



Dear Friends and Investors,

The Massif Capital Real Assets strategy returned -14.9% net of fees in the second quarter of 2022. Year-to-date, the strategy has returned -3%.

### Trailing Returns (%) – Annualized (except YTD)

Geometric average, net of fees and fund expenses

	YTD	1 Year	3 Years	5 Years	Inception (June 2016)
<b>MASSIF REAL ASSETS STRATEGY (NET)</b>	<b>(3)</b>	<b>11</b>	<b>18</b>	<b>8</b>	<b>8</b>
COMMODITIES <sup>2</sup>	18	24	14	8	6
INFRASTRUCTURE <sup>3</sup>	(1)	3	2	3	2
MLP'S <sup>4</sup>	10	4	0	(0)	(0)
S&P GLOBAL NATURAL RESOURCES TR	(2)	2	8	8	9
S&P 500 TR	(20)	(11)	11	11	12
MSCI AWCI NR USD	(21)	(17)	4	5	7

It was a challenging quarter. Our returns mirrored those of the market, although most of our losses were concentrated in the portfolio's materials exposure. Our tail risk hedge has not provided relief, which is roughly in line with expectations given the pace of the S&P 500 drawdown, with volatility remaining relatively calm. We continue to maintain the hedge at 100% of the value of our long book for a cost of less than 2% (annualized) of our portfolio's net asset value. Given the market environment, we favor patience in capital deployment, maintaining a high cash balance, and decreasing our net exposure selectively during market enthusiasm.

### HUMILITY TOWARDS FUTURE OUTCOMES

*"Jamie, [you] said a hurricane is on the horizon, but...I mean, it's like you're acting like there are sunny skies ahead; you're out buying kayaks, surfboards, wave runners, just before the storm. So is it tough times or not?"*

*–Analyst Mike Mayo, Managing Director of Wells Fargo Securities in conversation with Jamie Dimon, CEO JP Morgan Chase on the second quarter 2022 earnings call*

This is a fair question and encapsulates the most significant gap in recent memory between current economic conditions and the consensus expectation of future conditions. Jamie's response describes current conditions: "[C]onsumers are in good shape...jobs are plentiful. They're spending 10% more than last year, almost 30% more than pre-COVID. We've never seen business credit be better ever in our lifetime." Unemployment in the United States is very low, and job openings are high. At the same time, CPI just printed above 9%. It would be hard to describe this picture of the economy (albeit a narrow one) as

anything but strong. Strong to the point of overheating, perhaps, but strong nevertheless.

The back half of the yield curve is signaling something different, tilting heavily towards a belief that consumer prices have peaked, that an economic recession is all but guaranteed, and that the Federal Reserve (Fed) will be forced to relax and possibly pivot its posture on tightening financial conditions before the end of the year. Equities have been in a bearish mood all year, beginning with multiples contracting as the Fed started to raise interest rates, followed by the expectation of a severe earnings contraction based on producer cost inflation and decreased consumer demand as buying power erodes. In the coming weeks, we would not be surprised to see equities turn bullish as longer-dated treasury yields tilt in the same direction. This is the “things are getting so bad; corrective measures will have to be put in place so things will be good” thesis. There is a mountain of evidence supporting this hypothesis.

The inventory overhang in durable goods is daunting, the survey of manufacturing new orders is collapsing, consumer sentiment is at record lows, and small business indicators are plummeting. The rolling four-week average of gasoline demand in the U.S. sits at 8.06 million barrels daily, the lowest seasonally since 1996. Global liquidity is also tightening dramatically. There are no central banks in the world that are easing conditions right now. A rolling six-month measure of the U.S. dollar monetary base — a composite metric made up of the Federal Reserve Balance sheet and the stock of dollars held worldwide — has contracted 20%, the sharpest drop in at least 20 years.

A higher dollar has put pressure on commodities, which have subsequently pulled back — in some cases considerably — from 2021/2022 peaks. Many now point to falling commodity prices as further evidence of decreasing demand, adding to the expectations that inflation is subsiding. The assumed response is that central banks will be a core member of the firefighting team during the recession and will have ample legitimacy to loosen financial conditions in the face of collapsing inflation. A recession is not only consensus; it forms the core of the bullish position that the Fed will pivot sooner rather than later.

