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Dear Fellow Investors,

As material investors in the Arnott Opportunities Strategy[1] ('Strategy'), 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.

We will cover the following topics:

1.) A review of our investment approach.
2.) Performance summary over the last 12 months and lessons we have learnt.
3.) The investment landscape ahead and where we are looking for opportunities.

A REVIEW OF OUR INVESTMENT APPROACH

Arnott Capital is an absolute return fund manager. We seek to identify Asymmetric investment themes and opportunities on both the long and short side of the portfolio around the world.

We aim to produce above average returns with below average drawdowns. This is what Asymmetric Investing is. We have consistently achieved these goals over a very long period. In practice this is a difficult task that requires a delicate balance between two portfolio personalities. The risk manager and the opportunist.

The way we balance which portfolio personality is in charge, is to think of economies and markets in three broad layers. At the highest layer, is high-level macro data. We primarily study this level of data and trends for risk management, not for alpha creation. This is where the risk manager sits, watching for trouble that in reality, rarely eventuates. The middle layer is where we find investment themes. This is where the opportunist lives day in day out, searching for asymmetric investment opportunities, identifying ideas where we have a variant perception to consensus. Once the opportunities are found we go down another layer to individual stocks. It is here that we execute our investment themes.

These collection of investment themes are curated in the portfolio with a clear objective. They are to endure in different market environments. The result of this work, is a portfolio return profile that is genuinely asymmetric. An additional (although unintended) characteristic of our approach is that the returns are uncorrelated to any other asset class.

Figure 1. Arnott Opportunities Strategy performance correlation.

Asset Class	Correlation
Global Equity Markets	0.05
Government Bonds	-0.01
US$ Gold	0.03
Bloomberg Commodities Index	-0.02
Bloomberg Equity Long / Short Hedge Fund Index	0.02

[1] 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.

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PERFORMANCE SUMMARY FOR THE LAST 12 MONTHS AND SOME LESSONS WE HAVE LEARNT

For the twelve months ended 30 June 2023, the Strategy generated a net return of negative 0.67%. The Strategy's net average monthly exposure over the last 12 months was 32.18% net long and total average gross exposure was 114.12%.

Over the past 18 months, the risk manager has been firmly in charge of the portfolio, in hindsight that was not necessary. However, it was the right decision given our assessment of risks in the investment environment. The first step in improving our process is to identify what we mis-assessed. The discussion from here is a postmortem breakdown of where we were wrong, what has changed and then how we are evolving.

As we moved into 2023, there was compelling evidence based on traditional indicators that a material economic slowdown would occur within the first half of 2023. Given this, we positioned the portfolio to weather this storm and seek to generate reasonable returns from index hedges and equity short positions in the portfolio.

The four best lead indicators of a recession have been as follows.

1.) Yield Curve inversion, specifically the 3 months and 10-year inversion with a 100% hit rate;
2.) The senior loan officer survey ('SLOOS');
3.) Real money supply (M2);
4.) Lead economic indicators such as ISM's etc.

From the middle part of 2022 all of these indicators were flashing red. Twelve months on, and the global economy is still generating strong real economic growth, consumer confidence recently hit a two year high in the United States, most developed economies around the world are at record low levels of unemployment and economic growth is surprising to the upside.

With hindsight this cycle is unfolding very differently to others. Our belief is that the difference in this cycle verse prior cycles lay in these key areas:

1.) The rise of private credit;
2.) Changes in the labour market;
3.) Excess savings due to fiscal stimulus;
4.) Increased asset prices due to the excess stimulus.

