AROWANA CVF

Monthly Newsletter and Net Tangible Asset Release

As at 31 January 2018

In January, the Fund recorded +6.5% performance, net of all fees and charges vs the S&P/ASX Accumulation 200 Index return of -0.4%.

The top three contributors to performance were Afterpay Touch Group (APT.AU), Bellamy's Australia (BAL.AU) and Weight Watchers International (WTW.US), collectively generating 6.4% of net performance. Hedges made a small positive contribution.

In January *Afterpay Touch Group (APT.AU)* announced second quarter sales and a strategic relationship with US domiciled private equity firm Matrix Partners, who will assist Afterpay with their US market entry. The stock closed up 23% for the month. The sales result was a positive surprise, as was the instore sales contribution. The US market opportunity could be cast as pie in the sky, but the stock is priced cheaper than comparables with more pedestrian growth prospects, so we aren't actually paying for that blue sky either.

You seldom see new business models that are really unique. When you do, it always manifests mathematically. In Afterpay's case, their net credit loss rate is well below what you'd see in an Australian or US credit card portfolio. That comparison actually underplays the structural advantage Afterpay has, because some of Afterpay's customers wouldn't be accepted by typical credit card issuing banks; which in turn goes some way to explaining the near viral growth in adoption. Because historical US card loss rates are much higher than in Australia, it may ultimately be the case that the Afterpay business model can fare better in the US on a comparative basis than in Australia.

Bellamy's Australia (BAL.AU) surprised the market in January with a material mid-month upgrade to sales and earnings for fiscal year 2018. In response, the stock closed up 42% for the month. It seems as if the recovery in sales is occurring faster than expected, albeit with a skew to the first half of the fiscal year given Bellamy's is still awaiting recertification for Chinese label sales. Provided the company is able to execute, there is a large potential growth runway in Chinese sales for Bellamy's. Whilst the overall Chinese infant milk formula market ("**IMF**") is not growing rapidly in volumetric terms, there is a clear structural shift in market share from locally produced formula to foreign branded product, and Bellamy's is materially underrepresented in some key distribution channels.

Weight Watchers International (WTW.US) caught a bid during January, closing up 45% for the month, in a relative news vacuum. There was speculation (subsequently denied) that Oprah Winfrey, who is the Company's spokesperson and third largest shareholder, would take a tilt at the US Presidency in 2020. Perhaps it was optimism around the January sales data; Weight Watchers books a disproportionate volume of annual membership additions in January. Irrespective, we exited our final holding in early February 2018. At the time we acquired the stock at $18.49/share in March 2017 it was trading on a forward price to earnings multiple of ~13x; at the time of exit at $64.50 that was closer to 35x. Time to move on.

Market observations

As we write, a sell-off had engulfed global equity markets, with the S&P500 Index down 8.6% at the close on 8th February 2018. Australia is faring relatively better, which makes some sense given that market largely missed out on January's run up.

One plausible explanation for the global sell-off in equities is the increase in sovereign interest rates, especially developed market rates. Over the last 18 months, US 2 year bond yields have increased 148 basis points, from 0.66% to 2.14%. In percentage terms that's a 224% change. At the long end of the curve it has been the same picture; US 10 year bond yields have increased from 1.45% to 2.71% over the last 18 months.

Rising interest rates and rising equity markets have been proclaiming the same thing thus far; rising nominal growth rates. Typically, in the early stages of an interest rate cycle, rates rise in tandem with equities; increasing growth is after all good for equities. But at some point there is divergence. Higher interest rates drive higher corporate borrowing costs and lower valuation multiples via higher risk free rates.

Mathematically, the sharpest points of prospective divergence between an increase in interest rates and equity valuation should be in those stocks where the market has been insufficiently prescient and thus overpaid for either duration or growth. Many bond proxies (REITs, utilities) and over-valued growth stocks are likely to be firmly in this wheelhouse.

One driver of rising US sovereign interest rates is a dawning realisation that America is about to have much larger budget deficits than previously projected. Typically, in a Keynesian inclined economy, deficits increase in times of economic contraction, but then decrease in times of recovery. Keynes advocated this approach, in order to have the government sector act as a shock absorber to the private sector, in the process avoiding harmful self-reinforcing economic contractions such as the Great Depression.