We tend to agree with the data pointing towards a recession in the Western world and are dully concerned with the path many emerging markets and pockets of Asia appear to be on. We are not convinced this neatly outlines the timetable for a pivot by the Fed nor the chain of events and relationship of asset prices that financial markets will be tempted to expect.

**The zeitgeist most at risk for a rug pull is that the Fed will quickly pivot.**

We are less concerned about a gap between current economic conditions and the consensus expectation of future conditions and more concerned with future conditions coalescing around a precisely incorrect consensus. Below are three points for consideration:

1. A growth slowdown does not necessarily mean an inflation slowdown, and Fed Chairman Jerome “Jay” Powell is hyper-focused on inflation. That may come at the expense of providing an accommodative policy during a recession.

2. Policy responses (fiscal or monetary) provide little relief to problems of structural inflation, a root cause of this crisis. This suggests that today's concerns may persist, and *inflation volatility* will become a dominant concern over simply high aggregate inflation.
3. The risk of inflation transmitting across borders is significantly higher today than in historical periods of high inflation. This remains underappreciated.

**Point #1:** The Fed has been adamant about watching prices in recent meetings. Inflation is a lagging indicator. There is a real problem with hiking rates until CPI breaks, which looks like the direction we're headed. Cyclical, like housing and durable goods, only constitute ~10%–15% of GDP, but the swings are important as they account for the variations between growth and recession. The problem is that it is not clear that Jay Powell is looking at growth and recession indicators. He appears to be focused on prices. Is it possible there is too much inertia in inflation here? What if the only achievable, or eventual, path is to tighten beyond expectations? Are high single-digit nominal interest rates required?

Pandemic consumer goods demand certainly appears to be collapsing (durables, freight, retail) with reverberating impacts back up the supply chain. However, consumer discretionary demand is still \ hot (airlines, restaurants, lodging). Additionally, depending on the time horizon, inflation embedded in rent and wages is very sticky and may result in the even stickier inflationary psychology among consumers. *A growth slowdown does not necessarily mean an inflation slowdown.* This might not be intuitive to the average U.S. citizen but ask anyone in South America.

Many might also assume that commodities cannot rally in a recession. This is also incorrect. A look at the 1973, 1980, and 1990 commodity-induced recessions proves otherwise. Until we see politicians arguing more about the housing market and the S&P rather than inflation, the Fed may very well keep hammering financial conditions tighter until inflation subsides. The bond market is pricing the Fed to start cutting rates in April 2023. This appears to be encapsulated by the premise that "they will have to, as crashing forward economic indicators turn into reality."

The Fed doesn't have to, particularly if pricing concerns remain while the economy slides into recession.

**Point #2:** The last several economic crises came from exogenous forces unrelated to inflation and were thus "curable" with Q.E. (and more recently, Q.E. + fiscal stimulus). Monetary policy can inject liquidity into the financial system, so there are enough dollars to refinance the debt burden, and fiscal stimulus can boost spending.

The current crisis is different because structural inflation is the *cause* of the problem. As such, it cannot be addressed with liquidity injections — either in the form of collateral or currency. Play out the scenario in which we are incorrect with our statement above, and the Fed responds quickly to a recession or falling financial assets. Inventories of metals continue hitting new lows, even as prices continue to fall, and there is little in the way of capital expenditures spending geared towards bringing on new mines. Resurging demand will make many metals go vertical. The policy solution set of the last ten years

will not resolve malinvestment, the shift from globalization to regionalization, or the drive toward lower carbon energy systems.

Inflation will not be persistently high. The fact that we will see a decrease is not news. It is math arising from adjusting base rates. Absent solving the structural issues, we will see volatile inflation. Large swings in price can be problematic as they will distort the information contained within that price signal. This makes it very difficult for producers and consumers to decide about future production and consumption. There is a reason why the Fed has a mandate for price *stability* — even if you want to gripe about the level at which that should be.

**Point #3:** While a recession in the U.S. appears in the cards, Europe is looking at a potential economic disaster driven by energy, specifically natural gas. The potential for inflation to transit borders with trade needs to be considered.

