Dear Fellow Investors,

Since our last update six months ago, the world continues to be dominated by the COVID pandemic. We hope you and your families are as safe as can be.

As material investors in the fund, we, the staff at Arnott Capital, want to share with you, our fellow investors, our thoughts, and reflections on our job as portfolio managers and guardians of investor capital.

In this letter, we will cover the following topics:

1) Our investment approach and performance over a longer timeframe

2) Performance summary over the last 12 months and lessons we have learnt

3) Macro risks and opportunities for the portfolio

4) A few of our Current Themes and Ideas

HOUSEKEEPING ISSUES - *We run one strategy across two funds. For simplicity and consistency all performance references in this letter will be for the Arnott Opportunities (Cayman) Fund Ltd.*

1) OUR INVESTMENT APPROACH AND PERFORMANCE OVER A LONGER TIMEFRAME

The Arnott Opportunities Strategy is managed with the intention of delivering annual positive absolute returns over the long term, irrespective of any financial market performances. We seek to achieve this through our Asymmetric Investment Approach. In simple terms, asymmetric investing is about producing above average returns with below average drawdowns. We seek to achieve this by firstly finding good investments, and secondly, not losing money in the pursuit of realising these good investments.

We strive to achieve asymmetric returns through a thematic investment process. This process has four pillars: 1) Find asymmetric themes, 2) Invest in the best ideas within those themes, 3) Focus on macro drivers for risk & opportunities, 4) To generate an asymmetric return profile. We find our investment themes from four general opportunity subsets: asset backing, temporary out of favour ideas, supply / demand imbalance opportunities, and early-stage secular trends. 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. When we consider new themes, we always consider downside risks first. In our opinion, these opportunities require a lateral thinking approach. Lastly, we always keep an eye on macro drivers. 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.

Since 2013, the Arnott Opportunities Strategy has delivered annualised returns of 24.26% (see Table 1 below). Importantly, these returns have been delivered with significantly less downside than the equity market (Global MSCI). This has resulted in the peak to trough drawdown of the Arnott Opportunities Strategy at 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. Arnott Opportunities Strategy performance metrics

	From May 2013	
	Arnott	**MSCI**
Annualised returns	24.26%	9.29%
% Positive months	65.98%	65.98%
Average monthly return	1.90%	0.82%
Avg return in MSCI up months	1.81%	2.90%
Avg return in MSCI down months	2.09%	-3.21%
Best month	13.07%	12.66%
Worst month	-6.09%	-13.47%
Largest drawdown	-11.61%	-21.44%
Longest drawdown (mths)	24	20
Sortino	4.18	0.90
Sharpe ratio	1.78	0.68

FOCUS ON A CAREFULLY CURATED PORTFOLIO

The core of our asymmetric returns is thematic investing. We put together a collection of investment themes that are uncorrelated and have separate opportunities and linkages that will affect them. Linkages are defined as drivers that affect the underlying theme. For example, banks are affected by the yield curve structure and shape, so it is important to have a view where the yield curve is going. It is possible for us to gather a diverse collection of opportunities due to the large and unconstrained universe from which we find investment themes. The fund may invest in different physical and derivative assets in commodities products, carbon products, crypto products, fixed income, equities, and other assets and derivatives from time to time.

A key reason why we bucket our opportunities together in themes, rather than the traditional approach of sectors, is not only because they represent a group of opportunities, but they also represent a group of risks. By forcing ourselves to think about what risks will drive the underlying investments in one theme we are identifying external risks that may occur. We then think about how those risks apply to other themes in the portfolio.

This is a considerable challenge to take on as an investor. It would be far easier to be a pure investment opportunist without having regard to macro risks; find good ideas and invest in them. It is also easier to be a pure risk manager; never run much risk. The most difficult choice for an investor is to be an opportunistic portfolio manager who is responsible for producing reasonable returns, while concurrently responsible for ensuring the survival of the portfolio under difficult external and often unexpected events. Balancing these two opposing objectives is a very demanding task for any investor and is at the heart of asymmetric investing. This is what we think about every day in the management of our portfolio we run for our investors, including ourselves.

