2024 Interim Investor Letter

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Dear Fellow Investors,

Welcome to the Interim Investor Letter for the Arnott Opportunities Strategy[1] (the 'Strategy'). For the twelve months ended 30 June 2024, the Strategy generated a net return of 10.45%. The Strategy's net average monthly exposure over the prior twelve months was 38% net long and the total average gross exposure was 109%.

Zooming out of the monthly, quarterly and annual performance reporting cycle, over a longer time period, the Strategy has delivered annualised performance, net of fees as per below.

Figure 1. Strategy returns versus other asset classes

	1 Year	3 Year (p.a.)	5 Year (p.a.)	10 Year (p.a.)
Arnott Opportunities Strategy	10.45%	9.05%	16.14%	16.75%
MSCI World Index	18.22%	5.15%	10.00%	7.24%
Bloomberg Equity Long Short Hedge Fund Index	10.47%	0.90%	9.64%	6.19%
Bloomberg Commodities Index	0.86%	-1.01%	2.38%	-3.99%

Source: Arnott Capital, Bloomberg. As at 30 June 2024. Index returns are in US dollars (USD).

Over the prior ten years, the net exposure of the Strategy has averaged 32%, with an average gross exposure of 153%.

This letter covers three key areas:

1. An update on the prior twelve months' performance;
2. Our current macroeconomic outlook; and
3. Some of the key emerging themes in the portfolio.

As always, we are grateful to you for the opportunity to manage your capital alongside ours. In that spirit, we aim to write these letters in a candid manner, seeking to address the questions we would be asking if we were in your shoes. While we can't read minds, we encourage feedback and welcome any further questions you may have on the Strategy or the contents of this letter, by emailing us at investor@arnott.com.au.

1. Performance referred to in this document relates to the Arnott Opportunities (Cayman) Fund Founder Class. Past performance is not an indicator of future performance. Performance is net of all fees. The currency is in US dollars (USD). Other classes will be subject to different fees. Strategy performance data for the period from June 2013 – December 2017 is that of Bondi Capital Investments Pty Ltd ('Managed Account'), and for the period January 2018 –June 2024 is for the Arnott Opportunities (Cayman) Fund Founder Class. For a copy of the Information Memorandum, please contact investor relations at investor@arnott.com.au.

Arnott Capital Pty Ltd (ABN 23 086 081 889)
Australian Financial Services Licence No: 233743
Level 39, Aurora Place, 88 Phillip Street, Sydney NSW 2000

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1. PERFORMANCE SUMMARY FOR THE LAST 12 MONTHS

Whilst the prior twelve months' return was short of what we seek to deliver (and short of what we have delivered over a long period of time), we don't want to shy away from the fact that the Strategy's objective of double-digit annual returns, with minimal capital loss, comes with a cost.

When the Strategy enters a drawdown phase, we cut risk and look to de-gross the portfolio, working on the premise that positioning in the portfolio is wrong for the current market environment. This results in our returns coming out of drawdowns being subdued - the cost of limiting peak to trough Strategy drawdowns of -11.6%, whilst still seeking to achieve double digit annual returns.

Figure 2. Strategy drawdown versus other asset classes since May 2013

	Max Drawdown
Arnott Opportunities Strategy	-11.60%
MSCI World Index	-26.39%
Bloomberg Equity Long Short Hedge Fund Index	-13.99%
Bloomberg Commodities Index	-55.81%

Source: Arnott Capital, Bloomberg. As at 30 June 2024. Index returns are in US dollars (USD).

Whilst having exposure to strong structural trends such as Japan, Uranium and Data, the returns from these strong winners should have been materially higher. However, the focus on downside protection of the Strategy coming out of drawdown periods has been a drag on performance — but this is the cost of the Strategy.

2. MACROECONOMIC RISKS AND OPPORTUNITIES

There have been quite a lot of shifting dynamics in the macro landscape recently. This has brought the market's attention to growth risks that exist in the US economy.

US earnings have been mixed. Most importantly, given their large weighting, the earnings of the large technology companies have not been met with the same enthusiasm as they did six months ago. These companies are providing growth forecasting guidance based on Artificial Intelligence (AI) capital expenditure. If they are able to translate this investment in a similar fashion as they have in the past, then AI capital expenditure will translate into revenue. But for the moment, there are some questions around that. Sequioa Capital recently wrote a paper titled "*AI $600B Question - The AI bubble is reaching a tipping point,*" highlighting the challenges and potential turning points in the AI sector. Navigating what comes next will be essential.

