Dear Fellow Investors,

2020 has been a very strange and difficult year in so many regards. We hope you have all managed as best you can in what for many has been the most difficult circumstances.

This letter covers the following topics:

1) Our investment approach and performance over a longer timeframe;

2) 2020 performance and what we learnt from the year;

3) 2021 Macro risk and opportunities; and

4) A few of our 2021 Themes.

OUR INVESTMENT APPROACH

The Arnott Opportunities Strategy is managed with the intention of delivering annual positive absolute returns, regardless of how any financial market performs. We seek to achieve this through our Asymmetric Investment approach. In simple terms, our goal is to produce above average returns with below average drawdowns. In our opinion, to achieve this, you need to:

1) find good investments, and

2) not lose money along the way to realising the potential of those good investments.

This process has delivered the following returns since 2013 (see Table below). Importantly for us, these returns have been delivered with significantly less downside volatility than the market. That is, the peak to trough drawdown of the Arnott Opportunities Strategy is negative 11.61% vs 21.44% for the broader market (MSCI Global Index). The Arnott Opportunities Strategy performance metrics are shown below in Table 1.

Table 1

The Arnott Opportunities Strategy performance metrics

	From May 2013	
	Arnott	MSCI
Annualised returns	22.75%	8.28%
% Positive months	64.84%	64.84%
Average monthly return	1.80%	0.75%
Avg return in MSCI up months	1.67%	2.92%
Avg return in MSCI down months	2.04%	-3.27%
Best month	13.07%	12.66%
Worst month	-6.09%	-13.47%
Largest drawdown	-11.61%	-21.44%
Longest drawdown (mths)	24	20
Sortino	3.87	0.77
Sharpe ratio	1.71	0.59

Typically, this does not involve investing in the popular equities of the time (Amazon, Facebook, Google etc.), but instead sees us traversing the road less travelled. This is where we find genuine asymmetry and come across unique investment opportunities, such as Uranium, which we discuss in further detail later in this letter.

By constructing a portfolio of idiosyncratic themes with a focus on asymmetry, the Arnott Opportunities Strategy typically is uncorrelated with not only global equity markets, but also other asset classes and indeed other alternative asset managers. This is shown in the table below.

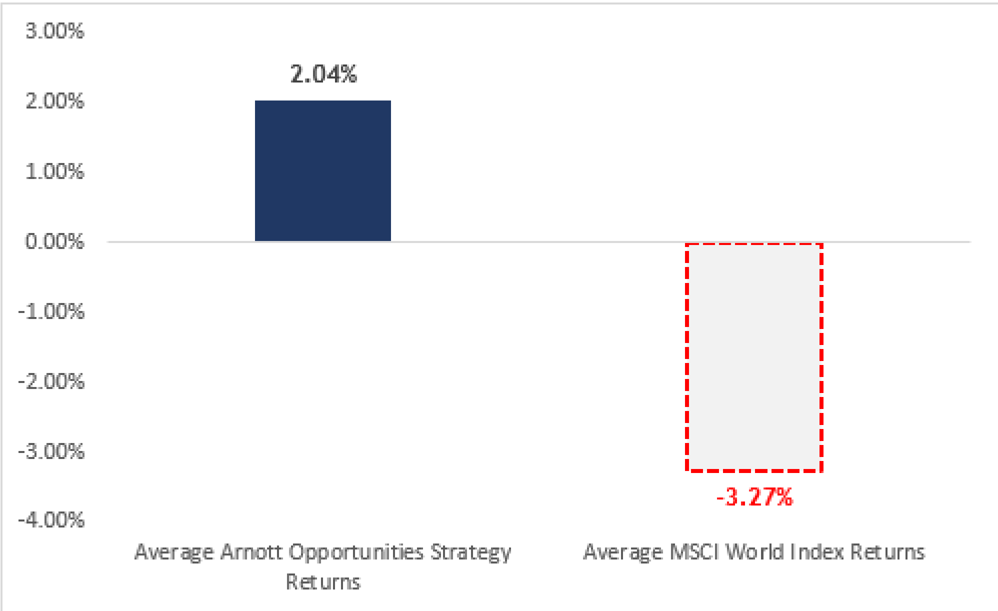
Table 2

Arnott Opportunities Strategy correlation vs other global indexes and assets

MSCI Index	0.06
US Government Bond Index	-0.03
US$ Gold	0.03
Commodities Index	-0.08
Hedge Fund L/S	0.12

One of the key differentiators of the Arnott Opportunities Strategy is that on average it materially outperforms during periods of equity market weakness. This is highlighted in the chart below. When the overall market (as measured by the MSCI World Index) had a negative month, it returned negative 3.27%. In those same months, the Arnott Opportunities Strategy returned a positive 2.08% return.

