

ARCO Investment Management

ARCO Benchmark Independent Fund

Monthly report: July 2018

Going up!? July was the 4th consecutive up-month for the ASX, which rose above 6,300 for the first time since April 2008. Offshore trade wars and onshore housing price trends were by-passed by the momentum in our market – for now.

Local market pushes through 6,300

Fundamental valuations by-passed

Downside risks elevated in our view

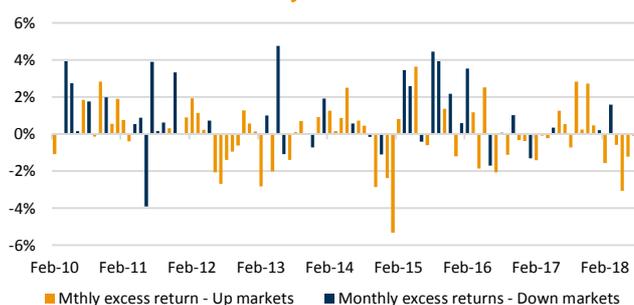
| | Month | Qtr | 1 Year | 3 Year | Life (p.a.) |
|--------------|--------|------|--------|--------|-------------|
| Price NAV | 1.0566 | | | | |
| Fund (a) | 1.22% | 1.3% | 15.6% | 12.5% | 13.0% |
| ASX300 Accum | 1.31% | 5.8% | 14.6% | 7.9% | 7.6% |

(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 | Transport, media, diversified financials |
| Negative | Materials, banks |
| Top Active | |
| | O/w – CTX, TAH, JHG, MIN U/w – CBA, WBC, CSL, NAB |

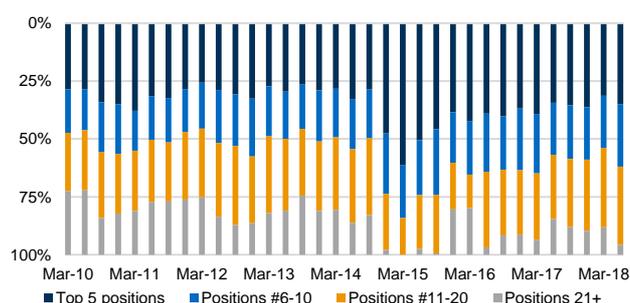
Performance: monthly excess returns



Sector weightings

| | ASX300 | ABIF | Active |
|------------------------|--------|-------|--------|
| Consumer discretionary | 5.0% | 16.2% | 11.2% |
| Consumer staples | 8.1% | 6.2% | -1.9% |
| Energy | 5.7% | 7.2% | 1.5% |
| Financials | 32.6% | 13.1% | -19.5% |
| Healthcare | 8.4% | 0.0% | -8.4% |
| Industrials | 7.2% | 10.9% | 3.7% |
| IT | 2.5% | 8.2% | 5.7% |
| Materials | 18.5% | 38.1% | 19.6% |
| Real Estate | 7.7% | 0.0% | -7.7% |
| Telecommunications | 2.2% | 0.0% | -2.2% |
| Utilities | 2.0% | 0.0% | -2.0% |

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 +1.22% for the month and is +15.6% for the year ending July.

July's equity market rise breached another watermark, seemingly unconcerned by trade war escalation, local house price trends worsening, another local inflation result below forecasts and the RBA's maintenance of a record low cash rate now entering its 3rd year.

Offshore capital inflows remained a notable feature of our market into early July though this effect appeared to moderate by the end of the month. This situation needs careful monitoring: any reversal of these flows will cause a headwind for many stocks that have enjoyed a recent price surge sponsored by this typically-transient and valuation-insensitive offshore interest.

The sustained market rise over the past 4 months and inflated financial metrics of many stocks continues to weigh on our thinking. Experience reminds us that when the market appears least interested in fundamental stock valuation, it is getting closer to the point where valuation is more important than ever!

The financial, healthcare and real estate sectors in particular screen more expensive to us now and worthy of only very selective and modest holdings where earnings growth paths are clear and downside risks are both obvious and tightly managed.

For us, the August earnings season will be a balance between conviction investing on the 18 months' time frame that is typical for our valuation process and the need to be tactical, recognising that price volatility around an earnings report can be extreme, and this is almost always a function of expectations – not absolutes.

