

ARR Global L/S Equity Strategy Investor Letter, Third Quarter 2021



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Dear friends and fellow investors,

I hope you are all well!

Last year, ARR Investment Partners was shortlisted as one of the best global long/short equity hedge funds with a long-term track record by the hedge fund journal HFM. This year's performance has been disappointing, to put mildly. In Q3, the strategy returned -9.13%. As I am one of the biggest investors myself and the company's success depends mostly on good performance, I probably feel the frustration more than anyone else. Given the time and effort spent building the investment strategy, internal systems, and running a business, I have reflected on what has gone well and what has not. This year has highlighted various weaknesses of my investment strategy as several investments in a row have performed below expectations. I would like to elaborate on those and what shall be improved going forward to avoid the same mistakes. It is important not only to recognise these mistakes, but to draw the right conclusions from them. For that reason, I looked at the successes and failures of major hedge fund managers and what their lessons learnt were and whether they are similar to ours.

Bill Ackman, a well-known hedge fund manager, got a lot of media attention last year as he made arguably the single best trade turning \$27mn into \$2.6bn by hedging his portfolio against the COVID sell-off. Investors now celebrate him once again as one of the world's top hedge fund managers as he returned 58% in 2019 and 70% in 2020. However, this comes after a period of poor returns for Ackman. From 2015 till 2018 he was down four consecutive years due to several loss-making investments like buying Valeant and shorting Herbalife. He argues that the reason for these losses was from deviating from the original, very simple strategy. In reaction to his shortcomings, Ackman wrote the basic rules of investing on his office wall in order to be constantly reminded by them and maintain emotional discipline. We decided to

do the same; simplify the investment process and have our simple rules constantly in front of our eyes.

Stanley Druckenmiller is my personal role model as he generated more than 30% annual returns over 30 years and has not lost money in any one calendar year. I am sure there is more to it, but he attributes his success to the simple steps in his investment process which gave him the necessary discipline to focus on the best risk-reward opportunities.

Firstly, he only invests in opportunities where both fundamentals and technicals align. Great businesses of which the stock price is in a downward trend might be a good investment in the long run, but for an absolute return mandate like ours, they are not suitable as you might have to cut your losses at the worst time. Unfortunately, this dynamic has played out several times this year. Many of our worst performing stocks are great businesses and traded at very attractive valuations, but at the end of the day we did not capture them in an upward trend. As a rule, it is better to be a little too late than too early.

Secondly, he focuses on different asset classes like equities, bonds and commodities and will only invest in an asset class if it has an attractive risk-reward. As a fund manager you face enormous pressure to constantly perform well and one of the biggest risks is to chase overvalued markets or stocks. By having an investment universe with different underlying drivers, you can avoid this risk. For the same reason I invest in sectors which have completely different underlying drivers like metals & mining, oil & gas, real estate, financials, pharma and technology. Over the years I have built expertise in these sectors and can judge the investment opportunities quite well. It makes sense to build new sector expertise over time, but as a rule of thumb the search for investment opportunities should always be in the existing circle of confidence, especially since they are already quite diverse and offer plenty of opportunities.

Another principle of Druckenmiller is to have a concentrated investment portfolio. It is better to have only several investment ideas and watch them closely. Many investors argue that you should be well diversified but there is a reason why Warren Buffett says diversification is protection against ignorance. In my case, this has been a reason for losses as several smaller positions cost us dearly and great investments like BioNTech were just too small to make an impact despite a 150% increase. Moreover, having 30 positions is not suitable for an absolute return mandate from a risk management point of view. When the market crashes, cutting 30 positions is extremely difficult. Initiating a hedge for these positions comes with risks as the positions have different underlying drivers. By limiting the maximum number of positions in the portfolio to 15, this should sharpen our focus when selecting investments. By applying stricter investment rules, certain opportunities may be missed, but the hit ratio should improve. When combined with bigger stock positions this should lead to better overall performance.

This year also revealed another weakness of my investment strategy of focusing on uncorrelated investment themes like gold stocks, Chinese tech companies etc. The US market is by far the biggest market globally; the FED and the US government in comparison with many other governments are very much interested in a strong stock market performance as the majority of US voters own equities. The US market is very broad and there are many great investment opportunities. Investing in different regions and asset classes like Chinese tech companies makes only sense if those opportunities are not only attractive but they have to be far more attractive than the US investment opportunities, given the higher political risks for example. Comparing potential investments to the major US indices is another step in being more selective. The FAANG stocks make up approximately 25% of the S&P 500. So the question is really whether potential

investments have a better risk-reward than these incredible businesses

Another step in simplifying my investment strategy is the use of futures and ETFs. Among others we manage our risks via exposure management, meaning we are not 100% invested when we think the market might correct. It pays to be out of the market when there is a crash but also being invested when the market bounces back. Use of futures and ETFs allows for quicker and more effective management of portfolio exposure and only when convinced a single stock can outperform the general market will single stocks be selected.

It is also important to build upon areas of strength where we have made the best return:

- Rebound situations in cyclical sectors. This is an area of our expertise where we look for attractive valuations and act when there is a clear trigger. Opportunities like this are infrequent but have delivered handsomely in the past. Given rising energy prices, we see several opportunities here in the oil and gas sector and are monitoring developments in the renewable energy space which got a strong boost from high gas and electricity prices.
- Companies with strong and predictable earnings momentum which are characterized by strong performance but relatively low volatility. These are long-term compounders which we want to own well into the future, and depending on the risk-reward the position size can vary significantly. Most of the winners we had this year fall in this category and are companies like Moody's, Adobe and AMD. We have a significant watch list in this area and are waiting for the right entry prices.

- Short positions in cyclical sectors like Oil & Gas, Metals & Mining, Financials when I see a heightened risk of a recession or market correction. These sectors, whilst not the most attractive long term, offer unique rebound situations from time to time. They also act as good early indicators of serious economic risks and stock market crashes. At the end of a bull market, they have either bubble-like moves (remember the oil price at \$145 in 2008) or have already begun a downward trend. Currently we do not observe this dynamic but remain vigilant as always.

In summary, my passion for investing remains as strong as ever. The process of searching, analysing, and having challenging discussions about investment opportunities is one I love. Exceptional performance in the past has always been a result of deep thinking and sticking to the game plan. By implementing simpler rules, through a more robust and repeatable system I seek to drive more consistent performance moving forward.

Thank you all for your continued trust and support in my team and me.

Best,

Christian

ARR Investment Partners Ltd
4 Devonshire St, Marylebone
London, W1W 5DX
www.arrinvestments.com
investor@arrinvestments.com

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