ARNOTT

CAPITAL

EST. 1999

Dear Fellow Investors,

To say 2022 has been an interesting year would be an understatement. In this, our 2022 annual investor letter, we want to share with you our thoughts and reflections on our job as Portfolio Managers and guardians of investor capital.

We will cover the following topics:

1.) Our investment approach
2.) 2022 performance summary and some of the lessons we have learnt
3.) Macroeconomic risks and opportunities for 2023
4.) Portfolio construction and key themes for 2023

OUR INVESTMENT APPROACH

The Arnott Opportunities Strategy (‘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.

Typically, this does not involve investing in the popular themes of the time (electric vehicles, high growth technology companies etc.), but instead sees us traversing the road less travelled, finding investment opportunities in the unknown, unseen, or discarded, where the skew of positive return is overwhelmingly in our favour.

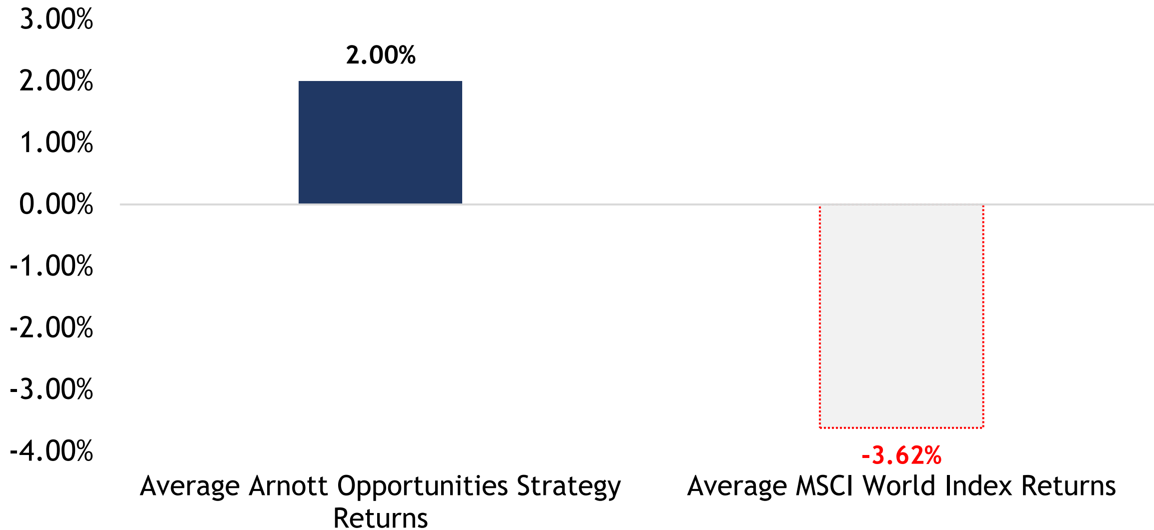
The end outcome (which is a by-product of our approach, not any specific goal) is a portfolio of idiosyncratic uncorrelated investment ideas that do not resemble any index or for that matter any one asset class. As you can see in Table 1, over a long time frame our return series correlates with none of the major indices or asset classes, nor fellow equity biased hedge fund managers:

Table 1. Arnott Opportunities Strategy correlation

Asset class	Correlation
MSCI World Index	0.05
US Treasury Total Return Index	- 0.02
Gold	0.02
Bloomberg Commodities Index	- 0.03
Equity Long / Short Hedge Funds	0.02

The intended outcome of our investment approach is a portfolio which is typically resilient in market drawdowns:

Figure 1. Average Arnott Opportunities Strategy performance in MSCI World Index down months



This is by design. Observing global macroeconomic events is not something that we occasionally look at on the periphery but is front and centre of our investment process (we cannot guarantee we will always protect the portfolio in periods of extreme market stress).

The reason for this comes down to a philosophical approach to investing that is intertwined with Arnott Capital, we want to compound capital for the long term.

It sounds obvious but to achieve this, you need to get to the long term. Readers may have a different opinion on how to get to the long term, but it is our core belief that to survive and achieve long term results there needs to be an unwavering focus on point 2.) stated above:

"To not lose money along the way."

It is therefore never up for debate; capital preservation stands above all else. This is not to say we will always be successful in our endeavour, but we highlight this to better inform you, our fellow investors on how we approach investing, especially in times like the present.

