ARCO Investment Management
ARCO Absolute Trust

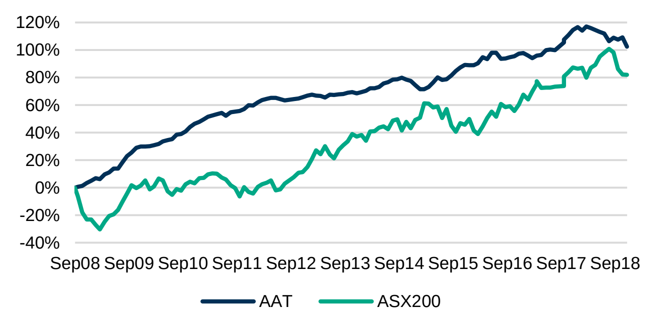
Monthly report: December 2018

No Christmas rally in December which brought to a close the toughest calendar year for equity returns since 2011. The gold price rallied, yield curves flattened, local credit conditions deteriorated further, looming deadlines for geo-political events – volatility to rise into 2019.

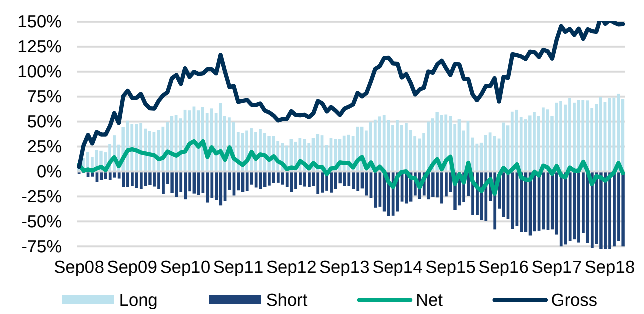
Performance	Month	Qtr	1 Year	3Yr(pa)	Life (pa)
Fund return (net)	-3.20%	-3.10%	-5.67%	2.32%	7.08%
Positive months			33%	64%	76%
Worst month					(3.2%)
Volatility					4.0%
Sharpe ratio					0.8

Monthly key contributors – by sector	
Longs	**30 positions**
Positive	Resources
Negative	Materials, media, gaming
Shorts	**18 positions**
Positive	Retail, building, banks, Index futures
Negative	REITs

Cumulative performance



Fund investment profile (% NAV)



Portfolio settings

% of NAV	Long	Short
Equities	72.9%	-35.5%
Debt/ Hybrids	0%	0%
Derivatives		-39.2%
Gross exposure		147.7%
Net exposure		-1.9%
Concentration by position	**Long**	**Short**
Top 5	26.1%	(17.9%)
Top 10	42.1%	(28.4%)
Top 15	54.4%	(34.6%)

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 -3.20% for the month.

No Christmas cheer was evident in local and offshore equity markets, and the Australian market had its worst close to a calendar year since 2011, with the ASX200 (Accum) down almost 3% for the year, while the MSCI World was -12.9%.

In December, our market view again turned more cautious as the US 10Yr bond yield tracked back to 2.7% - its lowest level in 2018 – and the subsequent increase in the Fed Funds Rate to 2.5% resulted in a flattening yield curve implying slowing growth in the world's biggest market. The shape of the Australian yield curve is similar, and has pointed to a similar outcome for longer. Such low rates can be supportive of equity markets, although only if investors are confident about earnings growth prospects. That remains very much the rub, both locally, given weakening economic signals and an ever less predictable public policy backdrop, and internationally.

Recent months have provided opportunities for us to expand the Trust's holdings at share prices that we considered to be attractive, and with limited downward risk. Our return in December highlights that even low net market exposure and careful risk management practices may not always be a match for periods of such pronounced stock price volatility.

As we look into 2019, we believe that market volatility is unlikely to moderate. Investor's nerves seem set to be tested further by US/China trade wars (with a March deadline on tariff inaction), US Fed action (or inaction), and Brexit outcomes: another March deadline. Locally, we face a Federal election, and the further unwinding of our credit and property market cycles. As with any really long-duration boom, a smooth and trouble-free exit seems a high-order challenge. Both long and short stock opportunities persist at these price levels, although investment theses will again be regularly tested, price moves will often be sharp and risk management will remain of highest importance.

Performance review

2018 was a particularly challenging year for investors, equity markets and for absolute return strategies including our own. December itself was a disappointing month for the Trust, as performance had held up very well over October and November when the Trust generated a small positive return.

December 2018: positive returns from the Trust's resource holdings (notably BHP and Regis Resources) together with the Trust's short positions offset most losses in the long portfolio. Essentially, the Trust's overall loss for December can be said to stem from two (long) exposures: the battery materials group (negative attribution of 160 bps of NAV) and our holding in NEC (-152 bps).

After strong returns in 2017, **battery material**s stocks have been more problematic in 2018. In our view, the market has looked through the impressive producer cash flow margins and landmark investments by end-users at very large implied premiums to market value. Its focus has instead been on spot lithium prices, which have been weak and, in the case of Lynas Corp (LYC), on the political uncertainty in Malaysia relating to the treatment of waste residues.

We changed our tactical positioning within the sector, greatly reducing our holding in LYC in the lead-up to the Malaysian review outcome, and cutting over 80% of our holding in Orocobre (ORE), where we lost patience with management's consistent inability to meet its own production guidance.

Instead, we tilted Trust's exposure towards Mineral Resources (MIN), and to a lesser extent Pilbara Minerals (PLS) and Galaxy Resources (GXY). In the case of each of these up-weights, we felt that pending third party strategic investments would provide: 1) much of the capital required to finance capacity or downstream product expansion; and 2) valuation benchmarks that would highlight the steep discounts at which lithium assets trade in the public market.

