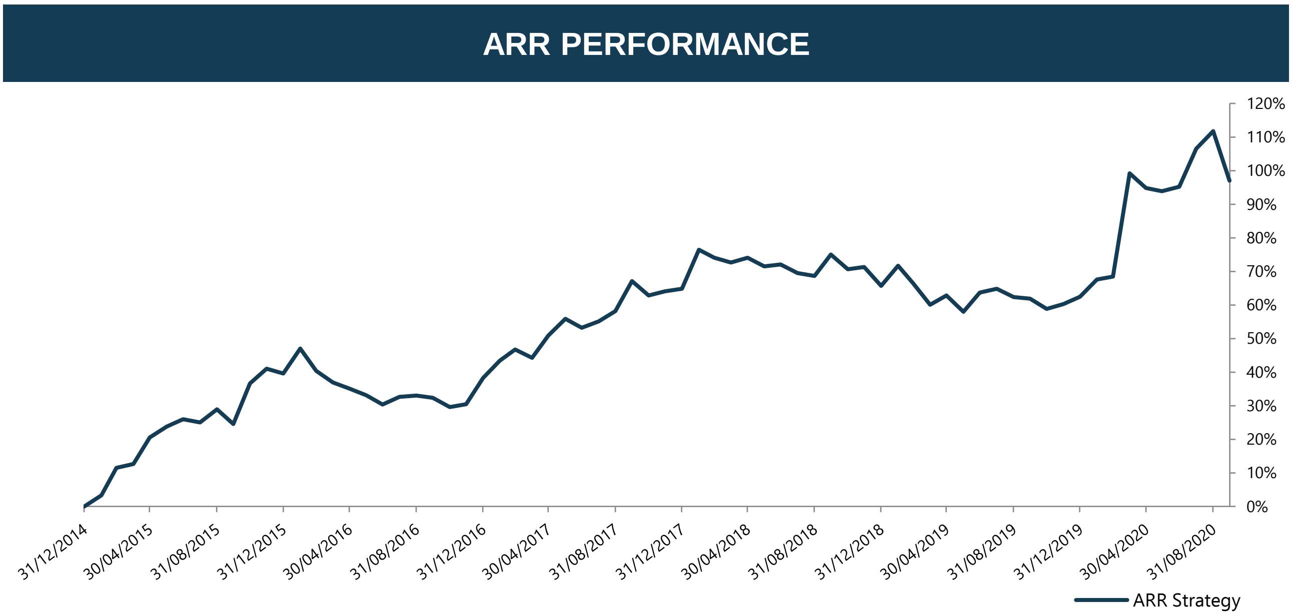
ARR Strategy

Investor Letter, Third Quarter 2020

ARR | INVESTMENT PARTNERS

Dear Partners,

ARR Investment Partners generated a net return of 0.9% in Q3 of 2020, year-to-date we achieved 21.3% net of fees in aggregation. The cumulative net return since inception in January 2015 is +97.0% in USD, or an annualized return of +12.5%[1].



Source: Interactive Brokers Account, in USD, net of 1.5% management fee and 20% performance fees; unaudited; as of 30.09.2020

In Q3 we again experienced a volatile market environment with a strong rally in July and August, and a market correction in September. Our largest return contributors were our investments in the sectors Basic Materials and Consumer Non-Cyclicals, while our largest loss contributors were in the sectors Technology and Financials. On average the top five best picks contributed 1.56% profit each and the bottom five picks contributed 0.78% loss each. In September we gave up part of the profits we made in July and August, mainly due to two factors: macro-views which did not materialize and unexpected events in single stock picks. On the positive side, we profited from our expertise in the material sector (especially in precious metals), the successful discovery of rebound stocks, and investments in the pharma industry.

By the end of August, the US long-term yield hovered around the historical low (see graphic A in appendix). This occurred because of the extraordinary monetary easing implemented by the Federal Reserve to allow companies to refinance at favourable terms. This, in combination with hiked bad debt reserves, has caused serious selloffs in multi-national bank stocks, as banks suffer from a flat yield curve. In August, we observed continuous economic recovery evidenced by improving leading economic indicators and strong earnings expectations in the financial sector (see graphic B in appendix). We believed the impacts of the coronavirus have been largely priced in and the US long-term yield should increase to reflect potential long-term inflationary risks. Our thesis was that the steepening yield curve would lead to a rebound of the financial sector stocks which have been strongly underperforming. As the market corrected in September, we reduced our exposure to the financial sector with a loss as our stop losses were hit. We might have been too early with this investment idea.

Our largest single stock loss contributor was S&T AG, an Austrian software company

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

specialized in the Internet-of-Things (IoT) industry. S&T AG recently corrected due to a sell recommendation from a research house. Having followed S&T for a long time, we accumulated a good understanding of its business. We reached out to its investor relations to clarify the situation. After carefully examining the management's response, we believe the sell recommendation is unjustified. Management confirmed the strong outlook for 2020 and the CEO bought shares worth approximately 700k EUR in the past weeks. We decided that the dramatic price movement provided a good entry point for a long-term growth firm and we decided to stay long with S&T AG.

