ARR Strategy

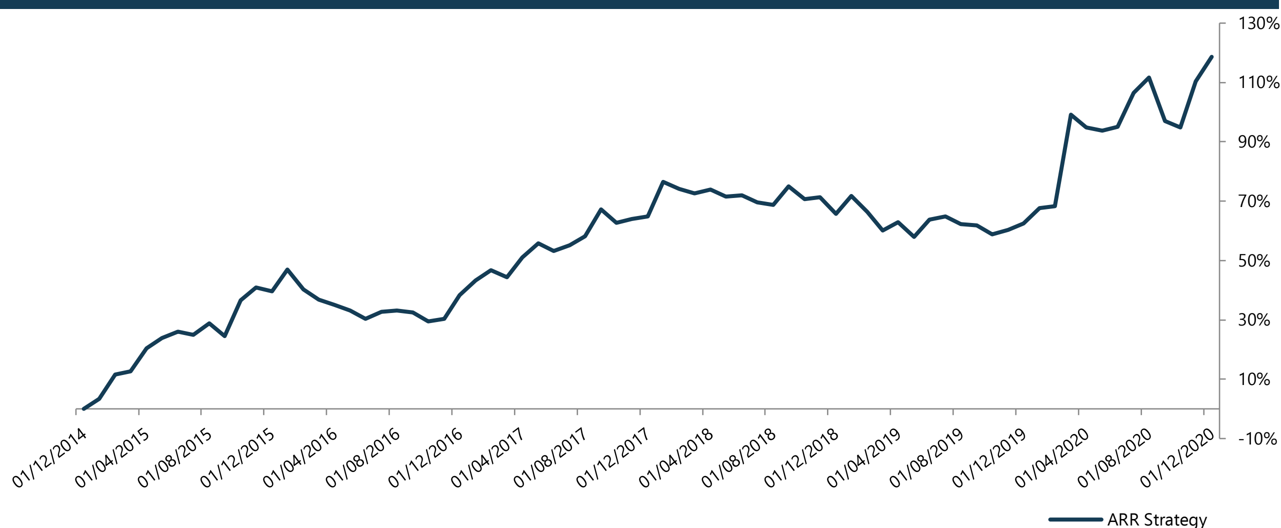
Investor Letter, Fourth Quarter 2020

ARR | INVESTMENT PARTNERS

Dear Partners,

ARR Investment Partners generated a net return of the first managed account of 11.0% in Q4 of 2020. For the full year of 2020, we achieved a return of 34.6% net of fees. The cumulative net return since January 2015 is +118.6% in USD or an annualized return of +13.9%. [1]

ARR PERFORMANCE



Source: Interactive Brokers Account, in USD, net of 1.5% management fee and 20% performance fees; unaudited; as of 31.12.2020

The final quarter of 2020 was an eventful one. In our Q3 closing outlook, we listed optimism towards a new stimulus bill and strong China rebound, cautions over new COVID lockdowns, and uncertainty from the US election. Entering Q4, parts of our outlook materialized. China's rebound was stronger than expected, with GDP surpassing the pre-crisis level. Elsewhere, the EU announced new strict measures to control COVID, fuelling a risk-off attitude in the market. From November onwards, positive vaccine news dominated the market, showing investors the light at the end of the tunnel. The sudden spread of a mutated virus near Christmas hardly changed the optimism in the market.

Sector-wise, our largest return contributors this quarter were Basic Materials, Financials, and Energy, while our largest loss contributors were Consumer Discretionary stocks. On average, our top five picks each contributed 2.19% to profits, and our bottom five picks each contributed 1.01% to losses. This highlights our focus on great risk-reward opportunities while limiting losses. We maintained a small gross exposure and net exposure throughout October because of the lockdown and US election uncertainties. This helped us preserve capital while global markets corrected in October. It also provided us with a lot of dry powder for the right opportunity.

