2024 Annual Investor Letter

ARNOTT CAPITAL EST. 1999

Dear Fellow Investors,

Welcome to the Annual Investor Letter for the Arnott Opportunities Strategy* (the 'Strategy'). The Strategy generated a net return of 3.33% for the twelve months ended 31 December 2024. The Strategy's net average monthly exposure was 29% net long for the prior 12 months and the total average gross exposure was 115%.

Broadening the view beyond the monthly, quarterly and annual performance reporting cycle, over a longer 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	3.33%	3.17%	14.80%	14.52%
MSCI World Index	16.46%	4.53%	9.38%	8.00%
Bloomberg Equity Long Short Hedge Fund Index	12.15%	2.55%	9.87%	6.77%
Bloomberg Commodities Index	-5.76%	-3.24%	0.82%	-2.11%

Source: Arnott Capital, Bloomberg. As at 31 December 2024. All returns above are in US dollars (USD). Past performance is not an indicator of future performance. Performance for the period is reported net of all fees.

Over the prior ten years, the net exposure of the Strategy has averaged 27%, with an average gross exposure of 129%.

This letter covers three key areas:

1. An update on the prior twelve months' performance
2. Our current macroeconomic outlook
3. Spotlight on an emerging theme: aerospace

As always, we sincerely appreciate the opportunity to manage your capital alongside our own. With that in mind, we strive to write these letters candidly, addressing the questions we would ask if we were in your position. We welcome your feedback and any additional questions you may have about the Strategy or the contents of this letter. Please feel free to reach out to us at investor@arnott.com.au.

* Strategy – refers to the period from 2013 – 2017 for Bondi Capital Investments Pty Ltd ('Managed Account'), and 2018 – 2024 is for the Fund. The Managed Account was externally administered by Apex, but not externally audited. The Fund is audited by EY. Performance referred to in this document relates to the Arnott Opportunities (Cayman) Fund - Main Class (Founder Class) (the 'Fund'). Other classes will be subject to different fees.

1. PERFORMANCE SUMMARY FOR THE LAST 12 MONTHS

Over the past year, the Strategy's performance has been more subdued than in previous years, with single digit returns. While the hit ratio and metrics remain strong, misallocating capital has limited our ability to maximise opportunities.

Looking at our broader history since 1999, this has been a disappointing year resulting from the misallocations of risk capital. However, our process for identifying solid investment ideas remains effective. The key takeaway is that while idea generation remains strong, refining our capital allocation strategy will be essential for improving future performance.

Nonetheless, we remain steadfast in our commitment to achieving double-digit returns on an annual basis, with a primary emphasis on capital preservation, as evidenced in Figure 2.

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

	Max Drawdown
Arnott Opportunities Strategy	-11.61%
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 31 December 2024. Index returns are in US dollars (USD). Past performance is not an indicator of future performance. Above data and fees apply to the Arnott Opportunities (Cayman) Fund – Main Class (Founder Class).

Figure 3 highlights the key thematic winners and losers for the Strategy in 2024. The **Structural Shorts / Capital Cycle** theme encompasses a collection of individual short positions. Notably, our short position in **Australian Banks** was managed well, given the magnitude of the move in these names.

