

ARCO Investment Management ARCO Absolute Return Fund

Monthly report: February 2019

Zenith Investment Partners reaffirms "Recommended" rating*.
*Refer disclaimer on covering email

Equity markets continued their sharp rally in February despite economic data and the reporting season pointing to weaker earnings momentum and quality. Faced with the prospect of lower interest rates, the market again appears willing to pay more for earnings...really!?

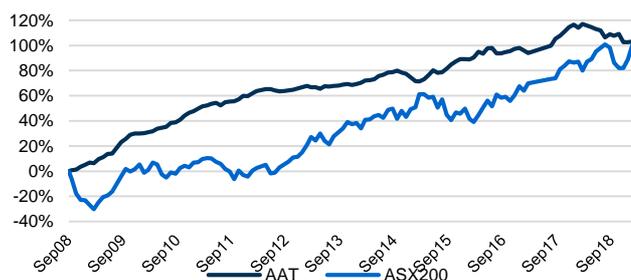
	Month	Qtr	1 Year	3 Year	Life (p.a.)
Fund return (net)	0.24%	-2.87%	-4.79%	2.16%	7.00%
Positive months			42%	64%	76%
Volatility					4.0%
Sharpe ratio					0.8

Note: Past performance is 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.

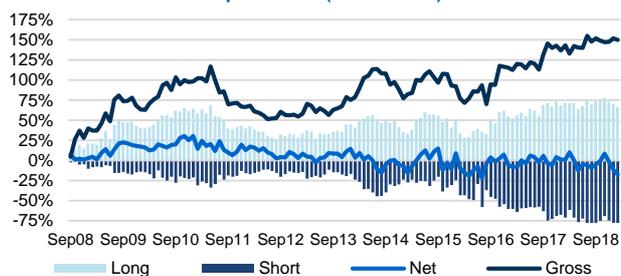
Monthly key contributors – by sector

Longs	24 positions
Positive	Media, resources, transport
Negative	Retail, building
Shorts	19 positions
Positive	Banks, retail
Negative	Healthcare, REITs

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	66.2%	-44.8%
Debt/ Hybrids	0%	0%
Derivatives		-39.1%
Gross exposure		150.1%
Net exposure		-17.8%

Concentration by position	Long	Short
Top 5	26.7%	(16.7%)
Top 10	42.8%	(29.5%)
Top 15	55.3%	(39.2%)

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 +0.24% for the month.

The equity market rebound continues to surprise us. From end-August, it took the Accum Index 16 weeks to fall 12.5% – after rising by a third over two years. We've now advanced 16% from the low in just over ten weeks. February's market was flattered by timing issues for two big sectors: financials (+8.1%) with a benign (vs expectations) final Royal Comm. report, and Resources (+6.1%) with the Vale supply shock. Leaving the issue of breadth, what exactly is going on?

Is it growth? Economic data in Australia continues to soften, with credit growth at a quarter-century low, and property-based wealth effects impacting activity. Internationally, markets have priced a happy ending to the US-China trade war multiple times this year, but actual US growth is softening. The ECB has cut its growth forecast, and reversed course on removing monetary accommodation.

Is it earnings? Ex-Materials (largely iron ore), aggregate earnings revision through February were slightly negative, with actual results also disappointing, with <30% earnings 'Beats', and the lowest Beat-to-Miss ratio in over five years. Ex-Materials, price advances were very much multiple expansion-based, a very consistent recent trend.

So its interest rates – yet again? The power of interest rate compression resonates strongly in a world of very unusual liquidity. The RBA moved to a neutral policy bias during the month, and the A10Yr bond traded down to generational lows at <2.10%. Coupon returns were boosted by several companies distributing excess franking credits, ahead of a raft of broadly shareholder-unfriendly changes under active consideration by a future Labour Government.

During February's rally, we reduced a number of the Fund's long positions as prices rose through our fair value range. Our short stock positions were hard going in such a strong market, but continue to represent an important risk hedge.

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Performance review

The long portfolio performed strongly for the Fund again in February, up almost 4% for the month. This was driven by strong contributions from a number of stocks where earnings growth is being driven by cost-out and digital revenue streams (NEC, TAH); or by factors other than the Australian domestic demand cycle (Brambles, Link, Worley, Downer).

On the short side, our regional bank shorts performed strongly despite the positive effect of the final Royal Commission report, as the reporting season (and interest rate backdrop) highlighted vulnerability in the earnings outlook and/or earnings quality issues.

In such a strong market, most other shorts detracted from performance, with losses concentrated in the REIT/ infrastructure sectors, where the effect of interest rate compression was to lift prices further away from defensible valuations on any non-yield metric.

The broad market strength in February led us to increase the Fund's net short market exposure, as we reduced a number of our long positions as prices rose through our fair value measures, or where we lost conviction in key strategic or cyclical drivers for certain holdings, including Caltex, Wesfarmers, Orora and Orocobre.

We added some fresh names to the long portfolio, including Treasury Wines, where the price has retreated to within our fair value range for the first time in quite some time, and where recent evidence suggests that the risks around the company's changes in distribution strategy in key markets are moderating. We similarly initiated a position in Star Entertainment Group, where we felt consumer cyclical exposure was overly discounted in valuation.

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%					
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	\$0.9618	Distribution frequency	Yearly
Strategy	Long-short Australian equities	Minimum investment	\$25,000 (\$10,000 min addition/withdrawal)
Objective	Positive return in all market conditions Overarching focus on capital protection	APIR Code	OPT7628AU
Firm AUM	\$141m	Platform availability	Netwealth, HUB24, Powerwrap, BT Panorama, Macquarie Wrap, Ausmaq, Managed.accounts
		Fund Inception	1/11/2017 (@ \$1.00 per unit)

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