2022 PERFORMANCE SUMMARY & SOME LESSONS WE HAVE LEARNT

For the twelve months ended 31 December 2022, the Strategy generated a net return of positive 1.75%. The Strategy's net average monthly exposure over 2022 was 33% net long and total average gross exposure was 127%.

Whilst disappointing in the context of our long-term returns, the overall net return for 2022, is in line with the return we seek to deliver for you, our fellow investors. When we have multiple themes working and the environment for taking risk is favourable, we seek to deliver reasonable returns. When the environment is fraught with risks and opportunities are symmetrical, we prioritise capital preservation. The latter is how we approached 2022.

Portfolio losses through 2022 were concentrated in our Carbon Credit theme and longer duration themes such as Connecting the Future and Real Assets, which despite attractive underlying fundamentals were impacted by the movement in interest rates. These losses were offset by gains in equity index hedges, long energy themes (Energy Paradox and Uranium) and tactical trading opportunities.

Before delving into the lessons we have learnt through 2022, it is worth taking a moment to touch on just how remarkable the cocktail of risk events were that transpired through the year:

- we saw the fastest rate rising cycle in developed market history. Central banks lifted the world out of Zero Interest Rate Policy ("ZIRP") to combat multi decade high levels of inflation
- in March, war broke out on continental Europe, with the invasion of Ukraine by Russia
- subsequent to the emergence of war, western nations sought to apply sanctions on Russia cutting off a former G8 nation and a nuclear power from the global economy
- in October "the GILT crisis" emerged, seeing a G7 nation's sovereign bond market collapse as their domestic pension system faced an existential crisis from rising rates
- in December, to close the year out we saw the Bank of Japan ("BOJ") make the first steps to exiting Negative Interest Rate Policy ("NIRP") with the widening of their yield curve control from 25bps to 50bps. The symbolism of the world's global anchor of duration moving away from NIRP cannot be understated.

These were only a few of the risk events that transpired in 2022! As the saying goes *"There are decades where nothing happens and there are weeks where decades happen"*. More aptly, when reflecting on 2022, it was a year where decades happened.

Some of the lessons we have learnt this year.

Flexibility

"When the facts change, I change my mind, what do you do sir?"

\- *John Maynard Keynes*

Throughout 2022 the ability to be flexible, proved to be crucial.

We spend a considerable amount of time researching potential investment themes and by the time these themes have entered the portfolio, we have assessed the idea from many angles. Like everyone, we are prone to making cognitive errors, specifically in this instance the cognitive error referred to as sunk cost fallacy[1].

What is crucial to remember in a rapidly changing environment, **this time is a sunk cost** – we receive no points or participation awards for the time we spent researching an idea, it is the dogmatic assessment of the risk and reward of the position given changing information that is crucial.

As global asymmetric investors, we have a world of opportunities available to us and if we cannot find any opportunities we can wait in cash. There is no need to hold onto "dead wood".

[1] A simple but great explanation of sunk cost fallacy https://thedecisionlab.com/biases/the-sunk-cost-fallacy

Change is afoot

The change we are referring to is specific to the increasing role of Governments in society and their emerging propensity to intervene with free market policies. The emergence of this trend will have wide ranging implications for investors.

In 2022, we primarily saw government intervention targeting energy, ranging from energy price caps in Europe, windfall profit taxes in the UK and even price caps on coal and gas domestically in Australia.

As the year progressed, the signs of increased Government intervention into areas outside of energy have accelerated. It is not our job to make comment on whether this is good or bad, however it is our job to think about the investment consequences. Most likely, in the next few years we will need to be paying attention to policy makers, as much as central bank actions. This was not the case in the last decade. There will be definite winners and losers from this increasing intervention in markets by political powers. We see this as an important macro trend to pay attention too, and we seek to adapt our process to account for the increasing role of interventionist prone governments in free markets.

The right investors

Make no mistake of the role, you, our investors play in the success of the Strategy. We wanted to take an opportunity to thank you all for letting us get on with our jobs as Portfolio Managers, enabling us the freedom to traverse the road less travelled.

In a financial world dominated by the need for immediate success, the ability to be patient and first prioritise capital preservation is only made available by having the right investors, which we are incredibly grateful to have. For this we thank you!

MACROECONOMIC RISKS AND OPPORTUNITIES FOR 2023

Recession, slowdown or goldilocks?