Diversification is often said to be the only free lunch in equity markets. It is also fair to suggest that diversification is a pillar of resiliency, making it essential for other complex systems like power grids. Suppose an electrical grid has too much of any single source of power. In that case, it is likely a system leveraging concentration efficiency (and thus margin expansion from economies of scale at some point in the value/production chain) to the detriment of resilience. We have written about this concept before, specifically regarding the need for utility business models to evolve so that resilience is better compensated for.

Europe has made a significant trade-off that started long before the Cold War ended but has accelerated and become entrenched in the 30 years since the end of that conflict. Energy diversification, especially in Germany, was sacrificed for expediency, efficiency, and out of a theory that economic engagement with Russia would produce political liberalization. This theory is not without logic, but it has, unfortunately, proven incorrect in this instance.<sup>i</sup>

We could discuss this same flaw regarding the China and U.S. relationship, but the Russia-Europe situation seems more immediately pressing. Twenty-four percent of Europe's cumulative installed power generation capacity comes from natural gas. This has been relatively consistent for the past 20 years.<sup>ii</sup> While capacity has remained constant, power demand has not. In 2000, 11.8% of the E.U.'s produced GWh of electricity came from natural gas; in 2020, 19.4% of GWh of electricity generated came from natural gas. So, while the capacity has remained stable, the demand for natural gas as a cornerstone of the continent's power consumption has doubled. In that context, the reliance on Russia has only increased, and there is little that the continent can do about it in short- to medium-term. Power sources have time to build problems, especially concerning the sources of power tied to continent-wide electrical grids.

Depending on the time of year and the region, Europe consumes between 35 to 80 bcf/d of natural gas and produces only 20 bcf/d. Thus, the E.U. has a shortfall of anywhere from 42% to 75% of its daily natural gas needs that must be made up via imports. Europe has three choices for imports: Russia, Africa, and Liquefied Natural Gas (LNG). Imports from Russia have, of course, been falling and may fall further. President Vladimir Putin, for all his apparent ham-handedness regarding his invasion of Ukraine, remains a clever operator well versed in how best to apply pressure to areas of weakness.

Fragmentation of the current European unity regarding Russia remains a possibility. It is hard to believe splintering the consensus is not a primary goal of Mr. Putin.

Europe is receiving roughly 5.3 bcf/d of Russian gas via pipeline. By comparison, last year, Europe received 13.7 bcf/d. The opportunity to make up the difference via Europe's other two natural gas import options is nonexistent. Africa, specifically Algeria, Tunisia, Libya, and Morocco, all have gas pipelines flowing into southern Europe. While all these pipes appear to be flowing below capacity, it is not clear that there is spare natural gas to ship out of the North African region. Even if there is, it will not change the overall deficit picture created by Russian export intransigence meaningfully.<sup>iii</sup>

This leaves LNG import capacity. Amazingly, Germany, which some might say is the most exposed country in Europe to natural gas prices, has no LNG import infrastructure. Spain and Portugal have the most but limited interconnection to the rest of Europe. France, Italy, and the Benelux countries (Belgium, the Netherlands, and Luxembourg) are all reasonably well positioned, but not in the presence of a 61% fall in delivery via pipe gas from Russia. This is currently adding up to punishingly high energy prices in Europe.

Russia has ramped down supplies when demand is on the wane. However, a hot summer is producing increased demand relative to history. Building up supplies for the winter is getting complicated; with tanks roughly 60% full, the goal of 90% by October looks near impossible, barring a boost of supply from Russia.

LNG cargoes have been easier to pick up in the last six months than expected, as Chinese LNG imports have faded with rolling lockdowns. Depending on the evolution of zero-COVID policies, regular access to LNG that would have gone to China may not be easy. Either way, competition for LNG looks set to increase over the period it takes to adjust energy sources for an electrical grid, even if Europe can attract LNG flows away from Asia in the second half of this year.

