ARCO Investment Management
ARCO Absolute Return Fund

Monthly report: May 2019

Defying the lead from its global peers, the ASX rallied further in May, fuelled by an unexpected election result, still-lower rates for longer and the 'rise and rise' of the price for earnings – any earnings. Time for caution as share price exuberance must give way to market logic.

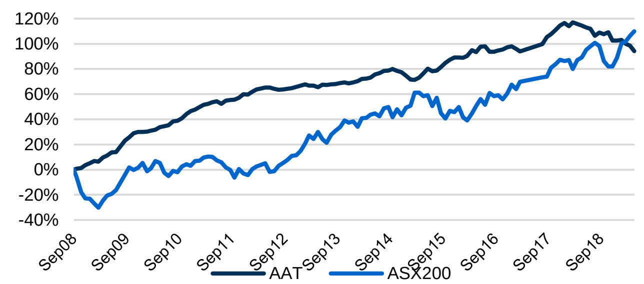
	Month	Qtr	1 Year	3 Year	Life (p.a.)
Fund return (net)	-2.05%	-4.23%	-9.1%	-0.6%	6.4%
Positive months			33%	58%	74%
Volatility					4.1%
Sharpe ratio					0.7

Note: Past performance in not a reliable indicator of future performance. The above return data for the month, qtr and 1Year is for the ARCO Absolute Return Fund. Longer-term data is for the ARCO Absolute Trust. Fees charged by the Fund are not identical to the Trust so performance would be slightly different over the longer time periods.

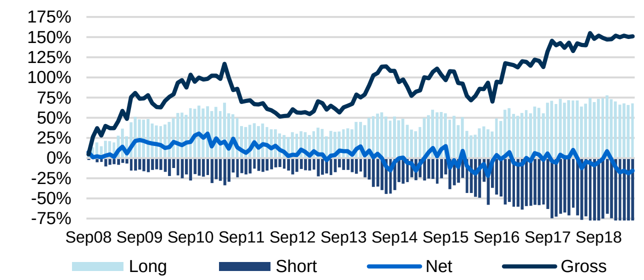
Monthly key contributors – by sector

Longs	25 positions
Positive	Media, resources, gaming
Negative	Diversified financials, chemicals
Shorts	**20 positions**
Positive	Retail, transport, food
Negative	Media, builders, banks

Cumulative performance



Fund investment profile (% NAV)



NOTE: The above data is for the ARCO Absolute Trust. Fees charged to the Trust are not identical to the ARCO Absolute Return Fund, net returns would therefore be slightly different.

Portfolio settings

% of NAV	Long	Short
Equities	67.7%	-45.5%
Debt/ Hybrids	0%	0%
Derivatives		-38.0%
Gross exposure		151.2%
Net exposure		-15.7%
Concentration by position	**Long**	**Short**
Top 5	25.8%	(17.6%)
Top 10	43.4%	(30.6%)
Top 15	55.4%	(39.3%)

Fund strategy and outlook

The Fund's objective is to generate consistent absolute returns through a market cycle, in excess of the RBA official cash rate, with an overarching focus on capital preservation.

The Fund recorded a net return of -2.05% for the month.

The tide flowed-out again in global equity markets during May with the MSCI down almost 6% for the month as trade wars escalated, the Brexit fiasco continued to plague markets, and as Central Banks grew more cautious about softening economic data.

Our market, by stark contrast, rose 1.7%. The snap-rally on the back of the Coalition victory at the polls was a sugar-hit that drove an already expensive market higher. We too believed that the RBA would reduce interest rates though out of growing concerns for our economy, not share market sponsorship.

We fail to see strong upside in the local banking and finance sector with private credit growth now at six year lows, business confidence waning, credit loss provisions still close to cycle lows, and NIM and real earnings growth capacity shrinking – even if there is an imminent levelling-out of house price declines. We were on the wrong side of the significant rally in bank stocks during the month but won't put investor capital at risk when we can't see a rational reason to do so.

