ARCO Investment Management
ARCO Absolute Trust

Monthly report: June 2019

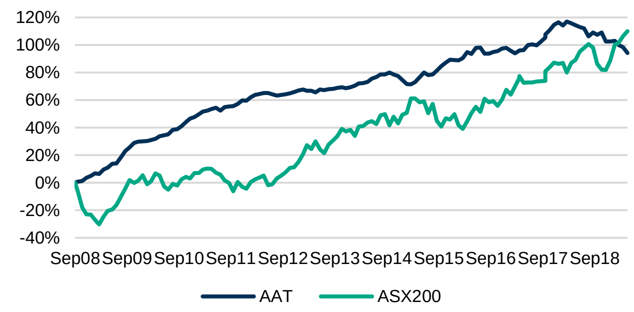
June highlighted the market's fixation with bad is good – i.e. weakening economic fundamentals globally will result in central bankers cutting rates, leading to higher equity prices…really? We remain a bit more circumspect…

Performance	Month	Qtr	1 Year	3Yr(pa)	Life (pa)
Fund return (net)	-3.90%	-6.63%	-12.4%	-1.96%	6.0%
Positive months			33%	56%	74%
Worst month					(3.90%)
Volatility					4.3%
Sharpe ratio					0.54

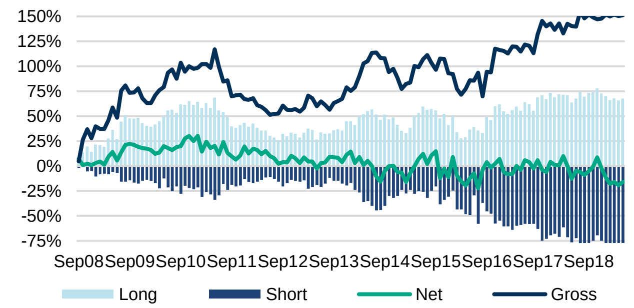
note

Monthly key contributors – by sector	
Longs	**24 positions**
Positive	Energy, Transport, Chemicals & Fertilizers
Negative	Resources, Media, IT
Shorts	**19 positions**
Positive	Retail, Media
Negative	Index Futures, Transport, Resources, Ban

Cumulative performance



Fund investment profile (% NAV)



Portfolio settings

% of NAV	Long	Short
Equities	62.6%	-40.1%
Debt/ Hybrids	0%	0%
Derivatives		-37.9%
Gross exposure		140.5%
Net exposure		-15.4%
Concentration by position	**Long**	**Short**
Top 5	23.0%	(17.3%)
Top 10	41.7%	(28.0%)
Top 15	53.8%	(35.7%)

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 recorded a net return of -3.9% for the month. To add insult to injury, having ***never*** previously recorded a loss over any fiscal year since inception some 10 years ago, the fund was down 12.4% in FY19. Further, our monthly win rate of 78% since inception going into the year fell to 33% for FY19. This begs the question: what's going on?

Not wanting to sound like a broken record, we'll let someone else do it for us, the Governor of the Reserve Bank:

"There are investors who think the outlook is sufficiently weak that they expect central banks right around the world to cut interest rates but they are not worried about corporate profits or credit risk," Dr Lowe said. "I don't really understand that." He pointed out the contradiction as central banks lower rates at the same time as equity markets "are very strong" and credit spreads are narrow. "So to me it's a strange world." (AFR – 25/6/19)

We concur: it's a very strange world indeed. In June markets continued to take good news as good news and bad news as, well, good news! The Australian market advanced by another whopping 3.7% to set yet another record. To put this in perspective, from the market record peak in 2007 it took until 2013 to regain the losses occurring courtesy of the GFC. Since that time the market (on an accumulation basis) is up over 60%. Additionally, since the low set in December, the market is up 24% in six months.

