# ARR Global L/S Equity Strategy

# Investor Letter, Fourth Quarter 2021

Dear Friends and Investment Partners,

I hope you are well!

Last quarter's performance was disappointing as the strategy returned -8.17% and capped off the most challenging year of my investment career.

Looking back, a bullish stock market and exceptionally strong performance in 2020 was perhaps a curse in disguise. I put heavy pressure on myself to achieve similar results and continue momentum into 2021, when in fact I ought to have detached myself from past success and focused on the basics when making investment decisions. Having enjoyed a peaceful Christmas period back in Austria, I have had time to reflect on why several of my investment themes did not perform in 2021, and what's in store for this year.

I believe successful investing can be boiled down to two aspects.

1) How often are you right?

2) How good is the risk-reward of your investments?

You can be right only 30% of the time but generate significant returns when your average losses are limited to 7% and your average gains are 30%. Of course, outstanding performance can be achieved when you are right more than 50% of the time and focus only on outstanding risk-reward opportunities where you limit your losses. In the past I have generated over 30% returns being right approximately 55% of the time.

You increase the probability of being right by:

- **Sticking to your area of expertise**.

  The large majority of gains are made from a relatively small number of investments with great risk-reward characteristics. By sticking to sectors in which I have expertise, I am able to better identify opportunities with asymmetric risk-reward. Moreover, fewer grey areas allows for higher conviction.

- **Balancing patience with conviction**.

  It is important to exercise patience and discipline to wait for only the best opportunities. When they come around, making concentrated investments allows you to pounce on your best ideas and reap the rewards. This is a more effective approach than spreading yourself too thinly across average ideas.

- **Investing in opportunities where fundamentals and technicals align.**

  The so-called 50/80 rule describes an observed phenomenon where a market leader, upon reaching an all-time high, has a 50% chance of losing 80% of its value and an 80% chance of losing 50% of its value. This is despite these companies being excellent businesses with strong fundamentals. Last year, many NASDAQ Composite stocks experienced this phenomenon as 40% of stocks in the index shed over 50% of their value at some point[1]. This is not apparent when looking at the strong overall performance, driven largely by the mega caps. As I also mentioned in the Q3 letter, it is therefore crucial to observe technical signals in conjunction with fundamental analysis.

- **Looking forward rather than backwards**.

  Where do I see the world in the coming 12 months? For me, this is easiest to judge when there are extremes in the commodity space. For instance, one does not have to be a genius to

[1]https://www.bloomberg.com/news/articles/2022-01-06/number-of-nasdaq-stocks-down-50-or-more-is-almost-at-a-record

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understand that oil trading below $0 is improbable long-term.

Great risk-reward opportunities are found in extreme *valuation* or extreme *growth* scenarios. With extreme valuations, stocks can be very cheap, and exhibit rebound characteristics, or equally, be very expensive and show signs of a bubble. In extreme growth scenarios, companies that are structural losers can have very negative growth, whilst others show dynamic profit growth.

Before judging the upside in an investment, it is crucial to focus on downside protection. Back in my Moscow days as a portfolio manager investing in Russian equities, I always cut my losses immediately, as often fundamentals did not matter in the face of oil price volatility or political risks. Last year, I maintained several losing positions either because of their extremely high growth characteristics or their very cheap valuations. Sometimes, this does not matter and for example in the case of polysilicon producer Daqo New Energy, a highly profitable, zero debt and fast growing company with a PE of only 5 at the start of Q4, whilst it appeared a very attractive investment, it nevertheless decreased by 50% from peak to trough in Q4.

I will not repeat this mistake again. Given the bullish environment we were in last year and the pressure I put on myself, I overlooked the three-tiered hierarchy with respect to risk management. First and foremost is the preservation of capital. Before asking what the potential profit could be, it is crucial to examine the potential loss one could suffer and to always have a disciplined stop loss policy where one strips away the emotion and is able to move on from mistakes. Interestingly enough, the majority of my most successful investments have made money right from the beginning.

