ARCO Investment Management
ARCO Absolute Return Fund

Monthly report: August 2018

Escalating EM and global trade problems, local politics gets even worse, home equity declines further, cautious business investment readings and earnings misses from very high P/E stocks being rewarded enthusiastically by investors – just another month, nothing to see here, play-on.

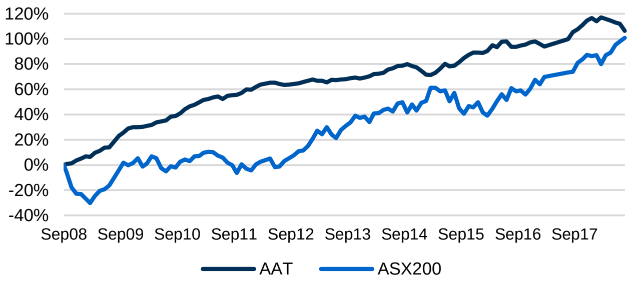
	Month	Qtr	1 Year	3 Year	Life (p.a.)
Fund return (net)	-2.51%	-3.56%	3.21%	4.37%	7.53%
Positive months			50%	67%	77%
Volatility					3.9%
Sharpe ratio					1.0

Note: The above return data for the month and quarter 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 and therefore would be slightly different over these longer time periods.

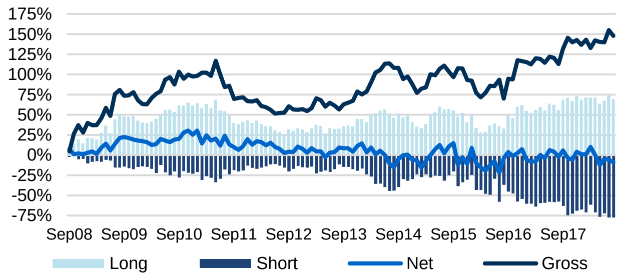
Monthly key contributors – by sector

Longs	**22 positions**
Positive	Transport, media, consumer services
Negative	Resources, energy
Shorts	**19 positions**
Positive	Banks
Negative	Telecoms, healthcare

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	69.5%	-40.3%
Debt/ Hybrids	0%	0%
Derivatives		-38.1%
Gross exposure		147.9%
Net exposure		-8.9%
Concentration by position	**Long**	**Short**
Top 5	30.4%	(19.4%)
Top 10	48.1%	(30.9%)
Top 15	60.7%	(38.1%)

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 -2.51% for the month.

Equity markets and valuations continued to defy gravity during August, powering through a decent-sized emerging market crisis, escalating trade tensions, the removal of an economically rational Prime Minister, further declines in house prices and a lack-lustre company reporting season. The recent GDP 'beat' was nice, but there's a limit to how often you can dine out on a still-lower savings rate, especially with a shrinking home equity backdrop.

With those considerations front of mind, we maintain a very defensive approach to both portfolio risk (net short) and stock selection. Much of the damage to August's return occurred on the short side, where we had selectively sold a number of stocks that, in our view, combine increasingly stressed business models with over-inflated valuations. Earnings reports would be a "moment of truth" for many such stocks – or so our thinking went.

Throughout our 10 years of running this strategy, plus our significant time in the markets before this, we struggle to recall a reporting season when so many outright earnings misses, often coupled with poor earnings quality and guidance that lagged prior estimates, were rewarded with stock price advances and still higher valuations. Financials also recovered some ground, despite further weakness in 3Q bank earnings updates, and are tracking at or above pre-Royal Commission levels – what Royal Commission?

Irrespective of the cause, strong price advances set against deteriorating fundamentals and already very high PE's reinforce our sense that market risk is very elevated at this point. For this reason, and noting the local market has risen almost 12% (accumulation basis) since April alone, we persist with an active short portfolio and believe that low risk correlation to strongly rallying markets will reward investors in time.

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Performance review

The Fund's shorts lost money in August as the high-PE, high-love, but stressed business model category in particular seemed impervious to any negative fundamental news, no matter how weak their earnings, or how creative the accounting used to get there. Revenue seems to be the new earnings – let's not mention cash flow.

In Financials, BEN's results and WBC's 3Q update highlighted both NIM and cost pressure, leading to earnings downgrades and subsequent loan repricing, (demonstrating strong oligopoly pricing power but with elevated political risks in our view).

On the long side of the portfolio, our investments in companies with quality franchises such as Fairfax, Qube, Brambles and Tabcorp delivered good earnings in the face of very cautious expectations, resulting in solid re-ratings and return contributions.

On a less positive note, we took hits on a few large, high-conviction long investments. The market continued to deal harshly with management changes at Janus Henderson which favour the legacy Janus team. Nufarm was similarly sold down heavily on uncertainty relating to contingent liability exposure in legacy glyphosate product lines.

In both cases, these developments departed materially from our positive medium-term thesis, and our risk management process required that we reduce portfolio exposure accordingly.

Mineral Resources also retreated for reasons that largely escape us. MIN's results were broadly as expected, and we believe that the current equity value can be justified on the basis of the company's mining services earnings stream alone and before ascribing value to its Wodgina mine which currently ranks as the world's largest hard rock lithium resource, and from which we expect annual cash flows approaching $1bn on full downstream development.

Post the recent turbo-charge to many stocks, we enter September with caution and continue short market exposure.

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%)**											
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

Fund facts

Month end unit price	$0.9768
Strategy	Long-short Australian equities
Objective	Positive return in all market conditions Overarching focus on capital protection
Firm AUM	$145m

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

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