Figure 1. Arnott Opportunities Strategy Average Performance in MSCI Down Months



2020 PERFORMANCE SUMMARY

For the twelve months ended 31 December 2020, the Arnott Opportunities strategy generated a net return of positive 28.38%. The strategy's net average monthly exposure in FY20 was 52% and total average gross exposure was 132%.

The overall net return for CY20 is in line with the return we seek to deliver for you, our investors.

The strategy's ability to outperform in weak markets was put to the test again this year in March, where the MSCI World Index returned **-13.47%** and the Arnott Opportunities Strategy returned **positive 7.77%.**

WHAT WE LEARNT THROUGH CY20

The biggest lesson from 2020 had its roots in earlier crises. So, before we consider what we learnt in 2020, it is worth considering the unusual events of 2020 compared with earlier market collapses.

In 2000, global equity markets fell around 50%. The Arnott Opportunities Strategy was in its early days of investing with a small amount of assets. Nevertheless, the strategy returned in excess of 100% that year. The collapse of the tech boom provided plenty of time to run short positions in overvalued companies. There was limited intervention by Central Banks, in fact we were in a tightening cycle which may have exacerbated the market fall.

The next major market fall was the Global Financial Crisis of 2008 when equity markets again fell around 50%. The Arnott Opportunities Strategy returned positive 1.62% in that year. The Global Financial Crisis was very different from the tech collapse in 2000, even though the market performance was very similar. There was little time to prepare a portfolio once the US housing bubble burst and the fall was very quick. It was the use of index futures during 2008 that was so critical to Arnott successfully navigating the market drawdown without losses. What did happen in 2008, which was new to us in markets (unless you had spent a large time investing in Japan), was the significant intervention into the financial system by the Fed and other Central Banks.

In early 2020, it appeared the crisis was going to be a solvency risk. Solvency and counter party risks are something on which we, at Arnott Capital, are very focused on through the cycle. And so, whenever markets become untidy, we always ask the question of who can remain solvent during a crisis. We positioned heavily short in sectors that would be affected by this.

In summary, the biggest lesson from 2020 was to follow the central banks actions around solvency risk. The actions the Fed and other Central Banks took in March was unprecedented both in speed and magnitude. That led us to reconsider solvency risk and to lift a number of hedges as we went into April 2020.

It is interesting to read a commonality among our peers that the overarching lesson from 2020 is *"do not sell during a crisis"*. This worked very well in 2020. But it worked very poorly in 2000 and 2008. A short drawdown of 20% is reasonably easy to weather, whereas a longer drawdown of 50% is very different. This belief system may be important going into 2021 and beyond, as investors will feel justified to hold positions despite large mark to market losses. This strategy will probably be effective as long as the Fed remains in control of markets. However, if there are doubts about the integrity of the financial system then investors may react differently. We cover this topic with a little more detail below.

2021 MACRO RISK AND OPPORTUNITIES

2021 looks on the surface to have all the ingredients for a year of great market performance:

1. **High growth** - In 2021 US GDP growth could well be over 6% this year.
2. **Low rates** - the Fed will likely be buying bonds, every day, to cumulatively add another ~ $1.5tr to their balance sheet.
3. **Fiscal stimulus** - the US would add to a fiscal pile that's equivalent to 1/5th of GDP. Modern Monetary Theory ("MMT") is no longer theory. We seem to live in a world where there are no limits on Treasury budget deficits or on Fed purchases of Treasury securities. The sky is the limit for the Fed in MMT land.

But not all agree. Let's consider the thoughts of a well-respected and articulate financial commentator - Jeremy Grantham.

The long, long bull market since 2009 has finally matured into a fully-fledged epic bubble. Featuring extreme overvaluation, explosive price increases, frenzied issuance, and hysterically speculative *investor behaviour, I believe this event will be recorded as one of the great bubbles of financial history, right along with the South Sea bubble, 1929, and 2000.*

These great bubbles are where fortunes are made and lost – and where investors truly prove their mettle. For positioning a portfolio to avoid the worst pain of a major bubble breaking is likely the most difficult part. Every career incentive in the industry and every fault of individual human psychology will work toward sucking investors in.

But this bubble will burst in due time, no matter how hard the Fed tries to support it, with consequent damaging effects on the economy and on portfolios. Make no mistake – for the majority of investors today, this could very well be the most important event of your investing lives. Speaking as an old student and historian of markets, it is intellectually exciting and terrifying at the same time. It is a privilege to ride through a market like this one more time.

We never spend much time predicting macro-outcomes. We think it folly to try to do so. What we do spend a lot of time thinking about is firstly what is priced by the market as a consensus outcome and secondly, where do the large consequences exist if that consensus does not play out as generally believed. Jeremy may be right. If he is, the bubble may end in 2021 or it may end many years away. This is what is going to make 2021 so interesting and challenging as an investor. If we are several years away from the end of the bubble then we should be positioned very long, because returns just prior to the end of bubbles can be enormous. Of course, negative returns after the bubble bursts can be just as spectacularly negative. And there lies the dilemma. When the bubble does burst, investors will have a much lower appetite for buying assets at stretched valuations, and it is unlikely that the risk management process that worked for most in 2020 will be equally as protective of capital.