One of the side benefits of constructing a portfolio of idiosyncratic themes with a focus on asymmetry, is that the Arnott Opportunities Strategy typically is uncorrelated with every major asset class. This includes global equity markets, and 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	0.07
US Government Bond Index	-0.06
US$ Gold	0.03
Bloomberg Commodities Index	-0.04
Hedge Fund L/S	0.02

2) PERFORMANCE SUMMARY OVER THE LAST 12 MONTHS AND LESSONS WE HAVE LEARNT

For the 12 months ended 30 June 2021, the Arnott Opportunities Strategy generated a net return of positive 44.81%. The Arnott Opportunities Strategy's net average monthly exposure over this period was 64.54% long and average gross exposure was 136.72%. This takes our average annual return to positive 24.26% p.a. since 2013.

The table below lists the most significant thematic contributors and detractors to the Arnott Opportunities Strategy's performance over the last 12 months (July 2020 to June 2021):

Table 3.

TOP CONTRIBUTORS TO RETURNS IN PERIOD TO 30 JUNE 2021	CONTRIBUTION
Uranium	**13.73%**
Connecting the Future	**6.82%**
Content Anywhere Anytime	**3.99%**
Hong Kong / China	**2.94%**
Real Assets	**2.92%**
Index Hedges	**-5.64%**

URANIUM contributed +13.73% to performance over the twelve-month period to 30 June 2021. Uranium has been in a thirteen-year bear market as spot prices declined by greater than 80% from a peak of US$140 p/lb in 2007. However, the fortunes for the sector are turning as headwinds (negative stigma associated with nuclear energy; excess inventory post Fukushima and declining demand as the ageing fleet of nuclear reactors in the US and Europe were slated for shutdowns), are now seemingly turning into tailwinds. As the only reliable source of green baseload power, nuclear energy is coming back into vogue as global economies face the reality of attempting to achieve net zero emissions by 2050. This apparent nuclear renaissance is coming just as industry demand / supply fundamentals reach an inflection point. With irrational prices prevailing over the past thirteen years, there has been no new mine development. This is now impacting global Uranium markets as currently there is not enough supply to meet the growing Uranium demand.

The only cure for the current and growing supply gap is higher prices. Spot prices of Uranium are presently at **US$32.50 p/lb** and the industry marginal cost of production is around **US$50 p/lb.** To incentivise the development of new projects, spot prices will need to rise to at least **US$60 p/lb**.

As we enter the second half of 2021 and 2022, we are tremendously excited about the prospective returns from this theme and have maintained it as our single largest thematic exposure. We believe a key catalyst should begin playing out that will drive Uranium prices higher in the intermediate term. Nearly all geopolitical overhangs have been removed from the US Uranium sector; uncovered forward demand from utilities is approaching dangerously low levels; nuclear reactor life extensions have been granted for various facilities around the world and excess inventory within spot markets is being soaked up by financial market participants. This sets the stage for the primary demand drivers of Uranium, utility companies, to re-emerge into the market and commence contracting in size.

In addition to this, we have seen in the past few months the largest Uranium miner, Kazatomprom, confirming they will not be ramping up production back to pre-pandemic levels until 2024 at the earliest. Demand is growing whilst more supply is being withdrawn from the market.

CONNECTING THE FUTURE contributed +6.82% to performance over the twelve-month period to 30 June 2021. As the roll out of 5G wireless technology commences, telecommunications companies with ownership of essential digital infrastructure will be the key beneficiaries. Over the period, we have begun to see our thesis bear fruit, with unsolicited takeover proposals coming for two core portfolio positions, Vocus Communications (VOC AU) and Infratil Limited (IFT NZ). In both instances, these companies owned essential digital infrastructure (Fibre and Data Centres) and were overlooked by equity markets due to either historical missteps or a conglomerate ownership structure, making the imbedded value difficult to discern. In the absence of equity market's ability to appropriately value these assets, we are seeing private capital step into the void, an emerging trend in the digital infrastructure space that we are seeking to ride the tailwind of.