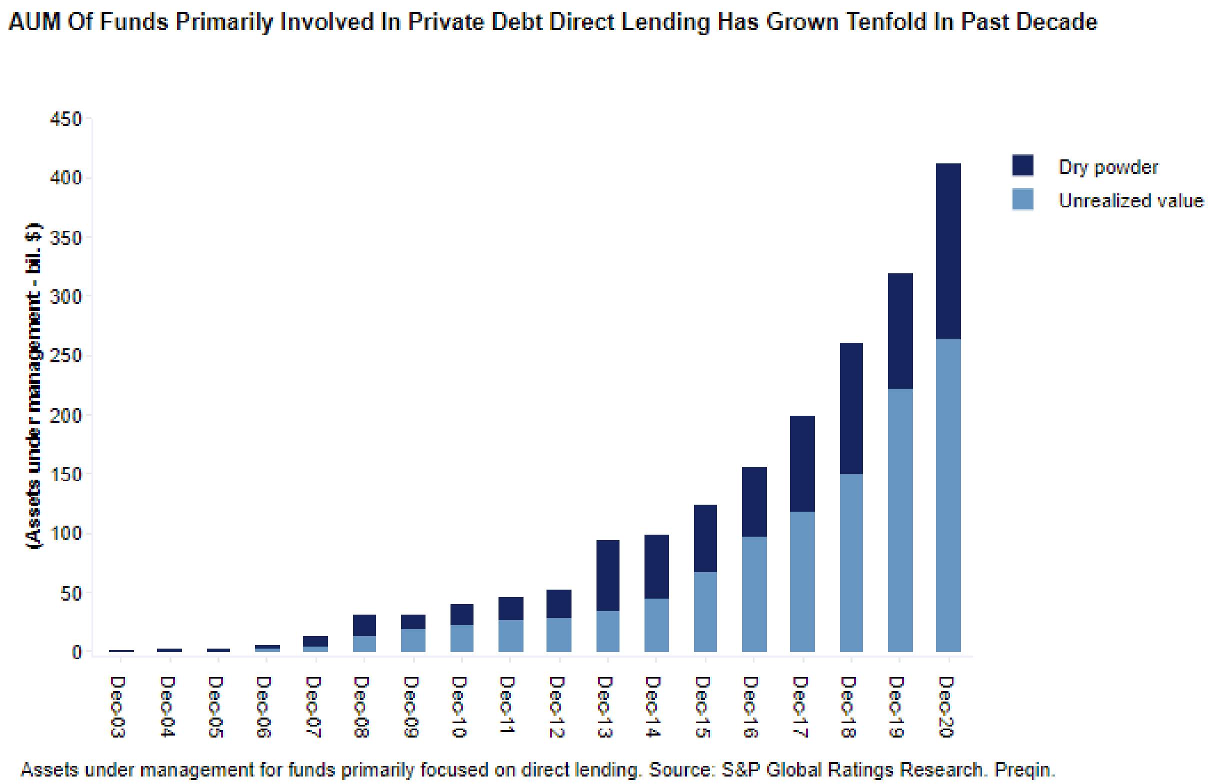
Rise in Private Credit

The rise in Private Credit post the Global Financial Crisis has seen the sector move from a small part of credit creation and relevance in the credit cycle, to becoming a key lender in the US economy.

The rise of Private Credit has been on full display through 2023. We have seen a couple of regional banks go bankrupt, tighter lending standards applied to the sector and small businesses are reporting little to no stress.

Using traditional economic indicators, this makes no sense. However, when considering the rise of private credit funds (who are primarily lending to small and medium businesses) the importance of the traditional banking system as a barometer for corporate health has been severely impaired.

Figure 2. Assets Under Management ('AUM') of private credit managers.



Source: S&P Global ratings research, Preqin

This rise in funding available to lend to small businesses by Private Equity firms may be a significant driver for why traditional measures such as the SLOOS are failing as an economic cycle indicator.

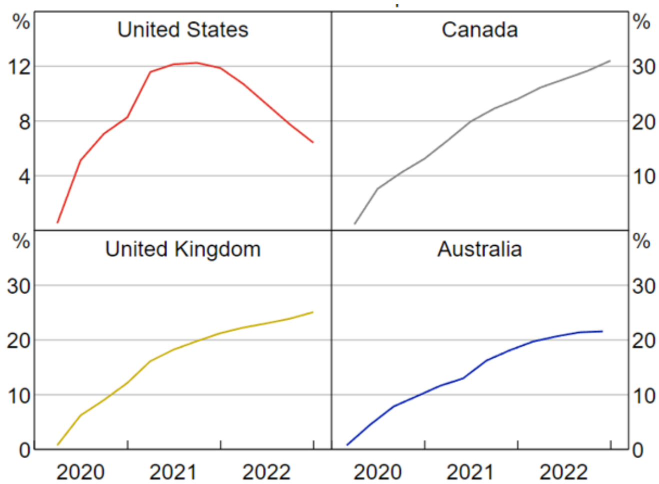
Changes in the labour markets

The US jobs market has shown signs of undergoing a seismic shift the likes of which has not been seen for generations. This reflects the country's changing demographics, governmental policies, technological change, and a re-evaluation of the contract between employer and worker. These factors have brought about the tightest labour market of modern times providing the worker with greater bargaining power. With job security and high levels of nominal wages rises, the US consumer is in a good position to continue spending. A trend we are seeing not only in the United States but globally.