The answer to this is we do not know. Thinking through all these scenarios it is clear the trend in corporate profits through 2023 is lower. The only question is to the magnitude the following headwinds will come into play through 2023: record high corporate profits begin to revert; the pull forward of personal consumption expenditure moderates; and higher interest rates begin to bite. These factors have been written about in more detail, in higher quality and more extensively than we can reproduce, so we will not expound on these but rather elaborate on what this means for portfolio positioning.

For the foreseeable future we will continue to run low net equity exposure as we enter the second stage of this bear market, the downgrade cycle. Whilst everything you read appears to be doom and gloom, suggesting a bearish bias is the consensus view and therefore factored into prices, when you invert the problem and ask what makes developed equity markets (more specifically the S&P 500) go higher from here, we genuinely struggle to come up with a rational argument for why. Our considerations in coming to this conclusion are based on the following:

- where current valuations are (Figure 2). Yes, valuations have moderated but are by no means cheap
- corporate earnings are still above trend (Figure 3). Which are already seeing signs of moderating as top line demand wanes with the Covid demand pull forward unwinding and structurally higher costs work their way through
- investors can earn 4.4% sitting in cash. You are for the first time since 2007 being paid to wait and

- the Federal Reserve is still on a war path to kill inflation.

Equity markets are typically driven by liquidity and earnings, both of which look to be trending lower through 2023.

Figure 2. S&P 500 NTM P/E

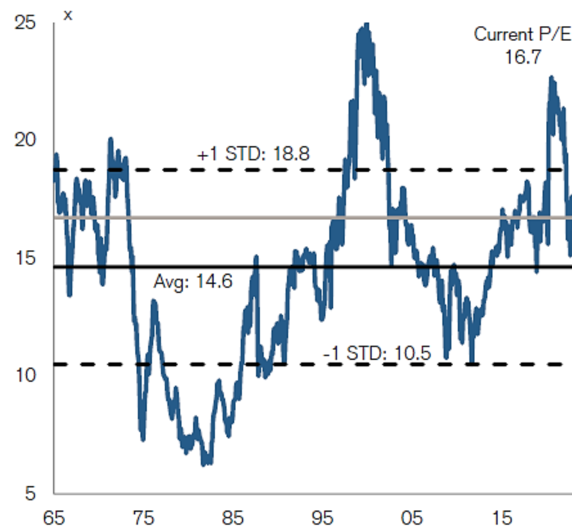
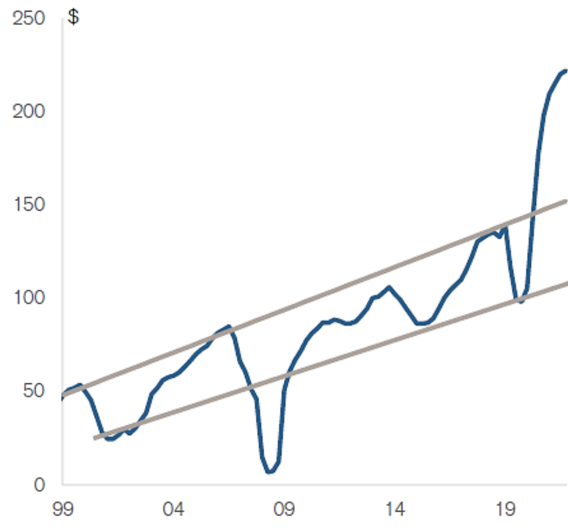


Figure 3. S&P 500 LTM Earnings Per Share ('EPS')



A tail risk for asset prices: the possible end of NIRP and ZIRP in Japan

Japanese investors have been large buyers of foreign assets, taking advantage of their ultra-low interest rates, borrowing money (essentially for free domestically) and then investing this in productive assets around the world. It has been one of the best carry trades for the best part of three decades (and we are certain the Japanese were not the only ones borrowing in Yen to invest abroad). However, 2023 is shaping up as the year we may see Japan exit NIRP and ZIRP and attempt to begin the path of policy normalisation as they deal with rapidly rising inflation and usher in new leadership at the BOJ.

What happens to asset prices if the global anchor for duration (and the last central bank holding the line at NIRP) exits their ultra-accommodative monetary policy? The likelihood, should this come to pass, is further downward pressure on asset prices in developed economies, as we see an unwinding of this three decade long carry trade. The return of Japanese liquidity to their domestic financial markets will come at the highest cost to US financial products and Australian and European bond markets. To put this into perspective, a UBS report estimates that Japanese residents own around 19% of outstanding Australian bonds!

