

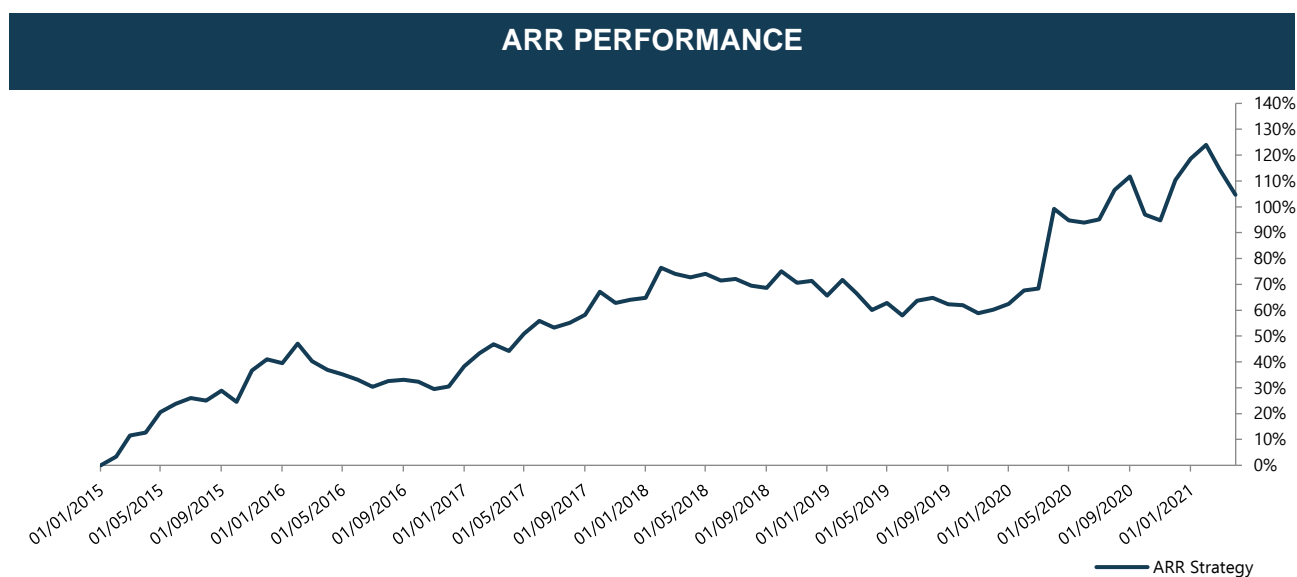
# ARR Global L/S Equity Strategy Investor Letter, First Quarter 2021



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PARTNERS

Dear Friends and Investors,

ARR Investment Partners generated a net return on the first managed account of -6.4% in Q1 of 2021. The cumulative net return since January 2015 is 104.7%, or an annualized return of 12.1%.<sup>1</sup>



Source: Interactive Brokers Account, in USD, net of 1.5% management fee and 20% performance fees; unaudited; as of 31.03.2021

## Investment and Performance Review

The central theme of Q1 2021 was a sector rotation out of top 2020 stocks. Stocks that were popular in 2020, such as those in technology and renewable energy, suffered a violent repricing. On the other hand, beleaguered stocks, such as cyclicals and travel & leisure, rebounded to pre-crisis levels. This shift occurred despite the 3rd COVID wave and continued lockdowns in Europe. Together with the strong sector rotation, the yield on long-term treasury bonds increased significantly in the US.

Our results in Q1 were underwhelming, and we have made significant changes to our investment portfolio to remedy the mistakes. Key drivers of losses were several gold positions, which came under pressure due to the rapid rise in US long-term bond yields.