Excess savings

Households all over the world were handed unprecedented levels of fiscal support during the COVID crisis. The monies that went to consumers all around the world are still sitting in their bank accounts acting as cushion, further supporting elevated levels of consumer spending. Based on lead economic indicators and traditional measures of real money supply, the global consumer should have materially cut back their level of spending. Full employment and additional monies in our bank accounts are clearly driving an elongation of the cycle, which when looking at major developed economies still has a way to go before burning through these levels of excess savings.

Figure 3. Percentage of disposable income per country held as excess savings.



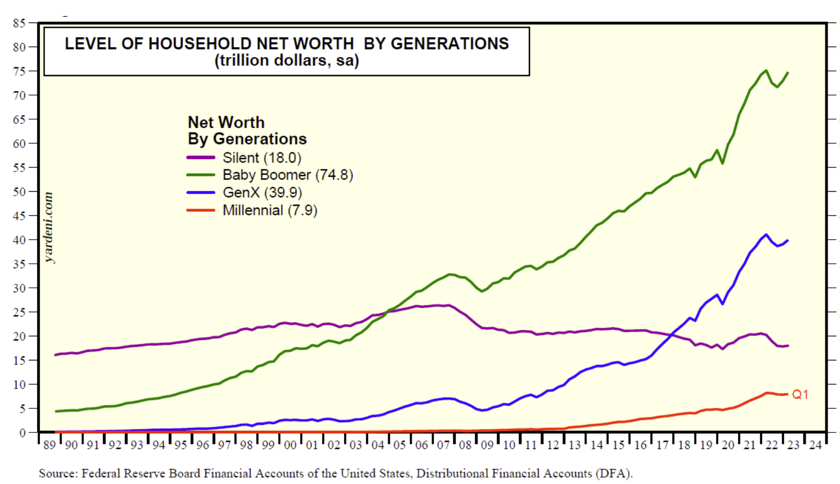
Source: Reserve Bank of Australia

Increased asset prices due to the excess stimulus

In a two-year period during the Covid Pandemic there was nearly a 30% increase in total money. It is unsurprising then that we have seen a tremendous increase in wealth for generations that had already accumulated assets (Baby Boomer and Gen X). When we feel wealthier, we spend more. So, whilst certain cohorts are under pressure in the current environment, at an aggregate level, due to the dispersion of wealth, total consumer spending can continue to rise.

It is our belief that the likely path forward, in the medium term, is pockets of stress in certain consumer demographics but continued strength at an aggregate level in consumer spending.

Figure 4. Level of Household net worth by generations.



Source: Yardini Research

These four factors are likely affecting this cycle differently. Given this, we believe that the economic downturn will not be as severe as these lead indicators would suggest and in unlikely to materialise until 2024 or beyond.

THE INVESTMENT LANDSCAPE AHEAD AND WHERE WE ARE LOOKING FOR OPPORTUNITIES

There is no question that we are in an environment of tremendous change. Be it artificial intelligence, rising geopolitical tensions and for the first time in a long-time, interest rates greater than zero. An environment of change is one where active manager's, such as ourselves should thrive. However, a key part of thriving in a changing environment is adapting to this new environment and acknowledging:

- the tried and tested traditional economic indicators either now do not work, or work with an immense lag;
- change drives greater uncertainty, resulting in higher levels of single stock realised volatility and dispersion; and
- governments are the main game in town now and have taken the baton away from central banks.

As we have previously written, the prescription is clear, we need to run *'light and tight'*. Which in practical terms means gross exposure will be lower (in the range of 80%-110%) and net exposure will remain low ranging between 0%-40% (as we are neutral on forward returns from equity markets from here). This gives us greater flexibility to take advantage of sector dispersions, which are becoming an ever-increasing embedded feature of markets.

We have adjusted our toolkit to account for the aforementioned changes. We now know what we need to remain laser focused on, as this cycle unfolds:

1.) Jobs and wages;
2.) Excess Savings;
3.) Delinquencies and how Private Equity lenders are seeing the environment; and
4.) Government policy. Regarding both geopolitical tensions and fiscal agendas.

With this slight tweaking of our process, it has enabled us to then return to working in the second layer of our investment process, finding Asymmetric Investment opportunities on both the long and the short side around the world.

So where are we finding opportunities?

Uranium

We have been invested in Uranium to varying degrees over the last four years. Our long-term investment thesis core drivers remain the same.