Secondly, one has to strive for consistent profitability by balancing risk relative to accumulated profits or losses. No one, especially me, likes an emotional and financial roller coaster ride where a year of great performance is followed by severe losses. The solution is to increase the taken risk when one is profitable and reduce it when one is loss making and obviously not in sync with the market. Last year proved it really does not matter how bullish the general market environment is, the decisive factor for risk taking is P&L.

Lastly, if one is successful in the first two goals and has a period of high profitability, one has gained the credit to aim for superior returns by increasing position size if the right opportunity presents itself. The key to building wealth is to preserve capital and to wait patiently for the right opportunity to make extraordinary profits.

**Outlook**

The two most important drivers for the stock market are the growth of company earnings and the discount rate / central bank liquidity as they have a significant impact on valuations. Despite all the Covid related fears, we saw very strong earnings growth in developed markets last year, coupled with ample liquidity from the global central banks. This year, earnings growth of major indices is expected to normalise to historic trends and the Fed is expected to increase interest rates three to four times. Historically, bear markets started at later stages of the central bank tightening cycle and not at the beginning. Given the strength of the global economy and further expected fiscal stimulus I am still optimistic about the outlook. But this year's general market performance will probably be more volatile than 2021, especially as valuations are extended in several industries and a Fed put becomes less certain.

I expect that several trends from last year will continue, first and foremost the semiconductor industry should continue to profit from strong demand and supply

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shortages. Historically, semiconductors have been very cyclical but with the appearance of new technological trends (EV, AI, IoT, cryptocurrencies, metaverse, cloud etc.), demand depends less and less on cyclical sectors like automotive. In fact, we currently see a reversal of dependency as car producers cannot produce enough cars due to a chip shortage. Our biggest position in the semiconductor industry is Taiwan Semiconductors which profits from an almost monopolistic market structure.

Last year we saw an energy crisis in Europe with gas prices rising an incredible 700% from their lows and historically high coal prices. There are many reasons for these developments. Due to political reasons, ESG and climate goals, we do not see supply reacting to increased prices. Hence, I expect energy prices to stay elevated which leads to many direct and indirect consequences such as higher electricity and aluminium prices.

Moreover, in the metals and mining space one can find great opportunities under the condition that China avoids a recession, which I expect it to do. China consumes approximately 50% of all major commodities. Generally, commodity prices are at elevated levels but due to the booming economy and supply side restrictions, I expect this trend to continue. I see several developments which might lead to even higher prices, for instance in the copper market. Chile is the largest producer of copper in the world, providing approximately 27% of global output. After a new socialist president was elected and a new constitution is being drafted, there is a high chance that investing in the mining sector becomes far less attractive and so supply should not increase mid-term as higher commodity prices might suggest.

I am also convinced that loss-making tech companies with extremely high valuations, as well as the Reddit meme stocks like GameStop and AMC should continue their downward trend that started in the second half of 2021. For the latter, such vertical growth in Q1 2021 was due to short squeezes and performance-driven social media hype. In the last year these companies issued new shares at high prices and avoided bankruptcy risks. However, at the same time existing shareholders were diluted and the short interest came down to insignificant levels. As a consequence the risk of short squeezes and therefore extreme price rises is now low. Moreover, it takes 10 times more buy orders to push a $10bn company to a $100bn valuation than from $1bn to $10bn. Many of these Reddit traders have likely been losing money since the peak in Q1 2020. AMC for example has shed 70% from its high.

As mentioned above, beneath the surface of great index performance, many high quality companies sold off significantly. Over the long term I see significant structural growth in payment processing companies, ecommerce platforms, pharma suppliers and software companies. I have several great businesses on my watchlist and if both my fundamental and technical criteria are met, I will act accordingly. Moreover, several real estate companies have decreased in value in the past months despite ever increasing real estate prices. This can be partly attributed to political uncertainties, but also the fact that real estate companies tend to underperform when interest rates rise. I do not expect significant interest rate hikes in Europe for the coming years, despite high inflation. As a result, I am conscious of significant opportunities in European real estate equities.

I look forward to an interesting 2022 and with many lessons learnt from 2021, I shall do my best to generate attractive returns this year.

Thank you for your trust in my team and me!

Best,

Christian

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

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