ARNOTT
CAPITAL
EST. 1999

Dear Fellow Investors,

In this, our 2023 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.) 2023 performance summary and some of the lessons we have learnt.
3.) Macroeconomic risks and opportunities for 2024.

OUR INVESTMENT APPROACH

The Arnott Opportunities Strategy ('Strategy')[1] 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.

This goal of seeking to achieve above average returns with below average drawdowns does come at a cost.

Figure 1. Arnott Opportunities Strategy Cumulative returns

[1] We run one strategy across multiple investment vehicles. For consistency purposes all references to the strategy are for the Arnott Opportunities (Cayman) Fund Ltd. Founder Class.

There are extended periods of time where the strategy will generate minimal returns. There are generally two reasons why we have flat performance periods.

The first is when we have decided the macro environment is not offering an asymmetric investment payoff. We spend many waking hours looking for potential trouble around the world. This pursuit of risk management comes at a cost. We sometimes prepare the portfolio for market crashes that never happen. The most recent being when the West implemented SWIFT banking sanctions against Russia. At the time, this was described as a major event. *"On 26 February 2022, the United States and its allies announced they would remove selected Russian banks from the SWIFT global financial messaging network. Exclusion from SWIFT has been described as 'the nuclear option' of financial sanctions, and will have far-reaching consequences for the global economy and trade."*

We de risked the portfolio, by doing three things. We reduced the number of positions, the gross exposure and the net exposure. With hindsight, we now know that there was no crisis. However, the events of the Russian invasion certainly had the potential to be one.

The second reason for flat periods is related to theme selection. First, some background on our selection process; we scour the world looking for asymmetric thematic investment opportunities. Generally, we find that to achieve asymmetric returns, we need to look in less crowded and less researched fishponds. This approach, sometimes described as being contrarian, serves a very important purpose. When we are wrong, we are not wrong with everyone else. That allows us to get out of our poor investment ideas with a little more dignity. Or put another way, we are not selling with the masses. This assists us in minimising drawdowns at a thematic investment idea level.

When we look for these ideas, we pay particular attention to the timeline of events that will trigger other investors to focus on the idea. We typically consider two separate time horizons. Our investment time horizon is typically two to five years for long ideas. Our trading horizon is less than six months. The tools we use to make investment decisions are different from the tools we use to make trading decisions. These two different time horizons are reflected in our returns. Finding good thematic investment opportunities and actively trading around those investment opportunities. Our return series has a lot of variances year by year - but the variances are all positive. In the years when we have achieved very high returns, we have typically made some strong investment decisions that have all worked together. In the years when we have flat returns, we have either decided the macro environment is not offering an asymmetric investment payoff or we have made some poor investment decisions. On the latter, these poor investment decisions normally result in losses. Our active trading approach minimises these losses. In other terms, we generally make trading profits most years that can offset poor investment decisions.

2023 PERFORMANCE & SOME LESSONS WE HAVE LEARNT

For the twelve months ended 31 December 2023, the Strategy generated a net return of positive 4.84%. The Strategy's net average monthly exposure over 2023 was 38% net long and total average gross exposure was 101%. We are being taught new lessons by the market daily, however, through 2023 there are a couple of key lessons.

What is in the price?

We entered 2023 with a pessimistic view of the global economy and by default a dour view on forward corporate profits. Our conclusion was driven by company meetings, headline macro data including M2, ISM, sentiment surveys (both consumer and CEO) and the overall concern regarding impacts the fastest rate hiking cycle in history would have on asset prices. As discussed in the interim investor letter, we overlooked key

things that had shifted in the environment, however, the fundamental takeaway was that our view was not differentiated.

"It is impossible to produce a superior performance unless you do something different from the majority."

