



Dear Friends and Investors,

The core portfolio for Massif Capital was up 7.7% net of fees during the third quarter of 2021. Year-to-date, the portfolio has returned 14.9%.

### **Portfolio Attribution<sup>1</sup>**

On an absolute basis, the 7.7% return is in the top quartile of quarterly returns since our launch in 2016. On a relative basis, the portfolio beat the S&P Global Natural Resources index by 12%, the second-largest outperformance of our benchmark since inception, trailing only March 2020 when we outperformed by 37%.

Our annualized alpha since inception ticked up to an all-time high of 6.4% against our benchmark (beta of 0.3%). Against a broader market index (S&P 500), results are similar, with an annualized alpha of 6.3% (beta of 0.1%). The high alpha is in large part being driven by the extremely low beta of the portfolio.

The portfolio's performance in the third quarter was driven by Lithium America's, which contributed 5.3%. Two other mining firms, Kazatomprom and Adriatic Metals, contributed 2.3% and 1.3%, respectively. Our two oil investments, transition leader Equinor and emerging pure-play market E&P Africa Oil, contributed 2.3% and 1.3%, respectively. Precious metals exposure in the form of event-driven investment Lumina Gold was our most significant portfolio drag, returning -1.2% to the portfolio, followed by a mix of energy and mining firms, none of which produced a drag of more than 0.75%.

Our short book contributed positively to the portfolio return for the first time in several quarters, contributing a combined 0.95%. This return was primarily a result of our timely short of an Australian iron ore mining firm and a gain, albeit minor, from our short on US railroads.

### **Hayekian Triangle**

*"The very same voices who argued that investment in gas supply has to stop as a climate policy tool now declare that it is inadequate gas supply rather than climate policy that is responsible for skyrocketing prices. While the current market tightness is primarily due to a robust demand it is a useful case study on how the economics of a supply restriction-driven transition could unfold. A well-designed, demand-focused climate policy would lower gas prices as better efficiency and renewables reduce gas demand. Trying to reduce consumption by restricting supply without changing the capital stock of heating systems and power plants that determine demand would hit the microeconomic reality of inelastic demand: In such a situation supply would have to be rationed by skyrocketing prices, leading to factory closures, energy poverty risk for lower income families and similar consequences whose social acceptance remains to be seen. The current market situation should refocus the policy conversation on reducing demand rather than artificially restricting supply."*

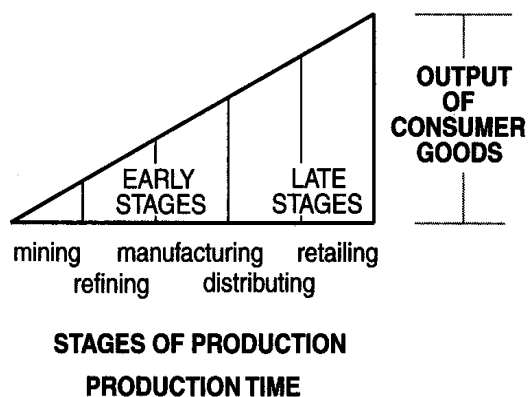
Laszlo Varro, VP Global Business Environment at Shell

We have echoed a version of this statement for years. Most recently [HERE](#), [HERE](#) and [HERE](#),

We're a bit hoarse from trying to get this point across. Why the shouting? Two reasons: first, we think industrial literacy is essential for an informed citizenry in particularly when we're looking to re-organize and re-build the energy and industrial sectors of the economy, what we refer to as the real-asset ecosystem. Second, it forms the basis of our opportunity set to invest productively in public markets over the next decade. The gap between expectations and reality of the rapid change possible in the real-asset ecosystem is wide right now, generating both unforeseen consequences and opportunities. Price shocks (up and down) are an important corner of the market for active investment managers who are paid not simply to ride a beta wave but place bets with an edge in complex markets.

Regarding price shocks, it has been a fascinating year in energy. In Texas, weather trumped human ingenuity; in the UK, shortages impaired supply and reliability; and in China, policy is suppressing economic activity in favor of environmental outcomes. All three situations foreshadow sequences of events we are likely to see repeated many times over as tensions between what is possible in the energy world, economic desires, and environmental concerns collide. The last thirty years have been a period of plenty when free markets could deliver stable prices or secure energy supplies, a rare occurrence from a historical perspective. This stability and reliability have been more critical than generally appreciated and may not be as readily present in the future as we might hope.