US rates have likely peaked. There is significant scope for the US Federal Reserve (US Fed) to cut interest rates, which will support the economy. However, in the short term any accelerated rate cuts by the US Fed would be unlikely to be seen as positive by markets. This is due to the conclusions the market would draw from this, which is that the economy is weakening, thereby shifting concern to aggregate employment. So, while the US Fed put is back in play, the markets would not be happy if it were implemented given the lofty expectations for earnings growth.

US elections in November are fast approaching. The unknowns are many, providing ample excuse for investors to warm their hands on the sidelines until certainty comes.

US employment will be a key macro driver over the next few months. A significant portion of recent employment has been very dependent on just two sectors. For the second straight month, in July, 70% of net new jobs came from healthcare and government. Both these categories are set to see decelerating growth throughout the remainder of the third quarter of 2024. We believe this will likely be the key data point to watch for markets.

Recently we have seen plenty of debate around the Sahm Indicator. The Sahm Recession Indicator signals the start of a recession when the three-month moving average of the national unemployment rate (U3) rises by 0.50 percentage points or more relative to the minimum of the three-month averages from the previous twelve months. Applied to historical data, as it was available in real-time, has been triggered early in every recession since 1970. It had only two false positives since 1959 — when the rule hit 0.50 or more, but the economy was not in a recession. This indicator has been recently triggered.

There are differences this time around that might mean the Sahm indicator will provide a false reading. Shifts in the labour force, including the fall in participation early in the COVID-19 outbreak and then the jump in immigration in recent years, are likely affecting the change in the unemployment rate in a way that would not be typical in prior business cycles. In any case, employment remains the key macro indicator to watch.

With a refocus on growth concerns, weak seasonals and global elections, our portfolio net exposure will run lower over the coming six months. Short positioning in the portfolio will be focused on segments of the global economy where we see air pockets in earnings. Meanwhile, we will look to hold our long themes such as Uranium, Data is the New Oil, Japan and Special Situations constant.

3. KEY EMERGING THEMES

Below we look at some of the newer ideas that are emerging in the portfolio.

CHINA

When we speak with fellow investors, allocators, analysts and really anyone for that matter ('Peer') on the topic of buying equities in China, the conversation will typically proceed as follows:

ARNOTT: "So how are you thinking about China?"

PEER: "China is uninvestable."

ARNOTT: "Why?"

> *"Skepticism calls for pessimism when optimism is excessive. But it also calls for optimism when pessimism is excessive."*
>
> Howard Marks

PEER: "Where do I begin:

- Their property market was the greatest bubble of all time and has now exploded, leaving a gaping whole in individual wealth and economic activity;
- They have demographic issues which are worsening due to extremely high levels of youth unemployment;
- It is a dictatorship, which has quelled any animal spirits."

The list goes on…

We cannot argue with any of the points put forward by the China skeptics / bears and clearly see how they are all valid. However, there is a point where negativity is so pervasive and overwhelmingly baked into consensus expectations that *maybe it is time to call for optimism*?

What if the situation in China is not as dire as equity market participants have priced? What if we are closer to the end than the beginning of the lingering impact of China's property bubble bursting?

We are not trying to be contrarian for the sake of it (and candidly we were wrong about China in 2022, so please apply a dose of skepticism to our preceding comments). In our opinion, contrarianism is one of the core building blocks to generating above average investment returns and it feels that being even slightly optimistic on China might be one of the most contrarian places an investor can be.