This situation is worth watching closely. It is not our base case that we see an extreme liquidity event unfolding but we are watching intensely, with investment opportunities on both the long and short side across multiple asset classes emerging.

Some thoughts around debt in a rising rate environment

This time last year developed economy interest rates globally were at, around or below 0%. Now:

- United States of America: 4.50%
- Euro Zone: 2.50%
- Canada: 4.25%
- Australia: 3.10%

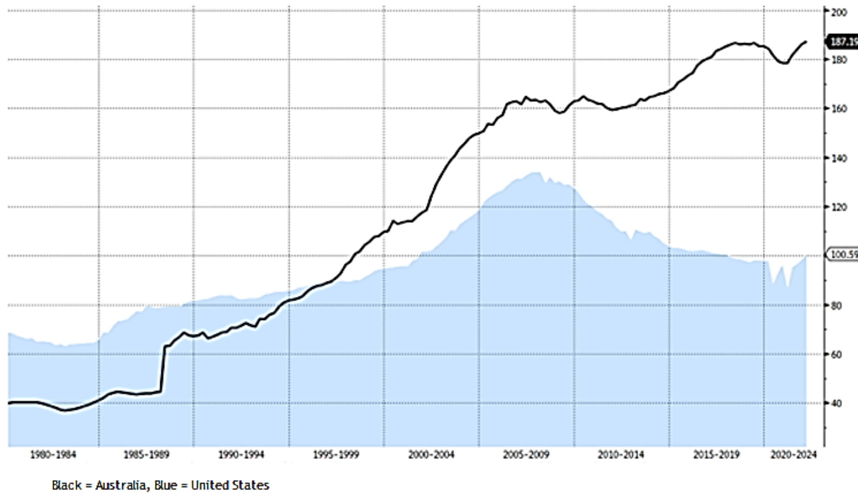
Interest rates have risen rapidly in a very short period. For savers this is great, for borrowers this is not ideal. This is not something investors have been accustomed to and it may take time for this to take effect in investment decisions.

There are three key areas where we believe opportunities arise from this:

1.) sovereign debt. Enough has been written about the *‘impending global sovereign debt crisis’*, so we will save this discussion for another day;
2.) corporates. This is factored into our views on margins which we touch on above; and
3.) consumers. Specifically, those consumers burdened with high debt to income ratios in nations with variable rate lending structures.

Over thirty years and running without a recession it can be argued that excesses have built up in the Australian economy, with the Australian consumer now one of the most leveraged borrowers in the world. The current debt to income ratio is now pushing up upon 2x. For a benchmark reference, the US is around 1x and at the height of their housing bubble this hit just under 1.4x.

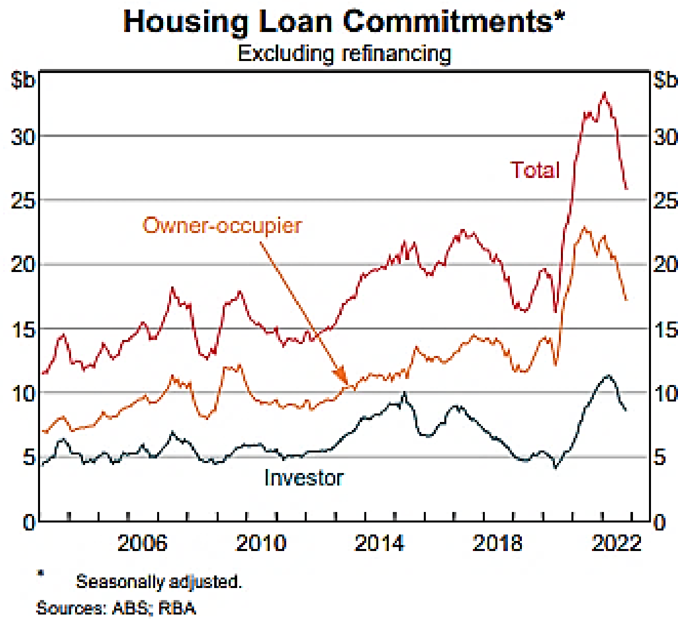
Figure 4. Household debt to disposable income ratios



Source: Bloomberg

With a low proportion of fixed rate debt and high household leverage, rising interest rates are a calamitous combination for the Australian consumer, which not very long ago, were told by the head of the Reserve Bank of Australia that interest rate rises, would not be on the cards until 2024 at the earliest. This opened the flood gates, resulting in a tidal wave of borrowing, which is only now beginning to moderate.