Neoclassical economic theory postulates that two factors drive economic growth: capital stock and labor supply, plus a third variable that remains challenging to interpret, referred to as total factor productivity (TFP).<sup>2</sup> In this model of the economy, energy is a product of economic activity, a product of capital stock, labor supply, and TFP. What is clear from this years' experience is that it is perhaps more helpful to think about energy as a *prerequisite* for economic activity. Labor and capital extract and utilize energy; they don't make it.<sup>3</sup> Energy services are not simply an essential part of the economy; energy services represent a critical input that drives the economy.



The Hayekian triangle is one way to highlight the path dependency of supply chains in the economy, all of which start with businesses in the real-asset ecosystem. In this framework, one can get a snapshot of the economy's value additive process, in which labor and capital are utilized through time and with the application of energy to deliver consumers a service of some kind. When one buys an iPhone, one is buying copper, aluminum, silicon, graphite, lithium, etc., that has been highly refined and stitched together

via the application of labor, capital, and energy. When conceived of this way, the criticality of energy and natural resources that form the substrate of economic activity are readily apparent.

All economic activity begins with physical materials and energy. The more economic activity that occurs, the more of both are necessary<sup>4</sup> and the larger each section of the triangle must become to support the section that comes after it.

We are currently witnessing widespread inflation in the cost of commodity inputs—the reasons are as diverse as the number of goods experiencing price increases. However, we feel comfortable suggesting that the widespread focus on the later stages of production has

come at the expense of thought, innovation, effort, capital, and labor in the early stages of production. Thus, it seems possible to suggest that certain forms of cost inflation within the real-asset ecosystem will be with us as long as investment in the early stages of production remains out of sync with the demands and constraints of later stages. One might conceive of this inflation not as a monetary phenomenon but as a poor capital allocation phenomenon.

To reiterate a statement we made publicly in September:

*While the science does indeed “unequivocally” point to societies’ role in climate change, we have yet to see any convincing evidence that the economic and policy response we have determined as the definitive path to follow is “unequivocally” good for us. Or, for that matter, will even unequivocally accomplish the goal. It seems readily apparent that the path outlined by governments and well-meaning management teams is one of unseen tradeoffs between objectives, environmental sustainability, and economic sustainability. If followed to their illogical conclusion, these tradeoffs will produce results unacceptable to large swaths of humanity and are thus unsustainable solutions. At Massif, we try to thread the needle between optimism and realism. We are optimistic that we will find investments that make incremental advances toward sustainable goals; frankly, investable advancements abound, in our opinion. We are realistic in our expectations about the impact of any single incremental advancement, that realism is grounded in constraints imposed by the complexity and difficulty of that task.*

## **The Portfolio**

We initiated one long position, one short position and exited one position during the third quarter. Our new long position was in Star Bulk Carriers (SBLK), a pure-play dry bulk operator with roughly 120 controlled vessels and 14 million tons of combined cargo capacity globally.

SBLK has one of the better management teams in the maritime shipping industry and the lowest cost structure among all dry bulk names. After announcing their new dividend policy in May, SBLK now has one of the best payout structures in shipping. The firm has paid out \$0.3 and \$0.7 per share in dividends for the first and second quarters of 2021. SBLK will most likely announce a dividend for the third quarter somewhere in the \$1.15-\$1.25 per share range, depending on movement in net working capital.

We believe the best way to look at this business is through cash generation potential and how much is returned to investors. The current equity valuation does not reflect current rates for shipping (earnings), partly because of the velocity of the move in rates and because shipping cycles turn, and it’s not clear whether this is a local top or the early innings of a multi-year cycle. Our belief is the latter. Part of our catalyst is the market re-rating the stock higher once the length of the increased earnings power becomes understood. It is a relatively strong catalyst in the sense that with a strong dividend policy, we can be patient for the market to underwrite this story as the cash is either returned to us via a high dividend yield if the market is either slow or chooses not to join our side of the trade.

Our estimates suggest a time-charter equivalent rate (net profit or loss of operating a vessel daily) of at least \$30,000 for SBLK in Q4, with the firm earning a potential annual average of \$26,000. Our base case is that this is a strong floor going into next year, with little need to articulate much more upside. If rates hold, which we expect them to do, we could see a 20+% annual dividend year next year for SBLK. If the market priced the equity such that the dividend yield was 8%, that implies a \$62 stock. Today our base case target for the firm is \$37 per share. This is likely conservative as we know that third-quarter rates are higher than the second quarter, and third-quarter dividends will most likely reflect that. We are cautious about diving too deep into the sensitivities to the upside with this position as

we are arriving at some pretty remunerative torque using current contracted values and seemingly conservative forecasts.