1.) Return of demand: After three decades of flat nuclear demand Chinese and Indian reactors are about to come online with 60 under construction, adding +15% to world demand. In addition to this 100 more have been approved. By 2035, global demand is expected to be 209 million pounds annually. This will lead to a supply shortfall of 114 million pounds.
2.) Dwindling Supply: The Uranium market has been in a bear market since 2007 seeing the spot price fall from a high of US$140 p/lb to a low of $20 p/lb. No new supply has come online in over a decade.
3.) Marginal Cost Support: With demand increasing, supply declining and the incentive price for new mine development north of US$70 p/lb the current spot price of US$55 p/lb represents an asymmetric investment opportunity.

The situation is now moving to a shorter time frame supply / demand imbalance. There are several factors currently at play.

1.) An increased number of countries are extending the life of reactors.
2.) The adoption of Small Modular Reactors which require larger amounts of uranium for the startup cycle.
3.) Restarting operations of the Japanese nuclear fleet.
4.) Supply issues at Kazatomprom, the world's largest-uranium miner. It struggled to meet the lower range of its production targets, with output declining 6% in 1Q23.
5.) Threat of restrictions on Russian sourced nuclear fuel deliveries.
6.) EU Green Taxonomy Allows Nuclear Energy to be available for green energy subsidies.

This year the expected supply deficit may be 60 million pounds. This is leading to an increase urgency from utilities who have had over a decade of no issues. Contracting volumes have increased in 2023 as a result. Prior bull market cycles in uranium were driven by a surge in contracting volumes by utilities. It was the catalyst to drive a material price appreciation in the underlying commodity.

Special Situations

From time to time, we discover single stock situations where the individual risk / reward skew is too compelling to pass up. We identify these individual opportunities as "Special Situations" to differentiate them from the bulk of our portfolio made up of thematic investment opportunities. One such recent position in the portfolio we have built over May and June 2023 is a long position in UBS Group Ag ('UBS').

We see UBS's acquisition of Credit Suisse (paying US$3bn for US$34bn of tangible assets) as a transformational deal for UBS propelling them to the 2nd largest global wealth manager, 3rd largest asset manager in Europe and accelerating their global growth plan with Credit Suisse's geographical strength complimentary to UBS's.

In addition to a knock-out purchase price, the deal has a significant amount of downside protection imbedded into it: 1.) US$4bn of provisions for CS related liabilities; 2.) Material mark downs of balance sheet assets; and 3.) a US$10bn guarantee from the Swiss National Bank for losses borne by UBS on non-core unit assets, after a first loss provision of US$5.5bn.

"*When you focus on return at the exclusion of risk, you try to take more risk to get the return; you get the risk but may or may not get the return. If you focus first on the risk and mitigate or avoid or reduce the risk, then you've protected the downside, and then maybe you get the return.*"

- *Seth Klarman*

Whilst the list of risks that may lie within Credit Suisse, which we will only know over time, is inherently unknowable, it appears that the purchase price in conjunction with write down of AT1 debt and guarantees from the Swiss National Bank more than accommodate for this. From here the synergies to be derived from the combination, scale benefits of being the 2nd largest global wealth manager and 3rd largest asset manager are only upside in our opinion and will begin to materialise over the months, and years ahead.

Short Australian Banks Theme

Before we delve into our thesis on why we are short the Australian Banks, it is worthwhile expanding a little on our portfolio construction process and what additional benefits a short position in the Australian banks brings to the portfolio.

Our goal in portfolio construction is to gather a group of idiosyncratic thematic ideas that will not all contain the same underlying economic drivers. Furthermore, we assume that our assessment of the current investing landscape will be wrong and think about how the individual themes will behave under different market outcomes. This is crucial to generating asymmetric returns. The practical implication of this is that some short themes in the portfolio are in isolation not the most outstanding short idea but add a layer of convexity into the portfolio so that when we are inevitably wrong about the market environment these positions behave more like a put in the portfolio.

This is exactly how we view the Australian Banks. The four Australian banks generally exhibit around 15 to 25 percent annualised volatility. This means we should expect them to move around each day 1 to 1 ½ percent per day on average. However, because they are financially levered, in a crisis they tend to move more. And those moves are typically on the downside. So, by shorting Australian banks, we view this as buying cheap puts to help protect the longs in the portfolio in the event of an unexpected macro driven crisis.

Before we think about the added portfolio benefits, a theme must stack up as short theme in and of itself, the tolerance we build into portfolio construction is around the absolute percentage return expectation of the idea.

