

ARCO Investment Management

ARCO Absolute Return Fund

Monthly report: July 2018

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Going up!?! July was the 4th consecutive up-month for the ASX, which rose above 6,300 for the first time since April 2008. Offshore trade wars and onshore housing price trends were by-passed by the market momentum – for now – and our list of long opportunities shrunk further.

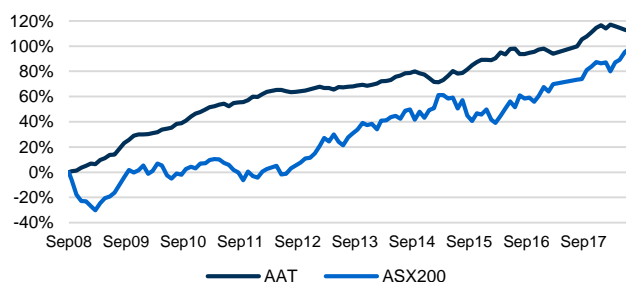
	Month	Qtr	1 Year	3 Year	Life (p.a.)
Fund return (net)	-0.44%	-1.63%	5.80%	5.87%	7.90%
Positive months			50%	70%	77%
Volatility					3.8%
Sharpe ratio					1.1

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.

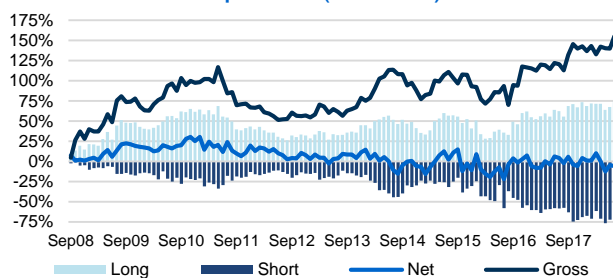
Monthly key contributors – by sector

Longs		23 positions
Positive	Transport, media, non-bank financials	
Negative	Materials, building materials	
Shorts		19 positions
Positive	Retail, resources	
Negative	Index futures, telecoms, 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	74.5%	-43.8%
Debt/ Hybrids	0%	0%
Derivatives		-36.6%
Gross exposure		154.9%
Net exposure		-5.9%
Concentration by position	Long	Short
Top 5	28.8%	(19.1%)
Top 10	48.6%	(31.8%)
Top 15	61.7%	(40.0%)

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 -0.44% for the month.

July's equity market rise breached another watermark, seemingly unconcerned by trade war escalation, local house price trends worsening, another local inflation result below forecasts and the RBA's maintenance of a record low cash rate now entering its 3rd year.

Offshore capital inflows remained a notable feature of our market into early July though this effect appeared to moderate by the end of the month. This situation needs careful monitoring: any reversal of these flows will cause a headwind for many stocks that have enjoyed a recent price surge sponsored by this typically-transient and valuation-insensitive offshore interest.

The sustained market rise over the past 4 months and apparent elasticity of many stock prices continues to weigh on our thinking, as well as on our recent performance. Experience reminds us that when the market appears least interested in fundamental stock valuation, it is getting closer to the point where valuation is more important than ever! With this in mind, the Fund further increased our stock short positions. While we still struggle to find new longs to buy in this market environment, we continue to identify plenty of opportunities on the short side, and the strategy's gross market exposure has recently approached its highest point in our 10 year history.

For us, the August earnings season will be a balance between conviction investing on the 18 months' time frame that is typical for our valuation process and the need to be tactical, recognising that price volatility around an earnings report can be extreme, and this is almost always a function of expectations – not absolutes.

We maintain our neutral-to-modest negative net market exposure.

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Performance review

The rallying market continued to challenge the strategy in July, most notably the short portfolio which was a drag on performance.

The long portfolio benefited most notably via strong contributions from Brambles, QUB, Fairfax and Janus Henderson.

Already priced at the lower end of our fair value range, corporate activity was a tailwind for Fairfax, with the proposed merger with Nine Entertainment. We have been of the view for a little while that a transaction regarding Fairfax was on the cards and a possible catalyst for positive price action, though a little

surprised to date that the move hasn't been stronger.

We continue to hold a significant (and broad) long exposure to the resources sector (even after reducing the Fund's MIN exposure recently). BHP and Pilbara Minerals were further positive contributors to July's result. Our lithium holdings came under pricing pressure during the month though we retain our confidence in the cash flow trajectory and valuations in the sector.

Having been long-term investors in the Janus Henderson merger thesis, we have recently trimmed this position post the announced departure of co-CEO

Formica, as we were of the view that his leadership was a necessary precondition for successful execution of the merger.

Our short positions in the banking and telecom sectors detracted most from the Fund's performance again in July. We continue to believe these sectors will come under increased downward pressure and are amongst the more expensive in our fair value calculations.

At both the bottom-up (stock) and top-down (macro) levels, we continue to favour a neutral-to-modest negative net market exposure, especially as equities sustain their recent rally and climb to higher altitudes.

ARCO absolute return strategy – net monthly returns

	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	FY
FY19	(0.44%)												
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%)	
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	\$1.0019	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	\$147m	ISIN	AU60OPT76287
		Fund Inception	1/11/2017 (@ \$1.00 per unit)

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