ARCO Investment Management
ARCO Absolute Return Fund

Monthly report: September 2018

The local equity market finally takes a breather and rising bond yields demand more investor attention. Equity risks remain broadly elevated: high valuations set against slowing growth, rising term interest rates, tightening credit standards and unsettling local and geo-politics.

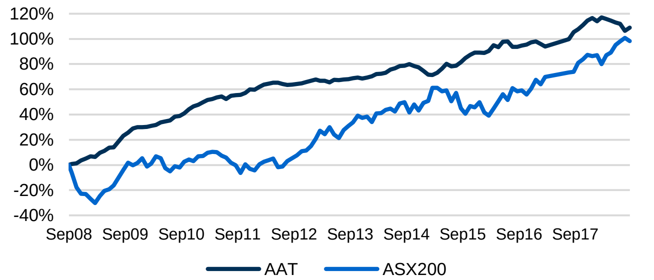
	Month	Qtr	1 Year	3 Year	Life (p.a.)
Fund return (net)	1.31%	-1.66%	1.72%	4.25%	7.60%
Positive months			50%	67%	77%
Volatility					3.9%
Sharpe ratio					1.0

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 so performance would be slightly different over the longer time periods.

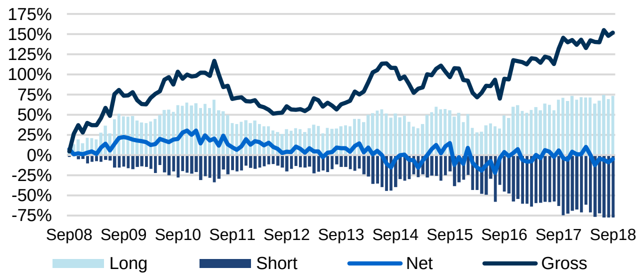
Monthly key contributors – by sector

Longs	**24 positions**
Positive	Resources, consumer, energy
Negative	Media, materials
Shorts	**17 positions**
Positive	Banks, healthcare, futures
Negative	Telecoms, energy

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	73.4%	-39.9%
Debt/ Hybrids	0%	0%
Derivatives		-38.5%
Gross exposure		151.8%
Net exposure		-5.0%
Concentration by position	**Long**	**Short**
Top 5	30.6%	(19.9%)
Top 10	47.9%	(32.5%)
Top 15	60.8%	(39.0%)

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 +1.31% for the month.

The local equity market took a breather in September from its strong run over recent months, recording its first negative return since March. Australia was the worst performing of the developed equity markets, with a number of factors weighing on returns: interest rates, credit conditions, currency and valuation levels.

Rising bond yields, unless accompanied by rising earnings growth, are a problem for equities both directly (the discount rate) and indirectly, through attitudinal change in investor risk tolerance. USD term bond yields have broken out in a convincing manner. Local term yields have moved up in sympathy, but the AUD-USD 10-year bond spread has further inverted, to -50 bps: a post-1981 high. This speaks to continued weakness in the AUD, which is rapidly losing its status as a 'carry' currency in the eyes of fixed income investors. Offshore coupon-seeking money is a very big (and historically very unusual) part of our equity market as well, and this remains another risk factor, especially for high-PE stocks.

A steeper yield curve is usually interpreted as a signal of economic strength. In Australia's case, the curve seems pulled between term reversion in the US and the likelihood that the RBA remains pinned-down on short rates due to concerns over the property market and broader economic fragility. Financials are the obvious play from a steepening curve but still appear fraught with risk to us, commanding high multiples for very little growth, even prior to the impact of the Royal Commission on costs, credit creation, credit quality and potential liability risk.

In this context, we remain actively defensive with the Fund's risk settings, retaining a modest net short equity exposure at month end.

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Performance review

September was a better month for the Fund with both long and short sides of the portfolio delivering positive results for investors.

On the short side, the retracement of a number of bank, healthcare and material stocks, along with many of the higher-PE cohort, were notable drivers of good performance from the short portfolio.

We noted through the August earnings season that we were in one of those market junctures where facts didn't seem to matter much to stock prices. It's under precisely those sort of conditions that prudent risk management requires taking market exposure down, difficult as it can be to short anything at such times.

Despite the down-month for the broader market, the long portfolio had some notably positive contributors in BHP, Mineral Resources and Tabcorp.

We also took advantage of weaker prices during September to further diversify our long positions. The long portfolio now straddles two broad themes. First, we own a core group of stocks trading well under our view of fair value and which feature defensive cash flows. In this category are Fairfax, Tabcorp, Caltex, Downer, HT1 and Link.

We have supplemented these holdings with selective higher-beta stocks which have been smashed-up in price terms and which represent low multiples of strongly growing cash flows. Mineral Resources is in this category whereby we believe its current equity valuation is attractive on the basis of the company's mining services cash flows alone, with a heavy discount applied to the company's Wodgina asset which is nearing a critical price discovery point.

Lynas Corp is a stock of similar interest to us. We have recently begun to rebuild our holding, having more than halved our investment at higher price levels on the initial news of the Malaysian Government review of the LAMP facility. Recent news on this risk exposure has improved and we find it very difficult to rationalise the company's loss of over half its capitalisation in terms of economic value risk.

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%**										
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	$0.9896
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, BT Panorama
Fund Inception	1/11/2017 (@ $1.00 per unit)

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