand is inelastic, production cost for the marginal new producer is around $90/lb, we would therefore expect spot prices to climb to at least $90/lb (see previous updates for a lengthier discussion). The timing was uncertain (when uranium became a large part of our portfolio in late March 2023 I was prepared to wait up to two years – it ended up happening in nine months), but the eventual outcome was fairly predictable. Currently, spot price is at a level that according to most estimates is higher than the cost of the marginal new producer. Which means that we are close to an "equilibrium" long-term level, at least in theory. Someone trading purely on the fundamentals would do well to just exit the trade now. Given that, what is the bull thesis from now on? Multiple major producers (notably, Cameco) find themselves in an unenviable situation: they have pre-sold volumes but due to recent production misses, their inventory does not suffice to cover the quantities already sold and awaiting delivery in 2024 and 2025; they will therefore need to tap the spot market to cover the shortfall. In summary, the bull thesis from now on is "the squeeze." Meaning, forced buyers scramble to buy the few remaining quantities of physical uranium, pushing the market to a crazy, unsustainable rally. Does this sound speculative? Definitely, and it basically is. However, this is a trade with big potential upside (*if* we do end up having a "squeeze") and limited downside (we are close to the $80-$90/lb range which is the minimum price that makes new production viable, and effectively puts a cap to the downside). If you

[16] You may recall that in the previous quarter uranium prices had declined temporarily following an announcement again by Kazatomprom that it was planning to *increase* its production in 2024 and 2025.

remember, back in Q2 2023, the "downside" would be to… still make money, just not as much.[17] I think that now the "bad case" scenario is that we end up "stuck" in a sideways market that goes up for a bit, down for a bit, and ultimately nowhere for the next 1-2 years. All things considered, the risk reward ratio remains favorable in my view. We did take some profits in January, but we maintain sizable exposure to the uranium space. It is a more speculative position now compared to two months ago, and we'll be watching it closely; but as discussed, this is still an asymmetric opportunity with potentially explosive upside and somewhat limited downside.

Uranium went "parabolic" in the start of 2024, reaching $106/lb before a sharp pullback to $95/lb. Chart shows the price of the 1-month forward futures contract. (Chart by TradingView)

There is another interesting aspect in the situation described above. Most uranium producers that have pre-sold production have done so at fixed prices that are lower than the current spot price. Which means that the higher the

[17] From the Phestos June 6, 2023 update, p.6 (emphasis added): "…even in the bear case the downside is limited: **the pessimistic view can be alternatively summarized as 'price will go up, but not as much as people think.'** I think most investors would feel comfortable with that bear case."

spot price, the more money these producers (who now must cover any deficit via the spot market) will *lose*. This creates a strange dynamic in the spot market, as the largest producers have a perverse short-term incentive for *lower* prices.

Petrobras

We continue to hold Petrobras. I don't have much to add here since the most recent update. I think the stock is reasonably priced. In the previous quarterly update, I wrote how based on our analysis we expected Petrobras to declare a dividend of $0.55 per ADR.[18] Approximately two weeks later Petrobras declared a dividend of BRL 1.34 per common and preferred share, which translates to US$0.54 per ADR – remarkably close to our estimate.[19] At the time of the announcement that corresponded to an annualized dividend yield of 14.2% for the common share (PBR) and 15.2% for the preferred (PBR.A). At current prices the div. yield is 12.2% and 12.5%, respectively. Considering the risks involved it seems reasonable, if not a bit low.

Two short comments related to our Petrobras position: first, the stock has had a great run despite the fact that 2023 was *not* a good year for oil prices and for oil and gas stocks in general. It serves as an example that when you buy cheap, you don't need many things to go in your favor. It also serves to show that good returns *do not* come from predicting "macro" outcomes such as the price of oil.

