Dear Investors,

In Q2 2022, Luna returned -39.1% on net assets under management. This brings our year-to-date performance to -33.3%.

As the first down quarter in our short history of equity management, what we knew as a likely inevitability (especially as long-only investors) has come to pass. Our feelings on the quarter as we weathered through it and now in retrospect are summarized below.

**The Macro**

It is hard to find periods in recent history where such prolonged declines have been experienced simultaneously across the common investment asset classes (stocks and bonds). Crypto even appears to have succumbed in the short-term. Equity declines in Q4’21 and the beginning of Q1’22 started as a rolling phenomenon impacting certain sectors sporadically. These bursts became more like falling dominos in Q2’22 as the broad market traded lower, and the selling became indiscriminate. Many parts of the market that were immune to declines in Q1, caught up quickly in Q2.

While it is not a surety that we are in a recession (at the time of writing), it would be hard to tell given how the markets have traded. Equity drawdowns already indicate we have fallen close to the medians of prior recessions despite the technical economic definition being unfulfilled. If Q2’22 data does show the economy has declined for a second consecutive quarter and a recession is confirmed, it will (at least so far) lack some of the more gruesome features of recessions past (mass foreclosures/bankruptcies, wide-spread unemployment, etc.).

Many economic recessions are caused by an idiosyncratic event that leads to a systemic impact on the market. The COVID-19 recession was caused by the rapid spread of an unknown virus which grinded economic activity to a halt. The “Great Recession” of 2008 was, at its root, a failure of regulation to curb toxic mortgage lending and excessive leverage in the financial industry. The illiquidity and stress on the financial sector had a contagion effect on many other parts of the economy. The tech bubble was more of your garden variety overexuberance but then became exacerbated by the events of September 11th.

The current period may share some similarities with the recession in the early 1990’s. The late 1980’s had been a period of economic growth, inflation began to increase following peacetime expansion, and the Fed raised rates between 1986 and 1989. These rate increases slowed but did not stop economic growth until the 1990 oil shock when Iraq invaded Kuwait. That event, combined with the slow-moving effects of the “Savings and

Loan" crisis in the 1980's and spike in consumer pessimism, caused a shallow recession. The current fed hiking cycle coupled with the Ukraine/Russia conflict's impact on energy markets shares some similarities. The max market drawdown in 1990 was ~20% and the market quickly recovered by the middle of 1991.

Another point of comparison is the soft landing of 1994. As the economy recovered strongly post the early 1990's recession, the Fed was concerned with rising inflation and proactively increased interest rates by 3% over a 12-month period. They managed to balance the rising rates with strong GDP growth and avoided a second recession. While this is potentially a best-case outcome and there are several reasons why luck more than Fed skill may have contributed to the success at the time, it is an interesting period to consider. Perhaps this serves as an upper bound in the range of likely paths forward (with a more traditional though potentially shallow recession on the lower bound).

**Our Portfolio**

We continued to deploy capital in Q2. In Q1, our software & technology exposure was negatively impacted by the broader industry decline, but industrial holdings like CLF, highlighted in our last letter, held up performance. While the weakness in technology persisted in Q2, the rest of the market caved in as well. As long-term investors, we have performed diligence not just on the companies themselves but also the underlying trends and industry dynamics. The long-term return profiles for many of these companies is little changed by potential short-term economic weakness, as it does nothing to hinder the underlying growth trends. In many cases, the return profiles are as attractive as they have ever been given the precipitous fall in prices. While the recent market movements reflect clear pessimism, we remain optimistic on the collective return profile of our portfolio.

If we are accurately predicting the trajectory of a business's financial performance and using a stable, through-cycle, discount rate, the intrinsic value of a business should change very little over time. How the market prices the shares of a business on any given day is the output of market participants, many of whom are riding the behavioral wave from euphoria to capitulation. We make similar observations to many of the active managers in the business – that stock price and a business's intrinsic "true" value can, and frequently are, dislocated. It's observable in the large day to day volatility of individual names on usually little-to-no company specific news. It's observable in the elevated correlation of individual securities in bear markets vs. bull markets. Investors seems to misjudge volatility (market oscillation) for risk (the chance of permanent value destruction) more frequently in down markets. The continuous assessment of intrinsic "true" value and conviction in the theses of the companies we look at and invest in is paramount to maintain investment discipline. [1]

One way we categorize our holdings is by the type of spending a business's revenue is based upon – spending by consumers or spending by businesses. Consumer spending is generally more cyclical (reliant on the prevailing economic environment), except for base necessities like food and energy costs. Business spending can also be cyclical, but it varies more based on the type of function being considered. Certain business expenses will have variability with fluctuations in the economy, but other core expenses are more fixed in nature.

In the first half of the year, we have primarily invested in business-to-business (B2B) service companies. Enterprise resource planning spend, for example, is more resilient in economic downturns than say the spending habits of consumers. In a recession, consumers may halt discretionary retail/restaurant expenses, but a business that has outsourced HR functions to a company like Workday (which we own), will not suddenly terminate services in the face of an economic slowdown. Certain critical enterprise platforms are too enmeshed in the corporate workflow, too complicated and too costly to make changes to in response to potential economic headwinds. A business is likely to try to make cuts to many other expense items before it would seriously look at making critical operating infrastructure changes. If anything, in search of cost cutting and/or productivity gains, a business may explore a service like Workday to create efficiencies in HR/Finance functions. Other examples of critical enterprise businesses in our portfolio include the tax compliance platform, Avalara, and property/casualty insurance software provider, Guidewire. We anticipate the topline of businesses like these to be highly resilient through an economic recession.

