ARR Global L/S Equity Strategy

Investor Letter, First Quarter 2022

ARR | INVESTMENT PARTNERS

Dear Friends and Investment Partners,

I hope you are well!

ARR Investment Partners generated a net return of 19.5% in Q1 of 2022. The cumulative net return since inception in 2015 is 107.1% in USD, representing an annualised return of 10.4%.

First and foremost, may I thank you for your patience and sticking by ARR following a challenging 2021. Whilst last year's performance was disappointing to say the least, it served as a useful case study for me where several lessons were learned and have been applied to the current trading strategy. Tough moments can often be a blessing in disguise and in this case it forced me to refine and solidify many elements of the investment process which has improved it. This is highlighted by an excellent start to the year. Looking forward, the top priority now is not only to generate strong performance, but do so in a way that is consistent and repeatable. Avoiding severe capital loss is the key tenet of the investment strategy.

This quarter presented me with numerous opportunities in the market, but the key challenge was to focus only on the best ideas. The old saying 'Good is the Enemy of the Great' rings true and relates well to the strategy at ARR. It is my duty to find the most compelling risk-reward opportunities possible, and not settle for mediocrity.

The best opportunities in Q1 sat within the 'Rebound' theme of our investment strategy, where valuations of certain companies were incredibly cheap due to high uncertainty or negative sentiment. A positive trigger can then change the reason for uncertainty or negative sentiment, thus re-raising valuations over an extended time frame. It was important to display high conviction in these ideas once a positive trigger surfaced, as these Rebound situations can offer spectacular returns. This was reflected in relatively large position sizes in the portfolio. A key lesson learned from last year was in execution; accurately executing a plan takes a great deal of discipline and objectivity. Once a position was initiated, they would be trimmed in strict fashion as the risk-reward became less attractive overtime, and other opportunities were deemed better recipients of capital.

Some investing highlights across our four investment themes are outlined below.

Rebound

EPAM, Halyk Bank, Kaspi.kv

Each of these companies saw excessively discounted valuations resulting from the Russia-Ukraine conflict. Fundamentals were of course affected by the war but to a much lesser degree than the stock price implied. All of these companies saw impressive rallies as they bounced back in March.

Dynamic Profit Growth

Leonardo, Rheinmetall, Thales

These defence companies have carried cheap valuations in recent times, as growth in national defence budgets has been muted. Defence spending as a % of GDP has been in decline around the world, and as such, companies in the sector have suffered from lower growth. Moreover, the rise and influence of ESG investing has led to the defence industry being shunned. In the context of the Russian invasion, we now observe the trend in defence budgets reversing and orders for military equipment and technology rising considerably. Leonardo, Rheinmetall and Thales are three European companies primed to benefit.

Structural Losers

Citibank, J.P Morgan, Societe Generale

The financial sector, recently touted as a beneficiary of the rising interest rate environment, is now at risk of negative earnings due to the flattening of the yield curve. Banks are increasingly bearing greater credit risk from loans and exposure to Russian assets which justified selling short the stock of these three names. These positions have since been exited as I believe they are not structural losers over the long term.

Bubbles

Nemetschek, Atlassian, ARK Innovation ETF

Technology companies have enjoyed high premiums on their valuations for an extended period, in light of low interest rates and an abundance of liquidity from central banks. There comes a time, however, when even great businesses fail to maintain their lofty valuations. In the case of Nemetschek, who traded at 96x forward earnings and Atlassian, whose market capitalisation grew to over 31x its revenues, such valuations could not be sustained. As the market entered a risk-off environment given the reversal of QE and increasing geopolitical tensions, we witnessed a sector rotation from growth to value companies, as investors sought balance sheet quality and dividends during uncertain times. This came at the expense of highly-valued growth stocks, best encapsulated by the ARK Innovation ETF, which has been the poster-child of this recent frenzy for growth names. These positions have since been exited as the risk-reward became less attractive after a strong sell-off.

Areas in which the strategy was less successful included the following:

Short Copper Stocks

Antofagasta

A global slowdown as a result of Russia's invasion, combined with strict COVID policies and vast lockdowns in China led me to believe that demand for copper would fall. Copper is highly correlated to Chinese growth as the nation absorbs 50% of global demand, and copper companies like Antofagasta appeared vulnerable. Antofagasta carries many political risks as they operate in Chile where the government is less stable than other markets. There was also proposed legislation announced that would significantly raise taxation for mining companies. Ultimately, an unpredictable factor was more important in determining the outcome for Antofagasta as we saw tightening copper supply raise prices as a result of sanctions. This appeared to outweigh the effect of recession risk and company specific factors.

IT/Semiconductor Stocks

Several chipmakers and software companies displayed strong growth characteristics, as well as very reasonable valuations. Nevertheless, the great sector rotation at the start of the year meant that there was a general exodus away from technology companies, despite improving fundamentals and an excellent long-term outlook. Given the strategy's mandate, it is necessary to exit such positions even if they may be long-term winners, since capital preservation is our priority and better risk-reward opportunities existed elsewhere.

Recognising the Opportunity Costs

As part of our continuous improvement process we do not only look at our investments based on merit, but also their opportunity costs. Are there opportunities in our area of expertise that we have foregone? Many of the top performing stocks in Q1 fell in areas of my expertise. These industries included the following.