Figure 5. Australian Housing Loan Commitments



As 2023 progresses, we expect the Australian consumer to be one of the hardest hit around the world as we grapple with the great interest rate normalisation. This will place the Reserve Bank of Australia in a difficult position with regards to their interest rate policy.

PORTFOLIO CONSTRUCTION AND KEY THEMES FOR 2023

Investing in the coming period is likely to remain challenging as risk assets deal with multiple headwinds in the coming days, months, and years. Suffice to say, it does not feel like an environment where money will be made by being long beta, so the key will be finding idiosyncratic pockets of alpha on both the long and short side – something we have been doing for over twenty years.

As stated above, our objective is to generate annual positive returns, irrespective of how any financial market performs. So how are we achieving this, given the environment we have described?

Put simply we will be constructing the portfolio in the year ahead as follows: firstly, net equity market exposure will be low. Long positions will be concentrated in unleveraged cheap assets; idiosyncratic special situations / tactical trading opportunities; and undersupplied commodities. Short positions will be focused on sectors of the market that will be impacted from the effects of de-leveraging and falling asset prices; changing industry structures and areas where speculative capital continues to from time to time rear its head. Overlaying our core equity long / short positions will be a variety of derivative positions, seeking to firstly protect capital and then secondly to profit from the macroeconomic environment.

To give you a sense of how we are expressing our views on the long and short side of the portfolio we will briefly outline our thesis for our long Gold exposure and our short Private Asset Managers theme below.

Gold

At the turn of the year gold sits as one of our highest conviction long themes for 2023. This statement will likely be met with derision, as the popular view of gold in the current investment environment is overwhelmingly negative, given the lack of performance in the highest period of inflation we have seen in forty years. The exact environment that gold bugs had been warning of that would see gold hit US$10,000 an ounce!

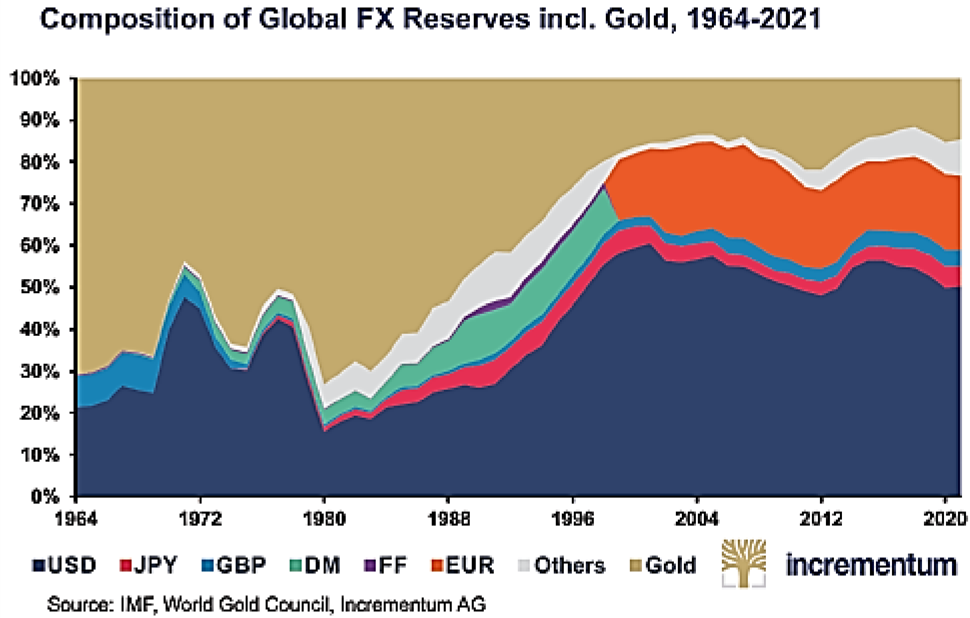
“Remember the golden rule! Whoever has the gold, makes the rules!!”

- *Wizard of ID*

In February 2022, the G7 and EU, in retaliation to the Russian invasion of Ukraine, froze Russia out of the US dollar monetary system. This act effectively isolated a former G8 nation and nuclear powerhouse from the global economy, highlighting the power held by the US in the current financial system.