The market is now capitalising record low interest rates (usually associated with tough economic times) ***and*** increasing corporate profits. Like the RBA Governor, the logical inconsistency of this premise troubles us. It's similar to watching the crescendo of calls on Wall Street for rate cuts from a 50 year low in unemployment. Meanwhile, real world risks to company earnings seem to be rising, with evidence of disruption to global supply chains in the wake of the trade war on an almost daily basis, and with bombs exploding in the Staights of Hormuz.

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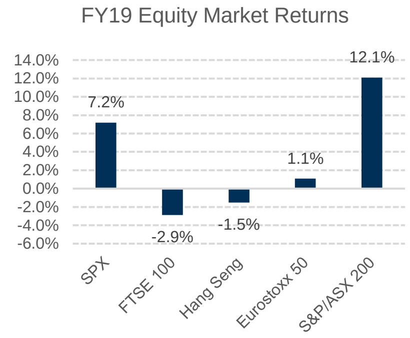
Performance review

June was again a disappointing result. Strong work from our short positions (where over 80% under-performed the market) weren't enough to compensate for some poor stock specific performance in our long book. Our net short position was clearly unhelpful in the face of a 3.7% rise in the market. More on that in a moment, but first a reflection on the last fiscal year.

While arbitrary, a fiscal year end is as good a time as ever to consider what's occurred in the previous 12 months. First, it's been a very big year for the Australian equity market, but not so much for others.



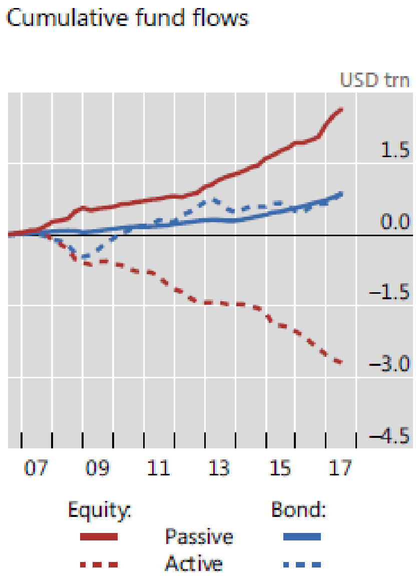
Bloomberg

Of course, we aim to make money irrespective of market conditions which, up until FY19, we've been fortunate to achieve every year since inception over 10 years ago. In fact, despite one of the longest and strongest bull markets ever our Absolute Return Fund was still able to keep up with the index.

That said, looking back on FY19 we'd make three general observations about equity markets and funds management:

1) The impact of passive funds (ETF's and index funds) became even bigger
2) In our experience, never have macroeconomic conditions and policy settings had such a huge impact on individual sectors and stocks (e.g. the thirst for yield)
3) The continued poor performance of active managers (long only and absolute return) only got worse, both in Australia and globally

Taken in turn, passive products are not price sensitive and are known to distort prices of stocks or sectors for long periods of time. Remember, flows into a passive fund simply buy a basket of stocks and are price- and valuation-indifferent. These funds have grown to be a very large part of the market with huge daily inflows:



Bank of International Settlements

Further, these funds have had a profound effect on the share registers of the majority of companies in the market. For example, Black Rock and Vanguard are among the top three shareholders in each of the top 20 companies in the Australian market. It doesn't stop there. The register of the bourse's 50th largest company by market capitalisation, Tabcorp, boasts Vanguard and Black Rock as its 3rd and 4th largest shareholder with quasi-passive fund, Australia Super, as its 2nd. The 100th largest company, Ansell, has Black Rock at #1 and Vanguard at #3.

The result of this trend is that sustained share price moves that are often related to index size and passive fund flows, are largely divorced from fundamentals. Inflows into passive funds have to be invested in the index or, in the case of ETF's, the underlying basket of stocks the fund is replicating. In many cases these flows can overwhelm the actions of active managers for sustained periods of time, although we believe that fundamentals eventually win out.