Our short Australian bank's theme is primarily centred on an intensifying competitive landscape re-establishing the downtrend in net interest margins, housing affordability issues lowering mortgage volumes and valuations that limit the upside from current levels.

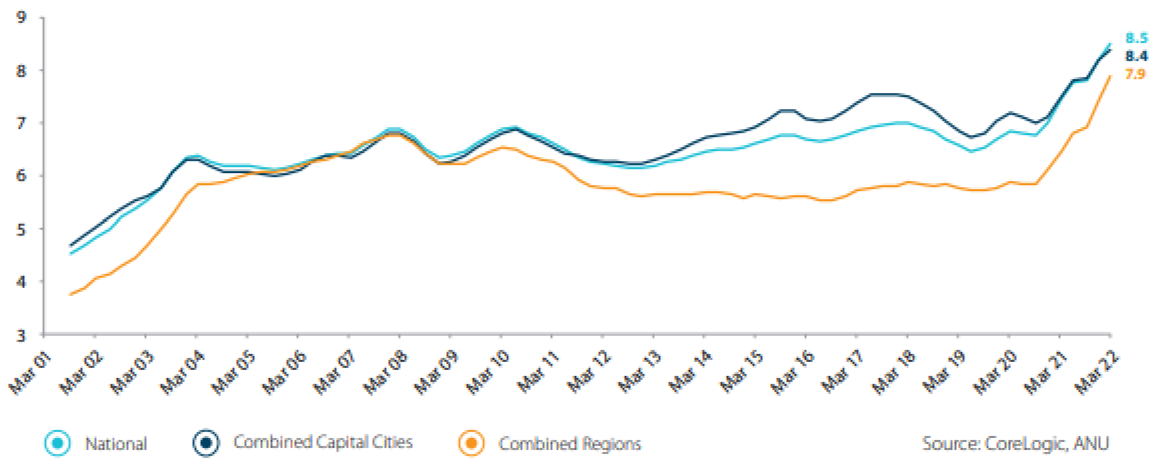
Competition

It is well flagged now, that the large reset of fixed rate mortgages in Australia has driven immense competition in Australia as banks fought to lure away customers from their existing banks, with peak competitive intensity being reached in February and May. Whilst we are past peak competition, the lingering impacts of these banks, by their own admission writing new loans below their cost of capital will have multiyear lingering impact on earnings, driving further downgrades. Whilst the war for lending has largely now played out the next battleground lies on the liability side of the balance sheet as the big four banks compete for household deposits, a far cheaper funding source than trying to access wholesale debt markets at the present time. The competitive intensity on the liability side of the balance sheet is only stepping up into the back end of the year as they seek to replace just under A$200bn of funding extended at a 0% interest rate from the Reserve Bank of Australia that comes due in 2024.

Housing Affordability

Despite high levels of net migration, we are of the view, that the current level of housing prices will ensure the level of new lending volume will remain anaemic for the years ahead as housing affordability has reached dire levels. It does not take a banks analyst to explain that new lending is the lifeblood of bank earnings, and we see a period ahead where the flow of new lending volume is incredibly subdued, with the solution not a simple fix.

Figure 5. Average Household Value to Income Ratio.