As we emerge out of the Covid crisis, this is a theme we believe will continue to deliver superior returns for the Arnott Opportunities Strategy. Our ability to work from home, stream endless hours of Netflix and, looking slightly further into the future, autonomous vehicles and smart cities, is dependent upon critical digital infrastructure being in place. We are continuing to find deeply undervalued opportunities that are set to benefit from these powerful tailwinds, left behind due to the perception of being ***'boring'*** telecommunications companies.

CONTENT ANYWHERE ANYTIME contributed +3.99% to performance over the twelve-month period to 30 June 2021. The smartphone has truly revolutionised our lives. Within arm's length, nearly 24 hours a day, is access to any form of content we could possibly desire. News, music, movies, TV shows, books or games are an application or download away and have been the backbone to success of companies such as Amazon, Apple, Spotify, Google, Facebook etc. Yet, over the past decade, the companies that have been tirelessly producing the content these platforms rely on, have seen their equity values decline as equity market participants have labelled these businesses as '***structural decliners'***. It is our belief that we are at an inflection point in this narrative. At the centre of our thesis is the premise that these platform companies are flush with cash, desperate to delight their users and will begin to bid up the value of prime content. As the bidding war unfolds, the value of companies that produce content such as news, movies, television shows, video games and music will rise.

Already in 2021, we have seen Amazon pay US$8bn for MGM studios and acquire NFL streaming rights for a blockbuster price of US$1.2bn per annum, commencing in 2023. As they seek to build out their Amazon Prime streaming platform, it would appear vertical integration is now heavily on the agenda. As has been Amazon's history, they are typically a leader within a trend. This trend will drive significant equity returns for companies that produce and create content spanning news, music, television and movies and games.

INDEX HEDGES detracted 5.64% from performance over the twelve-month period to 30 June 2021, averaging around 21% of the total portfolio for the period.

In hindsight, the optimal decision would have been to run unhedged. That is the thing about hindsight, everything looks so clear in the rear-view mirror. Whilst index hedges were a detractor for the period, this is a core part of our risk management process. By running index hedges we are able to reduce our exposure to equity market gyrations, providing the opportunity for our investments to generate absolute returns through the cycle.