When the Pfizer and BioNTech test results hit the market on November 9th, we acted swiftly. This news likely marked the nadir of the COVID crisis, and the most affected companies should bounce back from very depressed levels. We invested in energy and bank companies, including Total, Royal Dutch Shell, Deutsche Pfandbriefbank, and their peers in emerging economies. These positions later became our main profit contributors. We also covered the remaining short positions in hotel, casino, and mining stocks. We initiated those positions to

[1] **Source: InteractiveBrokers. Net of adviser fees. Time weighted return relates to the longest established separately managed client account, unaudited.*

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protect our portfolio in October when Covid cases soared in Europe and increased the risk of further lockdowns. To keep our net-exposure in check, we also unloaded some technology and gold exposures. This is not to say we were bearish on technology, but rather it was less attractive in valuation than Energy and Banks in the market environment since the start of November (Appendix).

We maintained our positions in the Energy and Financials sector for over a month until mid-December. Aggressive positioning coupled with a quick response helped us generate an 8% after-fees return for our clients in November and 3.9% in December.

Our average gross and net equity exposures over the third quarter were 114.5% and 95.5%, respectively. As a general rule, once we have a risk buffer in the form of profits, we increase our exposure if we see attractive investment opportunities. At the end of the quarter, we held 128% long exposure and 13% short exposure. Currently, we have approximately 30 portfolio positions across different sectors. There is no high concentration in any sector or single stock.

Overall, we are optimistic about the current market environment, which I will explain in more detail in the ***General Market Outlook*** section.

SYSTEM DEVELOPMENT

During Q4 2020, the system development focus was on testing trading strategies and expanding the database to allow our backtest results to be comprehensive in different economies and various time-periods.

We have expanded our database to include 6000 stocks globally. They are traded in over 70 exchanges and over 50 different currencies. Part of the database are stocks that were once large companies but later delisted or acquired. We focused on stocks that were once valued at over $500 million because our mandate focuses on liquid stocks. This expansion is crucial to avoid the 'survivorship' bias in backtesting, which means if we only include firms listed now, performance will be upward biased due to the longer history we use in the backtest.

In Q4, we started to design and test trading strategies based on a combination of fundamental and technical indicators. We adopt an idea-oriented approach, where we design a strategy conceptually and implement it. Then we use the result to reinforce our understanding of the behaviour theory and adjust our strategy accordingly. We believe this idea-oriented approach is better than a data-oriented approach because it ensures we always have a good understanding of whichever strategy we deploy and remain in good control of our portfolio.

We achieved good performance in the backtest of a new behaviour-based strategy. After careful verification of historical stock-picks by this strategy, we will start getting recommendations from this strategy next quarter. It will improve the Dynamic Profit Growth pattern we use aside the patterns Bubble, Structural Loser and Rebound. Over the course of the year, we also want to improve the investment success of those patterns.

GENERAL MARKET OUTLOOK

Our outlook for the first half of 2021 is broadly optimistic. Currently, all the major risk factors have either cleared or are in the process of clearing. The UK signed a provisional deal with the EU on December 24th. The White House signed the $900 billion stimulus bill on December 27th and plans another massive stimulus package. Although COVID is still raging worldwide, vaccines are widely believed to provide effective protection against the mutated strains. With vaccines being gradually rolled out over 2021, we expect to see stronger than usual global economic growth.

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Valuations, especially in the tech sector, are definitely stretched. However, high valuations are rarely a reason for a market correction or bear market. Some sectors, especially cyclical ones that suffered last year from the lockdown induced recession, still have the potential to bounce back further. We see this as the baseline scenario when lockdown restrictions are lifted, and the economic situation normalizes. For example, Total SE bested the FactSet estimations in terms of earnings for the first three quarters of 2020, showing it could profit in a sustained low oil price environment (see Appendix). Judging by the historic dividend, Total has a very stable dividend stream, which equates to approximately a 7% dividend yield at the current market price. In 2021 we believe travel demands will return to normal as vaccines are gradually rolled out both for business and leisure. Under this scenario, the risk of another significant oil price crash, like the one experienced in April 2020, is relatively low. We obviously keep an eye on Iran and whether sanctions might be lifted under Biden.