We see three factors worth watching at this stage that may upset the market.

The Fed becoming more hawkish.

This looks extremely unlikely, which is exactly why it is a tail risk worth watching. “Interest rates could rise sooner than forecast as the economy recovers quicker than expected from the throes of the Covid-19 damage”, Atlanta Federal Reserve President Raphael Bostic said recently. While most of his colleagues don’t see a rate hike coming through until at least 2023, Bostic said he thinks the emergency measures the Fed has taken to combat the pandemic can start to be rolled back within the next two years if not sooner. “I do think there is some possibility that the economy could come back a bit stronger than some are expecting…if that happens, I’m prepared to support pulling back and recalibrating a bit of our accommodation and then considering moving the policy rate.”

Inflation.

Again, at this stage there seems low risk of inflation getting out of control, but if it did, the markets would get very upset. Furthermore, it may upset the Fed, which will in turn change interest rate policy. Professor Kelton, a strong proponent of MMT, conceded that one limit to the theory is indeed consumer price inflation. Excess US savings are now around $1.4trn, and if this is translated into spending, then US consumer spending will be very strong. This spending boom will drive a reflationary environment.

Investor sentiment.

The rise of the importance of the retail investor and the ETF investor is important, because these are different groups of investors driving prices of assets higher. If they were to stop leading the bid, where is the next buyer? Much lower we suspect. And related to the Fed, if investors question in any way the ability of the Fed to maintain the integrity of the financial system then we will be in for a very different market environment. SPACs are so hot even Jay-Z is partnering with one. He's set to be the 'chief visionary officer' for California's largest cannabis firm.

What is priced?

The biggest risk may be that most of the good news is priced. Sometimes markets simply reach a point where consensus is too lopsided. It certainly feels like unusual times. I mean Greek bonds have a negative yield!

Notwithstanding the above risks, we will not sit on our hands. But we will not deviate from our disciplined pursuit of sensible investment opportunities. We are positioning long where we always have and always will. That is where we see asymmetric investment opportunities. We will focus on finding mispriced assets where we feel the potential losses under difficult conditions are tolerable. That does not mean we will be immune from losses ourselves if markets fall, but we will spend a lot of time ensuring we understand the downside risks.

SINGLE STOCK SHORTS & SHORT SELLING IN THE CURRENT ENVIRONMENT

"When the music stops, in terms of liquidity, things will be complicated… But as long as the music is playing, you've got to get up and dance" *– Chuck Prince, former CEO of Citigroup*

The tidal wave of liquidity that has been flooding global financial markets since March 2020 has made the prospect of short selling a perilous task. Typically, we seek to short sell equities that display one or both of the following characteristics:

Accounting shenanigans and governance irregularities; and/or

Concept stocks with over hyped equity stories.

With equity risk premiums shrinking to historic lows, these categories of equities have seen a rapid ascent in their share prices. Seemingly, market participants have thrown caution to the wind, throwing rigorous investment analysis out the window with the hope of investing in the *'next big thing'*, irrespective of the underlying fundamentals. As long as the quality of the investment narrative is high, fundamentals are irrelevant.

No stock is a better representation of the above than Tesla. Tesla rose over **+700%** through CY20 and is now the 6th largest company in the S&P 500. However, over the course of CY20 have the fundamentals drastically improved for Tesla warranting this share price appreciation? We would decisively argue "no". Tesla:

- Still does not generate a profit from selling cars;
- Is still run by a flippant CEO who believes government regulations do not apply to him or the company;
- Is facing increasing competitive intensity from legacy car producers pivoting into the electric vehicle market; and
- Is extremely over valued in an absolute sense and in a relative sense versus other car manufactures (We are certain readers have seen the multiple charts showing Tesla's market cap relative to other car producers so will not regurgitate the same here).

The clear and identifiable change is in the **narrative**. As the decarbonisation of the global economy has moved to the front and centre of investors' minds, Tesla is perceived as an environmental leader and therefore a beneficiary of this trend. In the face of a powerful narrative like this, the fundamentals of Tesla through CY20 were completely irrelevant.

Throughout 2020 we made the active decision to reduce the size and quantity of single stock shorts, as it was clear the music was playing and loudly at that. At Arnott, our process firmly ensures we are not drinking the 'Kool-Aid' and dancing the night away, owning the previously mentioned categories of equities with no fundamental grounding. This does not mean that we have ignored this part of the market and have given up on our traditional short selling process; quite to the contrary, it is the exact opposite. We believe this part of the market will be a rich vein of Alpha on the short side in the coming years and are looking for signs that the party is over.