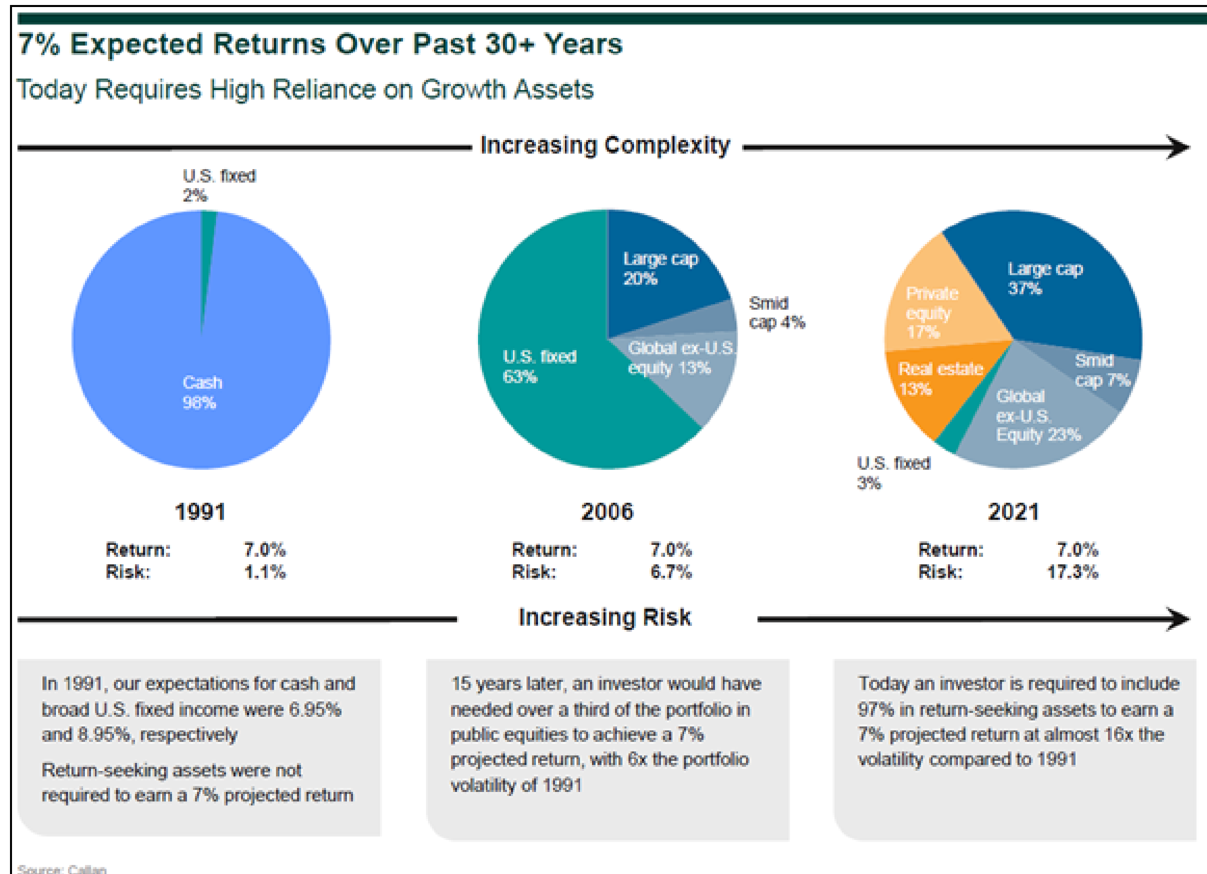
In this grinding equity bull market, the Covid crisis of March 2020 feels like a distant memory. However, it is important to bear in mind the fact that equity markets can, have and will likely fall in the future by 20% or more in a very short period. By actively running index hedges, it forces the long-ingrained discipline at Arnott to continuously watch out for Macroeconomic risks, opportunities, and tail risks with the view to protecting our investors capital.

3) MACRO RISKS AND OPPORTUNITIES FOR THE PORTFOLIO

THE SENSIBLE INVESTOR'S DILEMMA

The chart below is very important to consider when investing in the current environment. It graphically shows the sensible investor's dilemma in the current environment. In 1991, it was possible to attain 7% return without return seeking assets. In other words, you could achieve that result with a government bond and cash portfolio. Today, to achieve that same 7% return you need to be fully invested in return seeking assets. This portfolio mix carries significantly more risk than the 1991 portfolio.

