

ARCO Investment Management

ARCO Absolute Trust

Monthly report: September 2018

The local equity market finally takes a breather and rising bond yields demand more investor attention. Equity risks remain broadly elevated: high valuations set against slowing growth, rising term interest rates, tightening credit standards and unsettling local and geo-politics.

Performance	Month	Qtr	1 Year	3Yr(pa)	Life (pa)
Fund return (net)	1.30%	-1.91%	1.72%	4.25%	7.60%
Positive months			50%	67%	77%
Worst month					(2.7%)
Volatility					3.9%
Sharpe ratio					1.0

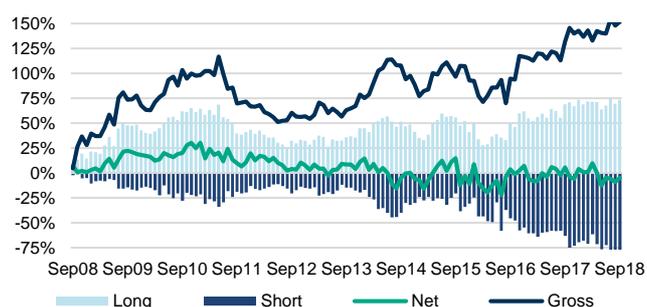
Monthly key contributors – by sector

Longs	24 positions
Positive	Resources, consumer, energy
Negative	Media, materials
Shorts	17 positions
Positive	Banks, healthcare, futures
Negative	Telecoms, energy

Cumulative performance



Fund investment profile (% NAV)



Portfolio settings

% of NAV	Long	Short
Equities	73.4%	-39.9%
Debt/ Hybrids	0%	0%
Derivatives		-38.5%
Gross exposure		151.8%
Net exposure		-5.0%
Concentration by position	Long	Short
Top 5	30.6%	(19.9%)
Top 10	47.9%	(32.5%)
Top 15	60.8%	(39.0%)

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 +1.30% for the month.

The local equity market took a breather in September from its strong run over recent months, recording its first negative return since March. Australia was the worst performing of the developed equity markets, with a number of factors weighing on returns: interest rates, credit conditions, currency and valuation levels.

Rising bond yields, unless accompanied by rising earnings growth, are a problem for equities both directly (the discount rate) and indirectly, through attitudinal change in investor risk tolerance. USD term bond yields have broken out in a convincing manner. Local term yields have moved up in sympathy, but the AUD-USD 10-year bond spread has further inverted, to -50 bps: a post-1981 high. This speaks to continued weakness in the AUD, which is rapidly losing its status as a 'carry' currency in the eyes of fixed income investors. Offshore coupon-seeking money is a very big (and historically very unusual) part of our equity market as well, and this remains another risk factor, especially for high-PE stocks.

A steeper yield curve is usually interpreted as a signal of economic strength. In Australia's case, the curve seems pulled between term reversion in the US and the likelihood that the RBA remains pinned-down on short rates due to concerns over the property market and broader economic fragility. Financials are the obvious play from a steepening curve but still appear fraught with risk to us, commanding high multiples for very little growth, even prior to the impact of the Royal Commission on costs, credit creation, credit quality and potential liability risk.

In this context, we remain actively defensive with the Trust's risk settings, retaining a modest net short equity exposure at month end.

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Performance review

September was a better month for the Trust with both long and short sides of the portfolio delivering positive results for investors.

On the short side, the retracement of a number of bank, healthcare and material stocks, along with many of the higher-PE cohort, were notable drivers of good performance from the short portfolio.

We noted through the August earnings season that we were in one of those market junctures where facts didn't seem to matter much to stock prices. It's under precisely those sort of conditions that prudent risk management requires taking market exposure down, difficult as it can be to short anything at such times.

Despite the down-month for the broader market, the long portfolio had some notably positive contributors in BHP, Mineral Resources and Tabcorp.

We also took advantage of weaker prices during September to further diversify our long positions. The long portfolio now straddles two broad themes. First, we own a core group of stocks trading well under our view of fair value and which feature defensive cash flows. In this category are Fairfax, Tabcorp, Caltex, Downer, HT1 and Link.

We have supplemented these holdings with selective higher-beta stocks which have been smashed-up in price terms and which represent low multiples of strongly growing cash flows. Mineral

Resources is in this category whereby we believe its current equity valuation is attractive on the basis of the company's mining services cash flows alone, with a heavy discount applied to the company's Wodgina asset which is nearing a critical price discovery point.

Lynas Corp is a stock of similar interest to us. We have recently begun to rebuild our holding, having more than halved our investment at higher price levels on the initial news of the Malaysian Government review of the LAMP facility. Recent news on this risk exposure has improved and we find it very difficult to rationalise the company's loss of over half its capitalisation in terms of economic value risk.

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%										
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	\$10.090	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	\$145m	ISIN	AU60OPT0014
		Fund Inception	15/9/08 (@ \$10.00 per unit)

ARCO Investment Management Pty Ltd
ABN 48 129 937 837 AFSL 325 159

Level 2, 121 Flinders Lane
Melbourne VIC Australia 3000

T +61 (3) 9660 9500
F +61 (3) 9660 9599

E info@arcoim.com
arcoim.com

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