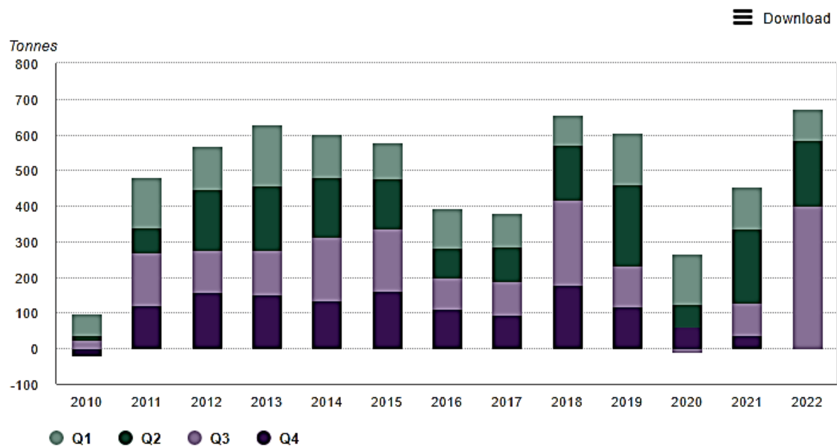
This was the catalyst for us to re-engage with gold again as a potential long as we pondered the thought - what if central banks around the world began to question the currency in which they hold their FX reserves? A small reversal in the trend away from gold in the last forty years (Figure 6) would likely trigger a significant price appreciation in gold.

Figure 6. Composition of global FX reserves



Fast forward to Q3 2022 and we saw the largest central bank demand for gold since 1967, a point in time when the US Dollar was backed by gold!

Figure 7. Quarterly central bank gold purchases



Source: World Gold Council

With increasing demand from central banks, high levels of investor pessimism and call like characteristics over increasing geopolitical tensions, we believe gold represents an outstanding asymmetric investment opportunity.

Private Asset Managers

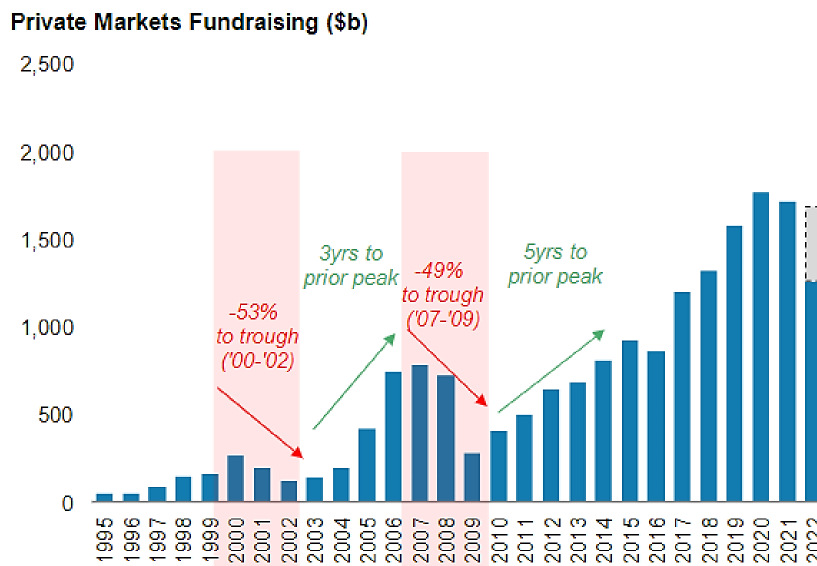
"As with most things, any inaccuracy in reporting will eventually come to light. Eventually, private debt will mature, and private equity holdings will have to be sold. If the returns being reported this year understate the real declines in value, performance from here on out will likely look surprisingly poor. And I'm sure this will lead plenty of academics (and maybe a few regulators) to questions whether the pricing of private investments in 2022 was too high…"

- *Howard Marks, what really matters November 2022*

We should probably just leave our thoughts at that. We will not say anything more succinct than one of the greatest investors of the modern time. However, we might just indulge ourselves a little and expand on our underlying thesis for this short investment theme.

The past decade has been the golden age for private market investing, with multiple trends driving asset inflows into private equity and private debt strategies. From 2010 onwards, industry AUM surged 4-fold to around US$10 trillion, with an ever-increasing amount of assets being raised, as real money investors sought the refuge of low volatility and reasonable returns (Figure 8 below).