The second comment has to do with our decision to go heavy on the preferred stock, which turned out to be a good one. The spread between PBR and PBR.A has narrowed materially over the past year or so, and as a result PBR.A has produced higher total returns than the common stock (both common and preferred pay the same dividend). Since 4/1/23 PBR.A has a total return of 137% vs 113% for PBR.[20]

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[18] From the Phestos October 2023 update, p.5: "Based on our analysis we expect the dividend for Q3 to be ~$0.55/ADR, which annualized implies a dividend yield at current prices of ~14.5% for the common and ~15.5% for the preferred."

[19] The exact dividend figure in BRL was 1.344365 per share. Each American Depositary Receipt corresponds to two shares.

[20] Returns as of February 26th (after market close).

The USD spread between PBR and PBR.A has narrowed significantly over the past year, from $1.40 to less than $0.50.

Just like with uranium, the "easy" part of the trade is done. As I wrote in a previous update, when we entered the trade, literally *nothing* had to happen for the stock price to rise. This is no longer the case. To see significant price appreciation moving forward, multiple things will have to go right for the company. I think Petrobras is likely to continue having market-beating total returns, but we are eyeing opportunities with better risk-reward profiles and are likely to move capital from Petrobras to these new opportunities over the coming quarter.

Other position updates

ASP Isotopes: ASPI has been a home run, with the stock price up more than 1,000% since our first purchase less than eight months ago.[21] Again, just like uranium and Petrobras, I think the "easy" move is done here.[22] When we opened our position, the rationale was that the market cap was unjustifiably low for a company with contracted revenue, operating in an industry with high barriers to entry. In my "back-of-the-envelope" calculations I was estimating that this is a company that could get to a market cap of $400mm over the next few years,[23] assuming

[21] This is officially the fund's first "ten-bagger," less than two years after inception. Hopefully there are many more to come.

[22] "The easy move is done" seems to be the theme of this update.

[23] Market cap was less than $20mm when we made our first purchase.

good execution of its business plan. Market cap right now is ~$200mm – but the company hasn't even posted its first quarter with revenue yet! So, at the current price the risk reward ratio is not very attractive in my opinion. I still believe in the story and think this is a company that is well positioned for growth – but, at the same time, a lot of growth is already baked in the price, to the point that stock price may be getting a bit ahead of itself. To continue going higher they will need to add a lot of revenue, quickly. ASPI can scale up production in its current facility quickly, however, continuing revenue growth will require adding more facilities (management has plans to acquire or build new facilities in locations with low energy costs), and due to the nature of the operations and the regulatory approvals required, adding new facilities would take time. We have reduced our position, and will continue to do so at prices near or above $4/sh.

Figs: we added aggressively to Figs when it was trading below $6/sh., and sold almost 90% of the position when the price crossed $8/sh. The reason for the sale was that the increase in the price was not justified by an improvement in the underlying business, and therefore was likely to regress (as it ended up happening). We will be slowly adding to the position again at prices below $6/sh. The main concern with Figs is whether they can expand their market share given the influx of competitors and the lack of a "moat" besides their strong brand.

Rocket Companies: we trimmed our position by more than half during the recent rally to $14/sh. I believe the rally reflected expectations for Fed rate cuts, more than improvements in the business itself. We don't hold this position as a proxy for rate moves (although the market, in the short-term, tends to treat it like that); we hold it because in our view this is the best company in its sector, with a lot of growth potential. Moves in the stock price that are driven primarily by speculation on the Fed's moves offer good trading opportunities (just like when we kept adding when the stock was trading below $8/sh.) During 2023 we traded actively in and out of this position, taking advantage of the market's overreactions not to changes within Rocket, but to changes in expectations for the Fed's moves. I think the current price is "fair" in the sense that it doesn't represent an amazing buying *or* selling opportunity. We continue to like Rocket as a long-term holding and will use any declines in the stock price to add to our position.

