AROWANA CVF

Monthly Newsletter and Net Tangible Asset Release

As at 31 March 2018

In March the Fund recorded -0.7% performance, net of all costs and fees, versus the S&P/ASX Accumulation 200 Index return of -3.8%.

For the first three months of calendar 2018, the Fund recorded performance of 3.6% versus the benchmark Index return of -3.9%.

Our hedge book made a positive contribution to March performance, buffering a negative result from our long portfolio of stocks. Our holdings in overseas stocks also contributed positively, bucking the market trend. The principal detractors from performance in March were our positions, respectively, in Silver Chef Limited (SIV.AU) and Afterpay Touch Group Limited (APT.AU). Our largest positive contributors were Bellamy's Australia (BAL.AU), Zillow Group Inc. (ZG.US) and Elders Limited (ELD.AU).

CVF's NTA per share at the end of March was $1.20 per share, post the accrual of a 4 cent per share fully franked dividend, which was paid on 5th April 2018.

At the time of writing, our largest holding, Afterpay Touch Group Limited (APT.AU), has fallen to $5.35 a share, a decline of 17% in early April, versus highs of $7.80 in mid-March. For perspective, our cost base is $2.84 a share, so despite the seeming calamitous decline of 31% from the highs, we're still up 88% on investment cost and the impact on fund NTA is not material.

Watching a stock you own decline in price is part and parcel of being an equity market investor. If you examine the share price history of any strongly appreciating stock, there are inevitably periods of significant price retracement. In such a situation we simply ask ourselves a) what caused the price decline and b) does it invalidate our investment case. Everyone makes mistakes; the trick is in recognising them *quickly*.

In this case, we think the bear thesis is fundamentally incorrect. The bear story is perhaps best encapsulated in a recent newspaper article which highlighted that a minor had signed up to the service under the name of "Mickey Mouse" and bought alcohol (the actual name was Miguel Lancha, which most non-Spanish speakers would not equate to "Mickey Mouse"). The story naturally leads the reader to extrapolate that fraud is rampant. However, nothing is more dangerous in statistics or investment than extrapolating from anecdote.

That it is possible to commit fraud on a payment system provider is hardly a revelation. A cursory read of the history of *Paypal* shows a litany of fraud attacks on that system. The more pertinent question is, can the attack vector used to commit the fraud be scaled such that the total cost of the fraud wipes out the payment systems profit.

In a typical credit system, the lender *wants* the borrower to have an outstanding balance for a long period of time because their business model is to charge interest on outstanding balances. They want you to pay *slow*. The catch is, the credit provider often doesn't find out if the customer can repay until after a significant period of time has elapsed.

In the case of Afterpay, their business model is to have the customer pay the outstanding balance *fast*. Afterpay charge merchants roughly 4% of transaction value. They charge the consumer nothing if they pay the balance on time. So, the faster the customer pays Afterpay and the more they use the service, the more Afterpay makes.

Because Afterpay absorbs fraud risk that credit card systems force merchants to absorb, they can justify this seemingly high 4% merchant fee. For most small merchants we've spoken to, all in, this is less than the cost of credit card system fees plus chargeback costs.

Customers must pay an outstanding balance within 60 days, in 4 instalments payable fortnightly. Customers cannot use the Afterpay system if they are late on a payment. So, Afterpay knows if a customer is delinquent within roughly 15 days. Given the average outstanding balance is less than

$500 per customer, unless you have a veritable tsunami of new fraudulent customers or all your existing customers go bad within 15 days of each other, it is quite difficult to get a catastrophic credit event. This is in stark contrast to say a revolving credit card receivables book. A key part of our diligence on this stock was an evaluation of how Afterpay detect new fraud vectors. We liked what we saw at the time; thus far this has been borne out in the reported financial results.

During March we initiated a new hedge position, in the equity of a business we believe faces significant structural headwinds, evidenced by a trend of revenue growing significantly slower than announced price increases, implying either negative volume or negative revenue mix shift. This stock has high valuation and might be considered a market darling. In response to the structural drivers that are causing negative revenue mix shift and market share loss, the company is increasing investment. There are two issues with this. First, we think the incremental returns from this new investment will be much lower than historical returns, which will lower overall investment returns and thus inexorably market valuation. Second, the investment is going to be debt funded, increasing the financial leverage of an already indebted business. Our prognosis, in time, is for "equity crush". When a company's enterprise value (crudely, the market value of its assets) doesn't grow, but debt does within an already highly geared balance sheet, the value of equity can face leveraged downside.

