

ARCO Investment Management

ARCO Absolute Return Fund

Monthly report: October 2018

The global equity market registered its worst monthly return since May 2010. 'Risk-off' sentiment impacted all equity market sectors and high growth stocks in particular. As much as it was an important pressure-release, the retracement also offered a number of buying opportunities.

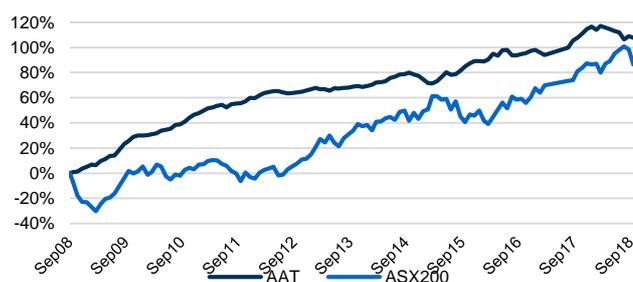
	Month	Qtr	1 Year	3 Year	Life (p.a.)
Fund return (net)	-0.69%	-1.91%	-0.07%	4.25%	7.47%
Positive months			42%	64%	76%
Volatility					3.9%
Sharpe ratio					1.0

Note: Past performance is not a reliable indicator of future performance. 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 so performance would be slightly different over the longer time periods.

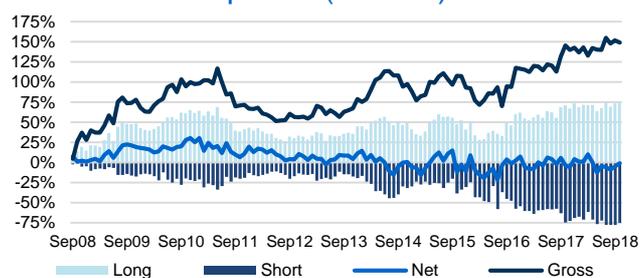
Monthly key contributors – by sector

Longs	30 positions
Positive	Resources, gold
Negative	Media, materials, building, transport
Shorts	15 positions
Positive	Banks, media, Index futures
Negative	Retail

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	74.1%	-38.5%
Debt/ Hybrids	0%	0%
Derivatives		-36.5%
Gross exposure		149.1%
Net exposure		-0.9%
Concentration by position	Long	Short
Top 5	25.4%	(20.0%)
Top 10	42.3%	(31.8%)
Top 15	55.2%	(38.5%)

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 -0.69% for the month.

Global equity markets staged a significant retreat in October, led by growth stocks, and fuelled by a rising US yield curve (10yr bond rate through 3.20% for the first time since 2011), some poor earnings reports by some leading tech/growth stocks, and worsening geo-politics. Locally, the ASX200 Accumulation index fell by 5.9%, with every sector in the red, led by energy and IT with double-digit losses.

While the Fund's loss in October was modest when set against this market context, we admit to disappointment with this outcome. We ran net short market exposure and a strong bias towards defensive longs and high PE shorts for some months, recognising that equity valuations had become extended and risk consciousness blunted. This positioning has been hard yards (especially in August), and we expected that October should have been a more profitable month for our investors. Much of our good work in terms of appropriate risk settings was undone by the impact of one or two stock-specific reversals, as detailed over-page.

Such a significant market pullback has, however, resulted in a number of stocks being rebased back to more attractive levels relative to our 'fair value range' assessment. We have added long exposure accordingly, and have also covered certain shorts that we consider to have done their job in hedging portfolio risk for the time being.

As a result, net market exposure increased to broadly neutral by month-end. Our view on markets remains broadly cautious. We view the earnings growth outlook for local companies to remain challenged, most notably in the consumer, housing and credit sectors (a broad band of the local economy). Interest rates globally have seen their lows, as has liquidity creation, absent a much more substantial market correction. Having said that, a few pockets of opportunity are opening up, where risk seems much more appropriately discounted in the valuation.

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Performance review

As for last month, the further retracement of a number of bank, healthcare and high-PE industrial stocks were notable drivers of good performance from the Fund's short portfolio again in October.

Select long positions in the Materials sector were also positive contributors to the Fund's result. Most notably, Lynas Corp recovered significant ground as the Malaysian Government's review of its refining and waste disposal operations took on a less hostile guise. We increased our holding in Lynas, at prices at which we felt very adequately discounted this risk, difficult as this assessment continues to be.

Regis Resources was also a positive contributor for the month, benefitting in part from the markets risk-off shift to the gold sector and also from confirmation in the 1Q production report that management's initial guidance on pre-strip ratios and costs at Duketon had been overly conservative.

Performance took a hit from a number of our higher-conviction holdings within the long portfolio, including, QUB, Boral, Mineral Resources and Nufarm. Most notably, Fairfax retreated 22% due to an earnings downgrade, mainly from Domain. This exposure has worried us for some time and we have (until recently) been short REA as a hedge.

We retain a fundamentally positive view of the economics behind the Fairfax-NEC merger.

Long portfolio additions during October included Amcor and Worley Parsons. Price retracements for both stocks were, in our view, exaggerated by technical factors, being arbitrage pressure from the Bemis offer, and the size of the equity offering to fund the Jacobs ECR purchase (and uncertainty relating to DAR Group's participation), respectively. As a result, we were able to buy at prices that were well within our fair value ranges: an unusual opportunity for both these high-quality companies.

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%)									
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	\$0.9828	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	\$142m	Platform availability	Netwealth, HUB24, Powerwrap, BT Panorama
		Fund Inception	1/11/2017 (@ \$1.00 per unit)

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