Dear Investors,

In Q4 2022, Luna returned 8.1% on net assets under management. This brings our 2022 performance to -24.6%.

It's been said and written several times by tenured investors that you never forget your first year in the business. With our first calendar year coming to a close, this will be a tough one to forget. 2022 was the first major punctation (second if you count COVID) in a nearly 13-year bull market. Interest rates (Fed Funds) rose over 4%, a pace not seen since Fed Chair Volker in the late '70s and early '80s. Additionally, 2022 also carried significant risk from geopolitical uncertainty, such as the Russia / Ukraine conflict.

The Macro

Pre-2022, the popular sentiment "Don't Fight the Fed" had been set against the backdrop of rising markets with a central bank policy of "easy money." This guidance became hard to follow as the environment changed, and the money spickets were turned off. Habit is hard to break and after over a decade of being rewarded for chasing beta and overemphasizing growth factors, many investors saw the tide come in and were found disappointingly, trouser-less.

After peaking on the first day of the year, the market headed lower and never looked back. The S&P P/E (fwd) fell from 21.4x to 16.7x, not far from its 25-year average. The S&P 500 EPS fell ~4% in 2022 as lower margins outweighed the benefit of continued revenue growth.[1] It hasn't been a 2008 sized wash-out (yet), but the areas that saw the greatest exuberance have been victims of the greatest pain. Those areas are well known by now as the profitless tech and "innovation" companies that were historically only talked about on a multiple of sales. ARKK (Cathie Wood's Innovation ETF) was the poster child for these types of investments and will now have to quintuple in value to regain its former highs. Technology was not alone as sectors like consumer discretionary and communication services also saw steep declines.

With the Fed Funds rate at 4.25-4.50%, the best-case scenario for equities is that rates only go as high as the Fed has signaled to date which is ~5.1%. However, even that level isn't believed by the market which expects a Fed Funds rate at least 50bps lower than what the current dot plot would imply for 2023. We remain very cautious while this disparity exists and feel it understates the risk that the Fed goes even higher (>5.25%). Through a behavioral lens, the fear of a back-to-back mistake is significant. The Fed's "transitory" mistake has left the institution's credibility wounded, and history teaches that getting something wrong tends to lead to poor

[1] JP Morgan Asset Management Report as of Dec 31, 2022.

decision making going forward. The Fed appears acutely aware of the risk of additional mistakes and have continuously acknowledged the hazards of not getting inflation sufficiently under control. At a minimum, we expect the Fed to reach the levels already communicated; however, we would not rule out a more hawkish swing. The Fed has clearly conveyed that a recession in their view is the lesser of two evils (the other, persistent inflation). Our view for the start of 2023 is that equities will be soft until the Fed gets to a Fed Funds rate >5% and provides further signaling.

The US consumer remains what we would consider "stable." Household debt payments as a % of disposable income is near 10%, still historically low but rising from its pandemic trough, with still above average excess household savings. Wages have been growing at rates not seen in over 40 years, job openings vs. job seekers are still near all-time highs, and layoffs are well below historical averages. Housing affordability has suffered, but housing activity has remained robust as evidenced by historically low single family home inventory and rental vacancy rates near 30-year lows. These above conditions are in large contradiction with the consumer sentiment data, like the University of Michigan poll, which was below 60 for most of the year (well below the long-term average of ~85). June 2022 marked the lowest score recorded in 50 years, beating out both 2008 and 1980 for lowest sentiment!

The most likely explanation for this contradiction is that the consumers being polled are aware that their cost of living has risen. Ginned up by media headlines of a "weak economy"[2] and the obvious increases in a myriad of day-to-day expenses, it's easy to give a pessimistic response. Behaviorally, this is unsurprising since housing and job decisions for any one individual are less frequent events with typically higher latency (wage growth lag, etc.) while changes in the cost of food and energy are higher frequency and lower latency events (prices can rise quickly and they are felt often).

Equity markets in 2023 face several headwinds, including a higher cost of capital, continued margin compression and the potential for a weak consumer. Demand destruction continues to be of concern as one of the most likely paths to successfully control prices. Pressure on both multiples and earnings is likely to keep the market range bound, with increased dispersion of performance among individual stocks. Despite these near-term considerations, we remain constructive on the opportunity set and optimistic that winners will emerge over the long term.

[2] Google Trends shows "weak economy" and "weak US economy" searches nearly doubled from 2021 to 2022.

Our Portfolio

From a process and strategy perspective, we would describe 2022 as a "year of refinement" for our firm. In this first year of business, we have made a multitude of adjustments and additions to our investment process while maintaining the foundation and key pillars of our strategy. We view these modifications as a never-ending evolution on our journey to master our craft. Many of these changes were focused on improving organization and efficiencies in our research process. The standardization and systemization of the analysis of certain investment factors is meant to improve our decision making and investment judgement. These new methods and systems improve and expand the tools in the toolbox we take to the market every day.

Defining and enhancing our process and tools is critical but for the strategy to be effective, it must be applied to the "right areas" of the market. An investor looking for a "high-quality" business for example will typically encounter the same problem: high-quality businesses are almost never cheap. The key here is "almost never" because on occasion, the market will give you an opportunity. When we look across technology and media businesses, one of the highest quality areas is software, specifically enterprise B2B software. For several years leading into 2022, you couldn't deny the attractiveness of these business models, but you held your nose when you saw the price. Many of these companies have maintained their growth and margin trends with little impact on operations from the macro-headwinds. However, their share prices told a different story with declines of 40%, 50% or greater in 2022. This is one of the "right areas" to apply our strategy and tools today.