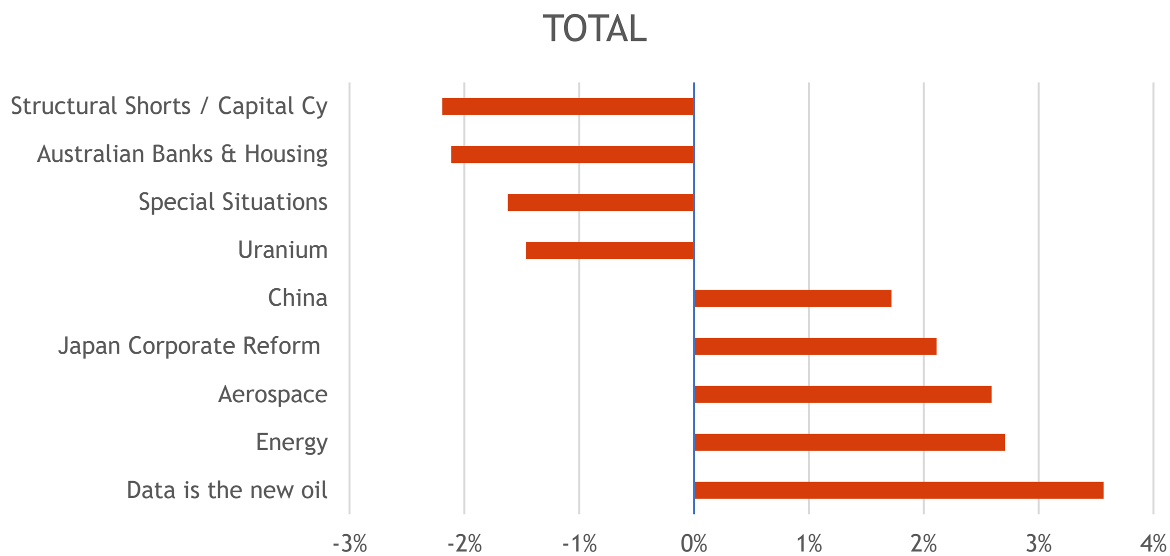
The long-standing **Uranium position** underperformed despite a strong start to the year. The uranium market remains relatively small and increasingly dominated by financial investors. In response, we have been actively reducing our exposure.

Japan continued to be a strong performer and remains an area of strategic focus for us. **Aerospace**, which we added to the portfolio late last year, also delivered solid returns.

China remains a market where we take a tactical approach. While we are not making long-term investments, we actively trade opportunities as they arise.

Finally, within the **Data is the New Oil** theme, one of our larger positions, **London Stock Exchange Group**, has performed well.

Figure 3. Strategy theme performance 2024



Source: Arnott Capital. As at 31 December 2024. Past performance is not an indicator of future performance. Theme Contributors to Performance is Gross of Fees and exclusive of Cash.

2. MACROECONOMIC RISKS AND OPPORTUNITIES

When looking at the Macroeconomic environment, we focus our attention on five key areas:

- **Liquidity:** global Central Bank policy and Government Fiscal spending.
- **The Economy:** Global economic growth with a focus on the United States.
- **Equity Fundamentals:** Both projected earnings forecasts and valuations.
- **Market Technicals:** Investor positioning and technical analysis.
- **Social:** Geopolitical environment and other social trends.

What we are focused on is not the absolute level but the rate of change, as this is where shifts in markets occur.

As we progress through 2025, on balance there appears to be more tailwinds than headwinds which we expand on below and two key areas that may loom as high impact events (albeit low probability) that could upset risk markets and particularly equity markets.

Tailwinds

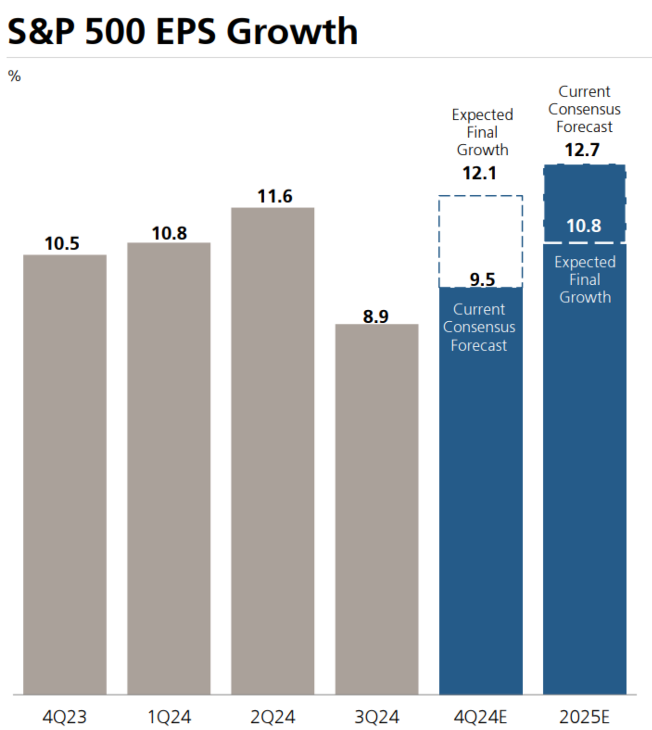
The **global economy** is shaping up to be on solid footing through 2025. Strength in the United States is more than compensating for weakness in the Eurozone and China, with risks skewing to the upside in our opinion in both the United States and Eurozone.

