Dear Investors,

In Q3 2022, Luna returned 4.6% on net assets under management. This brings our year-to-date performance to -30.3%.

The Macro

Before we delve into our "macro" commentary, we wanted to take a moment to examine the importance and reality of our views on these topics.

As managers of a concentrated, long-oriented, long-term equity portfolio, it is reasonable to wonder: why do we concern ourselves with trying to understand geopolitical and macro issues? In short, the "undercurrent" of the market is much stronger in periods of decline. Individual stock correlations rise and company specific developments matter less, making the factors that drive broad declines more meaningful. This is not to say that positive periods warrant no macro inspection, but the need to project macro-outcomes and the resulting benefit from correctly forecasting becomes diminished. As a result, this section in future letters may be minimized or temporarily eliminated.

It's also worth noting we are not geo-political experts and have no non-public avenues for which to claim "differentiated" information on relevant events. However, our analysis differs in two keys ways; 1) we attempt to separate the "narrative" from the economic reality, and 2) we stay focused on what "could" happen rather than what "should" happen. Our efforts to analyze these events is centered on understanding reasonable worst-case scenarios and the length of time the event is likely to remain a market factor.

Ukraine/Russia conflict. There is a narrative that Putin holds the keys to Europe. Russia has cut off ~80% of their gas exports to Europe, plunging the region into an energy crisis on the cusp of winter. However, the economic reality is one of a "two-way" street. A recent study by Yale University sheds light on the reasons to be skeptical of Russia's "resilient" economy. [1]

- Increased cherry-picking of select economic metrics to trumpet to the home audience
- Deterioration in position as a strategic commodity exporter, with challenges in shifting exports to Asia
- Collapse of imports of critical parts/technology, causing widespread domestic supply shortages
- Kremlin's delusion of self-sufficiency and import substitution

[1] Jeffrey A. Sonnenfeld, Steven Tian, Franek Sokolowski, Michal Wyrebkowski, Mateusz Kasprowicz, Business Retreats and Sanctions Are Crippling the Russian Economy, August 2022, Yale School of Management.

- International business retreat causing decades of foreign investment to be simultaneously withdrawn

The paper concludes, “there is no path out of economic oblivion for Russia as long as the allied countries remain unified in maintaining and increasing sanctions pressure against Russia.” If Europe manages to survive the winter, they buy themselves another year to transition away from their dependence on Russia. This would set the stage for Putin’s leverage to deteriorate rapidly. Coupled with the enlarging self-inflicted wound on Russia’s economy and the depletion that arises from continued armed conflict, economic and potentially societal collapse are possible.

Defining potential worst-case scenarios and “trough events” mid-conflict is more of an exercise in thinking about what catalysts could occur to cause the conflict to expand or contract. In the case of Russia/Ukraine, the use of a tactical/“battlefield” nuclear weapon, for example, is likely not an event trough since it would lead to a broadening of the conflict. Similarly, the assassination of President Zelenskyy is likely not a trough event, as this would only increase the uncertainty level and length of the conflict. While outcomes like these certainly carry a non-zero probability, it is nowhere close to a coin flip (unless you’re going for 4-5 heads in a row). The lack of diplomatic off-ramps is maybe the most concerning aspect of the conflict and seems almost undesirable by both the direct participants and Western powers.

Winter most likely presents a stalemate for the conflict with the severity of the crisis in Europe largely at the whim of mother nature. A brutal winter could have disastrous human and economic consequences while a mild winter would likely mean present inventories would be sufficient. This presents the most likely trough event: a recession/depression in Europe over the next several quarters.

One of the second-derivative impacts of the above is the trend toward de-globalization. The realization of global supply chain weakness and ongoing geo-political disorder is leading to “onshoring” by many corporations who have for decades sought the country with the cheapest labor for their manufacturing needs. While bringing this type of business activity back to the US is seen by many as a positive development (and in many regards like labor opportunity, societal sustainability, etc., it is), there is one obvious set back it presents. What happens to the costs of these goods that are now “Made in the U.S.A”? This is the cost of producing things in a developed economy; there are higher wages, higher social costs, higher taxes, and stricter regulations. Despite most of the arguments in favor of offshoring remaining true, there has been a new value placed on supply chain security by the corporate community.

