Arrow Capital
MANAGEMENT INC.

Experience. Active Management.

BLACKBURIED AND GAMESTOPPED!

FEBRUARY 1, 2021

"In a roaring bull market, knowledge is superfluous and experience is a handicap." – Ben Graham

I thought I would use this quote featured at a recent Veritas investment conference to make some comments on the trading in shares of GameStop ("GME"), Blackberry ("BB"), AMC Entertainment ("AMC") and others whose share prices in no way now reflect any sensibility. We have received numerous inbound calls from advisors worried about whether we have short exposure to these names specifically and what we are doing in the Funds to manage the "rise of retail day traders" more generally. Certain Arrow Funds, Arrow Global Advantage ("AGAA"), Arrow Canadian Advantage ("ACAA") and Exemplar Growth & Income ("G&I") were long GameStop and also long Blackberry. We were never short any of these names and we are also no longer involved in any of these names. We had a few other names that benefited from the short squeeze that we sold including MAC, JWN, MIK. To be clear, these were fundamental positions, with the underlying thesis predicated on a number of factors including positive change, economic re-normalization, valuation, and market positioning. We would look to re-enter these names if the right opportunity presents itself.

GameStop – A Great Example of How Our Process Works

With respect to GameStop, this was an idea we sourced from one of the research boutiques (Hedgeye) we work with in generating ideas. The shares were recommended for their turnaround potential given a rationalized store presence and new management along with a big investment by Ryan Cohen – founder of Chewy – adding strategic value and pivot to online growth in distribution. The bear case was that this was the next Blockbuster – a nice narrative but totally wrong (at least in our opinion). Now, we are not big gamers but we understood that video games were not going to go exclusively to digital download. The new Sony and Microsoft consoles have disk drive versions for a reason - it's what the consumer wants. And more specifically it's often what the GameStop customer wants as well. So you had a wonderful risk reward/reward set up for the shares to perform very well over the next 12 months. The icing on the investment cake was that if we were right, we could see the shares double into the 30's over the next few months given the huge short interest. We started buying the shares late last year in the mid-teens.

The first important thing we need to explain is the context in which the position was established. As you know, we take a macro approach to asset and sector allocation. In the current economic environment (one of inflationary growth), consumer discretionary names tend to really outperform – especially subsectors like autos, retail etc. We did not buy this stock because it was deep value – as you know we are style agnostic – we start with the top down environment. We also favour "factors" that fit with our macro model. Interestingly the factor known as "high short interest" is generally strong in inflationary growth for many reasons so the squeezes going on are not a big surprise. GME fit the right environment to be long and the research was sound so we put on a position of under 25 bps in AGAA and a bit more in ACAA (it has a higher volatility target and more net long exposure). Recall that we do not take big individual security bets – we want a high batting average (think Rod Carew) not a lot of home runs with many strikeouts (think the late Hank Aaron). We never want our performance to be handicapped by one call going wrong – think about the dozen hedge funds out there that have had double digit losses plus in January due to concentration risk being short GME.

The second thing of note is that we steadily booked our profits as the shares rose. We manage position sizing seriously for the reasons noted above. Had we held all our shares, the GME position would have been 10% of AGAA at the end of January! We understood that the short interest in the shares was well over 100% (will touch on that in a minute) and we were aware of the retail driven short squeeze that began in mid-January in earnest. Both of these facts did enter into our tactics for exiting the position. We exited the last remaining shares around $100 – as they say, we did have some luck on our side with this one.

In the end, our GME position generated gross performance of 25 bps in AGAA, 77 bps in ACAA and 17 bps in G&I.

Blackberry – Another Example of How Our Process Works

We won't go into as much detail as GME but a long position in BB fit into our strategy well. It is no secret that the automobile industry is in the midst of tremendous upheaval as the world pivots away from ICE's to EV's. Cars are being transformed into technological marvels and BB has the potential to be a key technological partner in the transformation. As a cyclical technology name, it fit into our model so we established positions in the $9 - $11 range. The initial boost in the shares we thought was related to the Facebook litigation settlement. In fact, BB insiders sold shares shortly thereafter but the shares continued to rise. Again the high short interest and the promotion of the stock on Reddit's "wallstreetbets" page were behind the next leg up (BB is inter-listed). AGAA/ACAA sold the last of its shares around $15 and G&I around $25 using the same exit strategy as GME.