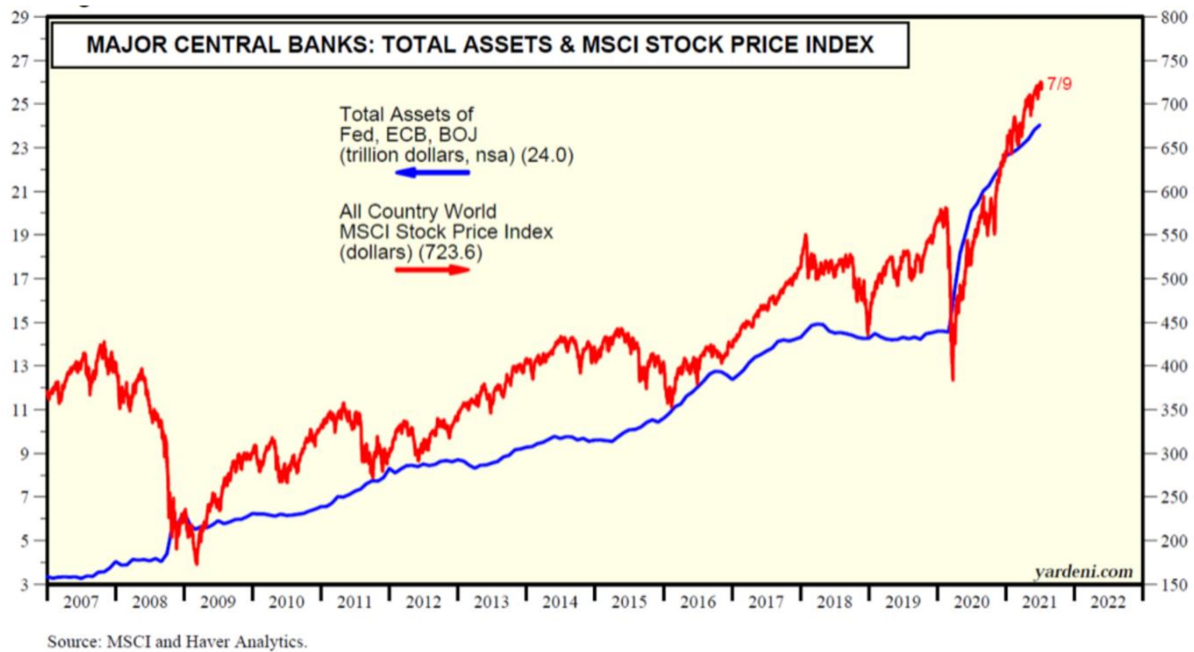
Figure 1.



Source: Callan

From 2010 through 2019, accommodative monetary policy successfully supported capital markets and lifted risk assets by making liquidity plentiful and yield scarce as shown below.

Figure 2.



Source: MSCI and Haver Analytics

However, despite the S&P 500 annualizing an impressive 13.5% performance from 2010 to 2019, sustained inflation of greater than 2% proved elusive, as did attractive real economic growth or a durable Capex cycle.

While asset prices were rising, deflationary forces were at work keeping price rises contained. These included technological innovation and expanding globalization. Examples are: Amazon vs. mall, AirBnB vs. hotel, Uber vs. taxi, China manufactured vs. US manufactured, robot vs. human. Moreover, technological innovation, in the context of increasing labor outsourcing, both raised the skill requirements and changed the skillsets necessary for people to find jobs with good wages that could compound in real terms over time.

This has led to a massive wealth gap between the rich and the poor. In the US, real household income for bottom 60% earners between the ages of 35 and 64 has been unchanged since 1980. While the percentage of 30-year old's who earn more than their parents declined from 90% in 1970 to 50% in 2019. The income share of the top 1% relative to the bottom 90% has widened to the highest level since the late 1930s.

This is now an increasing focus of both governments and central banks. In the US, targeted fiscal policies accompanied by higher taxes and higher domestic manufacturing focus, were tools employed in an effort to structurally transform its economic engine from low growth to high growth. The investment implications are meaningful. We believe that this meaningful fiscal policy combined with very supportive monetary policy is very positive for cyclical economic growth.

INFLATION

Over the next ten years, some commentators are forecasting inflation of between 4% and 5% in the developed world. Whether or not this is the case, it is unlikely that interest rates will reflect that rate of inflation. This is because we will be entering a period of financial repression, where governments keep interest rates below the rate of inflation, as they did after World War II. Under this scenario, bonds yields will not reflect price increases in the real economy. This will make it hard to use bonds as an indicator of inflation.

Rather than enter the debate about where overall inflation will land, we find it far easier and more fruitful, to focus where we can see price increases and identify which sectors and themes will benefit and be hurt by these increases. We currently see two broad themes that are interesting around pricing pressures: commodities and decarbonisation. We will discuss these two themes in a little more detail below in our current themes and ideas section.