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Performance review

The Fund benefited from the continued market rally through July and most notably via strong contributions from Brambles, QUB, Fairfax, Tabcorp and Janus Henderson.

Corporate activity was a tailwind for Fairfax, with the proposed merger with Nine Entertainment. We have been of the view for a little while that a transaction regarding Fairfax was on the cards and a possible catalyst for positive price action, though a little surprised that the move hasn't been stronger.

We continue to hold a significant (and broad) exposure to the resources sector (even after reducing the Fund's MIN exposure recently). BHP and Pilbara Minerals (since exited) were further positive contributors to July's result and we initiated a modest position in Regis Resources after its price retracement recently pushed it below our fair value range for the stock.

Our lithium holdings came under pricing pressure during the month though we retain our confidence in the cash flow trajectory and valuations in the sector.

Having been long-term investors in the Janus Henderson merger thesis, we have recently trimmed this position post the announced departure of co-CEO Formica, as we were of the view that his leadership was a necessary precondition for successful execution of the merger.

The portfolio also holds a number of consumer discretionary stocks which, importantly, are not directly leveraged to the local consumer and have very different price drivers, as in the case of both Fairfax and Tabcorp.

Performance summary

| | Qtr | 1 Yr | 3 Yrs | 5 Yrs |
|--------------------------|-------|-------|-------|-------|
| Returns | | | | |
| Fund (1) | 1.3% | 15.6% | 12.5% | 13.4% |
| Market (ASX300) | 5.8% | 14.6% | 7.9% | 9.1% |
| - Excess return | -4.6% | 1.0% | 4.6% | 4.3% |
| - Correlation | | -0.29 | -0.42 | -0.31 |
| Analytics | | | | |
| Information ratio – OBIF | | 0.17 | 0.76 | 0.68 |
| Tracking error | | 5.9% | 6.1% | 6.3% |
| Sharpe ratio – ABIF | | 2.2 | 1.6 | 1.7 |
| Sharpe ratio – market | | 1.6 | 0.7 | 0.6 |

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

Key portfolio changes

Additions/up-weights

Additions

MQG, RRL

Up-weights

MIN, FXJ, BXB, CPU

Deletions/down weights

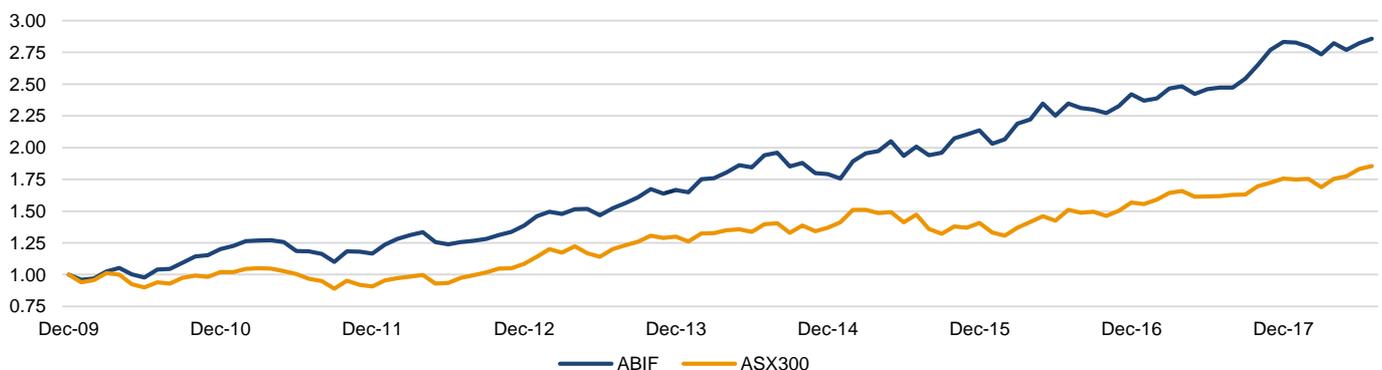
Deletions

SUN, PLS

Down-weights

AWC, LYC, LNK, QUB

Cumulative returns since inception



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