Figure 8. Private Markets Fundraising



Source: Morgan Stanley Investment Research

Our thesis is that we have exited a zero-interest rate environment, to one where there is a real hurdle rate for investments. This new interest rate environment provides investors with a genuine income alternative by

holding cash. Which will firstly slow asset raising for private asset managers and secondly drive redemptions resulting in a negative feedback loop for the managers. Asset growth slowing will drive an EPS revision downgrade cycle and redemptions will force managers to either a.) gate investor funds or b.) appropriately mark assets – both driving multiple contraction.

We are of the belief that we are in the early innings of this playing out. Take for instance the events that have transpired at Blackstone Inc's BREIT fund from July 2022 to present (which we believe is not an idiosyncratic event but likely typical of events to transpire in the industry):

JULY 2022:

"The response from individual investors for Blackstone-managed private real estate and credit has been powerful. We are now raising nearly $4 billion per month – that's $4 billion per month for BREIT and BCRED together. We believe demand for these two products will continue for years to come…"

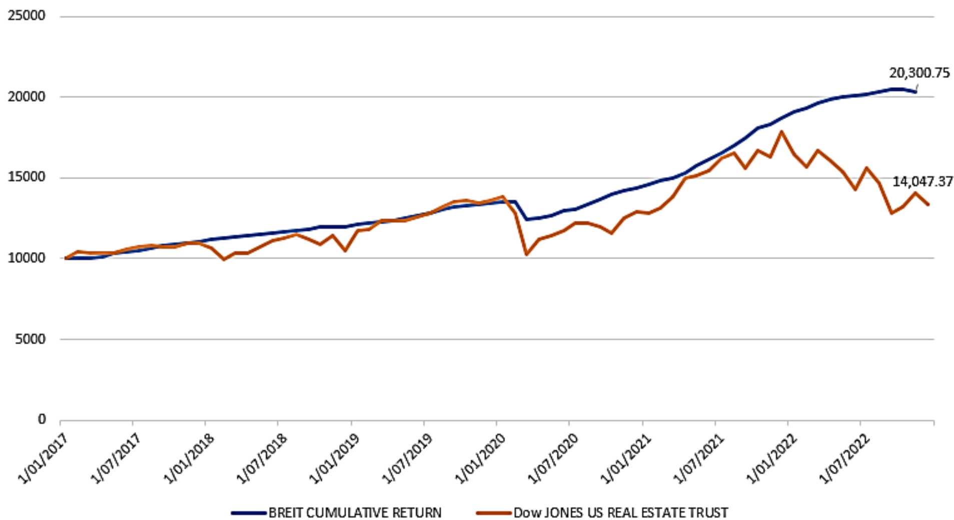
- *Steve Schwarzman, Q2 2022 BLACKSTONE EARNINGS CALL*

DECEMBER 1 2022:

Redemption requests of US$1.8bn in October and US$1.3 billion in November, trigging the gate provisions for the fund enabling only 0.3% of NAV available for redemption in December 2022.

Performance through 2022 had been tremendous, especially considering BREIT verse any other listed real estate index (Figure 9). The rationale given for the redemptions was Asian Family Offices forced redemptions, due to domestic property issues. It is worth noting these property issues began in November of 2021.

Figure 9: Performance of $10,000 invested in BREIT on 1 January verse the Dow ones US Real Estate Trust Index



Source: Bloomberg & BREIT investor website

ARNOTT
CAPITAL
EST. 1999

JANUARY 2023

Blackstone announces a landmark US$4bn investment in BREIT by the University of California ('UC'). UC will invest US$4bn into BREIT from 1 January 2023 for a lock up period of 6 years. In a separate strategic agreement Blackstone and UC have set up a waterfall structure whereby Blackstone will contribute US$1bn of its current holding in BREIT to support an annualised minimum 11.25% net return for UC.

The full link to the press release can be read here: https://www.blackstone.com/news/press/uc-investments-creates-strategic-venture-with-blackstone-to-invest-4-billion-in-breit-common-shares/

Without sighting the underlying documents, our face value assessment of this deal appears that Blackstone are guaranteeing 11.25% per year to UC and are utilising their balance sheet investments to collateralise this guarantee.

Steve Schwarzman has built one of the truly fantastic asset management businesses, however, to us this seems like a very interesting transaction to enter for a structure that is fine.