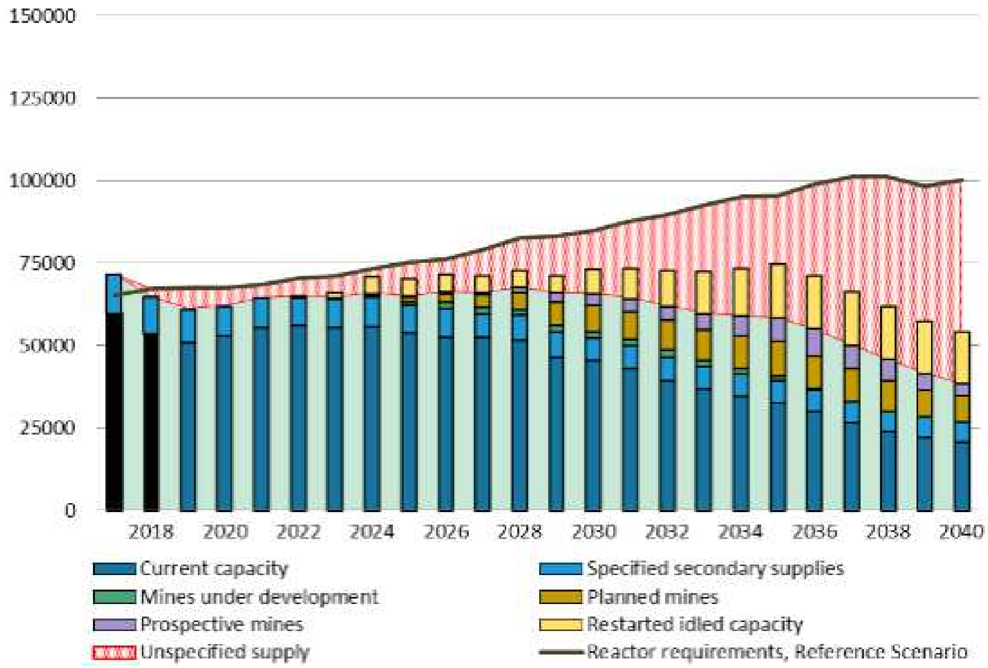
As we enter 2021, we are beginning to see signs that the party is winding up, we are not calling the end, but we are presently short Tesla…

THEMES FOR 2021

URANIUM

Uranium has been in a 13-year bear market. Spot Uranium prices have declined by 79% from a peak of US$140 p/lb in 2007 to US$30 p/lb by the end of 2020. As we enter 2021, we at Arnott believe that we are at the dawn of a structural bull market for Uranium & Uranium miners. As the only reliable source of green baseload power, nuclear reactors are coming back into vogue with global economies laser focused on decarbonising their energy sources. This will drive a significant increase in the demand for Uranium over the next two decades. From 2007 to present, capital expenditure in the sector has been minimal and primary production has been curtailed, as prices have gone well below the marginal cost of production.

Figure 2. Uranium long run demand / supply forecast



Source: World Nuclear Association

Demand

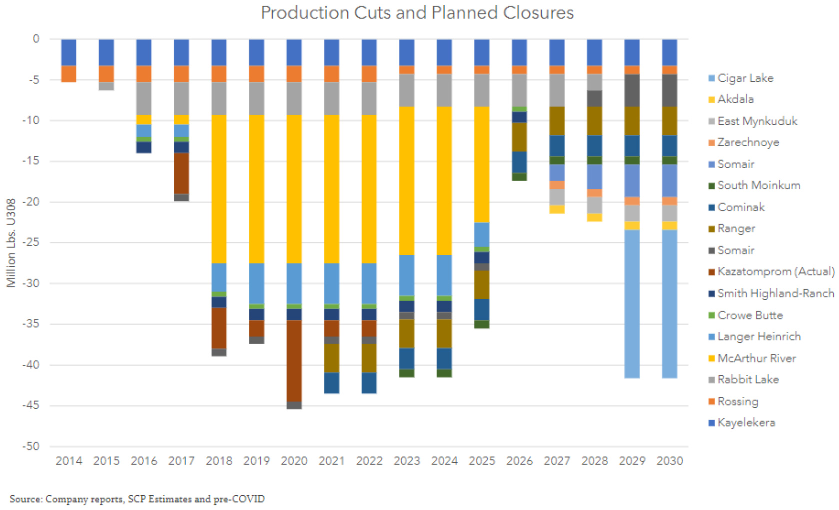
The whole Uranium industry was impacted by the Fukishima accident in March 2011, leading to dozens of nuclear reactors worldwide shut down in response. Demand has now risen to pre-Fukishima levels with the volume of nuclear reactors growing again and the strongest pipeline of new builds in years.