We can also see the effects of what we'll call YAAP: yield at any price. REIT's, infrastructure assets and a slew of other stocks are simply being priced on yield with only cursory attention to underlying risks to earnings and dividends. Of course, this is being fuelled by falling bond yields, liquidity creation and overall loose monetary policy, even as the real world efficacy of these policies seems to have reached a point of sharply diminishing returns.

Finally, we have seen aggregate active manager returns get progressively worse both here in Australia and globally. Thus the circular argument of poor performance and flows from active to passive has seen some once very large and successful firms leave the industry.

Sour grapes? Perhaps. But make no mistake, we are certainly not perennial bears actively searching for the next disaster. Nor will we be bucketed into the "growth" or "value" camps. We are simply bottom up stock pickers looking for solid risk/reward dynamics. Thus, while we are currently net short, over the journey it has been stock picking that has driven the vast majority of our returns. Therefore, currently, it is a sober look at the facts that drives our stock selection: economic data is deteriorating while equity markets hit record highs. *We simply cannot get on the growth at any price or yield at any price trains. We believe risk will eventually be priced, as it always has in the past.*

In the words of Ray Dalio founder of the $US150 billion dollar fund, Bridgewater.

"The world now is leveraged long. Because interest rates were so low relative to return on equities, the world has borrowed a lot of money to buy financial assets. The defining time will be when asset prices don't do well. We're getting close to that point."

We are of the firm belief that current performance notwithstanding, these are quite extraordinary times and sticking to fundamentals is never so important as when they are being ignored. This does not necessarily mean a market crash, nor are we predicting one, but at some stage fundamentals will reassert themselves and the tyranny of passive flow will be a much less distortive factor.

Turning to the June month, it was our long book that caused the majority of the damage, with a poor win rate (winners vs losers) coupled with a handful of particularly poor performers that impacted our results.

Bright spots on the long side were Worley, which benefitted from a rising oil price given its engineering exposure to the oil & gas industry; gaming company

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Aristocrat which continued its stellar run post its result in May; and pallet provider Brambles, benefitting from a reversal in cost inflation that hurt profits in the previous year.

Two stocks that did huge work for the Fund in May, Nine Ent and Lynas Corp (up 19% and 54% respectively), gave some back in June, though no new material news was present. Our long position in battery materials (especially Pilbara and Galaxy) was a drag on performance. Lithium prices have been under pressure as we work through what we view as a short term oversupply situation.

The weakness in the domestic consumer caused an earnings downgrade for Star Entertainment and a sell-off in those shares, though we continue to be attracted to the longer term outlook for the company. We were also caught in a downgrade by Link, and have substantially sold that investment.

With bond yields cratering during the month, our short positions in property trusts (Mirvac, Charter Hall) and infrastructure (Sydney Airport) were also detractors. In a market that was so strong, we had a number of short positions that contributed positively in absolute terms, including Dominos, Wesfarmers, Qantas, Domain and Inghams.

Two profitable long positions were exited during the month: logistics provider Qube, on valuation grounds post its price rise; and global insurer QBE as premium growth rates appear to have peaked, and the negative impact of lower interest rates is impacting its investment book.

Two long positions were initiated in their stead. Firstly, New Zealand telecommunications provider Spark was added as we see it as one of very few high yield, low risk companies trading at a fair valuation. We also added a small position in Webjet, as we are attracted to the long term outlook of its B2B hotel bed wholesaling business which has been going from strength to strength despite a somewhat soft travel market.

ARCO Absolute Trust – monthly returns

	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	FY
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
Series 1 units	$1.23	$1.31	$2.03	$0.41	$0.12	$0.34	$0.46	$0.71	$0.43	$0.93

Fund facts

Initial series NAV	$9.015 (cum distribution)
Strategy	Long-short Australian equities
Objective	Positive returns in all market conditions. Overarching focus on capital protection
Firm AUM	$142m

Distribution frequency	Yearly (bi-yearly in FY 2016)
Minimum investment	Wholesale investors only, $100k
APIR Code	OPT0001AU
ISIN	AU60OPT0014
Fund Inception	15/9/08 (@ $10.00 per unit)

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