While geopolitical risks remain, recent developments suggest easing tensions in key regions, potentially providing a tailwind for markets in 2025. Early rhetoric out of the Trump administration seemingly is not as hawkish to China (although this comment might change if Trump's first term of presidency is an indication) and we appear closer to the end of the war in Ukraine. A **thawing geopolitical environment** may be a tailwind through 2025.

While the last mile of core inflation remains sticky, the focus of global developed market central banks (except for Japan) has now shifted to maintaining full employment and easing extremely tight monetary policy. In addition to this, fiscal policy continues to remain ultra-accommodative, a feature we believe is here to stay in the post-Covid era. In short, there is **ample liquidity** in the system and an easing bias will act as a tailwind.

Corporate earnings growth continues to be extremely strong with double digit Earnings Per Share (EPS) growth in 2023, 2024 forecast to continue through 2025, further supporting risk assets.

Figure 4. S&P EPS growth



Source: Standard & Poor's, Refinitiv, FactSet, UBS

In Japan, we are focusing on interest rate normalisation, after nearly two decades of zero interest rates. That policy normalisation is bringing reflation and reforms. Also, associated with that, wage growth is taking place, which is driving inflationary forces domestically and exposing tremendous opportunities for exposure to domestic companies in Japan.

China is very challenging structurally at a country level. However, we do not believe there will be any sort of Western outcome in China. We should borrow from the playbook of Japan, where it will likely take decades to unwind the excesses. Notwithstanding that, there will be tradable opportunities on the long side, and that's how we have been assessing it. We view it as renting China from time to time, looking for exposure to the domestic economy and to the index at large. It's not a large part of what we do continuously, but it is an area where we think there are opportunities.

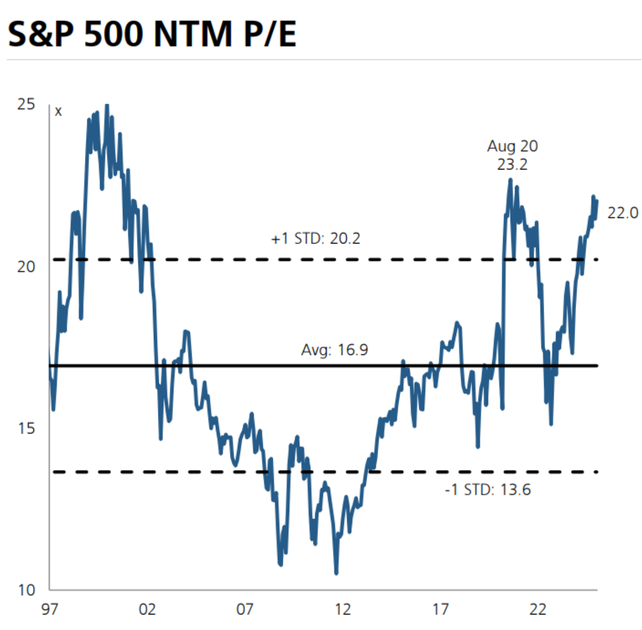
Headwinds

We spend time looking for low probability events that may unsettle markets. At present, our base case is that the headwinds to risk assets remain lower probability of eventuating. We would need to see multiple catalysts come to fruition to turn outright negative. But there are areas that we are on high alert through 2025 that we believe have the potential to upset the risk asset party. So, what might matter this year?

High valuations, high Artificial Intelligence expectations, negative equity risk premium and credit risk.

Valuations are elevated using any historical measure, the reasons for which we can understand but are cognisant of where we are in a historical context.