In Q3 we continued to profit from our expertise in the gold and silver stocks. Four out of our top five best picks were gold and silver investments. At the start of July, we began building positions in miners we know well, such as Fresnillo, and held them through mid-August to profit from the gold price boom. Similar to our logic in Q1, gold price maintains a strong negative correlation with the long-term real yield. Until Mid-August, the gold price rallied up 15% and the silver price a stunning 50%. We realized this has become a crowded trade and started to proactively reduce our exposure. The proactive exit helped us avoid serious silver price crashes in late-September. At present we are again rebuilding our gold & silver exposures, as several gold stocks corrected significantly.

The COVID pandemic has proven disruptive to many industries, but certain groups of the healthcare industry profited significantly. Medical service and equipment providers are differentiated drastically by their ability to mitigate impacts on their original business and embrace new COVID-related demands. Thermo Fisher Scientific (TMO) is a company we identified with these abilities. Their industry leading R&D capacity helped them to quickly develop testing kits for the COVID virus and an automated diagnostic system that can analyse 7000 COVID specimens per day. We built positions on TMO and other high-quality pharmaceutical stocks as early as April. They provided good profit contributions as well as reduced portfolio risk with TMO increasing 25% during Q3.

Our average gross and net equity exposures over the third quarter were 118% and 82%, respectively. At the Quarter end date (30th September), we held 62% long exposure and 8% short exposure. The current portfolio is more conservative compared to a year-to-date average of 106% long and 42% short. We are more cautious due to many uncertainties lingering in the current market environment, which I will explain in more detail in the ***General Market Outlook*** section.

SYSTEM DEVELOPMENT

During Q3 2020 we endeavoured to upgrade all components of our proprietary portfolio and risk investment system (PARIS). In terms of infrastructure, we maintained our emphasis on security and remote accessibility. We migrated the system backend to the Microsoft Azure cloud, enabling us to use PARIS anywhere. In terms of functionality, we also followed along the "quantamental" principle. We incorporated our classical investment patterns and market timing clues into the live monitor. We also tested and fine-tuned these investment criteria in extensive case studies, then blended them in our idea-generation process.

We upgraded our database from local to Microsoft Azure cloud. Under the coronavirus lockdown, ARR is embracing the new normality of remote work. We took this crisis as an opportunity to make our system more secure and flexible than ever. We used three layers of protection to shield from cyber-attacks and ensure we can always recover our database. On top of allowing global access, the Azure cloud also removes the upper limit of storage and processing speed. This is crucial, as we continuously expand our database with more historical prices, economic factors, and alternative data.

Lastly, we produced a detailed documentation of the ARR's proprietary Python libraries. This largely improves the convenience of continued maintenance and development of our PARIS system, especially when we need to onboard new team members in the future.

GENERAL MARKET OUTLOOK

Our outlook for the remainder of 2020 and early 2021 is cautiously optimistic. We are constantly facing the threat of a second COVID outbreak-induced lockdown with the cases accelerating in the US, UK, France, and South American countries. At the same time, we face uncertainties from the US election and the potential changes of geopolitical tensions following it. On the upside, we have seen a strong recovery in the Chinese economy. We are also open to the possibility of a fourth round US stimulus of $1.6 trillion or more.

One of the major contributors to uncertainty in the near term is the US election. Currently, Joe Biden appears to comfortably lead Donald Trump in various polls, especially after Trump contracted the Coronavirus. However, this is far from a certain event. Biden and Trump hold many different policy targets which can turn the direction of the market after the election. For example, one key dispute surrounds the tax rate. Joe Biden vows to revoke most of the Trump administration's 2017 Tax reforms, including raising corporate tax from 21% to 28%. Biden has also proposed increasing the tax on long-term capital gains to 39.6% - the same top rate he has proposed for ordinary income - for those making over $1 million. On the contrary, the Trump administration will consider further tax cuts in capital gain tax should they win the election again. Another main policy difference lies in the renewable industry. It is central to Biden's fiscal policies to attract federal spending by as much as $1.7 trillion in the coming 10 years to eliminate carbon emission from the electric sector by 2035. If Joe Biden wins the election, we could see long-term support for the renewable industry.

However, there are common grounds to be found in Trump's and Biden's policies to reduce uncertainty. For example, both candidates vow to expand nationwide COVID testing and contact tracing. Another common policy is that both want to penalize firms who outsource production of goods and service to other countries. These common grounds provide us with the direction of industries largely immune to the election results. We aim to reduce election risk before November 3rd and quickly reposition ourselves afterwards if we find the right opportunities. In general, we focus on industries which should not be affected by the outcome of the election.

One of the themes we believe presents good risk-return opportunities is the China rebound. China is uniquely fighting the COVID pandemic. China imposed extreme lockdown controls in Q1 of 2020 and almost eliminated new cases by April (if you believe the official numbers). Thereafter, it gradually reopened the economy while imposing strict travel controls to avoid virus import. Throughout Q3, we saw a full reopening of the economy in China, which led to a strong post-crisis rebound, evidenced by indicators like PMI, unemployment rate, and vehicle sales. During Q3, China's currency CNY strengthened by 5%. At the same time, China's equities are still relatively cheap with an average P/E ratio of CSI 300 (China's main index) at 15, while S&P 500 has an average P/E ratio of 29, both at the end of September. We believe, with careful scrutiny of both operating risk and growth potentials, there are gems to be found with good risk-return trade-offs in the Chinese market.