But why is this a concern, or, more specifically, why is this more of a concern than the market may be giving it credit for? The answer lies in the potential for spillover of widespread economic collapse in Europe to other countries. For example, energy price inflation is a significant component of U.S. CPI. The U.S. has become a critical LNG supplier to Europe. European LNG prices and demand are drawing U.S. gas supplies and pushing LNG export terminals to run at maximum utilization. On June 9, there was a fire at Freeport LNG's export terminal. That terminal consumes about two bcf/d of natural gas for export as LNG, or roughly 20% of U.S. LNG exports. That fire represented the local peak in gas prices, which have since sold off by approximately 27%.

Commodity prices are set at the margin. While two bcf/d of additional supply available domestically with the shutdown of Freeport LNG only represents about 2% of total U.S. capacity, that is more than enough to impact price significantly. The transmission via trade does not stop there. Take, for example, U.S. imports from Germany, which in 2021 was America's fourth-largest trading partner. In 2020, Germany exported roughly \$27.3 billion of chemicals to the U.S. In the current environment, those chemicals, critical building blocks, or at least an input, into almost everything, are more expensive because of energy costs, so they are inflationary.

As energy becomes more expensive, chemicals out of Germany are not just at risk of becoming more expensive but might stop flowing altogether. Sources in the European fertilizer trade recently told Bloomberg Green Markets that there are whispers BASF is planning to shut down its main facility in Germany (source of roughly 20 billion pounds of chemicals per year) if natural gas prices don't come down.

A shutdown of one of the world's most extensive chemical manufacturing facilities would create an inflationary pulse that is not confined to the German border. In the U.S., it would make itself felt as yet another supply shock, another inflationary pulse. This pulse may be less significant than others, and it may not overwhelm the deflationary pulse arising from future inventory liquidation of retailers, but it would have an impact.

The 1970s are frequently looked at as a period from which lessons can be learned about inflation. However, since 1965, the value of global trade, as measured by the ratio of export value over global GDP, has risen from less than 10% to roughly 25%. With this rise in interconnectedness comes a new transmission mechanism through which inflation or deflation can run.

## **A DEEPER DIVE INTO OUR SHORT BOOK**

Since inception, we have maintained a short book but have found the opportunity set limited. Consequently, the book has been on the smaller side. Our previous peak in short exposure was roughly 20% of the portfolio immediately before the COVID correction in March of 2020.

Failing to maintain a sufficiently sized short book coming into this drawdown has left money on the table. Some shorts, such as the narrative-driven clean tech companies we have long believed were built on smoke and ideal for shorting in a falling market, fell so quickly that we mostly missed those opportunities. Other pockets of the market are proving more resilient (in essence, falling slower than our ability to do due diligence), but it does appear that we have missed out on many of the easiest short-side returns. This is especially true if we are in the middle of a cyclical bear in the context of a secular bull trend, but perhaps not if we are in the midst of a cyclical bear in the context of a secular bear trend.

We are diligently working to correct this portfolio misstep and have built our short book back to roughly 20% of the portfolio. It remains undersized, offsetting only 2% of our unrealized losses on the long side during the second quarter of 2022.

We are currently cash-heavy, at only 55% invested, down from 75% at the end of the first quarter, primarily due to the 15% sell-off in the value of the portfolio relative to the cash we held at the time of the conversion to the fund (roughly 25%). If we take our existing positions to our desired portfolio allocations, we will again be at 75% invested, leaving room for four new positions on the long side at 6% each.

Our net exposure is currently 35%, and we are likely to focus on bringing that down to zero in the near term, such that when we make the decisions to both average down into our existing portfolio of long positions and add new positions, we will have a gross exposure of 154% and a net exposure of 44%. Given our macro-economic outlook and

its dramatically divergent outcomes, we believe this is a healthy operating paradigm for our portfolio. **That being said, we will continue to take things a day at a time and acknowledge that, unlike on the long side, on the short side, we are much more at the mercy of the market.**

As we look to grow our short book to a more appropriate long-term operating cadence, it seems prudent to outline our short framework.