Figure 5. S&P Next Twelve Months P/E

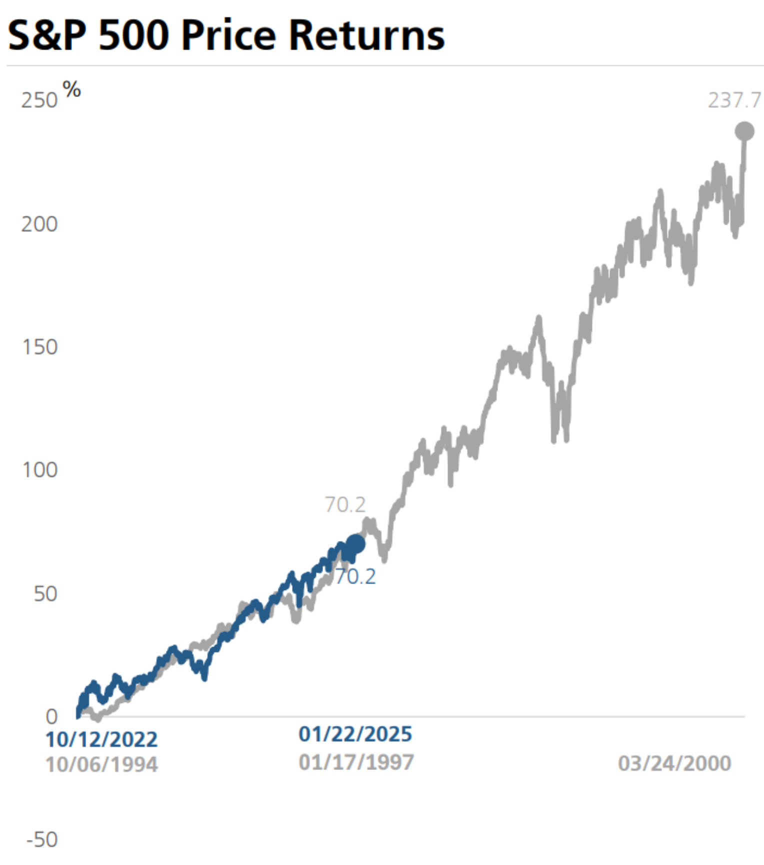


Source: Standard & Poor's, Refinitiv, FactSet, UBS

A more insightful concept to consider is the compensation that equity holders receive for taking on risk, which has recently turned negative for the first time since the Dot-com bubble.

Is this a reason to be negative risk? No. The level is high; however, this is driven by a compelling structural argument. We are in a period analogous to the roaring '20's with buoyant economic growth and future productivity set to be driven by the miracle of AI. The logic is sound and more importantly, the S&P 500 is delivering rock solid earnings growth to support this thesis, justifying why we are in the early innings of a stock market boom.

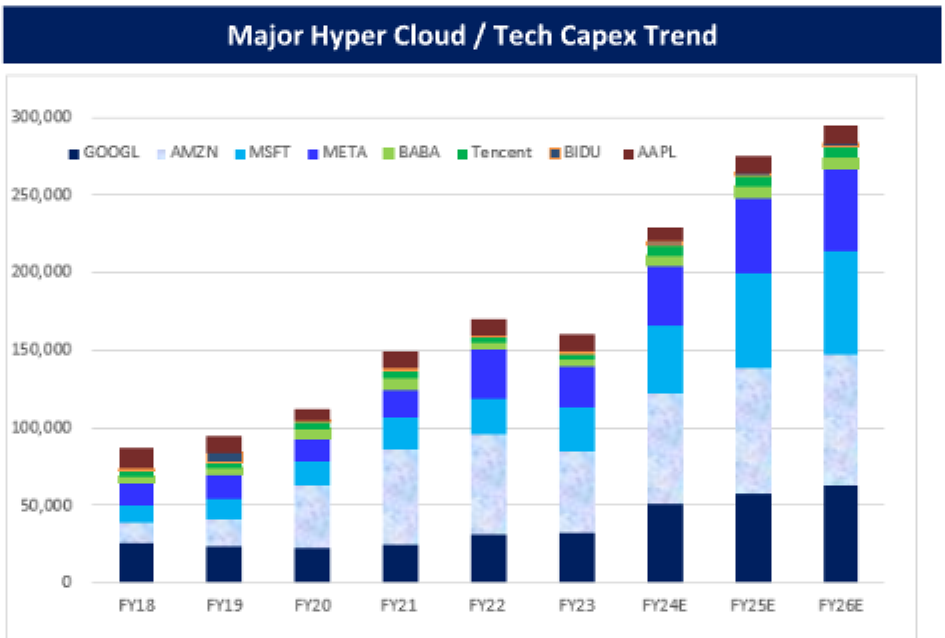
Figure 6. S&P 500 price returns overlayed with 1990's period