Is the Rise of Retail Day Trading ala Robinhood a Good or Bad Development?

This is a difficult question and to be truthful we don't really know. Our job is to manage to our mandate and do the best we can for our clients. To the extent the question is important perhaps we can divide it into two streams:

Firstly, does this type of trading behavior present a clear and present danger to our Funds or the way we manage money?

We don't think so. Our process navigated the craziness very well. For example, on the issue of short selling, we always consider the level of short interest before shorting a stock (now people are squeezing those high interest shorts as a long strategy). We would have never shorted GME even if we thought it was a flawed company or a potential zero. Why? Simple, the market believes it already "knows" this (it is 140% short!!) and more importantly if it were wrong, the losses can be extreme. I have witnessed countless short squeezes in my career but this one is for the ages. You can lose unlimited amounts of capital as the shares rise and also remember that highly shorted stocks generally cost a lot to borrow as well, compounding the problem. But these extreme examples do not change the case for short selling. It is a key tool in managing risk first and foremost. It can be a source of alpha but those situations will always be less attractive than being long because at most you can only make 100%. Short selling is valuable to our strategy and we have collectively a great deal of experience in managing shorts. If we need to, we will adapt our strategy, but for now things are working well.

Secondly, does this represent a systemic risk?

Once again short selling is coming under attack by the media, some sections of government and "Robinhoodies" – after all, how can you have over 100% short interest in a company's shares – is that not illegal? Are the "hedge funds" not to blame and is it not our right to fight back against them? Is it not our duty to go after these people - after all they caused the 2008 crash etc.? The issue is unfortunately extremely complex. What most people do, who neither have the time nor the inclination to truly investigate the issue, is jump on whatever heuristic or narrative they find fits their opinion or interest on the matter. Clearly the SEC is going to have to step in and review things – and certainly Congress will have its hours of endless uniformed debate – so we will see what happens.

Like the massive rise of passive money management (indexation and ETF's) that required attention by active managers, the growing retail activity – particularly in the options market – creates changes in market structure that require some tactical (not strategic) changes in our investment process. We did an AIMA video with other panelists on the subject (watch video here) and so we won't go into details. But does this activity represent a systemic risk? Maybe. For example, most clearing brokers introduced restrictions on trading and option activity on GME. The Chairman of Interactive Brokers said in a recent CNBC interview that there were billions of dollars of notional exposure long and short i.e. on both sides in GME. For clearing houses, it is their job to protect their business and their clients – how can they be sure the losing side can actually settle its losses? IB certainly does not want to be left holding the bag. And after all, if you want margin you need to post sufficient collateral – given the crazy volatility shouldn't much more collateral be demanded? It certainly looked to us by the end of the month that changes were coming.

Perhaps the whole GME situation is a microcosm of the growing awareness of wealth and income inequality in America and elsewhere. It is likely that the new Biden administration will be managing a tricky balancing act between keeping the economy growing pending mass vaccinations while undertaking some new taxation and income redistribution strategies. There will be consequences for investors and we do feel this is a key risk for later in 2021. We are keeping a close eye on it but that is for another discussion.

We hope this rather long note helps put the current frenzy in its context at least as it relates to Arrow's funds and our investment process. For the good news, in January, the equity markets were down while your client's made positive returns.

Trailing Returns	1 mo	3 mos	6 mos	1 yr
Exemplar Growth and Income Ser F	1.79	6.72	5.26	8.75
Arrow Canadian Advantage Alt Cl F	1.18	19.02	23.18	27.06
Arrow Global Advantage Alternative F	4.03	6.01	6.44	11.84

As of January 31, 2021

That is what really matters to us and to you. We'll keep battling.

Sincerely,
The Arrow Investment Team

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