Reflecting our continued cautiousness about the broader economy, plus our scepticism that stock price rises on the back of multiple expansion rather than proven earnings growth are additional reasons for conservatism, the Fund maintained a negative net market exposure during May.

The past year has been a tough one for our investors, (which includes ourselves). Our focus remains deploying capital into stock opportunities that we believe will deliver stronger (and rational) returns over time, to not trade short term momentum and to continue our longer-term track record of delivering positive, market-like returns above cash, with significantly less volatility than the broader equity market.

Performance review

May's performance was worse than our expectations and very disappointing.

Before discussing the usual math of "what went right, what went wrong", we think it is important to delve a bit deeper into what drives our thought processes which results in our cautious view of markets (and our net short position).

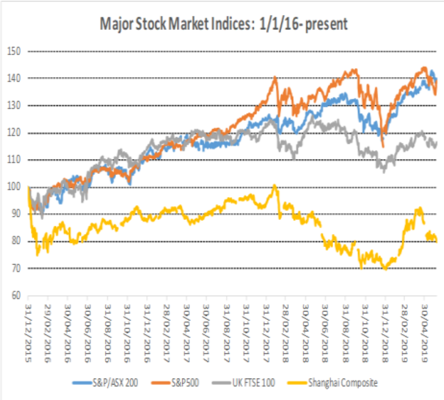
While we are far from happy with our current return profile, we have not changed our process or the way we view risk. The exuberance of current market movements certainly doesn't mean that risk has vanished. ARCO's strategy is designed to fill a particular place in an investor's portfolio: providing a means for improving the overall risk/return equation of a portfolio by smoothing returns, as well as downside protection in falling markets. In other words, providing equity market returns over the long term while limiting downside risk.

Recent performance notwithstanding, we believe the investment proposition of the Fund and our process are more relevant than ever: the value of its protection actually rises with exuberant markets as the metaphorical rubber band of lofty markets coupled with slowing earnings growth continues to stretch.

Having done this for more collective years than we'd care to remember, we constantly take a step back to consider not only what is driving markets today, but what will drive them in the future.

Firstly, to us valuation *does* matter! That doesn't mean we are "value" investors in the traditional sense of the concept (buying very cheap stocks irrespective of business model or outlook), but that we need to see value in the stocks we own; and the converse for our shorts. We are aware that valuation is only one factor, (and that it is a concept, not a fact), but we become most concerned when we view valuations as stretched either way.

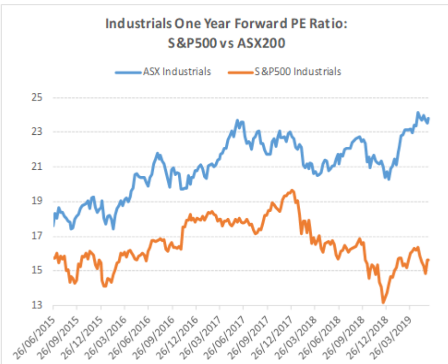
By way of example, let's first look at markets, which continue to enjoy a pretty good run. Since the turn of the new year in 2016, the Australian market (blue line) has returned a compound ~10% per annum. This is well above normal returns, influenced in large part by historically low interest rates. The US market (orange) has had similar returns while the UK market (grey) has been held back most likely due to Brexit issues, while Asian markets (yellow) have been hurt by growth slowing in the world's second largest economy, China. Of course, it's a matter of interest that China is our largest trading partner.



Source: Bloomberg.

Of more concern is that the rise of the Australian market has mostly been due to multiple expansion, rather than earnings growth. The remarkable chart below shows the one year forward looking Price /Earnings ratio for the ASX200 Industrials index (blue line) as compared to S&P500 Industrials, (orange line).

What this shows is the average multiple that investors are willing to pay for one dollar of earnings (ex-financials and resources) has risen from under 18x to nearly 24x. This essentially means that the vast bulk of the market's rise has not been due to sustainable increases in earnings, but by the price of those earnings going up. This is in stark contrast to its US counterpart which can attribute nearly all of its rise to earnings growth, a much less risky set of circumstances, especially as it also comes at a cheaper price.