As estimated by the World Nuclear Association ('WNA'), at present there are 441 nuclear reactors with the volume of new reactors set to explode. Presently, 53 new reactors are under construction, 108 are in the planning stage and more than 329 reactors are pending approval. To meet this new planned capacity there will be at a minimum a **+55% increase in uranium demand by 2036.**

Supply

Thirteen years of low uranium prices have caused a structural supply deficit. Firstly, primary producers have cut production by approximately 25% from peak levels in 2016, as persistently low prices and rolling long term supply contracts have made the proposition of supplying Uranium in the current market unsustainable. Secondly, capital expenditures for greenfield exploration and mine development have collapsed. In 2012, a total of US$2.1bn was spent, with that number presently estimated to be well below US$500m, representing a greater than 75% decline in capital expenditures.

Figure 3. Uranium primary producer production cuts



Source: UXC LLC

The only way to meet demand requirements is with higher prices

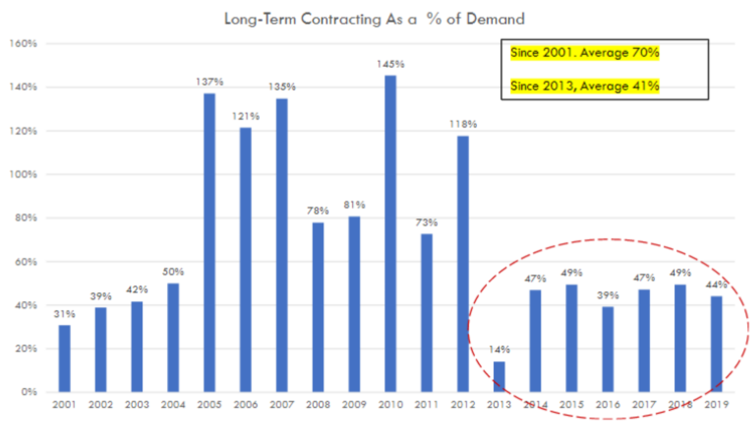
The Uranium market is currently in deficit which is set to widen in the coming years as more nuclear reactors come online. In 2020 uranium production was approximately 120mn lbs vs consumption of 181mn lbs, or a deficit of approximately 61mn lbs. This deficit just gets wider as we move to the outer years. The only way to correct this deficit, is with new mine development. Spot Uranium is currently trading at US$30 p/lb with the marginal cost of production estimated to be at US$50 p/lb. To incentivise mine development, the Uranium spot price needs to be at a minimum of US$50 p/lb and some would argue at least US$60 p/lb to begin the 5 year to 10-year process of developing a Uranium mine. In short, Uranium prices need to rise by at least +67% to begin meeting the supply gap.

Why invest in Uranium now?

There are a number of positive catalysts for Uranium which are here now.

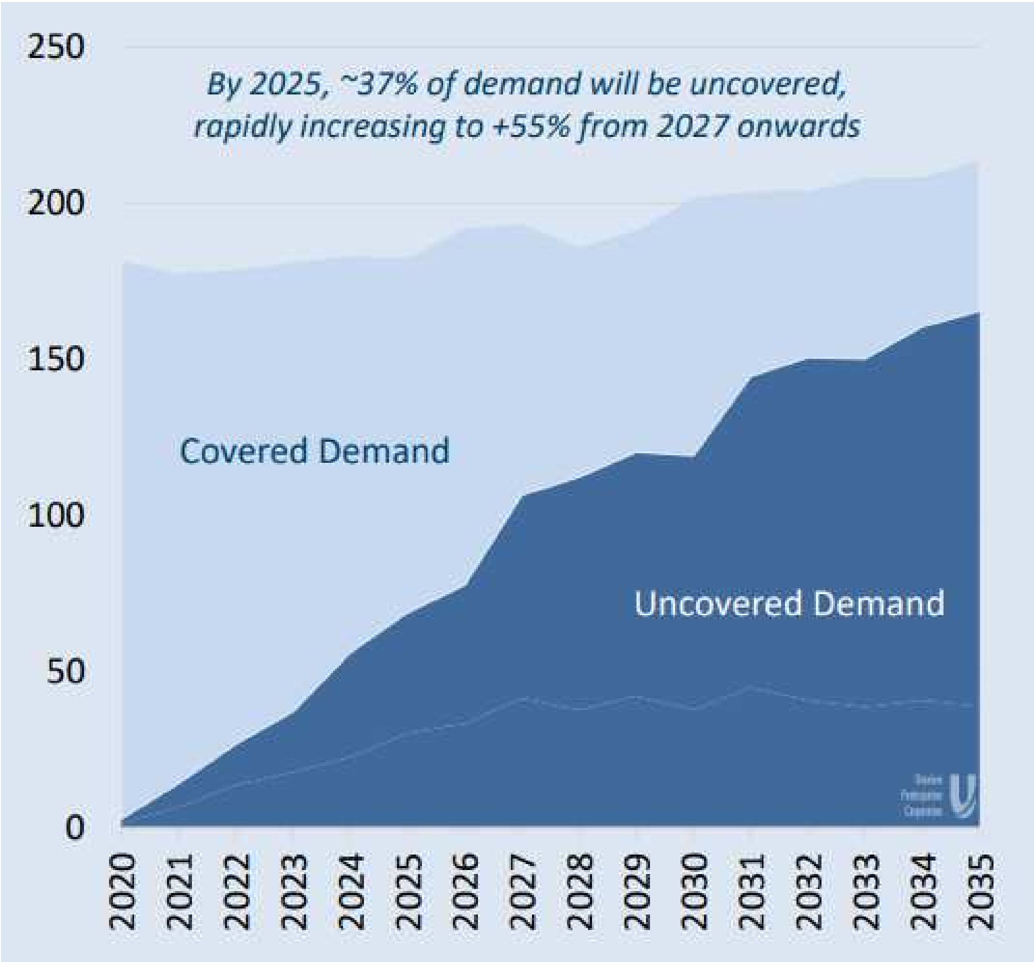
1. US and European nuclear utilities have begun a new year with inventories drawn down below usual safety margins at the same time that mined supply is in a record deficit and global uranium production is at its lowest level in 12 years. 2020 IAEA/NEA Uranium Red Book projects secondary supplies will fall in the future due to higher levels of contracting, as an overdue utility inventory restocking cycle begins, together with conversion and enrichment that will reduce underfeeding as facilities see their utilization rates rise.

