ARCO Investment Management
ARCO Benchmark Independent Fund

Monthly report: August 2018

Escalating EM and global trade problems, local politics gets even worse, home equity declines further, cautious business investment readings and earnings misses from very high P/E stocks being rewarded enthusiastically by investors – just another month, nothing to see here, play-on.

High PE stocks move higher

Fundamental valuations stretched

Downside risks elevated in our view

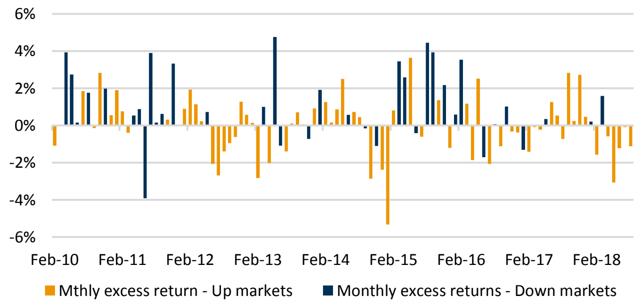
	Month	Qtr	1 Year	3 Year	Life (p.a.)
Price NAV	1.0595				
Fund (a)	0.28%	3.5%	15.9%	13.9%	12.9%
ASX300 Accum	1.40%	6.2%	15.4%	11.4%	7.7%

(a) Returns from the long portfolio of the ARCO Absolute Trust to Jun 16; actual Fund returns thereafter.

Monthly attribution and top active investments

Attribution	
Positive	Media, transport, consumer services
Negative	Materials, telecoms
Top Active	O/w – TAH, FXJ, CTX, MIN U/w – CBA, WBC, CSL, NAB

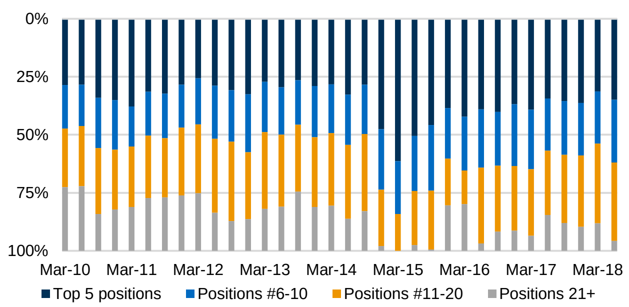
Performance: monthly excess returns



Sector weightings

	ASX300	ABIF	Active
Consumer discretionary	5.0%	16.9%	11.9%
Consumer staples	7.9%	6.6%	-1.3%
Energy	5.7%	7.6%	1.9%
Financials	32.8%	12.0%	-20.8%
Healthcare	8.5%	0.0%	-8.5%
Industrials	7.4%	11.4%	4.0%
IT	2.5%	8.8%	6.3%
Materials	18.2%	36.6%	18.4%
Real Estate	7.7%	0.0%	-7.7%
Telecommunications	2.4%	0.0%	-2.4%
Utilities	1.9%	0.0%	-1.9%

Stock concentration - % of equity exposure



Fund strategy and outlook

The ARCO Benchmark Independent Fund aims to deliver investors consistent growth over time, with a strong focus on capital preservation and low downside capture.

The Fund recorded a net return of +0.28% for the month and +15.9% for the previous 12 months.

Equity markets and valuations continued to defy gravity during August, powering through a decent-sized emerging market crisis, escalating trade tensions, the removal of an economically rational Prime Minister, further declines in house prices and a lack-lustre company reporting season. The recent GDP 'beat' was nice, but there's a limit to how often you can dine out on a still-lower savings rate, especially with a shrinking home equity backdrop.

Company earnings reports would be a "moment of truth" for increasingly stressed business models with over-inflated valuations – or so our thinking went. Throughout our 10 years of running an active Australian equities strategy, plus our significant time in the markets before this, we struggle to recall a reporting season when so many outright earnings misses, often coupled with poor earnings quality and guidance that lagged prior estimates, were rewarded with stock price advances and still higher valuations. Financials also recovered some ground, despite further weakness in 3Q bank earnings updates, and are tracking at or above pre-Royal Commission levels – what Royal Commission?