Precious metals are a theme we have on our radar and believe will shine in 2021. Historically speaking, gold serves as an inflation hedge and performs well in a negative real interest rate environment. At the end of the 1970s, it rallied almost 8-fold under the oil-price induced inflation threat. In 2009, the gold price also rallied significantly when the federal reserve adopted the money-printing QE program. In 2020 we saw the largest ever expansion of the Fed Balance sheet. (Appendix) Although inflationary pressure is not immediately present, it should gradually increase over the next few years as economic activity returns to normal. Sooner or later, the extraordinary monetary policy has laid the foundation for a long-term bull market of precious metals. On the other hand, although we are optimistic towards 2021, short-term volatility in Q1 might stay high, with many countries poised to impose stringent restrictions to clamp down on the spread of the mutated COVID virus.

INVESTMENT PRINCIPLES & LONG-TERM SUCCESS

Last year was an exciting year because it allowed us to demonstrate what our investment strategy is and what it is not. It is crucial for our investors to understand our investment philosophy and principles, as this knowledge sets the right expectations. Why is this crucial? Because most investors doubt an investment strategy when performance is not great. Based on ARR's track record, periods of underperformance were the best time to add to the strategy. Our performance chart looks a bit like a veritable staircase. Very strong upward moves followed times of weak/flat performance. We generated 34.6% net of fees last year, but I am well aware that there will be times of weak performance in the coming 20 to 30 years. By repeating the investment philosophy and principles, I hope you will have the confidence to add to your portfolio allocation and benefit from opportune timing.

In investing, you can earn a lot of money in the short run by being lucky. In the long run, great returns result from a well thought out investment philosophy, principles, and process.

Our goal is to earn attractive returns with low volatility and have a repeatable process in place so that we can do it in the long run. For example, if you earn 10% per year, you will double your money in a bit more than 7 years, quadruple your money in 14.5 years, and have increased your initial investment 8-fold in a bit less than 22 years. 10% is definitely ambitious in a 0%-interest rate environment, but it is not unrealistic.

How do we achieve attractive risk adjusted returns?

- We focus on opportunities both on the long and short side with great risk/reward characteristics. If our investment thesis turns out to be wrong or an unexpected global market correction happens, we will quickly cut our losses. We focus on four investment

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patterns (Rebound, Dynamic Profit Growth, Bubble, Structural Losers) that have attractive risk-reward characteristics. Additionally, we constantly improve the stock selection and implementation process.

- We avoid big losses by having both long and short ideas and cutting losing positions. In a whipsaw market, this can mean that we get stopped out at the bottom. Obviously, this can be very frustrating. We are willing to take those smaller losses to avoid a major loss like in a 2008 market environment. On the other hand, if we have generated an attractive return of 10-20% during the year and we see attractive investment opportunities, we will not sit back. Instead, we aim to generate a significantly higher return because we can take more risks due to the profit buffer. Stanley Druckenmiller, who generated more than 30% per year for 30 years and never had a negative year, sees this as one of the most crucial success factors. Do not lose money but when the opportunity set is right, try to make as much money as possible, especially if you have a profit buffer.

- In hindsight, we made many mistakes last year. Above all, we underestimated the abundant central bank liquidity impact and lost money on short positions in Q2 & Q3. We also missed many opportunities in sectors that profited from the Covid crisis and new Biden policies. Despite those mistakes, we still managed to generate a net return of 34.6%. Investing is all about probabilities, and by focusing on and improving our investment process, I am very confident that performance will continue to improve over the coming years. We only started building our own portfolio and risk management system in 2019, so I can confidently say that we are only getting started.

Thank you very much for your trust and confidence in me and my team! We are doing our best to continuously improve our investment system and generate attractive returns with low drawdowns.