Figure 4. Long term contracting as a % of demand



Source: Segra Capital

Figure 5. Forward covered and uncovered Uranium demand



Source: Uranium Participation Corp & UXC Uranium Market outlook 2020

2. For the first time in several years there are no geopolitical overhangs holding back the uranium contracting plans of US and European nuclear utilities. There are no potential Section 232 actions targeting uranium imports and no sanctions likely against UN participants (Russia, China, UK, Germany, France) in the JCPOA Iran Nuclear deal. Russia and the US have successfully negotiated a 20-year extension to the Russia Suspension Agreement that will see US imports from Russia decline over the coming 2 decades. The incoming US administration supports keeping nuclear power plants running and plans to immediately rejoin the Paris Climate Accord, pushing for global Net Zero emissions by 2050, a process in which nuclear energy will play a major role.

3. Nations around the world are recovering from a global pandemic with massive infrastructure spending programs that include boosting nuclear capacity to achieve Net Zero carbon emissions goals. A new “Nuclear Renaissance” is beginning to take shape on pandemic recovery spending to boost clean energy. The perception of nuclear energy is also changing to that of a safe, reliable, necessary baseload power source that fits with an emerging ESG investing model. Sustainability of so-called renewables solar and wind is now being called into question after failures by Germany and California to successfully transition to an economy powered by intermittent energy sources. Higher electricity prices, no net carbon emissions reductions, and rolling blackouts have demonstrated how ‘renewables’ are not able to fulfill their early promise.

4. Several countries have begun a new year embarking on Small Modular Reactor ('SMR') build-out programs with several pledging to deploy SMR's to power remote communities, mines, and industrial heat applications in the energy industries.

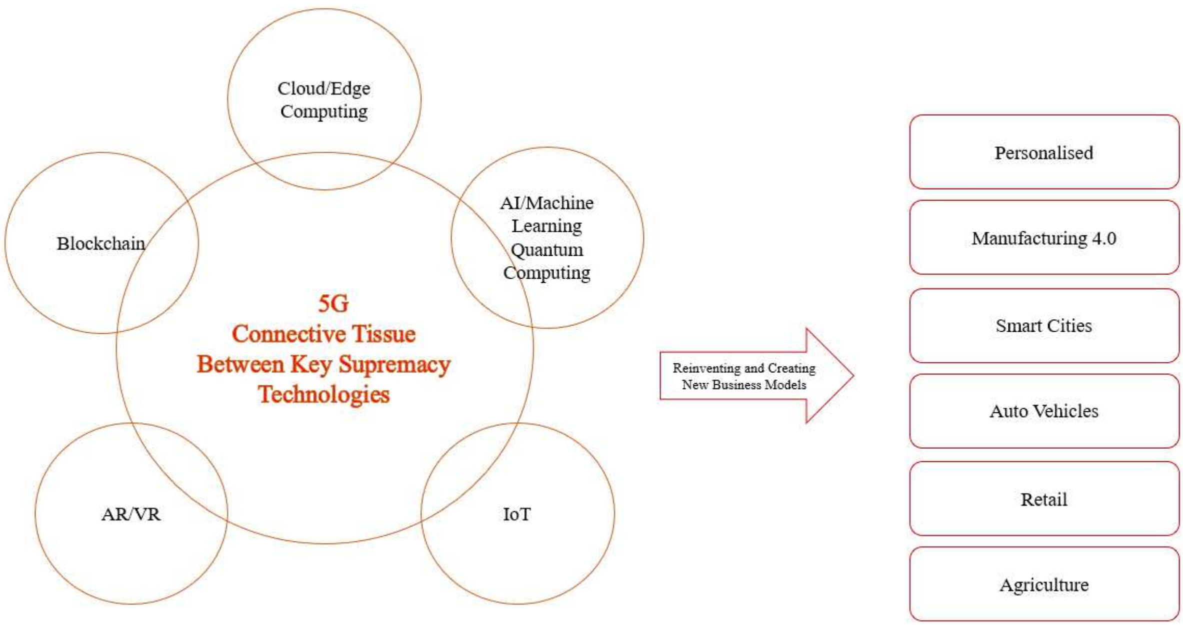
5. The US has decarbonisation goals that will lead to reduced use of coal and natural gas to produce electricity, cutting support for what have been nuclear energy's cheaper competitors. Grid markets are heading for restructuring to reward low carbon emission sources, changes which will boost nuclear power in a US clean energy transition.