\- *Sir John Templeton*

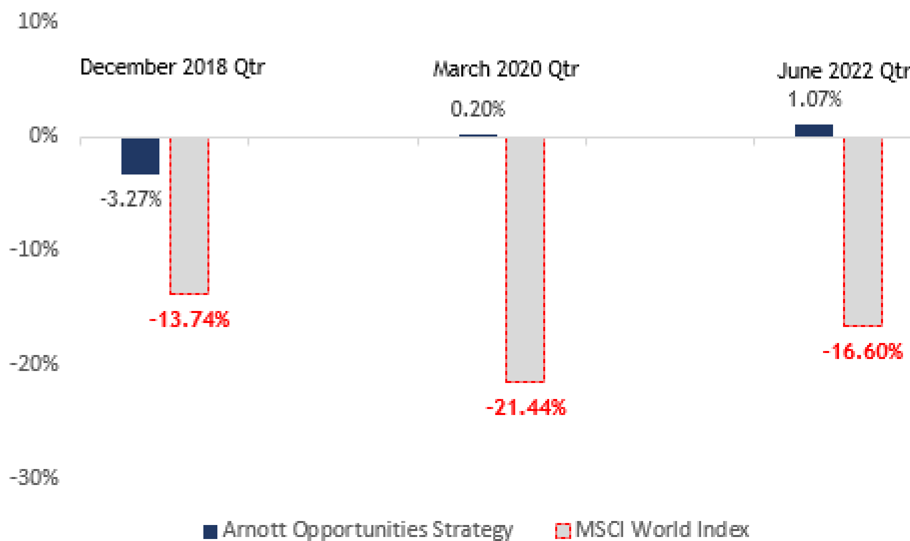
Positioning reflected this downbeat view. Forward earnings estimates had been dragged lower given outlook commentaries from management teams, so the real question we should have asked with this view seemingly being consensus - what is priced?

2023 taught us not to go against consensus for the sake of it, but to ask the question (as we do with our individual themes), that if our view is correct, how much can we make?

Finding Balance between the Risk Manager and the Opportunist

As discussed in past materials, when the Risk Manager is in charge, the focus is on identifying and monitoring risks, seeking to protect the portfolio, with the Opportunist almost playing second fiddle. And to the Risk Manager's credit, this aspect of the Strategy has been stellar at controlling drawdowns in adverse market conditions:

Figure 2. Strategy performance in MSCI World down quarters in excess of 10%



Source: Arnott, Bloomberg

However, we've been sluggish in recovering from risk-off periods as the Risk Manager has sub-consciously fed through to our investment process. To improve, we should confine the Risk Manager's influence on portfolio construction, allowing the Opportunist to freely pursue asymmetric investment opportunities and build a robust pipeline of ideas for future capital deployment.

Using these learnings, as we moved into the second quarter, we adjusted our positioning. This was in response to a more positive backdrop and reassessment on positioning. Following this pivot, the fund had reasonable performance - from the period of May onwards the fund delivered over 8%.

MACROECONOMIC RISKS AND OPPORTUNITIES FOR 2024

Many of the issues which were lurking in the early months of 2023 remain. There are significant amounts of debt in households, corporations and government. However, as long as the bond market is comfortable with this risk, then it is unlikely to derail equity markets in 2024. In addition, while the path for US rates is being questioned every day, what is not in dispute is what the Fed can do. They can cut 100bps quickly and they can expand the balance sheet aggressively, if things get messy. Obviously, this may happen in response to a crisis that first sends markets down. But they can. This option has not been available for the last two years. In addition to this, we have seen in the last 12 months targeted policy responses that have prevented contagion in risk assets – the BOE buying Gilts, the ECB with its TPI program and the US regional bank bailout. Adding liquidity to specific industries has worked very well. In summary, it could be argued that the central banks' power and perceived power has never been greater.

A repeat of the 1970's inflation is a tail risk but not main case in our mind. There always remains the risks of escalating geopolitical tensions around the known global conflicts including, Ukraine, the Middle East, and China/Taiwan. But there is nothing flashing red now. We have elections in the US which will be very important for trade. We will remain vigilant, however, for now we see no significant macro-outliers. This will allow us to focus strongly on researching and investing in thematic ideas. It does not mean we are outright bullish equity markets. We are finding plenty of short themes as well as longs. For example, there will likely be pockets of opportunity and risk that continue to play out as levered companies refinance looming maturities.

