

ARCO Investment Management

ARCO Absolute Trust

Monthly report: July 2019

Fuelled by the race to the bottom in global interest rates, equity markets again marched broadly higher. However, poor economic data, declining profit expectations, heightened trade tension and geopolitical risks all point to an increasing need to focus on capital preservation.

| Performance | Month | Qtr | 1 Year | 3Yr(pa) | Life (pa) |
|-------------------|--------|-------|--------|---------|-----------|
| Fund return (net) | +0.61% | -5.4% | -11.4% | -1.05% | 6.0% |
| Positive months | | | 33% | 56% | 74% |
| Worst month | | | | | (3.8%) |
| Volatility | | | | | 4.3% |
| Sharpe ratio | | | | | 0.54 |

note

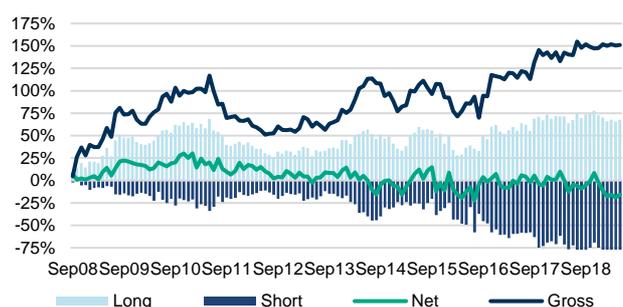
Monthly key contributors – by sector

| Longs | 24 positions |
|----------|------------------------------------|
| Positive | Energy, Media, Chems & Ferts, Food |
| Negative | Resources, Packaging, Banks |
| Shorts | 19 positions |
| Positive | Resources, Media, Gold |
| Negative | Transport, Retail, Index Futures |

Cumulative performance



Fund investment profile (% NAV)



Portfolio settings

| % of NAV | Long | Short |
|----------------|-------|--------|
| Equities | 61.6% | -40.5% |
| Debt/ Hybrids | 0% | 0% |
| Derivatives | | -37.3% |
| Gross exposure | | 139.4% |
| Net exposure | | -16.2% |

| Concentration by position | Long | Short |
|---------------------------|-------|---------|
| Top 5 | 22.9% | (16.6%) |
| Top 10 | 42.1% | (28.2%) |
| Top 15 | 52.4% | (35.9%) |

Fund strategy and outlook

The Trust's objective is to steadily compound investor returns over time through stock alpha generation, with an overarching focus on capital preservation.

The Fund was up 0.6% in July, despite the drag of our net short risk settings in another strong market.

Both the US Federal Reserve and our own Reserve Bank cut interest rates during the month in response to weakening global and domestic growth. In the case of the Federal Reserve, it was the first rate cut in more than a decade. At home, these were the first back to back rate cuts since 2012. We view these actions as highlighting the economic risks currently present, at a time when many developed equity markets are trading at or near record highs.

While investors would be aware that we have positioned the portfolio cautiously, we believe risks have intensified. The US clearly upped the trade war ante with increased tariffs near month end. China seems pinned between this initiative and the desperate bravery of some in Hong Kong in resisting inexorable statism. The lesson for markets is to expect the unexpected!

In Australia, early results of reporting season have been disappointing, with profits from GUD and Credit Corp missing estimates. Bellwether cement maker Adelaide Brighton downgraded its CY19 earnings forecast for the second time in just three months, to ~\$125m from ~\$230m a year ago. Earnings season seems fraught with risk, either directly, or through very high valuations on more defensive earnings, or in weakening commodity pricing undermining spectacular but transient cash flows in the bulks.

It is no surprise to us that downside volatility presented itself after month end in response to the US declaring China a "currency manipulator". Our view has been for some time that the risk/reward equation is not in favour of equities, although relentless falls in interest rates continue to push investors out along the equity risk curve in order to eat. However, our philosophy is that steady compounding of returns via limiting downside and thus preserving capital is the best path to wealth creation. We would submit that philosophy is now more important than ever.

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Performance review

While our “win” rate of our long positions was less than 50%, three of our larger positions had a much better July. Nufarm (which has been a very large negative contributor of late) advanced over 19% on no real new news, although after month end it announced a preferred share placement to its largest shareholder, Sumitomo. This is positive as it eases worries regarding its balance sheet, while the preferred conversion price is at a very decent premium. Nufarm did, as expected, downgrade its earnings guidance, but to a level no lower than feared.

Two other major contributors on the long side were Treasury Wines, up 18.6%, and Worley which advanced 9.8%. Scan data from the US and wine export data from Australia to Asia confirmed strong sales for Treasury, while the latter recovered from what we saw as a very oversold valuation.

On the short side, we took advantage of a poor operational performance in gold miner Regis to bank profits, while a handful of what we consider extremely overvalued shares actually fell in a strong market, including real estate

portal Domain, iron ore miner Rio Tinto, and oil and gas company Woodside.

Portfolio activity was minimal during the month. Small remaining positions in Link and A40 were exited. No additions and deletions were made in the short book.

We remain essentially cautious and despite a poor performance over the past quarter, we are satisfied with our settings. We will closely watch what has been a deteriorating macro environment coupled with very strong markets: a mix that historically has not ended well.

ARCO Absolute Trust – monthly returns

| | Jul | Aug | Sep | Oct | Nov | Dec | Jan | Feb | Mar | Apr | May | Jun | FY |
|------|---------|---------|-------|---------|---------|---------|---------|---------|---------|---------|---------|---------|----------|
| FY20 | 0.61% | | | | | | | | | | | | 0.61% |
| FY19 | (0.45%) | (2.73%) | 1.30% | (0.68%) | 0.79% | (3.20%) | 0.00% | 0.25% | (1.50%) | (0.75%) | (2.11%) | (3.90%) | (12.37%) |
| FY18 | 0.24% | (0.29%) | 2.79% | 1.08% | 1.57% | 1.76% | 0.91% | (1.16%) | 1.39% | (0.54%) | (0.65%) | (0.67%) | 6.53% |
| 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: returns are net of all fees and assume reinvestment of distributions. Fund inception date is 15/09/08. FY returns are compound returns over the stated period.

ARCO Absolute Trust – distribution history

| Y/e June | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|----------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|---------|
| Series 1 units | \$1.23 | \$1.31 | \$2.03 | \$0.41 | \$0.12 | \$0.34 | \$0.46 | \$0.71 | \$0.43 | \$0.93 | \$0.008 |

Fund facts

| | | | |
|--------------------|--|------------------------|----------------------------------|
| Initial series NAV | \$9.062 (ex distribution) | Distribution frequency | Yearly (bi-yearly in FY 2016) |
| Strategy | Long-short Australian equities | Minimum investment | Wholesale investors only, \$100k |
| Objective | Positive returns in all market conditions. Overarching focus on capital protection | APIR Code | OPT0001AU |
| Firm AUM | \$137m | ISIN | AU60OPT0014 |
| | | Fund Inception | 15/9/08 (@ \$10.00 per unit) |

ARCO Investment Management Pty Ltd
ABN 48 129 937 837 AFSL 325 159

Level 2, 121 Flinders Lane
Melbourne VIC Australia 3000

T +61 (3) 9660 9500
F +61 (3) 9660 9599

E info@arcoim.com
arcoim.com

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