CONNECTING THE FUTURE

Our connecting the future theme is focused on 5G Wireless Technology. Our focus in the intermediate term is on the enablers of these technologies that will usher in Industry 4.0.

5G Wireless is a truly transformational technology that delivers data faster, with greater efficiency and increased predictability compared with the prior 4G Wireless technology. For consumers that have had wide access to 4G Wireless, this upgrade in technology increases the speed with which we consume data, resulting in an enhanced customer experience. For multiple industries, this technology is truly transformational. 5G Wireless is the connective tissue propelling technologies of the future, such as Autonomous Vehicles, Robotic Surgery, Smart cities, fully autonomous factories just to name a few. These new technologies will drive significant productivity gains for companies across multiple industries.

Figure 6. 5G the connective tissue between key supremacy technologies



Source: 13D

With 5G Wireless technology being rolled out globally, the Internet of Things is set to undergo a period of hyper-growth. Ericsson is forecasting that there will be +350% increase in cellular connected devices by 2025. Technologies of the future need extremely fast, uninterrupted wireless connections to operate at a functional level. <u>5G Wireless enables these technologies to operate</u>. Given the significant industrial benefits of the 4G to 5G upgrade cycle, society will be a significant beneficiary of enhanced productivity. Human-less factories are not a distant prospect but are possible in Industry 4.0. This change will take time. However, in the intermediate term, with a rapid increase in cellular connections, we believe telecommunication companies and hardware suppliers, being the enablers of 5G Wireless technology, will be the near-term economic beneficiaries.

A core position within this theme is Telstra Corporation ('TLS'). TLS is Australia's largest telecommunication operator with a greater than 50% market share of mobile and broadband connections in Australia and sole ownership of a vast majority of their core infrastructure assets.
TLS is a classic Arnott Capital asymmetric investment opportunity.

The mobile industry in Australia has gone through four challenging years, as competitors lowered pricing aggressively, seeking to take market share from TLS, the incumbent. The result for TLS was year on year earnings declines. This period of poor earnings performance has resulted in an overwhelmingly negative perception held by the market towards TLS. The common view perceives the company as one that has done nothing but destroy shareholder value for the past four years, facing a bleak future, in a structurally challenged industry, thus making this company a poor investment. Whilst we acknowledge that TLS and the mobile industry have faced a tough four years, we disagree with the view that TLS is a poor investment. In fact, at the current share price, we think TLS presents an outstanding investment opportunity. You have an opportunity to own a company with ownership of prized infrastructure assets that limits your downside and a technology upgrade cycle set to turn earnings headwinds into tailwinds.

TLS currently owns a vast majority of their infrastructure assets, including telco towers, data centres, cables, ducts and pipes, which they have separated into a standalone business unit with the aim of generating enhanced returns from the prized infrastructure assets. We estimate these assets are worth approximately $3.00 - $3.50 a share, meaning TLS current share price is underpinned by high quality infrastructure assets. In other words, we believe the downside is limited in the current share price given this asset backing.

5G Wireless technology is the catalyst to reinvigorate the industry. On the consumer side, the experience of 5G deployment in countries located in Asia saw overall mobile industry pricing rise, as consumers were willing to pay more for a better-quality service. We believe this to be the likely scenario in Australia, which will turn mobile earnings headwinds into tailwinds for TLS. In addition , we believe TLS is uniquely positioned in Australia to participate in Industry 4.0. Their enterprise solutions business unit (presently only 15% of revenues) will be in a front row seat to ride the structural tailwinds that will come from booming growth of the Internet of Things.