Yours Faithfully,

Christian

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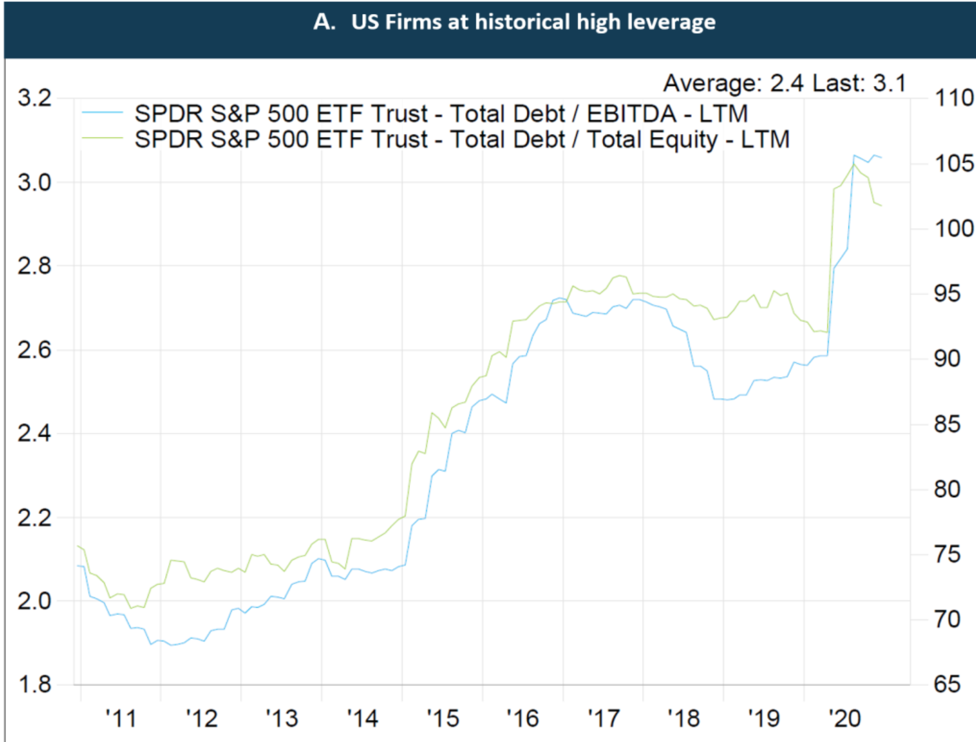
APPENDIX



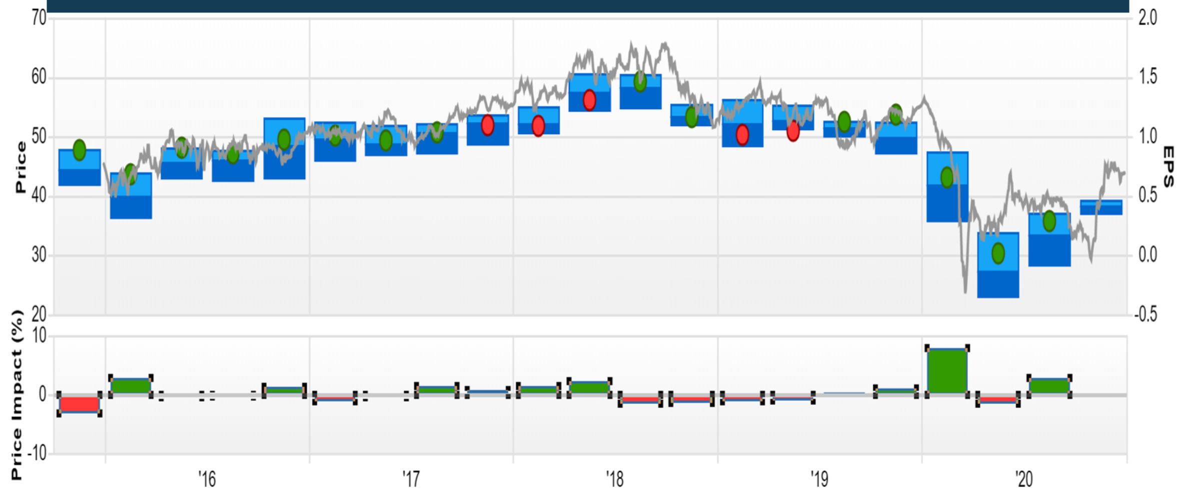
US firms are now standing at historical high leverage levels. We can see from the chart above that the S&P 500 index averages a 3.1 times Debt/EBITDA ratio and index companies have on average more debt than equity.