4) A FEW OF OUR CURRENT THEMES AND IDEAS

DECARBONISATION

Our planet is warming, primarily in response to increased levels of carbon dioxide ('CO2') and other greenhouse gases in the atmosphere, which change the climate in numerous ways, colloquially referred to as 'climate change'. The movement to mitigate climate change is accelerating at a frightening pace as more Governments, corporations and institutions join the pledge of net zero carbon emissions by 2050 and are targeting significant reductions in carbon emissions by 2030. The task of net zero by 2050 is arguably the most monumental challenge we have ever faced.

Presently, the world emits around 51 billion tonnes of CO2 per annum. Since fossil fuels were first burnt in the mid-19th century this has been an externality which has not been priced. As the collective 'we' transition towards net zero, pricing these emissions is key to achieving our transition to a net zero carbon emission world. It appears the momentum towards net zero is now irreversible and so too the active pricing of CO2 emissions in society. **So, who ends up paying for this and how much is it?**

We have thought long and hard about this question and distil our thinking on this broad issue down to the following.

Consumers will end up bearing the cost. To derive a hypothetical cost for the global economy we will reference the most liquid carbon credit market, which is the European Union Emission Trading Scheme. Currently the cost per tonne of CO2 emissions under this system is US$66 per tonne. With 51 billion tonnes of CO2 being emitted annually, the global economy has been receiving a free ride of **US$3.3trn** per annum, equating to around 3.7% of global GDP. We acknowledge this is an incredibly simplistic way of thinking about this question, but we believe it is the start of one of the defining Macroeconomic trends of the next decade: ***the emergence of carbon prices within the global economy***.

Instead of delving into extensive detail, we will touch on the areas where we are investing and researching to deploy capital within this theme:

- **Carbon Credits:** The path to net zero carbon emissions by 2050 is a monumental task, in lieu of a revolutionary technology being invested within the next couple of years, carbon credits will be key in assisting companies and Governments to achieve their climate objectives. Given this tidal wave of upcoming demand, we are of the belief that carbon credits on a global scale are both materially undervalued and underinvested in.
- **Picks & Shovels:** In the evolution of new markets, the infrastructure providers are key beneficiaries. We are actively investing in and seeking to invest in the companies that are measuring and testing carbon emissions, developing standardisation of global carbon contracts and establishing exchanges for the trading of this new commodity. The opportunity set in front of these companies is tremendous.

This is merely the tip of the iceberg, there are many themes and investment opportunities that will be affected by price rises associated with decarbonisation.

COMMODITY BULL MARKET

The financial crisis was a crisis of financial instability. Whilst the social need was high in the aftermath of 2008, the policy objective of central banks and governments globally was centred on financial stability. The Covid crisis, is a crisis of **social need.** Today the saliant concerns of central banks and governments globally are focused on social issues: unemployment; wealth inequality; and climate change. Given the social focus of policy makers, it is clear that we are entering a period of heightened government spending as Governments seek to improve the quality of life of their citizens. In this cycle, the key differentiator is the fact that ***Fiscal Austerity*** has been replaced with ***Modern Monetary Theory*** and has been widely accepted by economies around the world. We have no opinion on whether this new monetary experiment will work or not, but it is here to stay for the intermediate term and there is a plethora of opportunities that arise from this. With this in mind, we believe the floodgates of fiscal spending on infrastructure projects and decarbonisation initiatives are only just beginning and will underpin a prolonged material rise in commodity prices.

As mentioned earlier, our process involves 1) Finding asymmetric themes and then 2) Investing in the best ideas within those themes. Our Commodity Bull Market theme is an example of how we apply this in practice. Despite a positive outlook for commodities we are not investing across the whole commodity complex but are instead investing in targeted areas where we see the highest risk / reward opportunities. One such area where we see significant upside is in **Steel Equities**. We are at the intersection of two trends that will drive stronger for longer global steel prices:

1) China's path towards net neutral carbon emissions by 2060 and

2) Global fiscal spending.