Sustained earnings are core to our thesis and need to be further explained. Problems arise in the dry bulk industry when aggregate supply overshoots demand from eager owners flush with cash looking to grow their fleet. We saw this in 2007-2008 and again in 2012-2013. Today, the overgrowth from 2013 has been worked through by demand growth and scraping. The order-book to total fleet ratio is at historic lows and is key to an upswing cycle.

Rates are high, companies are cash-rich, and the order-to-fleet ratio is bottoming. This is a unique situation, perhaps unprecedented. Are we making an error in initiating an investment here? Investment managers with tunnel vision on high earnings in a cyclical industry have been wrong-footed before (we've made that mistake). A couple of facts accompany this low ratio which makes the forward prognosis intriguing.

First, there is zero evidence the newbuild ordering is picking up. At the start of the year, the orderbook-to-fleet ratio was 7.8% for Capesize ships and 6.8% for Panamax ships. Historically, we have seen owners running to the shipyards as soon as earnings increase. Yet today (~8 months after the earnings started increasing), we see Capesize ratios at 5.9% and Panamax at 6.15%. The orderbook is contracting despite an increasingly cash-rich environment, which is highly unusual.

Why is this? Part of the reason is that if one wants to order a ship today, they cannot expect delivery until ~2024. The container shipping companies have been in a rush to build more container ships (a trend starting in the fall of 2020) and have filled all available birth spaces at shipyards for at least three years. Second, large new orders are being placed on hold principally because of uncertainties in environmental regulations and specifically out of concern of building ships with the wrong propulsion systems given potential future regulations.

We know that the first significant piece of IMO carbon-related environmental regulation comes into play in 2023 and will require a 40% reduction in emissions (vs. 2008 levels) by 2030. But revisions and updates to proposals (and adopted amendments) have not slowed. In June 2021, the IMO amended MARPOL to introduce an Energy Efficiency Design Index (coming into force in January 2023). But the details have been deferred until November of this year. There is also a proposal outstanding for a bunker fuel tax. In short, it is an uncertain regulatory environment in which most companies feel uncomfortable shelling out \$59 million for a new ship.

Thus, orders are not necessarily low because of economic uncertainty (forecasts for demand are pretty bullish, in fact), but due to fear of future decarbonization rules on allowable new build propulsion systems. Ordering a ship with the wrong system would cause premature obsolescence. Add in close to zero shipyard capacity to this equation, and the supply side set up right now is uniquely attractive. We have essentially just removed the demand response function: excess capacity was taken away, utilization + market rates increased with healthy demand, but there is now no incentive to meet that demand with new supply (at least for several years). The general setup has never happened before.

The primary reason overbuilding supply is a problem is because market prices become highly elastic. The demand must be high for an oversupplied market to see movement in market rates. Today, with a uniquely favorable supply side, only marginal demand growth is needed to continue to put upward pressure on prices. It is probably too early to comment with any clarity past 2022, but 2021 and 2022 are well above marginal demand growth

by most forecasts. We are cautious about calling a super-cycle here, but the probability is increasing with the current new-build ordering trend. Market rates appear sustainable at levels 2x above cash break evens, and asset prices are playing catch up. We see very high fleet utilization through at least 2023.

Our newest short position is a mediocre iron ore miner out of Australia, facing an extended market with an inferior iron ore product. In addition, the firm's management team and strategy are increasingly unfocused with a diversity of project and business lines subtracting from the firm's core iron ore mining activities (the firm is not Fortescue Metals, although they are also a distracted management team, in our opinion).

Driven by its high leverage to the iron ore price and excitement around its iron ore opportunities, the stock price rallied hard last year. When we initiated the position, we saw the price reflecting 100% of the value for two unapproved development projects with little room for operating or capital cost increases. Further, our research suggested a real risk that the firm faced downside leverage to a worsening iron ore price and expanding low-grade discounts.

We entered the short near the recent iron ore peak on expectations that the commodities move was overdone. Our research indicated that a sustainable iron ore price ranged from \$75-\$95 per ton (then \$200 per ton) and that demand in the second quarter of this year was likely to fade. Our fading demand thesis arose from our reading of the steel production commentary coming out of China, the first time we have utilized insight from a long-term commitment to studying but not investing in China to our advantage. We were additionally of the mind that despite our strong opinion, weakly held, that there would be an absolute fade in iron ore demand in the second half of the year, supply would certainly swamp any miscalculation on our part of demand.

Our iron ore price thesis proved correct (at least in the immediate term) quicker than we expected, but we believe that the iron ore price may have further to go. As with all commodities, the iron ore price will overshoot an equilibrium price to the downside, but we don't expect that to occur until Vale's ramping of production in the next 18 months.