Another example would be "cyclical" businesses. Conventional strategy as it relates to investing in a cyclical company is to wait and have the patience to invest near the bottom of the cycle and exit some time later on the way to the top. However, there are other factors that can enhance the returns of a cyclical investment. Historically, these have included some type of demand shock, secular tailwinds, industry consolidation and lower levels of financial leverage. As we looked across the many cyclical sectors like industrials, semi-conductors, metals and mining companies etc., a promising area appeared in the form of the U.S. steel industry. The demand shock came during COVID when continued strong demand caught the industry by surprise as they lowered production and extended capital plans in anticipation of an economic depression that never came. Tailwinds for the industry remain strong as the backbone of industrial and infrastructure projects. Construction, automotive markets, the renewable energy industry, machinery/equipment manufacturing and the military are all in need of increasingly more steel. The U.S. industry has significantly consolidated from the early 2000's when over 20 separately owned mills existed (top 4 had 44% market share) to 2022 with only 7 players (top 4 had 84% market share).[3] As for leverage, the industry has never carried less debt and been better capitalized than today. This is another "right area" to apply our strategy and tools.

Matching our skills and tools to the right areas gives us the best chances of finding superior performers. As we look across the sectors we feel confident investing in, ideas tend to take a few similar forms based on the maturity of the company, its position in its respective industry, and the decisions management is making. These categories have been developed based on our internal observations but also our study and research of historically successful strategies. These areas are well worn paths to finding alpha.

- "Compounders": Monopolies, duopolies, market leaders, strong competitive moats, etc.
- "Shooters": Quality mid or small-cap, future "Compounders," companies with increasing penetration coupled with growing TAM, GARP, etc.
- "Cyclicals": Cyclical businesses with secular tailwinds (described in detail above)
- "Transformers": Restructurings, roll-ups, transformative M&A, spin-offs, etc.

It is important to note, these are general categories with some select descriptors, but specific opportunities take many forms and usually fall across multiple categories. Each of these categories requires a slightly different research approach as the pain points and levers for upside are different across each of these areas.

While we are long term investors, we continue to vigorously explore a variety of new investment ideas to ensure we are capitalizing on the opportunities being presented from market volatility and dispersion. Our objective is to hold a portfolio of our top 10-15 ideas, sized based on the upside we see in the share price and our confidence in the investment thesis.

As we bridge this objective to our portfolio construction, we'll briefly discuss our methods of diversification. While we heed the sentiment that "diversification is an enemy of performance" by owning a concentrated portfolio, it does not mean we forsake the idea completely. Given our concentration, we strive not to have multiple investments predicated on the same drivers. Even in areas of similarity, we'll target different geographies or sufficiently different spend types to spread exposure. To ensure we are not overly concentrating our portfolio to a few market factors/themes, we abide by certain exposure guidelines.

[3] United states hot strip mill capacity.

Some examples of our guidelines are as follows:

- No more than a quarter of the portfolio can have revenue primarily driven by the same industry. Example: Illumina and Veeva Systems are both at a high level driven primarily by spending in the healthcare industry. We also like this combination because one is a hardware business while the other is a software company.
- We generally don't own direct competitors. In situations where multiple direct competitors are attractive, we pick one.
- Stay reasonably diversified across business size (by market capitalization). The below represents our portfolio at year end and we would consider this a reasonable spread and in line with our opportunistic view of mid-cap and small cap opportunities.
    - Less than $10bn: 3
    - $10-$50bn: 5
    - $50-$100bn: 2
    - $100+bn: 2
- Are we unreasonably correlated to any major market factors or sectors inadvertently? This involves tracking our portfolio performance against rate indexes, market sector indexes, growth/value benchmarks, etc.

Our process here leaves whitespace for interpretation and choice. While standardization and systemization of various research processes have been helpful, security selection is where the rubber hits the road. Our diversification limitations (guidelines) are meant more as safeguards that still allow us to exercise our best judgement when we deploy capital.

Going forward, despite an unfavorable interest rate backdrop, we believe the set-up is the best it has been in years for active management in equity markets. Businesses will be forced to differentiate themselves with superior operating performance rather than ride the "easy money" wave. This separation of winners and losers will cause increased dispersion of individual stock performance. These environments reward active investors doing fundamental research and making focused picks.

In Q4 2022, the portfolio was resilient through the end of the year market chop. We made a small number of position sizing adjustments but largely maintained the portfolio for the last 3 months of the year. After exiting Avalara following their acquisition, we made a new investment in Veeva Systems (VEEV). VEEV provides cloud-based data, software, and services for the life sciences industry. As the existing market leader in customer relationship management (CRM) for sales reps in the industry, VEEV has leveraged this core business to expand into tangential markets, both moving into other areas for its existing customer base such as clinical trial execution, content/data management etc., as well as pursuing customers outside of the life sciences, like the consumer products & chemicals (CP&C) industries. We view VEEV as both a "Compounder" (its CRM business) and a "Shooter" (its higher growth, newer markets), with a savvy CEO who has been executing well since founding the business back in 2007.

We look forward to the year ahead.

Warm Regards,

Lucy & Nate

1/31/2023

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Appendix – Performance Since Inception

	Q4 2021	Q1 2022	Q2 2022	Q3 2022	Q4 2022	2022	Since Inception
Luna Partners	5.6%	9.5%	-39.1%	4.6%	8.1%	-24.6%	**-20.4%**
S&P 500	10.6%	-4.9%	-16.4%	-5.3%	7.1%	-19.4%	**-10.9%**
Nasdaq Composite	8.3%	-9.1%	-22.4%	-4.1%	-1.0%	-33.1%	**-27.6%**
Dow Industrial	7.4%	-4.6%	-11.3%	-6.7%	15.4%	-8.8%	**-2.1%**

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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