Equity markets do not believe record high steel prices are here to stay as the chant of ***'Transitory'*** grows louder. The result is that the current equity prices are implying steel prices that are 50% to 60% lower.

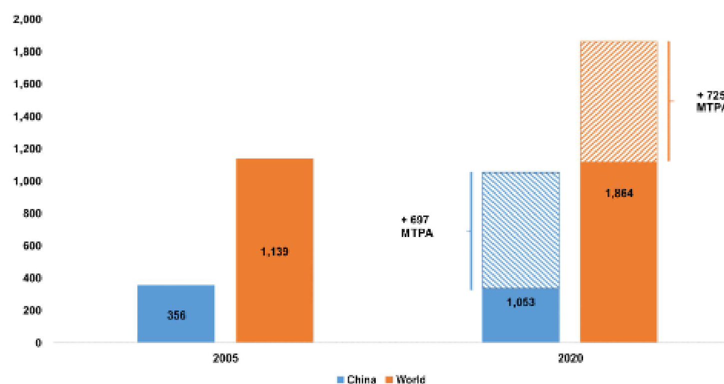
1) China's path towards net neutral carbon emissions by 2060

For the past 15 years steel prices have been suppressed by cheap supply from China, accounting for 96% of the world's incremental steel production between 2005-2020. This incremental supply has come at a high environmental cost for both China and the rest of the world, that has not been priced nor acknowledged by end markets. ***China emits two tonnes of CO2 for every one tonne of steel produced, whereas in Europe this number is one tonne of CO2 for every tonne of steel***.

With China's recent policy announcements regarding their path to net zero by 2060, the days of China paying for the world's environmental and carbon-emission costs are over.

Figure 5.

China Contributed 96% of Global Steel Production Growth from 2005 to 2020



Source: CISA, World Steel Association and 13D Global Strategy & Research

Source: CISA, World Steel Association and 13D Global Strategy & Research

China's steel sector accounts for roughly **15% of the country's total carbon emissions** with environmental efficiency of steel production clearly below global standards, making the steel sector a logical target for the Chinese Government to curb carbon emissions. The implications of this policy shift are significant and far reaching for global steel markets, as China begins to withdraw from seaborne steel markets.

Global steel consumers have been hooked on cheap Chinese steel flooding markets in the past decade, resulting in a prolonged period of underinvestment by the rest of the world. *Why invest in marginal projects when you cannot compete on price with China?* As China begins withdrawing from global steel markets, this period of extensive underinvestment in capacity by the rest of the world will come home to roost with higher prices.

2) Global Fiscal Spending

Covid-19 has been the catalyst for a change in how Government's approach fiscal spending. We have quickly transitioned from fiscal prudence to fiscal deficits. Government budget deficits have been and will likely continue to be accepted by the voting population as they target areas that address the social need. These areas are largely supportive of global steel demand:

- **Infrastructure:** Government stimulus bills focused on infrastructure are now discussed in the *US$ trillions*, as significant fiscal spending supports job creation, in addition to improving infrastructure for citizens. Steel is a key component in all infrastructure projects. The current proposed US infrastructure bills are estimated to add an additional 5% to US steel demand in the coming years.

- **The energy transition:** According the research by BloombergNEF, the energy transition will cost approximately US$15 trillion from 2020 to 2050 as countries re-tool their energy supply chains. From the EU Green deal to Biden's various proposed green initiatives, it is clear Government spending programs are supportive of the energy transition. It will likely come as no surprise that steel has a huge part to play in the energy transition: from electricity transmission grids to blades on wind turbines, significant amounts of steel are required. By 2030, it is forecast that demand from Solar and Wind projects will add 4% to global steel demand and the supporting energy transmission grid upgrades will add around 6%.

