

ARCO Investment Management

ARCO Absolute Trust

Monthly report: October 2018

The global equity market registered its worst monthly return since May 2010. 'Risk-off' sentiment impacted all equity market sectors and high growth stocks in particular. As much as it was an important pressure-release, the retracement also offered a number of buying opportunities.

Performance	Month	Qtr	1 Year	3Yr(pa)	Life (pa)
Fund return (net)	-0.68%	-2.15%	-0.07%	4.25%	7.47%
Positive months			42%	64%	76%
Worst month					(2.7%)
Volatility					3.9%
Sharpe ratio					1.0

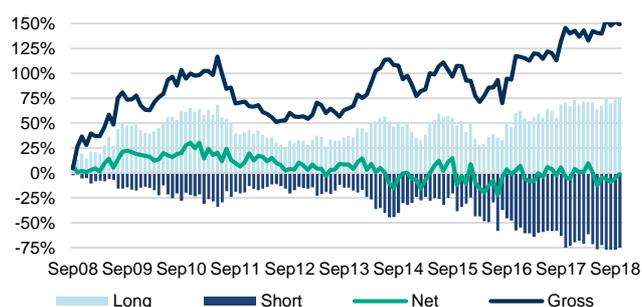
Monthly key contributors – by sector

Longs		30 positions
Positive		Resources, gold
Negative		Media, materials, building, transport
Shorts		15 positions
Positive		Banks, media, Index futures
Negative		Retail

Cumulative performance



Fund investment profile (% NAV)



Portfolio settings

% of NAV	Long	Short
Equities	74.1%	-38.5%
Debt/ Hybrids	0%	0%
Derivatives		-36.5%
Gross exposure		149.1%
Net exposure		-0.9%
Concentration by position	Long	Short
Top 5	25.4%	(20.4%)
Top 10	42.3%	(31.8%)
Top 15	55.2%	(38.5%)

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 -0.68% for the month.

Global equity markets staged a significant retreat in October, led by growth stocks, and fuelled by a rising US yield curve (10yr bond rate through 3.20% for the first time since 2011), some poor earnings reports by some leading tech/growth stocks, and worsening geo-politics. Locally, the ASX200 Accumulation index fell by 5.9%, with every sector in the red, led by energy and IT with double-digit losses.

While the Trust's loss in October was modest when set against this market context, we admit to disappointment with this outcome. We ran net short market exposure and a strong bias towards defensive longs and high PE shorts for some months, recognising that equity valuations had become extended and risk consciousness blunted. This positioning has been hard yards (especially in August), and we expected that October should have been a more profitable month for our investors. Much of our good work in terms of appropriate risk settings was undone by the impact of one or two stock-specific reversals, as detailed over-page.

Such a significant market pullback has, however, resulted in a number of stocks being rebased back to more attractive levels relative to our 'fair value range' assessment. We have added long exposure accordingly, and have also covered certain shorts that we consider to have done their job in hedging portfolio risk for the time being.

As a result, overall Fund risk (net market exposure) increased to broadly neutral by month-end, and to modestly positive by early November. Our view on markets remains broadly cautious. We view the earnings growth outlook for local companies to remain challenged, most notably in the consumer, housing and credit sectors (a broad band of the local economy). Interest rates globally have seen their lows, as has liquidity creation, absent a much more substantial market correction. Having said that, a few pockets of opportunity are opening up, where risk seems much more appropriately discounted in the valuation.

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Performance review

As for last month, the further retracement of a number of bank, healthcare and high-PE industrial stocks were notable drivers of good performance from the Trust's short portfolio again in October.

Select long positions in the Materials sector were also positive contributors to the Trust's result. Most notably, Lynas Corp recovered significant ground as the Malaysian Government's review of its refining and waste disposal operations took on a less hostile guise. We increased our holding in Lynas, at prices at which we felt very adequately discounted this risk, difficult as this assessment continues to be.

Regis Resources was also a positive contributor for the month, benefitting in part from the markets risk-off shift to the gold sector and also from confirmation in the 1Q production report that management's initial guidance on pre-strip ratios and costs at Duketon had been overly conservative.

Performance took a hit from a number of our higher-conviction holdings within the long portfolio, including, QUB, Boral, Mineral Resources and Nufarm. Most notably, Fairfax retreated 22% due to an earnings downgrade, mainly from Domain. This exposure has worried us for some time and we have (until recently) been short REA as a hedge.

We retain a fundamentally positive view of the economics behind the Fairfax-NEC merger.

Long portfolio additions during October included Amcor and Worley Parsons. Price retracements for both stocks were, in our view, exaggerated by technical factors, being arbitrage pressure from the Bemis offer, and the size of the equity offering to fund the Jacobs ECR purchase (and uncertainty relating to DAR Group's participation), respectively. As a result, we were able to buy at prices that were well within our fair value ranges: an unusual opportunity for both these high-quality companies.

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%)									
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	\$10.021
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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