Given the above factors, we have focused our current portfolio on primarily US and LatAm based businesses, limiting our exposure to a potential recession in Europe. As it relates to "onshoring" trends, we believe our current investments are either situated beneficially (strong existing domestic supply chains and/or benefits from domestic demand as imports decline) or will not be significantly impacted.

FED Policy. Narrative seems to matter even more here as it diverges from economic reality. At the September 2021 FOMC meeting (only 12 months ago) in the face of rapidly rising raw material, bulk commodity, and home prices, the Fed said they didn't view inflation to be a risk as they left rates at zero. Rising prices were blamed primarily on temporary supply related issues post-reopening.

Fast forward to today, many of the areas that experienced rapid price increases have turned over. Oil for example is now below the price it was pre-Russia's invasion of Ukraine. Our read of the hawkish (tighter policy) tone is that they misjudged inflation (evident in their forecast change) and do not want to exacerbate their mistake by not getting it under-control.

Prices of energy commodities, metals, agricultural goods, etc. experienced extreme price increases during COVID and peaked in the first half of this year. Now when prices have begun to reverse, the Fed has taken the position that they will keep rates elevated (over 2%) all the way through to 2025. Here in lies the contradiction of the Fed: they say they are "data dependent" but essentially ignored the rapid rises since January 2020. Then, after prices put in peaks and started to decline, they made the aggressive pivot to raising rates at one of the fastest paces in history. We still wonder why they provide dot plots out to 2025, which are scrutinized with surgical precision by participants, if they are willing to make such drastic policy changes when a few months of data diverge from their expectation. It is also important to remember how little control the Fed has over prices as they wield their blunt tools. Time is unfortunately the only remedy to the problems they face.

As noted in previous letters, longer duration technology businesses are most at risk of short-term valuation pressure in this higher interest rate environment. While our portfolio does have significant software and technology exposure, we have focused on more mature technology businesses and critical B2B software, and we believe these areas offer resiliency over the long-term. These holdings are well past their proof-of-concept stage and are either on the verge of profitability or are already cash flow generative.

Our Portfolio

Prospect theory was in full effect as the market swung higher off its June lows before reversing to end the quarter nearly flat. While a "flat" quarter should have been a desirable outcome after a tough first half of the year, the Q3 “bear market rally” and subsequent reversal left market participants with more pessimism than we believe a flat quarter should have warranted.

In August, we made several small shaves to some of our positions to raise cash and lower our risk profile. However, overall, our portfolio has remained largely unchanged as we feel confident that we are striking the right balance between offense and defense.

The only major company specific development in our portfolio involved our investment in the tax automation/compliance business, Avalara. After building a position in the business during the first half of the year, the company announced on August 8th a definitive agreement to be acquired by Vista Equity Partners. While the $93.50 transaction price is well above our cost basis, it is dramatically lower than the intrinsic value we believe the business to have. We also see Vista’s interest in the business as a clear indicator of the strong, long-term potential of the company. We wait with great anticipation to see if the shareholder base, which is required to vote on the transaction, will approve the deal.

We remain focused on managing our positions and taking advantage of this period of drawdown.

Warm regards,

Lucy & Nate

October 19, 2022

Appendix – Performance Since Inception

	Q4 2021	Q1 2022	Q2 2022	Q3 2022	YTD 2022	Since Inception
Luna Partners	5.6%	9.5%	-39.1%	4.6%	-30.3%	**-26.4%**
S&P 500	10.6%	-4.9%	-16.4%	-5.3%	-24.8%	**-16.8%**
Nasdaq Composite	8.3%	-9.1%	-22.4%	-4.1%	-32.4%	**-26.8%**
Dow Industrial	7.4%	-4.6%	-11.3%	-6.7%	-20.9%	**-15.1%**

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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