Our view is that this is an industry wide phenomenon, as the stellar returns are now being met with scepticism by the underlying investors, who can now take their profits and re-allocate capital into a genuine alternative.

IN CLOSING

Thank you for your support throughout the past 12 months and entrusting us with your capital. As we move into 2023, 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,
Co-Chief Investment Officer

ARNOTT
CAPITAL
EST. 1999

Disclaimer

This document is given to only wholesale clients (as defined in the Corporations Act 2001 (Cth)) by representatives of Arnott Capital Pty Limited (AFS Licence Number 233743) (**Arnott**). By viewing this document, you are representing that you are a wholesale client and agree to keep this document confidential. This document is directed at persons who are sophisticated investors with sufficient professional or other experience to properly assess the nature of the matter discussed herein. This document has been prepared for general information purposes only without taking into account any potential investors' personal objectives, financial situation or needs. It should not be relied upon by the recipient in making an investment decision. This document is intended to provide a general outline only and is not intended to be a definitive statement on the subject matter. The document is not intended to be relied upon by recipients given the contingent nature of the content matter.

Forward-looking information in this document is provided as a general guide only and should not be relied upon as an indication of the future performance of any financial products (including the Arnott funds). No representation is made as to future performance or volatility of the financial products. Persons should rely solely upon their own investigations in respect of the subject matter discussed in this document. Past performance information given in this document is given for illustrative purposes only and should not be relied upon as (and is not) an indication of future performance.

No representations or warranties, express or implied, are made as to the accuracy or completeness of the information, opinions and conclusions contained in this document. In preparing these materials, Arnott has relied upon and assumed, without independent verification, the accuracy and completeness of all information available to Arnott. To the maximum extent permitted by law, neither Arnott nor its director, employees or agents accept any liability for any loss arising in relation to this document. The offer of interests in the Arnott funds will only be made in the offering document for the respective fund.

Hong Kong

This document has not been reviewed or approved by any regulatory authority in Hong Kong. This document does not constitute an offer or invitation to the public in Hong Kong to acquire the units in the Fund. Accordingly, unless permitted by the securities laws of Hong Kong, no person may issue or have in its possession for the purposes of issue, this document or any advertisement, invitation or document relating to the units in the Fund, whether in Hong Kong or elsewhere, which is directed at, or the contents of which are likely to be accessed or read by, the public in Hong Kong other than in relation to the units of the Fund that are intended to be disposed of only to persons outside Hong Kong or only to "professional investors" (as such term is defined in the Securities and Futures Ordinance of Hong Kong (Cap. 571) and the subsidiary legislation made thereunder).

Singapore

This document is being furnished to you on the basis that you are an "institutional investor" (as defined in the Securities and Futures Act (Chapter 289) of Singapore) and on a confidential basis, solely for your information. This document may not be reproduced, disclosed, or distributed to any other person in Singapore. Arnott, as the responsible entity and manager for the Fund has not taken any steps to ensure that the capital markets products referred to in this document are suitable for any particular investor, and will not treat recipients as its customers by virtue of their receiving this document. This document has not been, and will not be, registered as a prospectus with the Monetary Authority of Singapore and this document is not intended to constitute an offering, and is not regulated by any financial supervisory authority pursuant to any legislation in Singapore. The investments or services referred to in this document may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about such investments or investment services. Nothing in this document constitutes investment, legal, accounting or tax advice or a representation that any investment or strategy is suitable or appropriate to your individual circumstances or otherwise constitutes a personal recommendation to you.

United Kingdom

This document may be distributed in the United Kingdom only to persons who: (i) have professional experience in matters relating to investments in accordance with Article 19 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (as amended) ("FPO"); or (ii) to whom this document may otherwise be lawfully distributed (all such persons together being referred to as "Relevant Persons"). This document is only directed at, or available to, Relevant Persons and must not be acted on or relied on by persons who are not Relevant Persons. Any investment or investment activity to which this document relates is available only to, and will be engaged in only with, Relevant Persons.

United States

This document may not be distributed in the United States and does not constitute an offer to sell, or a solicitation of an offer to buy, securities in the United States. Any securities described in this document have not been, and will not be, registered under the US Securities Act of 1933 and may not be offered or sold in the United States except in transactions exempt from the registration of the US Securities Act, the US Investment Company Act of 1940 and applicable US state securities laws.