Chart Source: FactSet

US Corporate bond trading at the decade low yields, reflecting the supportive policies of Federal Reserve (also Chart D). This chart shows Corporate bonds rated by Moody's as A-rating averages 2.66% yield at the moment. Thanks to the huge bond buying programs and high-street lending program of Federal Reserve, investors' risk appetites are fuelled. Low yield in turn made the high leverage (Chart A) sustainable.

Chart Source: FactSet

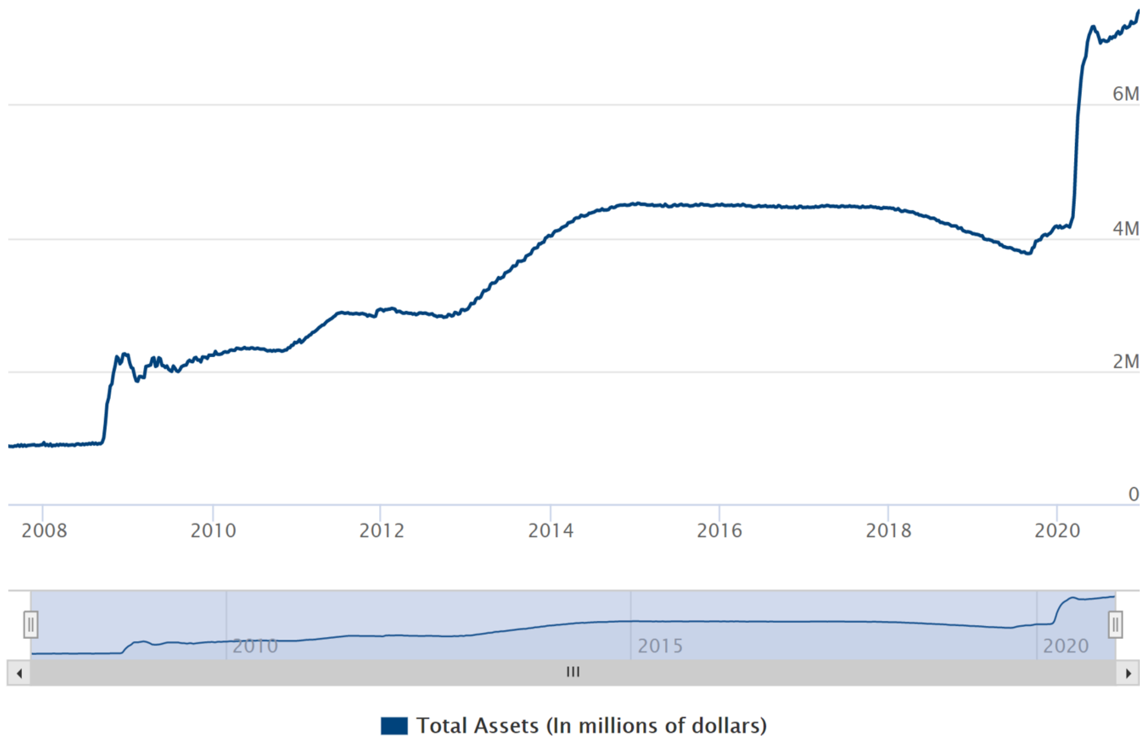
C. Total SE beats estimation



Many traditional energy providers are suffering under the current low-oil price. Total SE has adapted to the new market environment through a combination of cutting costs and redirecting new investments. Total has bested earnings expectations over the past four quarters. At the current price it presents 7% dividend yield, and we believe it is a good source of steady income.

Chart Source: FactSet

D. Federal Reserve Balance Sheet



After the Covid pandemic hit the US economy, the FED has introduced several lending programs at unprecedented scale. The FED's swift action has boosted its balance sheet at the fastest pace in history. In the short term this stopped many hard-hit firms from bankruptcy and avoided an even higher increase in unemployment. However, in the long-term the FED's policy might lead to high inflationary risks and create a long-term bull market for inflation-proof assets such as precious metals.