Irrespective of the cause, strong price advances set against deteriorating fundamentals and already very high PE's reinforce our sense that market risk is very elevated at this point. For this reason, and noting the local market has risen almost 12% (accumulation basis) since April alone, we have moved toward the outer limit of our cash allocation, in expectation of an opportunity to invest at more rational valuations.

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Performance review

Our investments in companies with quality franchises such as Fairfax, Qube, Brambles and Tabcorp delivered good earnings reports in the face of very cautious expectations, resulting in solid re-ratings and return contributions.

On a less positive note, we took hits on a few large, high-conviction long investments. These included Janus Henderson (after recent management changes, all of which favour the legacy Janus team) and Nufarm, with heightened uncertainty relating to contingent liability exposure in legacy glyphosate product lines following a junior court decision in the USA.

In both cases, these developments departed materially from our positive medium-term thesis, and our risk management process required that we reduce portfolio exposure accordingly.

We moved to increase our weighting to a number of our existing holdings during the month, and post their result announcement, including Caltex whereby we want to take advantage of its very pronounced price weakness post its earnings result (which contained few surprises, in our view).

We also initiated a position in Downer, which offers undervalued exposure to mining services and infrastructure capex.

Post the recent turbo-charge move in many stocks, we enter September with cash levels toward the upper end of our limit.

Performance summary

	Qtr	1 Yr	3 Yrs	5 Yrs
Returns				
Fund (1)	3.5%	15.9%	13.9%	12.9%
Market (ASX300)	6.2%	15.4%	11.4%	8.9%
– Excess return	-2.7%	0.5%	2.5%	4.0%
– Correlation		-0.30	-0.30	-0.31
Analytics				
Information ratio – OBIF		0.08	0.44	0.63
Tracking error		6.0%	5.6%	6.3%
Sharpe ratio – ABIF		2.2	2.0	1.6
Sharpe ratio – market		1.7	1.2	0.7

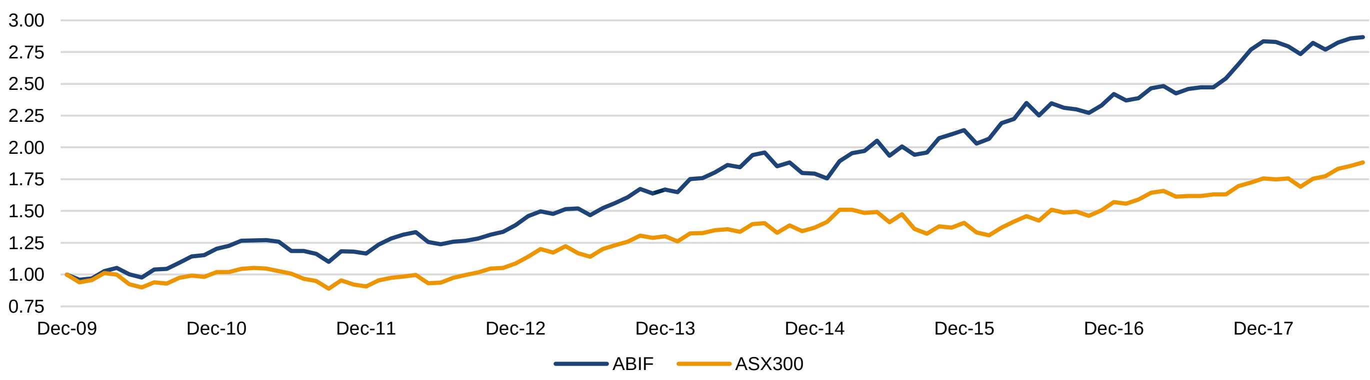
Key portfolio changes

Additions/up-weights
Additions
DOW
Up-weights
CTX, FXJ, JHX, MIN, TAH

Deletions/down weights
Deletions
AWC
Down-weights
BXB, NUF, AHG, JHG, QUB

Note (1): Returns from the long portfolio of the ARCO Absolute Trust to Jun16, actual Fund returns thereafter.

Cumulative returns since inception



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