The rationale for our gold trades was a chain of events that occurred in Q1. After Biden took office and the Democrats took both houses,

we expected sizeable stimulus bills and more money printing by the FED. The \$1.9 trillion pandemic relief bill and the recently announced economic recovery bill confirmed our expectations. Historically gold has been an established inflation hedge whose price enters a bull-run in times of massive money-printing and high inflation. The Federal Reserve's balance sheet had its most significant expansion ever in 2020, which continued through the first quarter of 2021. We expect this trend to hold as the new bills become law. Despite the FED's reluctance to raise interest rates, strong inflation expectations caused a mini 'taper tantrum'. The long-term US treasury yield climbed almost 80 basis points to over 1.7%, and the mid-term US treasury climbed over 50 basis points to 0.9%. The sharp rise in long-term US yields put downward pressure on the gold price. We realized we were too early in this trade and that a yield rise preceded any actual inflation signal. As soon as we realized this mistake, we cut our gold and silver exposures.

<sup>1</sup> \*Source: InteractiveBrokers. Net of adviser fees. Time weighted return relates to the longest established separately managed client account, unaudited. ARR Investment Partners Ltd is an appointed representative of Eschler Asset Management LLP which is authorised and regulated by the FCA

Looking ahead, we have improved our portfolio management system based on the lessons learned from this experience. We will pay extra attention to yield movements when evaluating future gold-stock investments even if the fundamentals of those companies are outstanding. We also examined our portfolio positions by analysing their sector and gold price correlation. Some stocks that are seemingly uncorrelated with gold had similar short-term movements with the gold price. We realized that approximately 30% of our portfolio positions had a higher correlation to the gold price than to their official sector. For example, Deutsche Börse and S&T AG were more correlated to the gold price in the past 12 months than to the financial or IT sectors. Because of this phenomenon, our actual gold exposure was more significant than meets the eye. We created a table in our risk management system that aggregates positions by their past 12 months' trading patterns instead of traditional GICS sector categorization to address this problem. This will ensure we do not place unintentionally large exposures on one theme. We believe that Deutsche Börse's and S&T's underlying drivers are not linked to the gold price, and the poor performance of these stocks is only temporary.

Our most material single company loss came from Sibanye Stillwater, one of the largest PGM producers globally (Platinum Group Metals, meaning Platinum, Palladium, Rhodium, and Iridium). We believe Sibanye has a lot of upside in the midterm and built a significant position in the company. We are not stubborn with our mistakes when proven wrong, but we also have the resolve to stick to high conviction ideas during undesired market moves.

We see significant upside for PGM producers. Palladium and Rhodium are predominantly used in gasoline engine catalysts. With ever-stricter global emissions standards and increased gasoline car sales after the VW diesel scandal, demand is outpacing supply.

PGM mining is concentrated in Russia and South Africa, characterized by an oligopolistic market structure. Due to the lack of alternatives and low usage per car, the demand is highly inelastic. These factors led to a more than tripling of Palladium prices since 2016 and a quadrupling of Rhodium prices in the last twelve months. Recently, Norilsk Nickel, a major PGM producer, incurred a significant mine accident with flooding that reduced their PGM production in 2021 by approximately 20%. All the above reasons give us strong confidence in the investment case of Sibanye Stillwater. At the current market price of PGMs, Sibanye-Stillwater is valued at less than 3x PE and hence significantly undervalued. The obvious risk for this investment is a strong decrease in the underlying metals prices. Given the recent supply reductions, we see those risks as limited. We see an upside of at least 30%, excluding the potential benefit from its applications in the renewable energy sector. The company is the biggest producer of Iridium which is essential for the production of green hydrogen. In early April, we have already seen an increase in the price of Sibanye.

Besides our harmful exposure to the gold sector and temporary loss in Sibanye, we suffered from some idiosyncratic events that were unpredictable. One of them was the aforementioned Norilsk Nickel mine accident, as we also had a position in this company. Another such case was when TeamViewer, a German software firm we held, announced an outsized sponsorship for Manchester United, which placed a burden on its profit margins. The stock price crashed, triggering our stop loss.

Our successful investments in Q1 2021 were in our sectors of expertise. For example, positions in the Energy, Financial, and European Technology sectors. This reminds us to focus on areas of expertise as they will continue to be the backbone of our trading profits. Furthermore, we also profited from the Cannabis legalization theme in Q1 of 2021.

Although we have covered most of our Cannabis exposures now, it served as a good source of diversification as it was uncorrelated to other positions we held. We also benefited from trading in several uncorrelated themes, including short bubble firms like GSX.