Source: Federal Reserve

ARR Investment Partners Ltd
25 North Row, Mayfair,
London W1K 6DJ
www.arrinvestments.com
+447546506784
investor@arrinvestments.com

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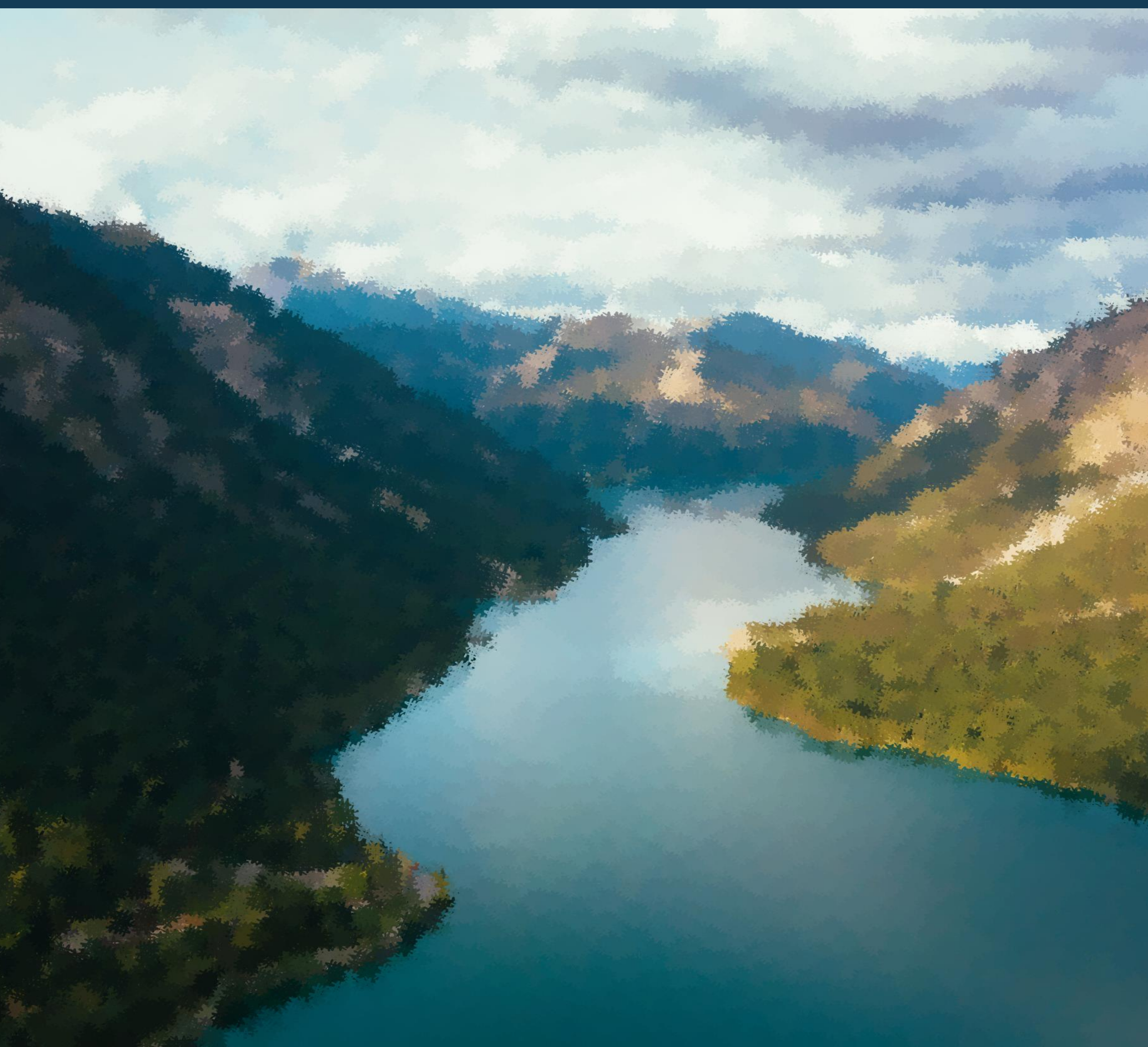

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