**Structural Shorts:** Short positions with holding periods of one to three years. Target companies with business model issues, structural changes in the industry, financial irregularities, changing competitive landscape, abnormally high valuations, and common negative catalysts. Two general flavors in our experience:

- **Unsustainable Operating or Balance Sheet Leverage:** Debt Issues (covenant breach, credit downgrade, zombie company, etc.) and declining value of assets financed by debt (especially when asset cashflows are also falling).
- **Technological Obsolescence:** The pace at which a firm's asset base depreciates may not be fast enough to offset technology risk to the business. Pricing power and moats may be at risk.

**Tactical Shorts:** Shorts with a holding period of two years or less. Target companies with peak operating margins on top of cyclical resources, peak-to-trough corrections, macro trend, momentum, and sympathy trades.

- **Cyclical Myopia:** The presumption of secular trends in a cyclical business and the extension of those trends at cyclical peaks.
- **Narrative-Fact Divergence:** Strong divergence between the reality suggested by the facts of a situation and the sentiment and narrative the market participants are telling themselves.

To the degree that we can still find them, narrative fact divergence opportunities are a potential opportunity. Still, as a category, the longer the downturn in the market, the fewer opportunities of this nature we expect to see, as these types of businesses tend to re-price early in corrections. Our experience has also been that these are some of the trickiest shorts, as the underlying companies are often understood by the market purely through management stories about the business's future. Untethered from any fundamentals, the spin can keep the stock prices of such companies afloat longer and at higher prices than one usually envisions.

The purity of the narrative element underlying the security pricing means that narrative-fact divergence shorts also critically require careful risk management via hedges, as they are the most likely type of short to go against you in a punishing way. This requirement complicates the short, as rarely do companies that fall within this category have a robust options market that enables cost-effective hedging. Additionally, these shorts are usually relatively obvious, resulting in significant short herding and, thus, an expensive cost of carry. These variables mean the timing is critical, yet we have not figured out the timing.



Technological obsolescence shorts are difficult to evaluate. In some regards, technological obsolescence is a category of short most dependent, counterintuitively, on a positive economic backdrop, as it is the corporate manifestation of Joseph Schumpeter's theory of creative destruction. For something to be obsolete, something must be better to supplant it. While creative destruction and progress are by no means confined to positive economic environments, they are often found there.

In our current thinking, we aim for our short book to accomplish two things. The first is to deliver a single-digit return to the portfolio, ideally 5%–7% per annum. Additionally, we would like the short book to neutralize some of the counterproductive factor exposure embedded in our long book. Please do not read into this hoped-for outcome that we will pick companies to short based on factors; we will not. But we will aim to find companies that can meet the hurdle to go into the portfolio and also happen to help minimize unwanted factor exposure.

We have made it a practice of not discussing names since the first short report we published was picked up by *Barron's* back in 2018. We did not care for the exposure the publication brought but will describe the industries and the high-level reasoning behind some of the shorts. We have shorted two U.S. transport and logistics companies, totaling 6% of the portfolio. These are both macro trend shorts, with the immediate-term return driver being the market's negative trend and the medium-term driver being negative domestic economic expectations impacting both firms' business operations.

We have also shorted agriculture chemicals as a cyclical myopia style short on the basis that peak margins have been achieved and that companies will fail to meet market expectations in the future. Our sole narrative fact divergence short is a 3% short in the clean tech space. If we return to a risk-on environment, we will exit this position quickly. The underlying company price is determined by narrative, even though the value is close to zero. We envision the return of a risk-on environment requiring the Fed to reverse course on interest rate hikes. Still, we would add that although a Fed reversal is probably necessary, it may not be sufficient on its own, depending on the economic backdrop and the degree to which the economic environment is coloring the market's forward-looking outlook.

Finally, we are short an independent power producer, an unsustainable operating/balance sheet leverage style short. This firm is attempting to execute a massive build-out of its operational base with a timeline that would be challenging in the best of situations, a balance sheet that makes perfect execution essential, and an inflationary backdrop that makes cost predictions difficult. This independent power producer is the type of opportunity we see a lot more of recently and the kind of opportunity we expect to be more prevalent in the future, assuming the Fed holds course with interest rate hikes.

We are currently exploring short opportunities in battery metals, especially any which would complement our battery metal longs. These would fall within the cyclical myopia-style short basket. We are also exploring shorts in civil engineering and construction, which would be macro trend or unsustainable operating/balance sheet leverage style shorts, depending on the company.



