Dear Investors,

In Q2 2023, Luna returned -1.2% on net assets under management. This brings our year-to-date performance to 14.4%.[1]

**The Macro**

Despite the first half of 2023 being defined by the belief that a recession was a "when not if" scenario, the economy has remained resilient. Inflation continues to moderate, employment remains strong, and potential super-cycle drivers are beginning to emerge (e.g., A.I.). The Fed's determination to raise rates further (and the subsequent detrimental economic impact) continues to be the most prominent headwind for the market, but the reasons for more hikes are quickly dissipating. That being said, the bar for a rate cut is incredibly high, and outside of some type of disaster, we think cuts are a long way off. In the same vein of the 2020 Fed comment "we're not even thinking about thinking about raising rates," it's possible we hear a similar line regarding cuts in the near future.

The market and its participants (notably the business media) seem to be reaching the point of exhaustion in the long and ongoing exercise of trying to guess the Fed's next move. We share some of that sentiment, especially as it seems to be an effort with increasingly diminishing returns. When inflation was on the doorstep of double-digit growth, it did not require a PhD in economics to understand that rates were going to need to be raised. Now that prices are trending towards more normalized levels, the decisions the Fed needs to make are more nuanced and much harder to forecast. Even if you could see future economic data, it would likely not be enough information to predict the Fed's reaction. The decisions they make from here on out are less about economic impact and more about messaging. They would prefer the market not mistake the end of rate increases as the start of the next easing cycle. Leaving the door open to hikes in the future helps this effort.

We don't put a significant amount of weight into any one market commentator, but we do broadly review the prevailing opinions of equity strategists at the major US banks. Understanding generally how market participants at large are positioned and the fund flows each bank is observing helps shape our view on positioning within a cycle. While there were a few that called market moves with some accuracy 12-18 months leading into Q2'23, such as Michael Hartnett of BofA, almost all of them have been caught off-guard by the

[1] Net asset value calculations are provided by Interactive Brokers and returns are after expenses and fees. Clients should always check their individual statements for returns which may vary due to timing and other factors. Past performance is not indicative of future returns.

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equity rally that started in late March and has continued to power ahead. Some have moderated their views from imminent recession to be neutral or "range bound" while others like Mike Wilson of Morgan Stanley have doubled down on their recession expectations. The lack of consensus around market direction speaks to the confusion and uncertainty level many investors feel. At the core of this uncertainty is an observation; typically, rate cuts have not arrived until some sort of economic weakness has occurred. These occurrences can take many forms (housing / tech bubble burst, geopolitical crisis, banking failures, COVID-19, etc.) and have varying magnitudes, but there has almost always been a negative catalyst preceding rate cuts.

However, we can't help but sympathize with the recent positive shift in market sentiment. If growth hangs in there while inflation subsides and employment remains strong, the possibility of a "soft landing" grows.[2] The stock market seems to care less and less about what the Fed does (until it causes growth to slow, or disaster strikes). US GDP grew by an annualized rate of 2% in Q1 2023, and expectations are that it will be similar in Q2. Q1 2023 S&P 500 earnings were nearly flat QoQ and down ~3% YoY,[3] making most of the year-to-date stock market move multiple driven. Valuation moving ahead of earnings growth is a pattern many early bull markets exhibit.

**Our Portfolio**

While our bread and butter are emerging and established monopolies and oligopolies, we do have a small number of investments that we consider "transformer" situations. Transformer investments can take a number of forms, from turnaround stories to roll-up strategies. This category tends to be the hardest to execute on successfully. They usually require a contrarian view, confidence in management, and operational follow-through (among other factors) to turn into successful investments. Additionally, even if financial performance can be turned around, you also need other market participants to realize it for the stock to emerge from purgatory.