CONTENT ANYWHERE ANYTIME

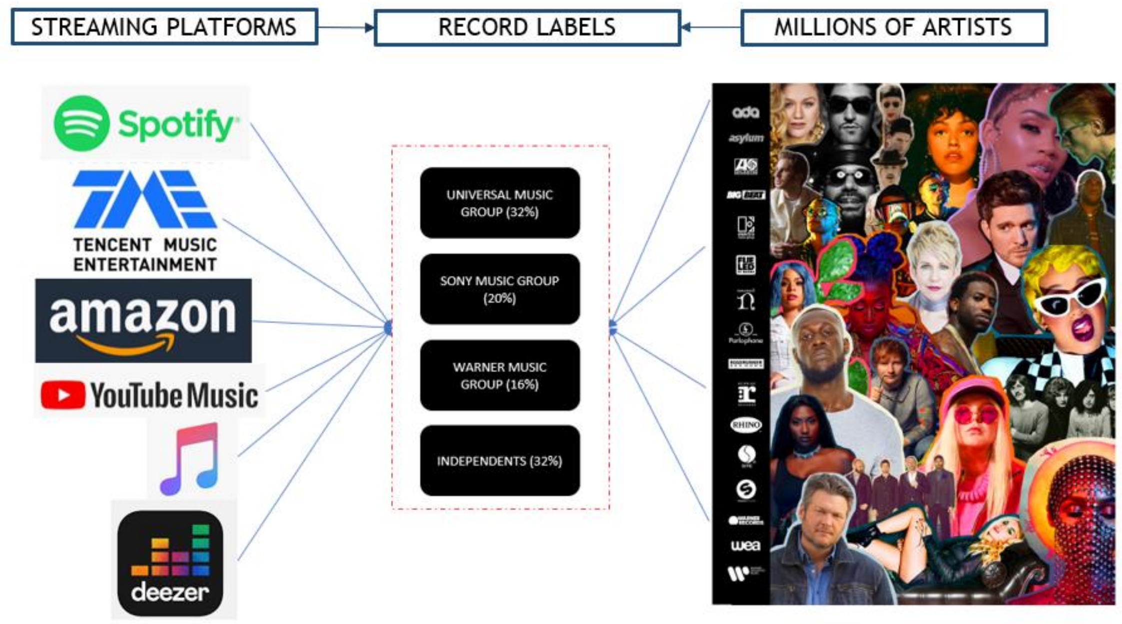
The smartphone has truly revolutionised our lives. At our side is access to nearly any form of content in the world that we could desire. The old world of set television programming, newspapers and CD's for both music and games is behind us – we consume content anywhere, at any time with the touch of a button. This structural trend has decimated some industries whilst simultaneously giving rise to some of the incredible companies of our generation, such as Netflix, Spotify, Facebook etc. The companies that have been the winners of the past decade have been those that aggregate content and repackage it in the most engaging manner to drive an enhanced user experience. This has been incredibly profitable for the platform companies in recent years; however, we believe times are changing. Over the coming years we are of the view that value will accrue to the companies that own and produce content, as the major platforms, flush with cash from the winnings of the past decade compete intensely to acquire content. The result will be higher prices, with a greater portion of the pie going towards content companies.

<u>Music</u> is one of the core investments that we have made within this theme. Music is an ingrained part of the human experience and has been with us for millennia. It is therefore no surprise that the music streaming industry, which makes available to us almost all recorded music in history, is growing rapidly. With this growth in users so too comes the growth in the volume of music streaming companies and inevitably the entrance of global technology giants. To be a successful music streaming company the core ingredient for success is indeed recorded music.

Consumers demand a one stop shop when it comes to streaming music. They love listening to the oldie's just as much as they enjoy listening to fresh hits. Thus, the ability for Amazon, Google or Apple to go out and sign all the hit musicians of the time and develop the dominant vertically integrated music streaming company is simply not possible. Music streaming companies need to acquire the rights for the whole back catalogue not just the "hot hits".

This is where we see an emerging demand/supply imbalance brewing in the industry. The three major record companies (Universal, Sony & Warner) have a circa 68% market share of the recorded music industry. Demand is expanding rapidly, and supply is constrained by three dominant players with incredibly rich back catalogues of music. In the coming years we expect extremely strong earnings growth for the major record companies that benefit not only from secular tailwinds in music streaming, but from ownership of high-quality content. In this space, we currently own Vivendi (VIV FP), the majority owner of Universal Music Group and Warner Music Group (WMG US).

Figure 7. Music streaming demand and supply



Within this theme, in addition to Music, we have investments in the news media space and are conducting detailed research into the Video Gaming market. You will hear more from us on both areas as time goes on.

IN CLOSING

Thank you for your support throughout 2020 and entrusting us with your capital. As we enter 2021 we are more confident than ever in our Asymmetric Investing approach and are tremendously excited for the opportunities that lie ahead.

Yours faithfully,

Kenny Arnott,
Chief Investment Officer

Yianni Gertos,
Portfolio Manager