Equity markets have been buffeted in the first quarter of calendar 2018 by multiple exogenous factors.

President Trump's announcement of tariffs on a host of Chinese imports, notably steel, appeared motivated by his desire to curry favour with his voter base. In the 12 months to March 2018, the US imported around 50% *less* steel from China than it did two years ago. The US is also structurally dependent upon steel imports, given it produces less than it consumes. So, if the US doesn't buy the steel it needs from China, it will simply buy it from another exporting nation. Which means to say that the total or multilateral trade picture, is a more holistic view than the simplistic bilateral trade balance the US has with China. The other observation here is that incremental trade is a bit like water…it runs to the lowest level. Presumably US steel consumers bought from China because prices were low there. Now, they will be forced to buy at higher prices from the next most competitive supplier. Trade tariffs in this way are an inefficient tax on domestic consumers.

China responded with its own tariff package on US imports that appeared to target Mr. Trump's voter base. Equity markets watched aghast as all this unfolded. It was as though the lessons from the damaging Smoot-Hawley Tariff Act of 1930 had been forgotten.

The other event of the month was a sharp sell-off in technology stocks. Valuations in this part of the market have expanded over the last few years. What has happened is that the market has extrapolated the success of many of these business models well into the future. Some of the subject businesses may be deserving of this valuation enthusiasm, but likewise it is very hard to predict the future.

We added a cheap tech stock to the portfolio in April, as the confluence of a sector sell off and the company's own operational miscue presented an attractive opportunity. In calamity there is always opportunity.

Gary Hui	Ben Wolrige
Portfolio Manager & Lead Analyst	Co-Manager & Senior Analyst

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 March 2018	Basic NTA per share ($)
NTA after tax and before estimated tax on unrealised gains	1.20*
NTA after tax and after estimated tax on unrealised gains[1]	1.13*

1.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.

****After declaration of dividend on 28 February 2018, of 4 cents per share, fully franked and paid on 5 April 2018.***

Investment Performance

					Since inception (5 Jan 2015)	
At 31 March 2018	1 mth	3 mths	6 mths	12 mths	Annualised	Cumulative
Arowana CVF Gross performance	**(0.7) %**	**4.8 %**	**20.8 %**	**43.3 %**	**17.4 %**	**68.3 %**
S&P/ASX200 Accumulation Index	(3.8) %	(3.9) %	3.5 %	2.5 %	6.6 %	23.2 %
Gross outperformance	3.1 %	8.7 %	17.3 %	40.8 %	10.8 %	45.1 %

					Since inception (5 Jan 2015)	
At 31 March 2018	1 mth	3 mths	6 mths	12 mths	Annualised	Cumulative
Arowana CVF Net performance*	**(0.7) %**	**3.6 %**	**16.8 %**	**37.2 %**	**13.9 %**	**52.8 %**
S&P/ASX200 Accumulation Index	(3.8) %	(3.9) %	3.5 %	2.5 %	6.6 %	23.2 %
Net outperformance	3.1 %	7.5 %	13.3 %	34.7 %	7.3 %	29.6 %

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

Ordinary Shares

ASX ticker	**CVF**
Last price	$1.16
Number on issue	69,002,131
NTA per share*	$1.20

Market capitalisation	A$80.0m
Gross portfolio value	A$89.3m
Interim dividend 2018**	$0.04/share

** Before estimated tax on unrealised gains*

*** Interim dividend declared 28 February 2018, paid 5 April 2018, fully franked.*

Arowana CVF Asset Allocation

Asset class	A$m	%**
Australian Equities	40.9	46%
International Equities	21.2	24%
AUD cash and equivalent	24.3	27%
USD cash and equivalent	6.5	7%
CAD cash and equivalent	3.7	4%
JPY cash and equivalent	0.7	1%
Australian Hybrids & Bonds	-	0%
Hedges	(8.0)	(9%)
Gross Portfolio Value*	**89.3**	**100%**

* *Totals may not sum due to rounding*

** *Percentage of gross portfolio value*

Top 5 Equity Holdings

Ticker		%**
APT	Afterpay Touch Group Limited	18%
TSGI.CA	Stars Group Inc	11%
EHL	Emeco Holdings Limited	6%
BAL	Bellamy's Australia Limited	6%
ELD	Elders Limited	5%
Top 5 as % of Gross Portfolio		**46%**

* *Totals may not sum due to rounding*

** *Percentage of gross portfolio value*