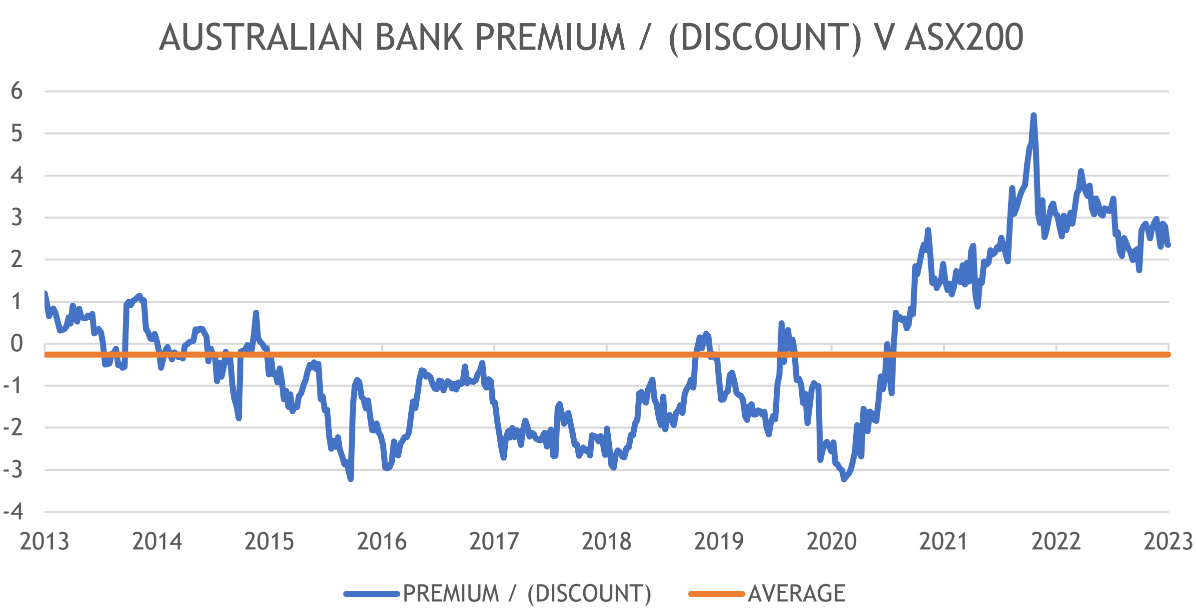


Source: Corelogic, ANU

Valuation

Whilst we avoid valuation as a core driver for a short thesis, we use it as a rough guide for thinking about upside risk when shorting a mature industry such as the Australian banks. Given structural headwinds, housing affordability issues, risks to their cost base one would think that the Australian banks would be trading at a discount to the ASX200, as they have on average historically traded, however they are now trading at a premium per figure 5 below.

Figure 6. Australian Bank P/E premium / (discount) verse ASX200.



Source: Bloomberg

In the event we are wrong, and competition has disappeared, costs are fine, Australians dig deeper to pay for homes, the premium verse the ASX200 would suggest the upside risk is limited.

This is an example of the dual purpose that some of our short positions serve in the portfolio. Although all ideas are intended to be alpha generators, we are sometimes willing to accept lower return expectations if the short will assist in downside protection.

Capital Cycle

We find the best shorts follow the typical capital cycle. What we are seeking to identify is the inflection point where the market's perception of future industry revenue growth and profitability is in stark contrast to the underlying fundamentals. Primarily what we are looking for are industries / sectors exhibiting the following traits:

1.) Rising competition;
2.) Increased supply of goods, capital etc;
3.) Buoyant market perception extrapolating growth into perpetuity; and
4.) Deteriorating demand that acts as the catalyst to accelerate the deteriorating industry structure.

Naturally, the volatility at the end of trends is significantly higher as the market oscillates between the continuation of a bullish equity market narrative in the face of deteriorating fundamentals. Given this, we tend to limit the amount of capital deployed into these themes but given the nature of these themes as idiosyncratic *"Alpha"* shorts, the returns generated from these should be material to the portfolio irrespective of equity market movements.

An example of a portion of capital deployed from the short side that sits within this broader theme is centered around the electric vehicle supply chain, primarily focused on South Korea. There is no question electric vehicle adoption will increase over time especially considering the dollar value of fiscal support being provided by Governments, however, ***everything has a price***.

We have been monitoring the meteoric rise year to date (share price rises of between 400%-1000%) in South Korean companies which are key suppliers to battery manufacturers. The rally in these companies share prices have been happening despite increased commoditisation of their products, threats from competing technologies and now market capitalisations which exceed that of the companies they supply, despite only generating a fraction of the profits.

We have avoided the siren song of initiating short positions in these names all year as the rally has been driven by retail speculation, primarily led by an individual going by the name of *'Mr Battery'*, and the deteriorating fundamentals of the sector were not yet made apparent. However, we are now seeing signs of a slowdown in the electric vehicle battery market with leading battery supplier LG Energy Solutions warning of a slowdown in 2HY23, Ford flagging a delay in their electric vehicle roll out due to affordability concerns as consumers cut back on spending of big-ticket items. With market caps exceeding US$30bn – 40bn, a slowing economic backdrop and investors with YTD returns exceeding 1000%, it is shaping up that the risk / reward for this sector is skewed to the downside as we move into the second half of 2023.

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IN CLOSING

Thank you for your support throughout the past 18 months and entrusting us with your capital. As we wrote in our 2022 annual letter, it is the strong support of our investors that enables us to traverse the road less travelled and create a portfolio of unique opportunities, and most importantly seek to preserve capital at times, as in 2018, March of 2020 and through 2023 where tight risk control is warranted.

Yours faithfully,

Kenny Arnott,
Chief Investment Officer

Yianni Gertos,
Co-Chief Investment Officer

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