Source: Bloomberg, UBS

We are now more than two years on from the big bang moment of 'AI' and frankly, we are all still searching for the killer app or use case for AI that justifies the monumental capital expenditures going into this space.

Figure 7. Mega Cap Tech capital expenditures



Source: Bloomberg, Eikon, Daiwa/DCMA estimates

As Sequioa posed back in June 2024, where is the $600 billion in revenue from AI? Currently, market participants appear to be backing the historical execution of the US mega cap technology companies and are more than happy to hold the line. However, we are of the view crunch time is approaching and the accelerated capital expenditures will need to be met with genuine use cases that can demonstrate returns on invested capital in line with what was historically produced by these companies.

Why this matters is the starting level, given elevated valuations we are on high alert for any shift in the narrative around AI and are conscious that the largest multiple contraction moments are in periods of cognitive dissonance for market participants. There is no argument around the fact that AI is here to stay and will only expand in use cases, the issue is that we are economic beings and at some point, we will need to see that tied to returns.

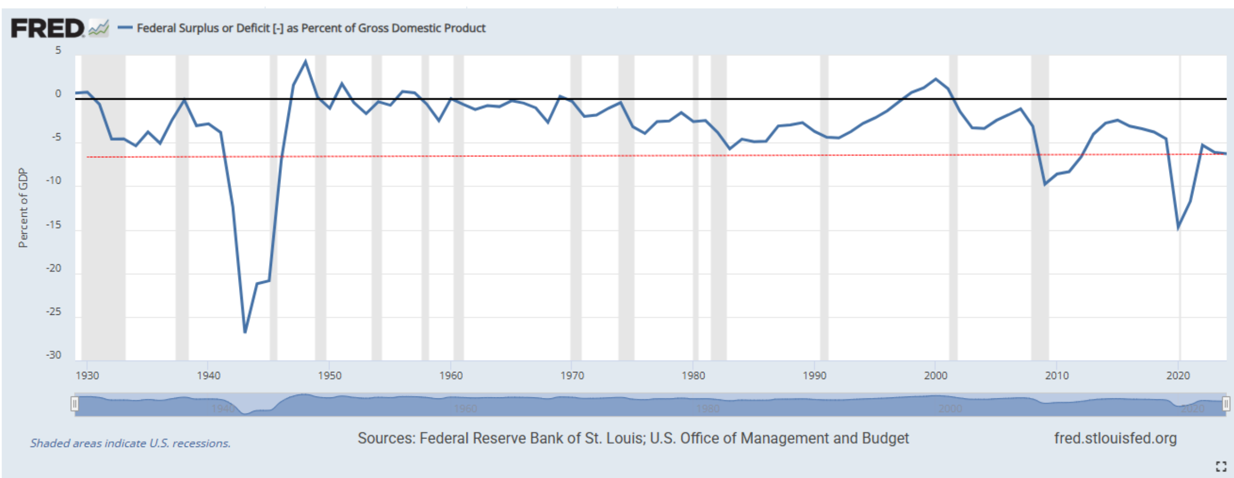
The Era of fiscal dominance

For the decade prior to Covid, when thinking about fiscal and monetary policy, we would have focused primarily on monetary policy. That is not the case now. It seems the US Federal Reserve is second fiddle to much larger fiscal implications and fiscal stimulus that's happening around the world. We are now in the era of fiscal dominance.

In response to the energy transition, nearshoring supply chains, AI investment and aging populations fiscal policy has been a significant driver of growth within developed economies. This trend of increased Government spending is only set to accelerate in the years ahead, as quite frankly spending is unsurprisingly a very popular political tool.

