

ARCO Investment Management

ARCO Absolute Trust

Monthly report: February 2019

Equity markets continued their sharp rally in February despite economic data and the reporting season pointing to weaker earnings momentum and quality. Faced with the prospect of lower interest rates, the market again appears willing to pay more for earnings...really!?

Performance	Month	Qtr	1 Year	3Yr(pa)	Life (pa)
Fund return (net)	0.25%	-2.95%	-5.18%	2.16%	7.00%
Positive months			42%	64%	76%
Worst month					(3.2%)
Volatility					4.0%
Sharpe ratio					0.8

note

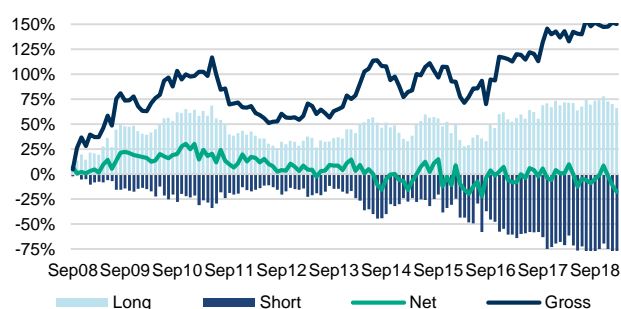
Monthly key contributors – by sector

Longs		24 positions
Positive		Media, resources, transport
Negative		Retail, building
Shorts		19 positions
Positive		Banks, retail
Negative		Healthcare, REITs

Cumulative performance



Fund investment profile (% NAV)



Portfolio settings

% of NAV	Long	Short
Equities	66.2%	-44.8%
Debt/ Hybrids	0%	0%
Derivatives		-39.1%
Gross exposure		150.1%
Net exposure		-17.8%
Concentration by position	Long	Short
Top 5	26.7%	(16.7%)
Top 10	42.8%	(29.5%)
Top 15	55.3%	(39.2%)

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 0.25% for the month.

The equity market rebound continues to surprise us. From end-August, it took the Accum Index 16 weeks to fall 12.5% – after rising by a third over two years. We've now advanced 16% from the low in just over ten weeks. February's market was flattered by timing issues for two big sectors: financials (+8.1%) with a benign (vs expectations) final Royal Comm. report, and Resources (+6.1%) with the Vale supply shock. Leaving the issue of breadth, what exactly is going on?

Is it growth? Economic data in Australia continues to soften, with credit growth at a quarter-century low, and property-based wealth effects impacting activity. Internationally, markets have priced a happy ending to the US-China trade war multiple times this year, but actual US growth is softening. The ECB has cut its growth forecast, and reversed course on removing monetary accommodation.

Is it earnings? Ex-Materials (largely iron ore), aggregate earnings revision through February were slightly negative, with actual results also disappointing, with <30% earnings 'Beats', and the lowest Beat-to-Miss ratio in over five years. Ex-Materials, price advances were very much multiple expansion-based, a very consistent recent trend.

So its interest rates – yet again? The power of interest rate compression resonates strongly in a world of very unusual liquidity. The RBA moved to a neutral policy bias during the month, and the A10Yr bond traded down to generational lows at <2.10%. Coupon returns were boosted by several companies distributing excess franking credits, ahead of a raft of broadly shareholder-unfriendly changes under active consideration by a future Labour Government.

During February's rally, we reduced a number of the Trust's long positions as prices rose through our fair value range. Our short stock positions were hard going in such a strong market, but continue to represent an important risk hedge.

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Performance review

The long portfolio performed strongly for the Trust again in February, up almost 4% for the month. This was driven by strong contributions from a number of stocks where earnings growth is being driven by cost-out and digital revenue streams (NEC, TAH); or by factors other than the Australian domestic demand cycle (Brambles, Link, Worley, Downer).

On the short side, our regional bank shorts performed strongly despite the positive effect of the final Royal Commission report, as the reporting season (and interest rate backdrop) highlighted vulnerability in the earnings outlook and/or earnings quality issues.

In such a strong market, most other shorts detracted from performance, with losses concentrated in the REIT/ infrastructure sectors, where the effect of interest rate compression was to lift prices further away from defensible valuations on any non-yield metric.

The broad market strength in February led us to increase the Trust's net short market exposure, as we reduced a number of our long positions as prices rose through our fair value measures, or where we lost conviction in key strategic or cyclical drivers for certain holdings, including Caltex, Wesfarmers, Orora and Orocobre.

We added some fresh names to the long portfolio, including Treasury Wines, where the price has retreated to within our fair value range for the first time in quite some time, and where recent evidence suggests that the risks around the company's changes in distribution strategy in key markets are moderating. We similarly initiated a position in Star Entertainment Group, where we felt consumer cyclical exposure was overly discounted in valuation.

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%					
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	\$9.802	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	\$141m	ISIN	AU60OPT0014
		Fund Inception	15/9/08 (@ \$10.00 per unit)

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