While the recession risk has increased and invited volatility into the market, it has not dramatically changed the long-term prospects of many of these businesses. It has however offered attractive entry points, and we have taken a disciplined approach to adding exposure over the course of the quarter. The major long-term trends underlying many of our investment theses are unchanged by a momentary slowing in economic growth. While we are relatively novice compared to more successful, tenured investors, we heed their philosophy of calm, tempered decision-making through volatile market periods. Indiscriminate, panic selling is generally not a recipe for creating LT returns. Differentiating between volatility and a material change in risk level is critical as

[1] We'd recommend Richard Thaler's book Misbehaving: The Making of Behavioral Economics as he devotes a significant portion of that book detailing these types of observations.

the environment changes. Our view is that while short-term volatility is elevated, long-term risk for our investments is little changed, making this an opportune time for capital deployment.

**Some Observations**

At a certain point *the fear of missing out on upside becomes greater than the fear of losing* if the broader markets continue to decline. This was seen most recently in the V-shaped market recovery that took place during COVID. The market low in March 2020 was well before we had significant vaccine progress but may have represented the point of peak uncertainty for the pandemic. As soon as the momentum swung positive into April, the market never looked back and instead regained its old highs before the end of Q3'20. This was despite the near universal belief by the investment community through the second half of 2020, that a "double dip" was imminent. The period served as a good reminder and example of how quickly things can change when the sentiment of the herd inflects.

*Money has to go somewhere*. If investors are selling bonds, equities, crypto and gold, it implies that all the popular places people have been putting their money into for the last several years are experiencing outflows. So where is the capital going? In most cases, at least temporarily while investors figure out what to do, it appears many are holding cash (US Dollar Index was up 9% in 1H22). This is interesting given that if we are in inflationary times, classic investment guidance would be to not hold a significant amount of cash. Now it is possible that bond yields have become attractive enough that investors will begin to deploy into the fixed income markets, especially if the Fed continues their aggressive policy stance and hike profile. Investors are probably more likely to do this than buy gold which just can't seem to gain traction. However, with the threat of recession, the Fed may have no choice but to slow-down tightening sooner than expected, capping incremental yield potential. While we are not crypto experts and have no investments directly related to the space, we believe large drawdowns like the "crypto winter" create long-term behavioral scarring for investors that may ultimately lead to its unpopularity in the future. We watch the crypto space with great intrigue from the sidelines and admit there may be long-term applications to the underlying technology, but we still believe it is an unlikely place investors will deploy capital in bulk, at least in the near to mid-term. By process of elimination, this leaves equities, much of which is experiencing the most significant drawdowns since the pandemic and 2008.

*The future can be self-fulfilling*. Going into 2022, consumer sentiment was souring while inflation, rising rates, and the inevitability of a recession (since that is how each past rate hike cycle has ended) became top of mind for consumers and investors. This perception of imminent economic struggle caused many to become cautious, in preparation. That cautiousness may have manifested into the decreased spending and tightening of labor that could ultimately slow growth enough to induce a recession. However, we'd postulate that without the introduction of another significant exogenous event, a "self-inflicted" recession may be shallower. Consumers may limit spending but are unlikely to take more drastic actions like downsizing their home/car (assuming employment remains robust). Market participants may strategically exit positions but are less likely to resort to the capitulatory behavior that adds stress to the financial system like complete and rapid liquidation. The behavior of a "cautious" participant is likely to be moderate relative to those responding to "fear," which not only dictates how deep/long a bear market goes but also how quickly it recovers once sentiment inverts.

*Tendency for expectations to be heavily shaped by recent experiences.* The last three recessions '00, '08 and '20 were all significantly more severe on average, than those that came before the turn of the century. However, many current market participants only have the experience of those three recessions and set their expectations accordingly. A "shallow recession" can barely be conceptualized by most investors today, but it is certainly an economic possibility.

In closing, we remain confident in our strategy and optimistic about the businesses we have invested in. We look forward to keeping you updated on our progress and remain grateful for your support.

Warm Regards,

Lucy & Nate

7/27/2022

**Appendix – Performance Since Inception**

| | Q4 2021 | Q1 2022 | Q2 2022 | YTD 2022 | Since Inception |
|---|---|---|---|---|---|
| **Luna Partners** | 5.6% | 9.5% | -39.1% | -33.3% | **-29.6%** |
| | | | | | |
| S&P 500 | 10.6% | -4.9% | -16.4% | -20.6% | **-12.1%** |
| Nasdaq Composite | 8.3% | -9.1% | -22.4% | -29.5% | **-23.7%** |
| Dow Industrial | 7.4% | -4.6% | -11.3% | -15.3% | **-9.1%** |

Note: Equity market returns above based on underlying index prices. Standard and Poor's 500 is a popular stock market index representing 500 large companies on US stock exchanges. The Nasdaq Composite is a stock market index that includes all the stocks listed on the Nasdaq Exchange. Dow Jones Industrial Average is a price-weighted stock market index of 30 prominent companies listed on US stock exchanges.

Luna Partners' performance is based on net asset value calculations provided by Interactive Brokers and calculated net of expenses and fees. Luna's portfolio typically consists of 10-15 long, US based public equity positions. Returns are after expenses and fees and presented on a time-weighted basis to be comparable to the index returns in the table. Past performance is not indicative of future returns.

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