In broad terms, the type of transactions that we expected did occur for MIN and PLS, but this did very little for sector stock prices – a disappointing outcome and perhaps a reflection of very nervous investors fleeing development and commodity exposure, even when these were being rapidly de-risked.

We continue to look favourably on this group. Unlike much of the no-growth Australian market, we believe that the underlying demand drivers (electric vehicles and energy storage) represent a fundamental step-change in the industrial supply chain, and as such are structural and multi-year in nature. Further, the equity valuations of the Australian sector are, in our judgement, very low, with EV to cash flow multiples (at rated production levels) typically in the 2-5x range. Low valuations set against structural growth is often a very profitable intersection for equity returns, even given commodity-style price risk, and especially when short interest in the sector is so high.

NEC's stock price in December fell from \$1.80 to \$1.39. As there has been no explicit recent changes in earnings expectations, this 23% price fall continues the savage de-rating in progress since the announcement of the Fairfax acquisition, at which time NEC traded at \$2.50. It may be worth highlighting just how cheap NEC's valuation has become through this process. At today's price (\$1.43), and net of \$400m of (currently) non-earning asset value in SVOD platform Stan, NEC's equity value is 7x forecast FY19 pro-forma earnings, with EV to EBITDA at 4.5x. If we then deconsolidate NEC's equity in public market holdings Domain Group and Macquarie Media (and adjust debt accordingly), these ratios fall to 4.5x and 3.5x, respectively: multiples at which NEC or Fairfax never traded down to on a stand-alone basis.

Quite how the merger has ripped up so much shareholder value so quickly, as implied by the stock price, is just not clear to us. It's certainly not a function of too much leverage. Quite the reverse. With pro-forma debt to EBITDA at 0.7x, NEC has plenty of scope for capital management and retiring equity on the above multiples would be the easiest source of EPS accretion that management will ever find – a point that we stressed to NEC's CEO in a late December meeting. Advertising, is clearly cyclical and economic indicators are weakening. We have faded Street estimates considerably in the above analysis, and note that TV advertising has already been impacted by near-zero activity in some key sectors over the last six months, such as Govt (guaranteed to lift sharply ahead of the federal election) and Banks, which are only just now seeking to restore huge brand damage sustained during the Royal Commission.

We again see NEC's outlook as differentiated from the swollen growth outlook of most Australian industrials, through: cost-out (now at \$65m ex IT, and only just after merger completion); better national agency sales penetration (NEC's bread and butter) for the key Fairfax mastheads; and NEC's key structural growth assets, in Stan, and the 9Now Broadcast VOD unit. As for the Fairfax dogs (such as ACM), NEC has the cash flow scale to hit the bid (low as it may be), and more rapidly re-shape the asset configuration of the company.

CY 2018 review: Share price volatility had been notably absent from our market leading into 2018 with unprecedented easy monetary policies at home and around the globe, plus "synchronised global growth" commentary adding significant support to capital flows into stocks, and especially those with decent dividend yields – i.e. large cap Australian equities.

Q1 of 2018 provided a healthy circuit-breaker. Share price volatility ticked-up, the US Fed progressed on the path back to more "normal" interest rate settings and March (ASX200 down 3.8%) reminded us that equity markets can quickly move into reverse. While the ASX200 was down almost 4% for the quarter, our Trust was up a little over 1% for the same period and we were hopeful that the market was returning to more traditional, 'higher-volatility, value-matters', settings.

Not so fast! The April to August period was a rapid return to hope-over-fact, as the local equity market rallied nearly 12%, defying gravity and, in our view, earnings and valuation logic. PE multiples expanded rapidly despite credit supply retreating in the wake of Royal Commission findings, anxious consumers slowing their spending as home equity levels fell, APRA taking action to constrain higher-risk lending and wage growth remaining tepid.

The market quickly forgave missteps from favoured companies, and a crescendo of bullishness greeted earnings misses and more cautious guidance in the August reporting season. Growth stocks continued their rally and value stocks were abandoned. We missed this rally, conscious as we were of a dangerously ambivalent market 'risk-on' sentiment, and we acted to preserve investor capital via a neutral-to-negative net market exposure for the Trust.

September offered a hint that the game may be changing, with the market down 1.2%. Then came October! Suddenly, valuation mattered again, the US yield-curve steepened, although the siren story of ‘synchronised global growth’ seemed over, and the ASX200 tumbled over 6%. By the end of the December quarter, the ASX200 had continued its fall, down 8.2% over these 3 months.

Throughout the year, our use of leverage remained deliberately modest (average gross exposure of 144%) and our risk settings at or close to market neutral (average net market exposure -1.1%).

Moving into 2019: Significant market noise will likely again feature in 2019 and, now conditioned, a nervous market will likely be more sensitive to it than in 2018. We expect markets to remain volatile as a result.

Our key focus for the long portfolio remains one of finding companies with credible growth which is not Australian economy-dependent, with high earnings quality and appropriate leverage, and at stock prices that represent sensible valuations. Further, in order to manage our market exposure levels, we need to find enough stocks that feature many of the inverse of these qualities, and which we believe are safe to short.

Our expectation for 2019 is that the market most likely continues its path to more ‘normal’ trading patterns as it navigates rising interest rates offshore, tougher credit supply conditions, important geo-political events (Federal election, Brexit, another year of US rule by ‘tweets over action’ and Chinese economic gymnastics), plus the unexpected events that will inevitably arise.

Collectively, this backdrop should provide opportunities for us to not only recover recent lost ground, but to also compound returns whilst maintaining an overarching focus on preserving investor capital through another phase of the market cycle.

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%)							
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	$9.777
Strategy	Long-short Australian equities
Objective	Positive returns in all market conditions. Overarching focus on capital protection
Firm AUM	$135m

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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