As mentioned above, the pharmaceutical industry, especially firms who adapted to the new COVID-induced demands, will be relatively immune to the various risks. They provide assurance under an uncertain environment. On top of TMO, we are also interested in similar healthcare companies with strong development capacity. For example, BioNTech SE (BNTX) has recently applied for a potential COVID-19 vaccine. Being the second on the approval waitlist with a potential to be the first on the market, BioNTech has secured an order of 300 million doses from the EU. We believe well-picked high-quality pharmaceutical firms like TMO and BNTX will be a healthy source of return while at the same time reducing our portfolio's total risk of COVID influence.

We identified renewable energy as another potential candidate to provide healthy returns. All around the world, policy makers, or potential policy makers such as the US presidential candidate Joe Biden, are stressing the importance of replacing traditional energy providers with renewable providers. Aside from the apparent policy benefits, certain companies in the renewable sector have a very stable business model. For example, one of the largest residential solar server providers Sunrun (RUN), has a recurring revenue rate of over 90%. This is due to their adoption of a 25-30-year lease model to provide solar panel maintenance with no starting cost. Even under extreme economic conditions like in 2008, the default rate of lease contracts was lower than 1%, providing a stable revenue stream in uncertain times, like now. We aim to pick firms who are largely non-cyclical in the expanding renewable sector but at the same time not overvalued.

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

Yours Faithfully,

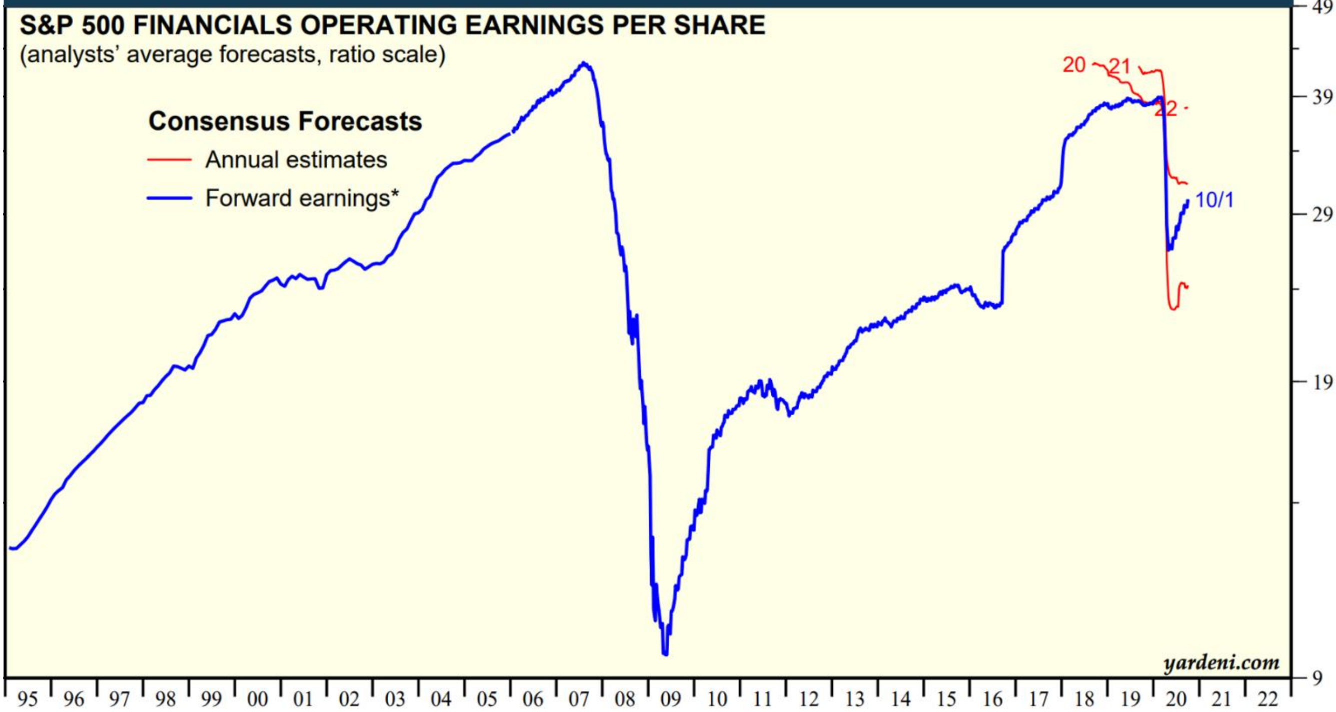
Christian

APPENDIX

A. US 10-Year Treasury Yield

Source: TradingView; Link: uk.tradingview.com

B. Financial Sector Earnings Forecast



Source: Yardeni Link: yardeni.com

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

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