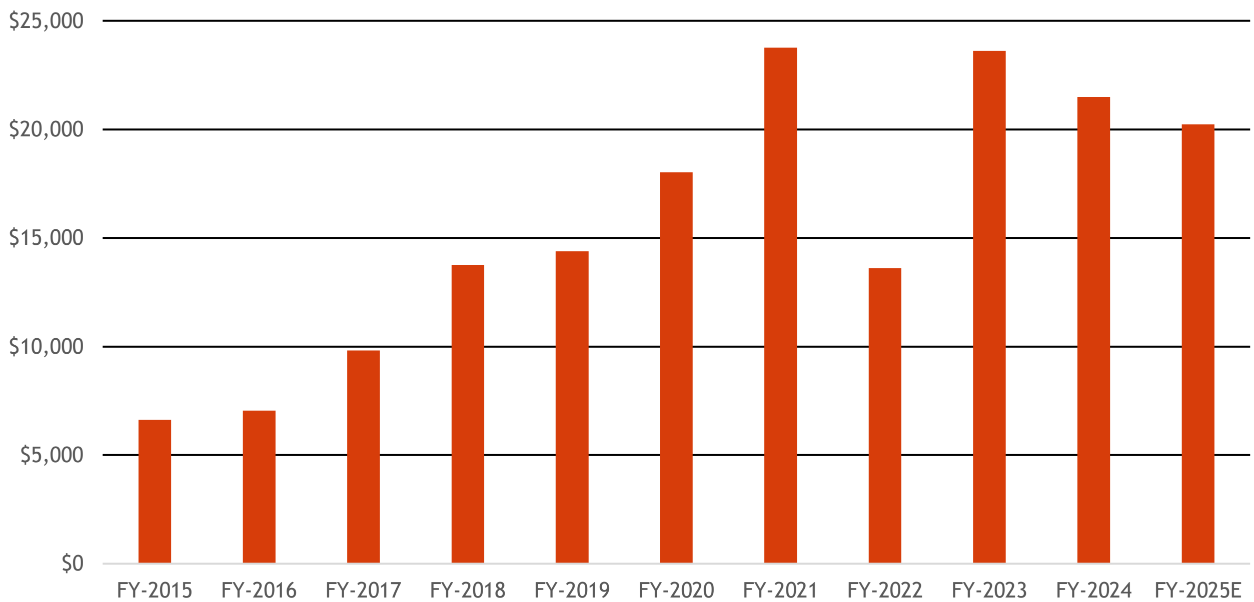
Take Alibaba Group Holding Limited ('BABA') one of China's leading companies. Since the bursting of the Chinese property bubble in late 2020, the stock has seen its multiple de-rate on concerns of the dire state of the Chinese consumer and intensifying competition, as the market grapples with a tough consumer backdrop.

Figure 3. Forward Earnings Multiple of BABA

Source: Arnott Capital, Bloomberg. As at 19 July 2024.

Whilst the multiple has collapsed on concerns of the consumer collapse, structural challenges and the overall sentiment towards China, the underlying reported earnings of the company have held up remarkably well:

Figure 4: Free cash flow BABA (USDm)



Source: Arnott Capital, Bloomberg, Visible Alpha. As at 30 June 2024.

Since the company reported 2020 earnings, the share price is down over 65%, but the underlying free cash flow generated by the business is up by over 20%.

As you may have already likely guessed by now, the Strategy has commenced building positions in China, focusing on the leading e-commerce companies and platform businesses. We do not expect the market to re-rate these equities, the free cash flow generation of these businesses is running in the high teen percentages with a significant portion of that being returned to shareholders via buybacks and dividends. The companies are now the buyers of their stock, limiting the downside.

If things in China were to get slightly better from here, maybe there will be others too…

DATA IS THE NEW OIL

We are of the view that generative AI will drive increased value to companies which are the 'picks and shovels' in the AI arms race. However, as we continue our research into the impacts of generative AI and assessing the winners and losers, an emerging opportunity set is arising — data rich companies, which are about to accelerate monetisation of that data library. One key name, we see as a mispriced beneficiary of this trend, is London Stock Exchange Group (LSEG).

LSEG, despite the name is much more than a stock exchange. With the acquisition of Refinitiv, LSEG is now the number one real-time data provider in capital markets, with the greatest data depth, breadth and history. A position we believe will only become further entrenched as they commence the product roll out in the months and years ahead from their partnership with Microsoft.

As the only scale vendor working with Microsoft, they are set to benefit from upcoming product releases imbedding their data in the Office 365 product suite and the launching of Co-Pilot for the financial services industry.

By embracing their strengths as a scale commercial data vendor and investing in this core capability via their partnership with Microsoft, we believe that LSEG has positioned itself perfectly to capture a royalty stream on enhanced financial services industry productivity in the years ahead.

IN CLOSING

Thank you for entrusting us with your capital and we wish you a happy and prosperous second half of 2024. Please don't hesitate to contact us if you have any further questions.

Yours faithfully,

Arnott Capital

Kenny Arnott
Co-Chief Investment Officer

Yianni Gertos
Co-Chief Investment Officer

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