New positions

Mama's Creations (MAMA)

In Q4 we opened a position in Mama's Creations, a marketer and manufacturer of fresh deli prepared foods. MAMA's products are available in all 50 states via partnerships with large grocery stores via either branded, pre-

packaged offerings, or as deli market solutions (the turkey and beef meatballs at many Whole Foods locations, for example, are prepared by Mama's, as are the meatballs for the meatball subs at Publix). MAMA was founded in 2009 as "MamaMancini's" and was originally a manufacturer of frozen, pre-packaged Italian food (with Mama Mancini's Meatballs being their signature dish). In September 2022 Adam Michael, formerly an executive with Mondelez, took over as CEO and brought with him a team of experienced industry executives. Under the new management, the company plans to become a "one-stop solution" for the deli isle in grocery stores and the nationwide market leader. MAMA also changed its name from "MamaMancini's" to "Mama's Creations," presumably to place less weight on the Italian part of its offerings, since it plans to continue expanding its product line to include popular non-Italian choices such as tacos or sushi.

The new management team's compensation plan is heavy on the stock-based portion, aligning incentives with shareholders. Collectively, management and directors own almost a fourth of the outstanding shares. So far, the stock price has reacted very positively to the changes: it has almost quadrupled from its late 2022 lows. Despite the huge return over the past 14 months, I believe the stock price is still low compared to the company's growth potential.

There are many reasons to like this company. **First**, market and sector tailwinds: the deli prepared food category is growing not just by total revenue but by volume as well, as consumers increasingly substitute dining out or cooking at home with prepared food from grocery stores. **Second**, huge runway for growth: despite MAMA's products being available in all 50 states, the company currently has no sales from the three largest retailers in the country (Walmart, Target, Kroger's). Management has a clear vision for growth and, in my view, the ability to execute (the first-year signs are very encouraging). Note also that this is a business with *negative* working capital – meaning, they collect payment from the clients before they pay their suppliers. So essentially the business finances itself, providing potential for quick growth. **Third**, favorable competitive landscape: this is a fragmented market with no clear leader; most competitors are privately held companies, many of which family-run. **Fourth**, a solid balance sheet. And finally, even after a 173% increase in 2023, the stock price is still reasonable.

The new CEO has set a goal of reaching $1 billion in sales within the next five years. Part of it will likely come from acquisitions, which means there will be some dilution to current shareholders. Even so, I think the growth prospects here are exciting. We made our first purchase at a price of $3.30 and have continued to add since. After a rally like the one MAMA has had, a large pullback would not be a surprise. We will use any such pullback as an opportunity to add to our position.

Alibaba (BABA)

This is a "tactical" position with a shorter time horizon (1 year or less) than our usual investments. The reason is simple: the stock is so cheap! Ok, there's a bit more to it. After all, the "value" argument for BABA is not new; many investors have lost a lot of money over the last few years buying into the "Alibaba is undervalued" thesis. Alibaba has certainly been undervalued *by U.S. company standards* for years now. The issue is, of course, that it is *not* a U.S. company (very simple, I know, but sometimes simple is all you need). The reason for the stock's dismal performance is China, not BABA per se. However, after years of underperformance, the stock now seems cheap even for a Chinese company. There were two recent catalysts for opening this position. The first is the Chinese government's apparent resolve to stimulate the economy and specifically the stock market. The second is the increase in the share buyback program that Alibaba announced in its most recent earnings call. Alibaba may now buy up to $35 billion of its stock over the next three years. That is $35 billion against a market cap of ~$180bn, in other words almost 20% of the shares outstanding in current prices. With numbers like this, it is evident that the only risk here is the geopolitical one. And I'm not discounting that risk; all I'm saying is that, at current valuations, the risk-reward seems attractive, with the caveats mentioned above re: position sizing. Again, this is a speculative position which we will be constantly re-evaluating.

As always, I am available if anyone wants to discuss any of the above in more detail.

With warm regards,

For Phestos Fund, LP

Nikos Angelopoulos

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