- Oil & Gas
- Steel
- Fertilisers

With these industries, I feared a repeat of a 2008 scenario where a price spike was followed by a crash, and I therefore deemed the risk-reward to be unattractive. This is unfortunately not the first time where I missed out on great opportunities because I deemed long-term prospects as not attractive enough. The Russia/Ukraine war has proved once again that the future is highly uncertain and almost impossible to predict. However, strong short to mid-term trends tend to last longer than expected and are not priced in within several days. If we consider a trend to last at least another 6 months and we are only in the first month, there is a high probability that those developments are not yet fully priced in the market.

Looking back over the last year and this quarter it has become obvious once more that it pays to take risks when one is in sync with the market to leverage good momentum. This should be actioned by strong conviction in only the best opportunities available, rather than taking risks across sectors and themes in which the risk-reward is simply 'good' or not in the field of expertise. Often, the most difficult part in investing is to do nothing and sit patiently for the right moment. Any superiority an investment process may have will only emerge with time, so patience is important. Truly great opportunities present themselves rarely and when they do, one must make the most of them.

In the past I have been successful following periods of strong performance as confidence is often self-perpetuating. When I feel in harmony with the market, the goal is not to sit back and protect the attractive returns garnered (as of 13/04/2022 the strategy has returned +27% YTD). Instead, the goal is to go for the jugular and make truly exceptional returns, echoing a notion from my investing idol, Stanley Druckenmiller. This is of course, on the condition that the right opportunities present themselves, which they do not always do. Whilst the appearance of great opportunities is not in my control, what is in my control is being incredibly well prepared to capitalise on them. If you are well prepared you stand to make more money, and on the best opportunities where fundamentals and technicals align you tend to make money immediately.

It is evident that my prowess as an investor, and the bulk of portfolio returns, often comes during market corrections. Whilst I have performed well in bull markets, for instance in 2017, this is an area with further room for improvement. Several lessons were learnt last year which have benefited me, but I have decided to further develop myself with specific coaching from a trading champion which has been invaluable. If I can achieve the goal of being a great investor in both bull and bear markets, our investment strategy is then one of the best strategies globally, which is of course incredibly motivating and exciting.

For the remainder of 2022, I see many opportunities on the horizon, and I am keeping a close eye on the following sectors which may turn out to have great entry points in the near future.

Energy

Opportunities in the renewables sector, for instance across solar, wind and biogas where there is surging demand. Companies in this space should also directly benefit from government incentives which drive higher consumer demand.

Precious Metals

Companies in this sector should do well in a potential stagflation scenario, which we last saw in the 1970's. In this period, the price of gold went up by almost 2000%. Investors have historically viewed precious metals as stores of value and an inflation hedge.

Metals & Mining

The scale of infrastructure needed for the transition away from carbon requires vast amounts of rare earth elements and metals, which must be mined. For instance, solar panels, wind turbines and EV's cannot be built without key metals like cobalt, copper and nickel. This remains a long-term secular trend.

Fertilisers

Given the ongoing war in Ukraine, trade restrictions on Russia and Belarus have tightened fertiliser supply. The two countries supply 40% of the world's potash, and Russia alone produces two-thirds of the world's ammonium nitrate. Both are critical compounds in the production of vital foods.

Fertiliser companies around the world stand to benefit from this fall in supply.

Kazakhstan

The market appears to view Kazakh companies as vulnerable to Russia-Ukraine shocks. Upon closer inspection, many businesses operating here are fundamentally unaffected and distinctly separate from the issue. In fact, some companies stand to benefit from higher commodity prices, for instance in the uranium market. This mismatch between narrative and economic reality should narrow overtime.

Biotech

Valuations in this space are very attractive, considering the low cyclicality and high growth prospects.

(Short) ARKK, Financials

In the case of a recessionary environment, overvalued and loss-making tech companies will be out of favour as investors seek comfort in steadier companies that offer better value. Banks are vulnerable to a downturn as lending would dry up, reducing fees.

Longer-term winners

Semiconductors, Chinese technology, cannabis and online marketplaces are all high growth areas which could do very well when the market becomes more 'risk-on' at a later stage of the year. They have all been discounted by the general market selloff but have outstanding fundamentals and long-term prospects.

<u>Update on Business Strategy:</u>

As aforementioned, we focus mainly on four investment patterns

- Dynamic Profit Growth
- Rebound
- Bubbles
- Structural Losers

The approach taken for each pattern can be quite different and certain market environments will tend to favour particular patterns. Since the opportunities found within each pattern are uncorrelated (for instance a company in one pattern may have completely different demand drivers to a company in another), this carries diversification benefits and improves the risk-reward profile of the portfolio. We set up our proprietary portfolio and risk investment system (PARIS) in order to screen for opportunities across these different patterns and to analyse them as efficiently as possible. Of course, deep fundamental analysis is still necessary and my vision for ARR is to have dedicated analysts to work on each pattern. Considering the size of the business at present, this plan is some way into the future, but certainly achievable. With the introduction of every new client we become one step closer to achieving our ideal setup, with incremental improvements to the strategy along the way.

I look forward to the rest of the year and hope to continue the good progress made thus far. Thank you for your trust in my team and me!

Best,

Christian

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