Source: Bloomberg

Furthermore, we believe that the rally in Australian banks makes them the most expensive in the western world at a time when bad debts are virtually zero, competition and costs are simultaneously rising, and ROE falling. Again, these stocks are rallying from an extremely high starting point.

The table below highlights this, a phenomena made all the more precarious by the fact that earnings and dividend estimates are falling as bad debts begin to tick up from virtually zero. The opposite, however, is true for many of their international counterparts further bolstering the argument that these share prices are relatively unsustainable.

Bank Valuation Metrics

	PE	Price to Book	Forecast ROE
National Australia Bank	12.3	1.5	11.4
Commonwealth Bank	15.5	2.1	12.9
Bendigo Bank	14.5	1.0	7.7
ANZ	12.2	1.4	11.4
Westpac	12.8	1.5	11.3
Bank of Queensland	12.3	1.0	8.6
Bank of America	9.3	1.1	11.3
Wells Fargo	9.4	1.2	11.9
Citibank	8.2	0.9	9.6
Royal Bank of Scotland	7.7	0.6	7.9
Lloyds	7.5	0.9	12.5
Barclays	6.6	0.5	6.8

Source: Bloomberg

While the above are factual observations, the interesting bit for us is contextual. Markets are typically forward-looking, which historically has meant they sell off going into a slow-down and start to rebound prior to the economy bottoming as policy response went to work. The paradox of our current rally is that the market "sentiment" boost post the surprise liberal party election win, followed quickly by some policy measures aimed at the housing market, is that the stock market was already at record levels. It wasn't like the market was bouncing off a low. And let's be clear, the current turnaround in central bankers' thinking in the last few months is because of unexpected softening in economic conditions: it was only a very short time ago that the bias was toward rate rises. So while these measures will have some impact, it highlights the precarious nature of an already over-geared world (we "fixed" the GFC by doubling global debt) where monetary policy has very few bullets left….yet our market marches on.

Bringing this all together, we are often asked what type of markets we feel is most difficult to navigate. Our answer is consistently the same: strong rising markets where valuation is de-emphasized. This has been the case for a while.

It's also fair to say we've had a fair share of disappointing bottom-up stock picks. More importantly, and not entirely unexpected, is that current market conditions weigh on our "win rate" due to market leadership being focussed in a narrow range of what we deem as very expensive stocks: banks and high PE growth stocks.

On the month that was, the Australian market's march upwards in complete contradiction to the rest of the world weighed on returns given our net short position. We were heartened by our two largest contributors being investments in **Nine Entertainment** and **Lynas**, both of which were held, and added to, during periods of share price stress which we believed were due to non-fundamental facts. It was only a few short months ago that Nine, for example, traded at $1.30 before rebounding to close out May at $2.08 as the market began to realise, as we have long argued, the company isn't simply captive to the Australian advertising cycle.

The privileged nature of Lynas rare earths asset continued to be recognised post the conditional bid from Wesfarmers, especially given that China is using rare earths as leverage in the ongoing trade war. Lynas owns the largest resource outside of China. Both of these positions highlight the bottom up, long term fundamental nature of our process.

In addition, as we have maintained, the individual stock volatility of the market also throws up opportunities for the patient investor. Our investment in **Aristocrat** (made under substantial price stress in November) again paid off, as its result revealed continued strong momentum in its traditional businesses coupled with evidence of the potential of its burgeoning digital gaming business.

Nufarm and **Link** were the two largest negative contributors during the month, both long positions. Unfortunately, both have featured before as major detractors, though our view on the two has diverged. The investment thesis for Nufarm was and is the value creation from its European acquisitions, the value of a global distribution footprint to novel chemical producers (hence its biggest shareholder is Sumitomo Chemical) and the promise of its novel Omega 3 canola.