## **LONG BOOK**

The decision to bring down our long exposure in March — albeit in the presence of pivoting to a fund structure — was a market call.<sup>iv</sup> We are reluctant to highlight it but think it warrants mentioning. It is not typically what we do. We do not invest based on market timing, but in the last few years have made two market calls (the other was to not reestablish our short book following the depths of the 2020 COVID market). The thrust behind the market calls was less about a high-confidence expectation about what the future held and more about high conviction in the idea that almost anything could happen next. So rather than make a market call based on high confidence in a specific future, we made a market call based on a high conviction in uncertainty.

In the case of 2020, the market ripped up so hard and fast that expecting to be able to generate strong alpha on the short side seemed borderline arrogant. As such, we tilted in favor of a portfolio that generated high alpha on the long side. In March of this year, the situation was slightly different. The market seemed capable of moving in either direction, so the response was to bring down market exposure by 1) not rebuilding the long book fully and by 2) growing the short book. As we look to the next few quarters, we maintain our belief that there is a high degree of uncertainty about the markets. As such, we expect to continue to tilt in favor of bringing our net down to 0%, resulting in the portfolio representing a cleaner expression of our stock picking, with more limited directional exposure.

## **CLOSED POSITIONS**

During the 2<sup>nd</sup> quarter, we exited three positions: RWE, Star Bulk (SBLK), and Global Ship Lease (GSL).

RWE was a position closed out earlier than we would have liked. Management changed their capital allocation strategy, leaving us with few options. Although they had done an excellent job shifting the company from a coal and nuclear-based utility to a leading European renewable power producer, they have committed themselves to doing too much in the coming years.

The business had been shifted from a real asset business growing at a comfortable pace that was not imperiling the balance sheet or heavily reliant on outside capital markets for funding to a high-growth company with long-term negative cash flows and massive capital expenditure commitments. In short, it is unclear if management recognizes that they may make themselves economically unsustainable in pursuit of environmental sustainability. It has become very unclear to us whether management will be able to execute on the development they have penciled in and informed the market of. Furthermore, the cost expectations seemed risky, with commitments likely to imperil the balance sheet rather than grow the asset base prudently.

The management team has set the firm on a course to grow and invest significantly, but they have developed a course that risks value destruction rather than value accretive growth. The gross cash investment the firm expects to make between now and 2030 is 50 billion euros, and the investment penciled in for the next two years is roughly 3.2 billion euros, meaning management foresees a significant backloading of capital expenditure in the latter half of the decade, as they aim for a smooth 5 billion euros a year in

average investment. If the firm could maintain a high cash flow from operations they experienced in 2021, this level of expenditure might not be a problem, in theory, but it would still be financially tight.

The year twenty-twenty-one was buoyed by solid returns from the firm's trading segment, a source of funding we consider far from reliable. This is not to suggest that the trading arm won't have further successes, but it is far from the quality revenue stream on which one wants to build significant capital commitments. From our perspective, over the next ten years, RWE is unlikely to produce any free cash flow to the firm, even while the assets they build have the potential to deliver significant free cash flows in the 2030–2050 period (assuming investment declines during that period).

At the same time, the balance sheet is becoming concerning. Debt has reached 157% of equity, up from roughly the 30% level when we first invested at the start of 2020. Debt as a percentage of capital is now 61%. CFO/Capex has been negative for several quarters, and the firm's Altman Z score has been trending down sharply. This is not a suggestion that the business will go bankrupt but rather an indicator that a period of prolonged financial stress is ahead.

Capex as a percentage of sales has increased to 15%, but current spending does not appear to have peaked yet. Management believes they can offset a big chunk of forward-looking Capex with asset rotations (selling pieces of renewable developments to outside organizations), but it is not clear that such a claim can be taken seriously. Returning to the 2020 investor day presentation, management expected \$2–\$3 billion of asset rotation proceeds to reduce the capital expenditure burden between 2020 and 2022. Given that there have been few times better in history to sell renewable assets in Europe (the market was red hot), we are uncomfortable that RWE management failed to sell any, despite that stated intention.