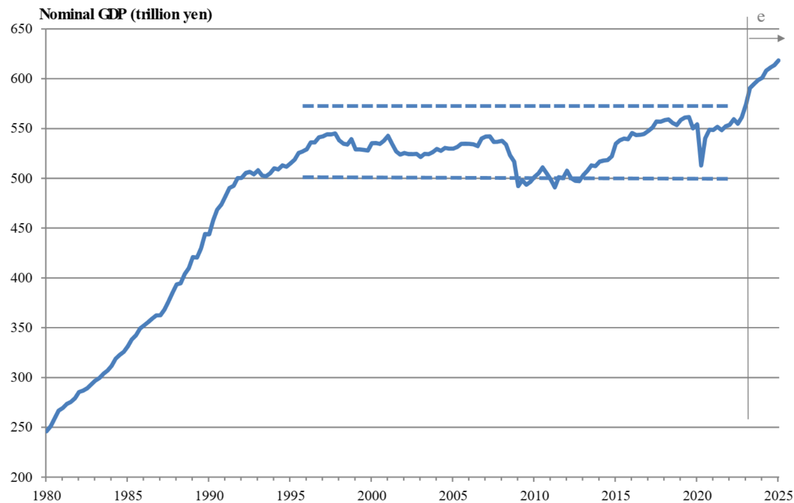
JAPAN

In our opinion, the secular bull market for Japanese Equities has arrived as macro and micro forces collide to drive a sustained period of expanding corporate profits.

Macroeconomic Drivers

Japan is now firmly exiting a thirty-year period of deflation and achieving nominal GDP growth, for the first time since the bubble burst in the early 1990's.

Figure 3. Japan Nominal GDP



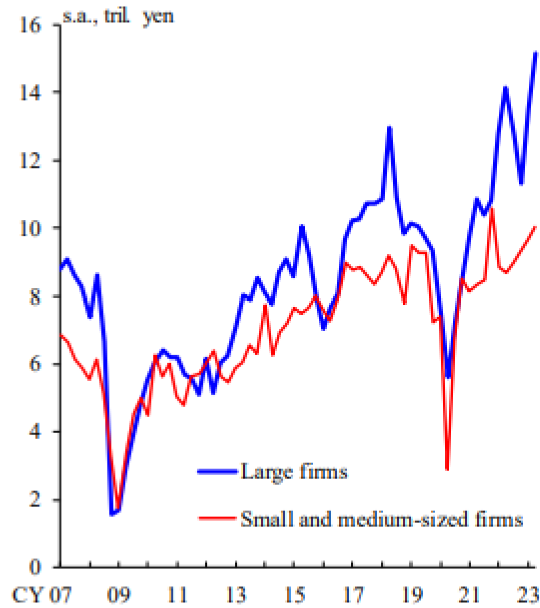
Source: Morgan Stanley Investment Research

This growth revival is no accident. It is the culmination of a prolonged period of successful government policy which began in 2012 with '*Abenomics*' and has been accelerated with the current Kishida administration seeking to create a virtuous cycle of economic growth driven by wage growth and corporate capital expenditures.

Accelerating these trends is Japan's unique position in the *Multipolar* world. A global manufacturing powerhouse, with stable rule of law and deep economic ties with the United States and allies. We are already seeing Japan emerge as a supply partner of choice as corporates seek to diversify their supply chains away from regions of the world which may be at risk of geopolitical tensions, boosting inbound foreign direct investment.

Most importantly, Japanese corporate profits are on the rise, giving impetus to Japanese companies to invest in Japan:

Figure 4. Corporate sector profits



Source: Bank of Japan

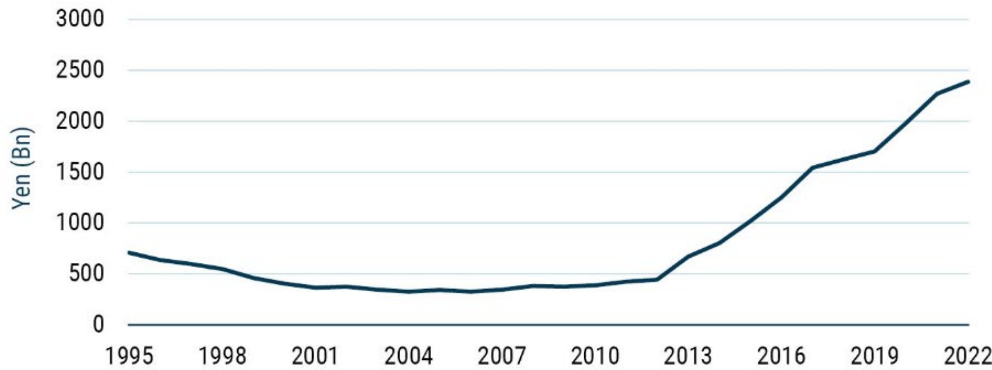
With increasing mobility of labour, rising capital expenditure and expanding corporate profits, it is our belief that wages are set to rise further. From our discussions with multiple Japanese corporates, it appears that for the year ahead wage rises are likely to come in the range of 3.5% - 7% year on year, well ahead of forecasts, such as Goldman Sachs predicting a 2.5% rise[2].