The average gross and net equity exposures over the first quarter were 105% and 83%, respectively. Due to the stringent risk limit we set for ourselves, we have gradually cut our gross and net exposures in March. We will trade small risks in only high conviction ideas to back a profit buffer progressively before taking on more aggressive positions again. At the end of the quarter, we held 69% long exposure and 1% short exposure. Currently, we have approximately 20 positions.

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## SYSTEM DEVELOPMENT

In the first quarter of 2021, we started live-testing our systematic momentum stock-picking strategy, as mentioned in earlier quarterly investor letters. The live test of those automatically generated ideas, implemented in a paper portfolio, marks our first milestone of using well-researched and back-tested systems to generate new investment ideas. The strategy has an annualized return of over 18% for the last 20 years and has consistently outperformed the S&P 500 index. We restricted companies by their market cap and country of listing only to trade reasonably sized and liquid companies in well-established stock markets. In the back-test, we took the precaution to avoid survivorship bias by including firms that were delisted. In the live testing, we would rebalance the portfolio every month following the strategy's recommendations. Once it has proved capacity in both back-test and live-test, it will become a good idea generation tool to identify a small pool of momentum stocks.

At the end of Q1, we performed a thorough analysis of our historical trading activities. We let the data speak for itself to reveal our

strengths and weaknesses. We analysed our performance in different markets and industries. We observed how our performance has changed over time and separated our expertise from other uncorrelated themes. We summarised the common themes among the best trades we have made over the six years and the common issues among the missed opportunities. From this analysis, we generated a methodology of monetizing on our strengths and avoiding our weaknesses.

In Q1, we continued to use the database and quantitative research tools we built to conduct case studies, including modelling the movements of commodity prices. We also improved our live monitor to contain more features, including technical signals to spot rebound opportunities in over 100 indices across a panoply of markets and alternative investments. Additionally, we improved our fundamental screening tools to understand and compare target companies quickly. These system improvements contributed to the efficiency of our idea generation process.

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## Market and Performance Outlook

Going into the second quarter of 2021, we have a cautiously optimistic view of the market. Economy-wise, the Biden administration has laid a perfect ground for explosive growth after the pandemic ends. Not long after the \$900 billion relief bill was signed last December, the White House signed a \$1.9 trillion relief bill in March. These relief bills have boosted household savings. If China's post-pandemic recovery is any reference, it will cause a rapid and powerful domestic demand surge as soon as people are free from restrictions to spend it. In addition, the Biden Administration proposed a new infrastructure stimulus bill with a size of \$2.3 trillion, which can further boost GDP growth by 1-2%. Combining the above effects, we are likely to see the economy grow in 2021 and 2022 at a rate not seen for decades. Pandemic-wise, over 150 million doses of the Covid vaccine

have been rolled out in the US and over 590 million worldwide. Scientists expect it will take four months for the US to reach herd immunity. Given the market is a discounting mechanism, we are optimistic about the remaining quarters in 2021.

Despite our positive outlook, we are cautious about picking investment targets in the current environment. Many companies have enjoyed an over-extended rally either in 2020 (such as technology stocks) or during Q1 2021 (such as energy and financials). We look for attractively valued investments with great business models. Sibanye-Stillwater listed above is one such company where fundamentals and valuation align, resulting in limited risk and much more significant return potential. Similarly, we built positions in two stock exchanges with a very stable business model, monopolistic market structures, and which profit from the recent boom of retail brokerage account openings. Other high conviction investments include rating agencies, a biotech company profiting from Covid, a German real estate company, and several IT companies.

At ARR, investing is our passion. We are well aware that our Q1 performance was very disappointing, especially after a stellar 2020. As mentioned in the Q4 letter, historically, it is always the best time to add to investment when we had a temporary loss, such as September 2020 or in the past two months. I know it feels easier to add after a strong performance, but if history offers any guidance, underperformance is the best time to add to the portfolio.

Our team's interest is aligned with our investors. Not only do I have more than 90% of my liquid net worth invested in the strategy, but last year's performance fee will be invested alongside our investors and in further strengthening the team.

Thank you very much for your continued trust 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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