Overall, RWE was a good investment with a slightly disappointing outcome. Money was made, but not as much as we envision could have been made. In our opinion, the firm has become caught up in the excitement of the renewables and green trend that occurred in 2021 and, unfortunately, deviated from an economically and environmentally sustainable path to a much less-certain one.

In addition to RWE, we exited our two shipping positions, GSL and SBLK. We exited GSL with a loss of 16% and SBLK with a gain of roughly 31% in less than a year. We like both companies' management teams and the macro backdrop for SBLK, so why did we exit both positions?

SBLK has a straightforward explanation. We entered the position as a capital return opportunity; we wanted to buy the dividend stream for as long as the capital position seemed secure. In total, we collected \$5.6 of dividends per share in 10 months on \$22 in capital at risk per share. This is a reasonable risk/return spread in our books for a capital return opportunity.

With the shift in market sentiment and economic narrative tilting toward recession, the capital deployed in the position was at significant risk in a way that the strong dividend would not compensate for. We like the shipping industry; it is a fascinating industry with significant volatility (which we like) and a useful link to the real economy that makes

tracking the industry informative. But in the portfolio, shipping firms are businesses we date, not businesses we marry.

The sale was a portfolio protection decision. We might miss out on a robust dividend for a few quarters, but we also believe, given the economic backdrop, we may miss out on a punishing fall in the equity. The order book for dry bulk remains very favorable; combined with fuel spreads and management, SBLK looks particularly attractive to us, but not at the current prices in the current environment. We may re-engage in the future.

We entered GSL in October 2021 based on their extensive contract cover on growing rates in a tight containership market. We believed it was trading at an 80% discount to 2022–2023 earnings and that the market would give credit for this contract coverage once it demonstrated a few more quarters of sustained cash flow. Our business assessment proved correct over the subsequent three quarters, with the firm posting phenomenal cash flow and impressive contract coverage through 2023.

During the first quarter and into the second quarter of 2022, we became concerned that the market was less interested in the volume of cash flows today and more focused on the future directionality of cash flow. In the past, we have made the mistake of holding onto businesses that appear to have significant value relative to their equity prices based on contracted cash flows, but where the market is pricing in cash flow deceleration (Graftech). Needless to say, it went wrong. We wanted to avoid a similar situation this time around.

## **NEW POSITIONS**

**Ionic Rare Earths (IXR AU)** is an Australian company implementing a strategy to become an integrated Western supplier of value-added rare earth products. The company's unique advantage is its Makuutu deposit in Uganda, one of the largest ionic clay deposits outside China at 315 million tons of resources drilled out since 2017. The announced acquisition of Seren Tech in the U.K. adds midstream and magnet recycling intellectual property to Ionic's integrated downstream strategy. The potential is to leverage primary supply from Uganda with recycling and third-party materials to become a western supplier of value-added products.

Similar to nickel and uranium, we have patiently waited and watched for an opportunity in rare earths. The macro setup, like several other energy-related metals we have profited from in the past, is similar: demand for raw materials (NdPr and DyTb) and magnets is growing faster than supply, but we had to wait for the right company, and Ionic appears to be that company.

One of the reasons we like Ionic is the firm's exposure to heavy magnet rare earth dysprosium (Dy) and terbium (Tb). The main application of heavy rare earth minerals is adding heat resistance to permanent magnets and improving the resistance of the magnets to demagnetizing conditions. Heavy rare earth metals are especially important for high-performance applications such as wind turbines, E.V.s, and aeronautical equipment. The supply chain for HREEs is dominated by ionic clay production from China and Chinese-owned operations in Myanmar. Chinese and Chinese-owned output represents

90% of global HREE production, even more concentrated than their collective 70% share of LREE (Lite Rare Earth Elements) production (including Nd and Pr).

Makuutu is one of the few HREE-enriched projects with 3–4x the typical Dy and Tb assemblage compared to hard rock projects such as Lynas’s Mt Weld or M.P. Material’s Mountain Pass mines. Among the notable HREE projects we are tracking, Makuutu has the most attractive combination of size, simple metallurgy, and infrastructure. In April 2021, Ionic signed a non-binding MOU with Chinalco and its subsidiary China Rare Earths Jiangsu, outlining potential technical support and offtake. However, Ionic retains the option and intention to pursue a Western-aligned development path.