The level of spending by the United States government is now far outstripping income, with the current budget deficit running around 7% of GDP a level unseen without an accompanying recession or during war time.

Figure 8. US Government budget deficit as a % of GDP



Source: Federal Reserve Bank of St Louis

As the reserve currency of the world, the base case is the United States can continue to run budget deficits without any significant implications, and as market participants we need to remain conscious of that fact. But when you consider the fact that every G-20 nation except for Australia is running budget deficits, the risks around refinancing of debt and the resurgence of 'Bond Vigilantes' commanding a wider term premium to be compensated for the risk increases, which is presently not priced by market participants.

Chair of the US Federal Reserve, Powell told us last year that fiscal policies are on an unsustainable path and that the level of government debt relative to the economy is unsustainable. We will continue to watch the term premium and other indicators to gauge concern for government debt levels. This is one of the key risks we are watching through 2025 where we believe the rate of change can move decisively negative, with wide implications for risk assets.

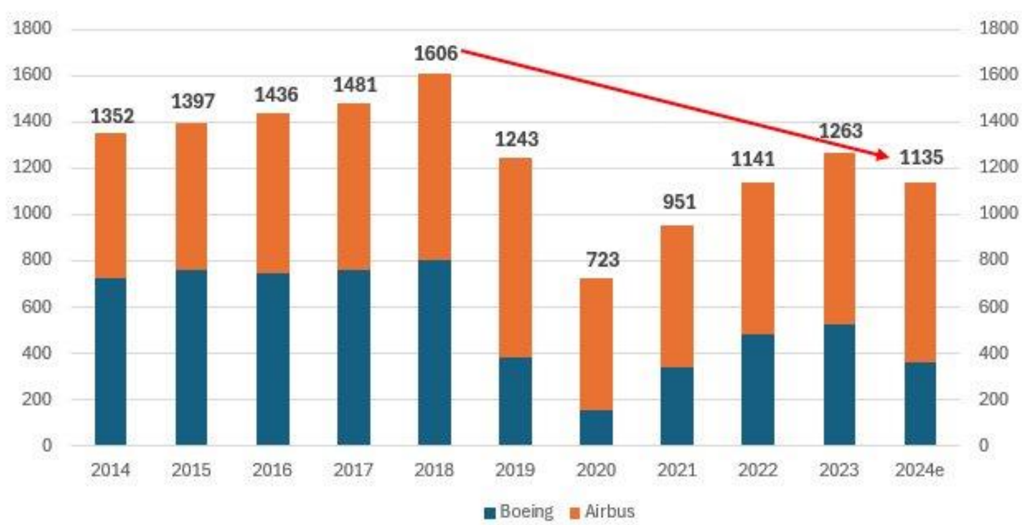
3. SPOTLIGHT ON AN EMERGING THEME: AEROSPACE

To say the commercial aviation industry has gone through some recent turbulence would be an understatement. Within a period of less than five years, we have seen the complete shutdown of the industry, a troubled re-opening as the system was under deep strain after taking off from zero (and we're certain more than one person reading this had luggage lost, flights deeply delayed or cancelled, to now, a system that is nearly operating back at 100% of pre-COVID-19.

We now see issues impacting the industry that are less publicised but are at the heart of our long Aerospace theme, and at the centre of it all is Boeing.

For the decade prior to COVID-19, the global commercial aviation industry was balanced with Boeing and Airbus scaling capacity to meet the growing demand of the global commercial aviation industry. Then in 2020, the aviation industry went to zero overnight, seeing Airbus and Boeing shutter production as mass cancellations threw their businesses into turmoil. Now nearly five years on, it would seem logical that we are facing a linear path towards scaling production but that is not the case. Boeing are paying for the sins of their past as supply chain woes and Government oversight of the 737-MAX program crimp production levels seeing overall industry deliveries falling year on year in 2024, sitting around 30% below 2018 levels.

Figure 9. Airbus & Boeing commercial aeroplane deliveries



Source: Airbus, Boeing, Visible Alpha

With the system now at, or in some jurisdictions exceeding pre-Covid levels of demand and global commercial aeroplane deliveries significantly down, with ongoing issues Boeing is set to linger through 2025 and 2026. We have an industry that is no longer balanced, with multi-year implications from the change in industry production profile.