These factors have not changed and hence our continued holding. However, what we see as transitory issues of poor weather conditions on its working capital and balance sheet and the negative press surrounding glyphosate has seen the stock trade down on sentiment.

Conversely, we believe that the structural issues faced by Link in its Australian funds administration business coupled with the uncertainty surrounding its European acquisitions has resulted in a change of view and we have begun exiting the stock.

On the short side of the ledger, a position in **Dominos** continues to perform well as the investment thesis we followed (that earnings growth expectations are just too high) continues to play out.

Our largest short detractors were a combination of banks, building material companies and property-related stocks, all sectors under worsening earnings pressure, but which have bounced post the election. We addressed this phenomena above and note that, in the main, we have not changed these positions.

ARCO absolute return strategy – net monthly returns

	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	FY
FY19	**(0.44%)**	**(2.51%)**	**1.31%**	**(0.69%)**	**0.75%**	**(3.16%)**	**0.06%**	**0.24%**	**(1.46%)**	**(0.78%)**	**(2.05%)**		
FY18	0.24%	(0.29)%	2.79%	1.08%	**1.72%**	**1.77%**	**0.89%**	**(1.12%)**	**1.35%**	**(0.52%)**	**(0.55%)**	**(0.65%)**	Ref note
FY17	(2.28)%	0.02%	0.56%	0.35%	0.95%	0.29%	(1.00)%	(0.98)%	0.94%	0.07%	0.17%	1.88%	0.93%
FY16	0.31%	1.52%	1.79%	1.42%	1.01%	(0.11)%	0.02%	0.77%	2.34%	(0.69)%	2.29%	0.11%	11.21%
FY15	1.03%	0.06%	0.64%	(0.71)%	(0.53)%	(1.53)%	(1.88)%	(0.08)%	0.98%	1.96%	2.04%	(1.09)%	0.80%
FY14	0.36%	0.14%	0.43%	0.32%	(0.52)%	0.54%	0.57%	1.06%	0.04%	0.57%	1.38%	0.63%	5.64%
FY13	(0.54)%	0.26%	0.29%	0.37%	0.57%	0.66%	0.46%	(0.50)%	(0.06)%	(0.70)%	1.22%	(0.18)%	1.86%
FY12	1.69%	0.29%	0.29%	0.97%	1.63%	(0.09)%	1.51%	1.03%	0.46%	0.46%	0.00%	(0.60)%	7.88%
FY11	2.34%	0.36%	1.45%	2.23%	1.66%	0.86%	1.36%	1.26%	0.50%	0.74%	0.57%	(1.38)%	12.57%
FY10	4.00%	3.88%	2.00%	2.68%	0.78%	0.09%	0.17%	0.52%	0.68%	1.45%	0.59%	0.57%	18.75%
FY09			0.67%	0.59%	2.19%	1.47%	1.81%	(0.56)%	3.10%	1.37%	2.43%	0.09%	13.90%

Note: Monthly returns (net) are for the ARCO Absolute Trust (companion fund) to October, 2017 and the **ARCO Absolute Return Fund** thereafter.

ARCO Absolute Return Fund – distribution history

Y/e June	2018
Cents per unit (part year for FY18)	0.02

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Fund facts

Month end unit price	$0.9211
Strategy	Long-short Australian equities
Objective	Positive return in all market conditions Overarching focus on capital protection
Firm AUM	$142m

Distribution frequency	Yearly
Minimum investment	$25,000 ($10,000 min addition/withdrawal)
APIR Code	OPT7628AU
Platform availability	Netwealth, HUB24, Powerwrap, BT Panorama, Macquarie Wrap, Ausmaq, Managed.accounts
Fund Inception	1/11/2017 (@ $1.00 per unit)

ARCO Investment Management Pty Ltd
ABN 48 129 937 837 AFSL 325 159

Level 2, 121 Flinders Lane
Melbourne VIC Australia 3000

T +61 (3) 9660 9500
F +61 (3) 9660 9599

E info@arcoim.com
arcoim.com

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