

# ARCO Investment Management

## ARCO Absolute Trust

Monthly report: June 2018

A solid quarter for the local equity market after a volatile start to 2018. Offshore capital flows and FX moves during June provide support for Australian equities and bank prices return to pre-Royal Commission levels - though we question for how long.

Performance	Month	Qtr	1 Year	3Yr(pa)	Life (pa)
Fund return (net)	-0.67%	-1.85%	6.53%	6.14%	8.02%
Positive months			58%	72%	78%
Worst month					(2.3%)
Volatility					3.8%
Sharpe ratio					1.1

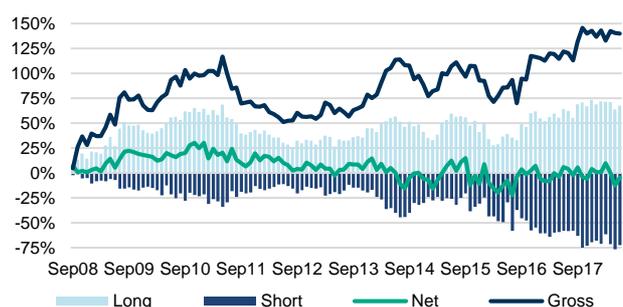
### Monthly key contributors – by sector

Longs	23 positions
Positive	Energy, Div Financials, Retail
Negative	Resources, chemicals
Shorts	18 positions
Positive	Building materials, telcos, REITs
Negative	Healthcare, banks, index futures

### Cumulative performance



### Fund investment profile (% NAV)



### Portfolio settings

% of NAV	Long	Short
Equities	67.6%	-37.4%
Debt/ Hybrids	0%	0%
Derivatives		-34.8%
Gross exposure		139.8%
Net exposure		-4.7%
Concentration by position	Long	Short
Top 5	24.9%	(16.7%)
Top 10	43.4%	(27.9%)
Top 15	57.4%	(35.6%)

### 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 -0.67% for the month and +6.5% for FY'18.

June was another strong month for equities and the ASX200 again outperformed its global peers (in both AUD and USD terms), up over 3% and trading at levels last seen in 2007. Similarly, the June quarter was the strongest quarter for equity market returns in over three years, up almost 8.5%, and fuelled notably by energy and consumer staples.

With this backdrop, all must be well in Australia, right? Well, not necessarily. Offshore capital flows and FX have had a significant impact on recent returns, in our view. The AUD/USD cross fell by over 2% for the month, driving flows into Australian stocks from offshore investors. These investors may have been buying Australia less on its own merits, and much more as a means of fleeing emerging market equities, spooked as they have been by local currency devaluation against the USD, economic weakness in China and trade war concerns.

There are two problems with this money: 1) it is typically transient; 2) it is valuation-insensitive. Valuations have really moved up sharply, the 1-year forward PE ratio for the ASX 200 Industrials (i.e. excluding financials, REITs, and resources) has pushed out to 22x on a market-cap weighted basis, against earnings growth estimates that are broadly unchanged. The effect of this has been to greatly truncate our inventory of long stock candidates trading anywhere near our view of fair value.

We have been suggesting for some time that the stocks leveraged to the local economy (especially property and bank credit) are not where we want to be – other than by exception. Yet even financials staged a recovery in June, with banks breaking their 3 month losing streak, to be back broadly in line with their pre-Royal Commission levels. As such, investors seem to view the impact of the RC on credit growth and/or costs as purely transitory: a view that we consider too optimistic.

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### Performance review

June was the end of another financial year for the Trust and we were pleased to record its 10<sup>th</sup> consecutive positive yearly return for investors.

For the 2018 fiscal year specifically, the Trust's long portfolio comfortably outperformed the ASX200 Accum Index. The short portfolio was, perhaps predictably, a drag on returns in a market up 13% for the year – although doing its job to hedge market exposure, and hence the volatility of investor returns.

Market volatility during the last 6 months in particular was notable. The relative outperformance of the Trust's stock shorts compared to longs reversed in the June qtr, as the equity market rallied strongly and volatility abated – for now.

The Trust's net short market exposure hurt our performance in June. Long positions, especially Caltex, Link, Computershare, Fairfax and BHP drove a solid result from the long portfolio. The short portfolio broadly detracted from performance, primarily via our bank and healthcare exposure. The Trust's Index Futures ('insurance') position was also a drag on performance.

During the month, we exited Atlas Iron (which no longer represented a discounted entry into MIN with the lapse of the latter's scrip offer), trimmed our exposure to AHG, LNK and HT1 and increased our weighting to Caltex, Boral and Fairfax as their prices implied greater upside potential compared to our view of their fair value.

In the financials sector, we moved to reduce our long-held exposure to CYB as its price ran higher on the back of the Virgin Money transaction in the UK. Our bank shorts were a drag on performance for the month as the sector staged a recovery from recent falls. We remain comfortable maintaining our short exposure within the sector.

We believe that such a strong month/quarter for the local equity market has pushed several stocks well above their fair value. Consequently, we have moved to initiate additional short positions in the IT and consumer sectors and continue to research several others.

The Trust finished the month maintaining a slightly net short market exposure.

### ARCO Absolute Trust – monthly returns

	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	FY
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 15/09/08.

### 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	\$11.222
Strategy	Long-short Australian equities
Objective	Positive returns in all market conditions. Overarching focus on capital protection
Firm AUM	\$147m

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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