One of the investments we made last year was in Digital Turbine (APPS), which provides several advertising products and solutions to those in the mobile ecosystem. The legacy business was a very successful product that allowed device OEMs to capture a slice of application and brand advertising dollars when a new phone was sold. Starting 2-3 years ago, advertising dollars started shifting towards more productive channels despite the company's increasing penetration, causing the profitability and value proposition of the product to erode. This

[2] Interestingly, the economic term "soft landing" came into popularity in the 1970's, following the *Luna*-r landing in 1969.
[3] Source: Yardeni Research.

led the company to diversify its business model via two acquisitions in 2021 that expanded its reach in the mobile advertising stack. Management had a history of execution, and we felt these moves were prudent in helping re-invent the business and capturing ad revenue through a larger portion of a phone's lifecycle.

We were patient through the first few quarters of investing, but financial performance continued to decline as integration of these acquisitions faltered, and the company faced a difficult macro environment. Headwinds included declining new phone sales (specifically Androids), declining marketing budgets, and more selectivity in how those marketing dollars were spent. A growing disparity between management's commentary on ad spending and trends in third party data started to emerge, giving us some pause. While the acquisitions may ultimately bear fruit, the company's focus has become more fragmented as it encounters challenges to a critical patent and has indicated further interest in diversifying its business. Given these challenges, we chose to divest the holding completely in Q2.

The lessons learned from investments that don't go as expected become clearer the more time that passes. A deeper post-mortem is ongoing, but preliminarily, there are a few takeaways. Some of these are big-picture lessons while others are more nuanced, but all are important learnings we can incorporate into future analyses. Big picture, there is the common trope about the likelihood to cut oneself while trying to catch falling knives. While topline growth was still positive when we invested, financial performance was deteriorating, and the stock price was making the market's disappointment clear. Choosing to wait and invest when glimmers of turnaround success started to shine through would have been more prudent. The other high-level lesson that we had studied but hadn't internalized to the extent we should have were the risks associated with "transformer" investments. The reason some of the best performers come out of this category historically is because the risks are the highest, and most companies that end up in these situations don't turn it around.

When looking at this investment more granularly, there were also many takeaways. Given the higher level of risk of "transformer" ideas, sizing these ideas accordingly is important. Keeping these in the 3-4% range or smaller limits the loss potential while giving us sufficient exposure if the turnaround is successful. We were guilty of "anchoring bias" in the early days of the investment, both in terms of the price we paid and the importance we placed on the different parts of the business during the diligence process. We entered the investment when shares were well off their highs thinking we were getting a relatively good price. As it relates to our diligence, we liked the legacy business but didn't appreciate the dramatic change the M&A would have on the company's offerings and earnings capabilities. We had a propensity to fit the data we were seeing during the transformation to the story and thesis we built initially. An objective analysis would have likely revealed the underlying struggles. This was magnified by the lack of quality company KPIs and our inability to find third-party or higher frequency indicators to map their performance to.

The deeper post-mortem will likely reveal more, and we intend to make the appropriate adjustments to avoid the decision making that led to this investment in the future. The review of our mistakes is critical as we continue to master our craft and understand the predispositions we bring to our work. One of the beauties of investing is that while some ageless principles exist, the environment is ever changing and requires continuous learning and observation to be successful. The evolution of markets will never end, but the most painful parts of the journey are when a learning point has to be achieved at the cost of capital. Nonetheless, we remain steadfast in our pursuit to become better investors – through every success and every mistake.

As the year unfolds, we look forward to keeping you updated on our progress and remain grateful for your support.

Warm Regards,

Lucy and Nate

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**Appendix – Performance Since Inception**

| | Q4 2021 | CY 2022 | Q1 2023 | Q2 2023 | YTD 2023 | Since Inception |
|---|---|---|---|---|---|---|
| **Luna Partners** | 5.6% | -24.6% | 15.9% | -1.2% | **14.4%** | **-8.9%** |
| S&P 500 | 10.6% | -19.4% | 7.0% | 8.3% | **15.9%** | **3.3%** |
| Nasdaq Composite | 8.3% | -33.1% | 16.8% | 12.8% | **31.7%** | **-4.6%** |
| Dow Industrial | 7.4% | -8.8% | 0.4% | 3.4% | **3.8%** | **1.7%** |

Note: Equity market returns above based on underlying index prices. Index prices are sourced from Koyfin. 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' inception date is October 1, 2021. Luna's 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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