With Governments lighting a rocket under global steel demand and China withdrawing from global export markets, the question we have is ***where is all this steel going to come from?***

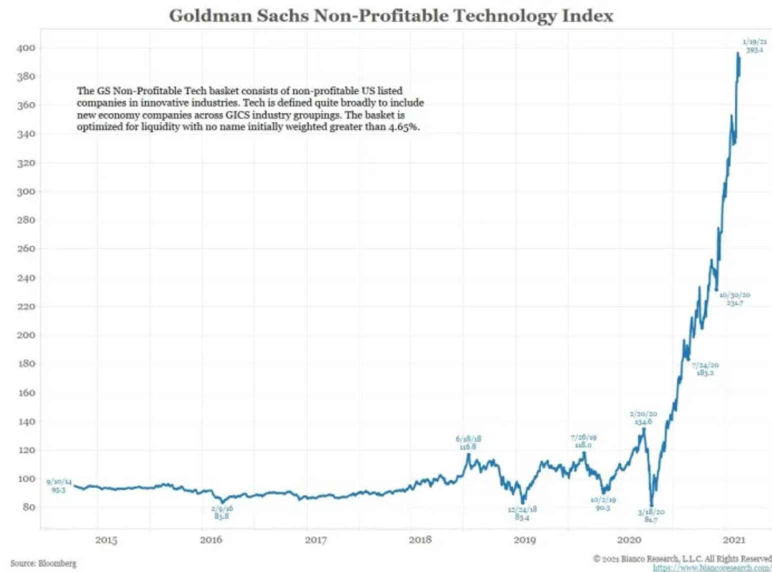
Given the muted price outlook being discounted in current steel equity prices we are of the belief that stronger for longer steel prices will drive a material re-rating in these names.

SHORT THEME: SECOND TIER TECHNOLOGY

Amazon, Apple, Facebook, Google and Microsoft are dominant franchises operating in industries with high barriers to entry and long durable growth. It would be nearly impossible for a company to come in and replicate the Azure cloud network Microsoft has built, in fact, we would hate to think of the time and amount of capital it would take. These companies are not overnight success stories but have built their strategic moats by investing well ahead of the crowd.

The current trade du jour of market participants is to seek outsized returns by 'investing' in the next Amazon, Apple, Facebook, Google and Microsoft. With endless liquidity flooding global markets a burgeoning number of investors are in the chase to find this holy grail. As with any market, the result has been significantly higher equity prices for these **'Second Tier Technology'** companies or looked at another way a much higher cost to play lotto. The cost of admission into the game has gone up, but the prize pool is exactly the same.

Figure 6.



Source: Bianco Research LLC

Our theme, *Second Tier Technology*, is premised on the view that the very liquidity that has driven sky high valuations for technology companies will also drive their de-rating. The global glut of excess liquidity has not only poured into buying equities on exchanges but has also gone into equity raisings, both primary and secondary, bolstering these companies' firepower to invest. The ability to raise funding to compete for a share of a large addressable market has never been easier. Consider the *buy now pay later* market. It feels like almost every day more competition is entering the space from both extremely well-funded global titans such as Pay Pal but also from a huge volume of start-up companies. The below table sums up our concerns. The intermediate term will be characterised by declining returns as customer acquisition costs rise with more and more participants flooding attractive markets such as Buy Now Pay Later.

Figure 7. Buy Now Pay Later Participants

Source: Financial Technology Partners

This thematic is playing out across multiple sectors. There are more and more companies competing for a slice of the same pie. Expectations of future profits are sky high; companies are well funded and all targeting customer acquisition growth. As competition slows the rates of growth for these companies, we believe the de-rating will be phenomenal and are seeking to profit from this.

This letter was written prior to the announced transaction of Square Inc taking over Afterpay Limited on the 02/08/2021. Yes, we were short Afterpay within this theme. However, this is why we are thematic investors. Within any one theme we have multiple security positions, so that no one position will significantly detract from overall returns of the theme.

IN CLOSING

Thank you for your support throughout the past 12 months and entrusting us with your capital. As we move into the second half of 2021 and into 2022, 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

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