Something has changed in the aviation industry and the cleanest opportunities we see to profit from this change are in the following three areas:

- *Higher for longer airline prices*. We are of the belief that due to delayed deliveries of new fleet, we will all be facing a period of higher for longer airfares. This will underpin a period of strong earnings growth for airline carriers with strong market share positions in busy routes, as the ability for competing carriers to re-allocate more capacity to these routes is diminished.

- *Leased demand for aircraft increases*. We believe aircraft leasing companies are in pole position to benefit from this disruption with increasing demand for aircrafts set to drive higher leasing rates.

- *Demand for planes*. Lastly, we believe the issues at Boeing have severely impaired their industry position, resulting in this multi-billion-dollar duopoly looking as though it is a field of one. And that one is Airbus.

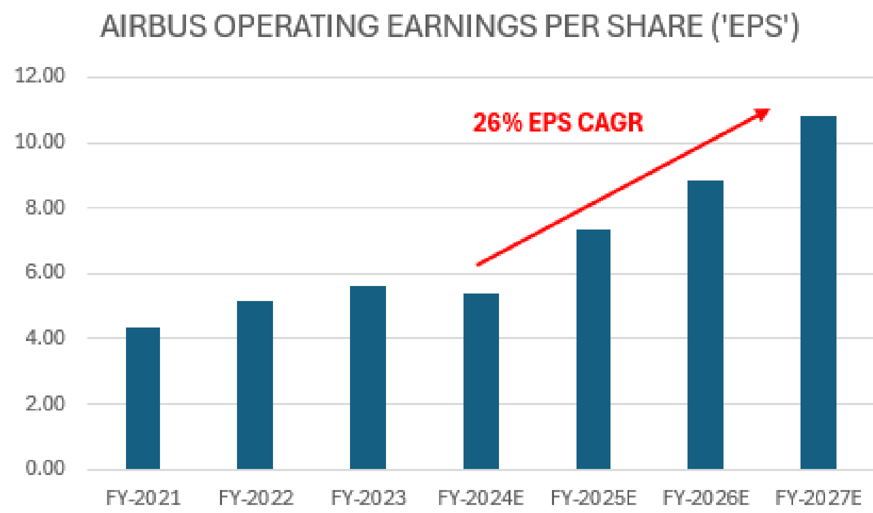
In the past six months, the Strategy has been building a material position in Airbus.

We are of the view that Airbus is the largest winner from the disruptions at Boeing. Demand for new quality technology aircraft is increasing, and their long-time competitor Boeing is operating from an impaired position further stretching relationships with both customers and their suppliers. This sets Airbus up for multiple ways to win in a large multi-billion-dollar industry.

Firstly, given Airbus' increasing ability to execute customers will gravitate towards them for new aircraft purchases. This will continue to build on their already extensive order book, underpinning earnings for at least the next decade. Given the weakened position of their competitor may place them in a position to negotiate more favourable contract terms with customers.

Secondly, as Airbus continues to execute on their production ramp earnings growth will 'take off' as the company delivers operating leverage from their wide manufacturing base, seeing earnings more than double over the next three years.

Figure 10. Airbus earnings per share (‘EPS’)



Source: Airbus

With strong double-digit earnings growth, structural tailwinds supporting the industry they operate in and now a firmly entrenched number one position with a weakened competitor, we believe there is a lot to like about Airbus.

IN CLOSING

As we begin 2025, we want to take a moment to reflect on the past year and thank you for your continued trust and partnership. 2024 was a year that presented its share of challenges, but through resilience and adaptability, we navigated it together.

Looking ahead, we remain committed to supporting you and helping you achieve your financial goals in the year to come. While uncertainty may persist, we are optimistic about the opportunities that lie ahead and remain focused on delivering value.

Thank you for entrusting us with your capital. We look forward to working with you. Please don’t hesitate to reach out if you have any questions.

Yours faithfully,

Arnott Capital

Kenny Arnott
Co-Chief Investment Officer

Yianni Gertos
Co-Chief Investment Officer

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