Prices today likely reflect at least a “new normal” — a permanent shift up and to the right. Even with pricing signals, suppliers will either be unable, less willing, or incur long lead times to bring new supply to the market, given some of the complex nature associated with mining and permitting these deposits. Many deposits have radionuclides — particularly in the West — and miners need permits for Thorium, which can take years. Energy Fuels is an interesting company in that regard, given its ownership of such a permit and the theoretical optionality this provides. Ionic will likely build slowly in our portfolio, but we expect an asymmetric return in the fullness of time.

Our final addition to the portfolio this quarter is *Keppel Infrastructure Trust (KIT)*, a Singapore-based holding company that owns infrastructure assets that it “leases” out via the rough equivalent of triple net leases. The firm owns significant portions of critical infrastructure in Singapore, including 100% of the city’s natural gas pipeline infrastructure and a substantial share of the city state’s water, waste and electricity infrastructure. The firm also owns chemical production infrastructure in Australia and the largest oil storage assets in the Philippines. Finally, the firm has acquired a stake in the Saudi Arabian Natural Gas Pipeline company, which owns the natural gas pipeline infrastructure of the kingdom.

This trust has long been managed sleepily, with management incentivized not to shake the boat. That changed in 2021 when the board put a new management team in place and reworked the team’s incentive structure, such that they are compensated based on distributable income and increases in distributions per unit rather than income. Management has ambitious plans to expand the asset base and grow the distribution per unit. In a roaring bull market, KIT would likely not make it into our portfolio; although we expect to achieve our hurdle rate via a combination of capital return and portfolio appreciation, we don’t expect much more than that. It is, in our opinion, a stable and safe place to allocate capital in an inflationary environment and much cheaper (and more interesting) than other publicly traded infrastructure assets.

Take, for example, Brookfield Infrastructure (BIP). If we evaluate both KIT and BIP based on each firm’s respective FY2021 EPS and dividend, as well as assuming the same 4% discount rate with the same long-term growth rate, we find that KIT is slightly undervalued while BIP is 71% overvalued. Admittedly, some might argue the risk profile of KIT is higher than the risk profile of BIP, but we would disagree, believing any argument about the political risk of KIT vastly overstates the potential impact of political risk on cash flows. One of the challenges with publicly traded infrastructure has always been the premium placed on the earnings or the yield; we have long found infrastructure cash

flow stability to be dearly purchased. In KIT, we believe we have found a collection of infrastructure assets that have been mispriced, a rare occurrence in the slow-moving infrastructure world.

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As always, we appreciate the trust and confidence you have shown in Massif Capital by investing with us. We hope that you and your families stay healthy over the coming months. Should you have any questions or concerns, please do not hesitate to reach out.

Best Regards,



WILL THOMSON



CHIP RUSSELL

## ENDNOTES

- i Note that we do not critique this theory overly harshly, in different context it is a theory that has played out. The theory of economic engagement should not be abandoned across the geopolitical landscape because it has proven so incorrect in regards to Russia and China, what should be abandoned though is the startling lack of thesis reassessment. The US State Department, and European Ministries of Foreign affairs have been painfully slow to refresh their thesis. In the portfolio of positions these organizations have, they have allowed theories to go stale and allowed bilateral relations with autocratic regimes to tilt in their favor.
- ii In 2000 natural gas represented 20.92% of capacity and in 2020 it represented 23.94%.
- iii There is actually a fourth route for piped gas into Europe, the Trans Adriatic Pipeline from Azerbaijan via Turkey, but its capacity is 1 bcf/d and it is running at full capacity.
- iv We would note that we, apparently, were not the only people to deploy this strategy, a presentation from Philippe Laffont's Coatue Management that we were passed highlights that they brought their gross exposure down from ~130% to 23% in a single quarter. Given they manage roughly \$70 billion, we think that is an impressive reshuffling of a portfolio in a single quarter.

## DISCLOSURES

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