We closed out our position in Kazatomprom this quarter, earning a return, inclusive of dividends, of 200% in a little less than two years. This return far outstripped the return on the uranium price, which is up 40% since we entered the position. Our exit is surely a heretical move among diehard uranium investors, but we remain content to stick to our knitting and process.

The diehards will inevitably say that uranium is going to \$100+, to which we would respond, possibly, but what are the odds? When it comes to investing in commodity companies, we find ourselves regularly confronted with the investor who says, "I am investing in company X because commodity Y is going to price level Z." The issues with this thesis construction are numerous and do not just apply to commodity companies.

The first question we ask when we see a thesis such as this is: "Are you 100% certain that commodity Y is going to price level Z?" The answer is inevitably no, all investors can envision more than a singular future, yet they often bet on a particular future. If that is the case, why is that scenario receiving 100% weighting? We will readily admit that we experience only a singular future in our portfolios returns and that bets on a singular future will pay off more handsomely than bets on price targets that reflect an aggregation of potential futures. Yet, making a bet on a singular future when one can conceive of possible alternatives futures seems a short-sighted and foolish anchoring to a price target that is likely to be precisely incorrect.

For this reason, we utilize a price target with weighted scenarios. We bet on a probabili-

ty-weighted value arising from a spread of imagined futures, not on the singular hoped-for future representing the best outcome for an investment.

Most importantly, our THESIS to enter the position was not predicted on a continually appreciating uranium price. At the time of our investment, KAP had just gone public in London, and it represented the lowest-cost producer in the industry. At meager uranium prices, the firm could still cover and pay a 6% dividend yield. Absent a hypothesis that uranium would be rendered non-existent as a global fuel source, KAP would be profitable. Furthermore, the value of its assets were mispriced relative to the price of uranium at the time. Perhaps this is not a huge surprise for a commodity producer out of Kazakhstan with lackluster interest in the dwindling volume of the London equity markets. We did feel that uranium would likely appreciate over the next several years but had no real ability to develop either conviction or a timetable around that thesis. We felt comfortable underwriting the market discount to its net asset value and getting paid to wait for an eventual turn in low uranium prices with a parabolic move in prices viewed exclusively as option value.

At the time of our exit, KAP was overvalued relative to both spot and contract Uranium prices according to our company model. To hold the position from there would mean we had to develop a thesis around a significantly higher jump in prices and that equity flows into uranium stocks would persist. The recent enthusiasm around the uptick in price was in part a function of a closed-ended fund that began to buy a significant chunk of physical uranium as capital began flowing into their fund. As their discount to NAV closed, we believed that buying pressure would subside and we have limited visibility into longer-term utility contracting cycles that might lend credence to a more robust market in the short term.

One of the challenges that comes with managing any portfolio is when to sell. We believe this is a more complicated decision than when to buy. This is especially true of commodity producers who tend to run when their underlying commodities run. Although our portfolio is heavily tilted toward commodity producers of all sorts (whether that be oil/natural gas and mining firms, traditional commodity producers, to utilities, which are such producers of electricity as a commodity), we try only to make bets with an edge. As far as we can tell, few, if any, have an edge in commodity price forecasting of such a specific nature that they can successfully bet repeatedly on commodity price volatility.

When dealing with volatile and highly cyclical assets, we must stick to the bets we know we can make with an edge. This means bets sufficiently conservative to allow for ample error, sufficiently confident of foreseeable outcomes, and sufficiently aware of speculative pressures not to allow ourselves to get carried away playing for grand slam when a double will do.

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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

## FOOTNOTES

<sup>1</sup> Attribution of the core portfolio, gross of fees. Results in individual managed accounts will vary.

<sup>2</sup> Total factor productivity is a measure of productivity calculated by dividing total production by the inputs of labor and capital. It represents growth in real output which is in excess of growth in inputs such as capital and labor. It's often challenging to interpret as things such as creativity, technology development etc., bleed into the value of factor productivity which in essence is just a residual value of productivity that cannot be explained by labor and capital.

<sup>3</sup> We will readily acknowledge there is a bit of a chicken or egg problem here, energy can't be extracted without labor and capital and labor and capital cannot come into existence without energy, but in many regards that is the point. Energy exists as a starting point necessarily present for all that comes after it, as does labor and capital.

<sup>4</sup> We are not suggesting this scales linearly. Gains in efficiency, productivity, creativity etc., make this relationship messy but it does not derail our broader emphasis that growth in the end goods and services requires a scaling or transformation of energy and fundamental materials at some point.

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