Microeconomic Drivers

After the bursting of the bubble, Japan Inc went under an extended period of deleveraging, seeking to hoard cash (Figure 5) and refrain from investment. Both of which drive negative outcomes for shareholders, with declining shareholder returns and a reduction in corporate profits given a lack of productive investment. This has also been mirrored by the Japanese household sector with 54.2% of household assets held in cash of deposits versus the US at 12.6% and EU at 35.5% (Figure 5).

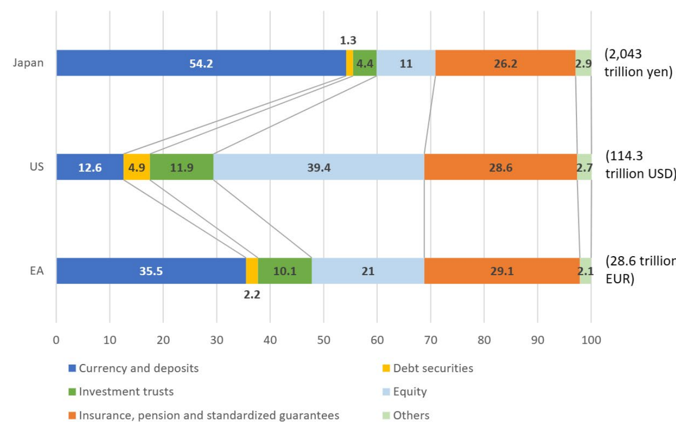
[2] Please note our discussions have been with large listed Japanese corporates and we do acknowledge the risk that our discussions with corporate Japan may miss the large quantum of unlisted SMEs in regional Japan.

Figure 5. Topix Cash



Source: GMO

Figure 6. Share of household assets Japan, US, EU



This trend is decisively changing with The Tokyo Stock Exchange ('TSE') seeking to accelerate corporate governance reform, with a slew of initiatives announced in March 2023.

"The purpose of these actions is to have the management of the company carry out their management duties with more consideration of cost of capital and profitability based on the balance sheet, rather than just sales and profit levels on the income statement, in order to achieve sustainable growth and increase corporate value over the mid- to long-term."

- *TSE: Action to Implement Management that is Conscious of Cost of Capital and Stock Price (March 2023)*

This enhanced focus on the cost of capital and profitability is only a good thing for shareholders and likely to see an acceleration of the expanding corporate profits in the years ahead as the TSE continues to push ahead with their reform agendas.

A good thing for equity holders.

Where are the asymmetric opportunities as we see them?

- **Exit from Negative Interest Rate Policy:** With the Japanese economy growing in nominal terms, sustained wages and increasing corporate capital expenditures, we are likely to see the end of negative interest rates in Japan in the first half of this year. This creates a series of opportunities, the most asymmetric of which we believe is in being long the Yen as Japan begins raising rates at a period when the rest of the world are set to commence cutting;
- **Corporate Reform Beneficiaries:** Japan is home to some phenomenal companies, with world leading products and services, driven by a relentless pursuit of *"Kaizen"*[3]. This has not translated into shareholder returns with profit margins, ROE and ROIC measures trailing well below fellow developed nation peers. It is our belief that the new wave of corporate reform spreading across Japan will drive a material uptick of profitability for Japanese corporates which have prioritised stakeholders over shareholders for the past thirty years.
- **IT & Capital Expenditure Beneficiaries:** Productivity growth is high on the agenda for corporate Japan. With a rising profit pool, we are of the belief that the propensity to spend increasing capital on IT systems upgrades and plant and equipment to lift operating efficiency is rising. This provides a long tail of potential winners from this trend.

The lingering question we still have burning in our minds, touched on in our 2022 annual investor letter, what happens when the significant amounts of capital invested outside of Japan comes home? With rising domestic returns, increased foreign exchange volatility, the relative attractiveness of investing in Japan is surely rising. So, what happens when one of the largest creditors to the world calls back their capital?

We definitely do not have an answer for this but are incredibly conscious of the immense liquidity drain this would bring for the global economy.

IN CLOSING

"Choose clients as you would friends."

\- Charlie Munger

Thank you for entrusting us with your capital and we wish you all a happy and prosperous 2024.

Yours faithfully,

Kenny Arnott,
Chief Investment Officer

Yianni Gertos,
Co-Chief Investment Officer

[3] Japanese term meaning change for the better or continuous improvement.

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.