Current US economic policy advocates aggressive spending growth in tandem with tax cuts, in order to stimulate economic growth well past the point of economic recovery, in the notion that the resultant economic expansion will drive higher tax receipts and staunch the budgetary deficit bleed. This is essentially *Reaganomics*, or what George H.W. Bush disparagingly called *Voodoo Economics*. At best, such policy amplifies economic cycles, at worst, it is just plain reckless.

Now, in a time of relative economic prosperity, US Congressional Budget Office deficit forecasts are on an upward trajectory, and will be exacerbated by tax cuts and rising outlays driven by an aging population and a lack of entitlement reform. What this will likely mean is that US budget deficits as a percentage of GDP are likely to break below 4-5% in the years ahead, which is almost unprecedented outside periods of sharp economic contraction. Should an unexpected economic contraction eventuate, the US budget deficit is likely to be even bigger as a percentage of GDP given both numerator and denominator move the wrong way in those situations.

This may be why the AUD and many other currencies are actually strengthening against the USD, despite falling interest rate differentials. US interest rates may in time have more upside than we would like.

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Arowana Contrarian Value Fund

As at 31 January 2018

About Arowana Contrarian Value Fund (CVF)

ACVF (ASX ticker: CVF) offers investors an opportunity to gain exposure to a concentrated portfolio of securities built from a bottom-up research process. Whilst the majority of the portfolio is built around Australian listed securities, CVF is able to invest in overseas listed securities and to hedge its portfolio.

The core objectives of the fund are to:

1. Generate superior returns over the medium to long-term,
2. Provide shareholders a rising stream of dividends, and
3. Grow Net Tangible Assets per share

Net Tangible Assets (NTA) per Share

At 31 January 2018	Basic NTA per share ($)
NTA after tax and before estimated tax on unrealised gains	1.29
NTA after tax and after estimated tax on unrealised gains	1.19

** The Company is required to estimate the tax that may arise should the entire portfolio be disposed of on the above date and show the result per share after deducting this theoretical provision. Any such tax would generate franking credits, whose value would not be lost but rather transferred to shareholders on payment of franked dividends*

Investment Performance

					Since inception (5 Jan 2015)	
At 31 January 2018	1 mth	3 mths	6 mths	12 mths	Annualised	Cumulative
Arowana CVF Gross performance	**8.3 %**	**13.7 %**	**32.2 %**	**43.2 %**	**19.5 %**	**73.4 %**
S&P/ASX200 Accumulation Index	(0.4)%	3.0 %	7.9 %	12.2 %	8.2 %	27.6 %
Gross outperformance	8.7 %	10.7 %	24.3 %	31.0 %	11.3 %	45.8 %

					Since inception (5 Jan 2015)	
At 31 January 2018	1 mth	3 mths	6 mths	12 mths	Annualised	Cumulative
Arowana CVF Net performance*	**6.5 %**	**10.4 %**	**26.6 %**	**36.2 %**	**15.8 %**	**57.1 %**
S&P/ASX200 Accumulation Index	(0.4)%	3.0 %	7.9 %	12.2 %	8.2 %	27.6 %
Net outperformance	6.9 %	7.3 %	18.7 %	24.0 %	7.6 %	29.5 %

** Net return after all costs and fees (including estimated performance fee accrued) and before tax.*

Ordinary Shares

ASX ticker	**CVF**
Last price	$1.20
Number on issue	69,002,131
NTA per share*	$1.29

Market capitalisation	A$82.8m
Gross portfolio value	A92.6m
Final dividend**	$0.035/share

** Before estimated tax on unrealised gains*
*** Final dividend declared in August 2017, paid 29 September 2017, fully franked.*

Arowana CVF Asset Allocation

Asset class	A$m	%**
Australian Equities	55.3	60%
International Equities	22.2	24%
AUD cash and equivalent	9.6	10%
USD cash and equivalent	8.6	9%
CAD cash and equivalent	3.7	4%
JPY cash and equivalent	0.6	1%
Australian Hybrids & Bonds	-	0%
Hedges	(7.4)	(8%)
Portfolio Value*	**92.6**	**100%**

* *Totals may not sum due to rounding*

** *Percentage of gross portfolio value*

Top 5 Equity Holdings

Ticker		%**
APT	Afterpay Touch Group Limited	22%
TSGI.CA	Stars Group Inc	10%
SIV	Silver Chef Limited	9%
BAL	Bellamy's Australia Limited	7%
EHL	Emeco Holdings Limited	6%
Top 5 as % of Gross Portfolio		**53%**

* *Totals may not sum due to rounding*

** *Percentage of gross portfolio value*