

ARCO Investment Management

ARCO Absolute Trust

Monthly report: April 2019

Macro-economic policy settings continued to drive market direction during the month. Stock prices and data evidence from the real economy are giving wildly different narratives, pushing investor risk higher.

Performance	Month	Qtr	1 Year	3Yr(pa)	Life (pa)
Fund return (net)	-0.75%	-1.99%	-8.07%	0.9%	6.9%
Positive months			33%	61%	75%
Worst month					(3.2%)
Volatility					4.0%
Sharpe ratio					0.8

note

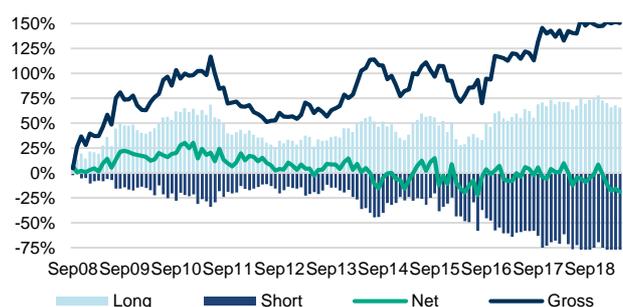
Monthly key contributors – by sector

Longs		23 positions
Positive	Food & beverage, gaming, chemicals	
Negative	Materials	
Shorts		19 positions
Positive	Materials, consumer services	
Negative	Gaming, banks, builders	

Cumulative performance



Fund investment profile (% NAV)



Portfolio settings

% of NAV	Long	Short
Equities	65.7%	-43.9%
Debt/ Hybrids	0%	0%
Derivatives		-40.8%
Gross exposure		150.3%
Net exposure		-18.9%

Concentration by position	Long	Short
Top 5	27.5%	(17.3%)
Top 10	45.6%	(30.6%)
Top 15	57.2%	(40.1%)

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 Trust recorded a net return of -0.75% for the month.

Our market continued its strong recent momentum in April, and has now gained 13.5% (total return basis) over four months. These gains are certainly impressive, but seem driven by factors other than company profits. Earnings have, in fact, continued to stagnate, so that the price-to-earnings multiple of the ASX200 Index has expanded by almost two full points, to 16.4 times over this period.

Importantly, we are now in the midst of the April/May mini-reporting season that includes most major banks and a handful of large industrials. Nothing we have seen so far changes our view that the engine room of the non-mining economy, being credit growth, is anaemic at best and the consumer appears to be tired. We have seen the profit outlooks for most building materials companies follow activity levels down as the building boom passes its peak. Retail sales have also softened materially and house prices continue their slide, albeit at a slowing rate. For balance, there have been earnings upgrades in bulk commodities, but spot iron ore prices are unlikely to command 16x multiples.

So, with a poor economic background and the ASX200 at a 12-year high, predicated largely on the growing expectation of near-term rate cuts or liquidity measures by central banks (fuelled locally by another weak inflation result), what does a rational investor do? Well, we retain relatively cautious risk settings for the Trust, as our assessment of both the macro environment and individual stock fair values indicate elevated risks. These measures have proven good lead indicators over this strategy's 10+ year life, as capital preservation is a high priority for the strategy, it would be remiss for us to ignore them now.

Thus, while it may be attractive to chase the current momentum, we continue to rely on a sober review of the facts which, to us, dictate caution. As the old saying goes, when valuation doesn't seem to matter...that's precisely when it matters most.

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Performance review

The typical correlation between the Trust's overall return and our "win rate" (number of stocks with a positive vs negative contribution) is quite high. In April, the Trust's win rate was solidly positive but three stocks more than offset all broader portfolio gains - a disappointing outcome.

First, risk management dictated that we cover a short position in Crown Resorts on the first (leaked) news of takeover interest from Wynn. Crown's earnings have been under pressure, and we had been using the stock, with some success to hedge long gaming exposure (Star and Aristocrat) – but we have no interest in being short contingent M&A deal risk.

Secondly, we have been interested in the very low price-to-fair values for two stocks we hold in the battery materials space - Galaxy (GXY) and Pilbara Minerals (PLS). Our view on long term industry economics also remains positive: structurally rising demand for a product (lithium) in limited reliable supply. In a market with high individual share price volatility, short term dynamics have very severe share price impacts. This was the case for Galaxy as it deemed offers from potential JV partners for its Sal de Vida project as inadequate, and terminated the partner process.

The market reaction punished GXY, taking PLS down with it. While no doubt a negative outcome, this does not in our view signal any fundamental retreat of broader strategic interest in the sector. Locally, Wesfarmers backed-up its interest in acquiring rare earths company Lynas Corp. (also held) with an agreed bid for another lithium miner, Kidman Resources. As such, we continue to note a very pronounced disconnect between private and public market prices for these assets.

Moving into early May, we have reduced the negative net market exposure by trimming the short portfolio though retain overall cautious risk settings.

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%)			
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	\$9.583
Strategy	Long-short Australian equities
Objective	Positive returns in all market conditions. Overarching focus on capital protection
Firm AUM	\$140m

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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