ARCO Investment Management
ARCO Benchmark Independent Fund

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 - although we question for how long.

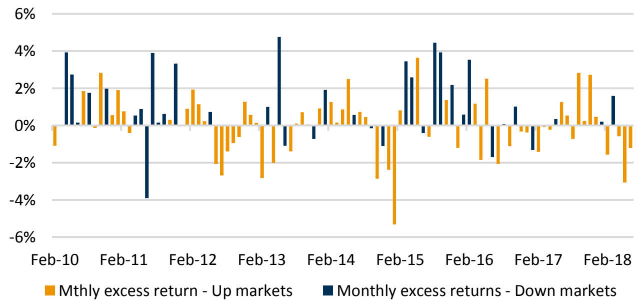
Equities trade up to 2007 levels | High PE stocks pushed even higher | Banks back to pre-RC prices

	Month	Qtr	1 Year	3 Year	Life (p.a.)
Price NAV	1.1925				
Fund (a)	1.97%	3.3%	14.8%	13.4%	13.0%
ASX300 Accum	3.19%	8.4%	13.2%	8.9%	7.5%

(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	Energy, software services, media
Negative	Healthcare, banks
Top Active	O/w – CTX, TAH, JHG, NUF U/w – CBA, WBC, CSL, NAB

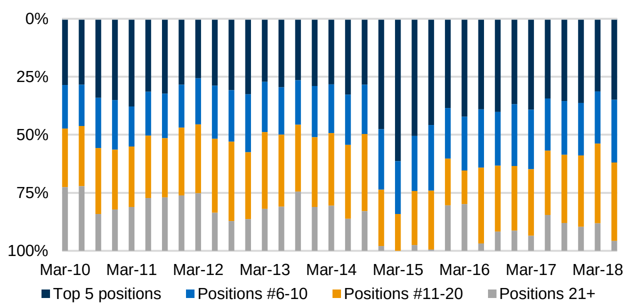
Performance: monthly excess returns



Sector weightings

	ASX300	ABIF	Active
Consumer discretionary	5.0%	15.1%	10.2%
Consumer staples	7.9%	6.2%	-1.6%
Energy	5.5%	6.9%	1.5%
Financials	32.1%	12.0%	-20.1%
Healthcare	8.4%	0.0%	-8.4%
Industrials	7.5%	10.4%	2.9%
IT	2.4%	8.4%	6.0%
Materials	18.6%	40.9%	22.2%
Real Estate	8.2%	0.0%	-8.2%
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 +1.97% for the month and is +14.8% for the year ending June.

June was another strong month for equities and the ASX300 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%.

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.

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

FY 2018 was a good year for the Fund, finishing with net returns over 150bps above the ASX300 Accum Index, although the Fund gave back some performance over the last quarter.

The strength of the market rally in the June quarter (and retracing of market volatility post March) was greater than we were anticipating, especially in bank and (already) high PE stocks.

During June specifically, our holdings in Caltex, Link, Computershare, Fairfax and BHP drove a solid result for the Fund.

We moved to exit our position in 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.

Among financials, 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. Despite adding ANZ (which had underperformed its way into the top end of our fair value range at the start of the month) on a tactical basis, we remain comfortable maintaining a very limited exposure to the sector.

We also up-weighted TAH. Despite a relatively soft finish to the June quarter in lotteries, we see recent regulatory developments as greatly strengthening TAH's competitive position in wagering, and believe that merger synergy gains may well be upgraded.

We believe that such a strong month/quarter for the local equity market has pushed several stocks well above their fair value. Our inventory of high conviction stock candidates has reduced as a consequence and cash levels have risen, anticipating cheaper stock entry points and consistent with the Fund's strategy of minimising investor drawdown exposure.

Performance summary

	Qtr	1 Yr	3 Yrs	5 Yrs
Returns				
Fund (1)	3.3%	14.8%	13.4%	14.0%
Market (ASX300)	8.4%	13.2%	8.9%	9.9%
– Excess return	-5.1%	1.6%	4.5%	4.1%
– Correlation		-0.29	-0.43	-0.32
Analytics				
Information ratio – OBIF		0.30	0.74	0.64
Tracking error		5.9%	6.1%	6.3%
Sharpe ratio – ABIF		2.0	1.8	1.7
Sharpe ratio – market		1.4	0.8	0.6

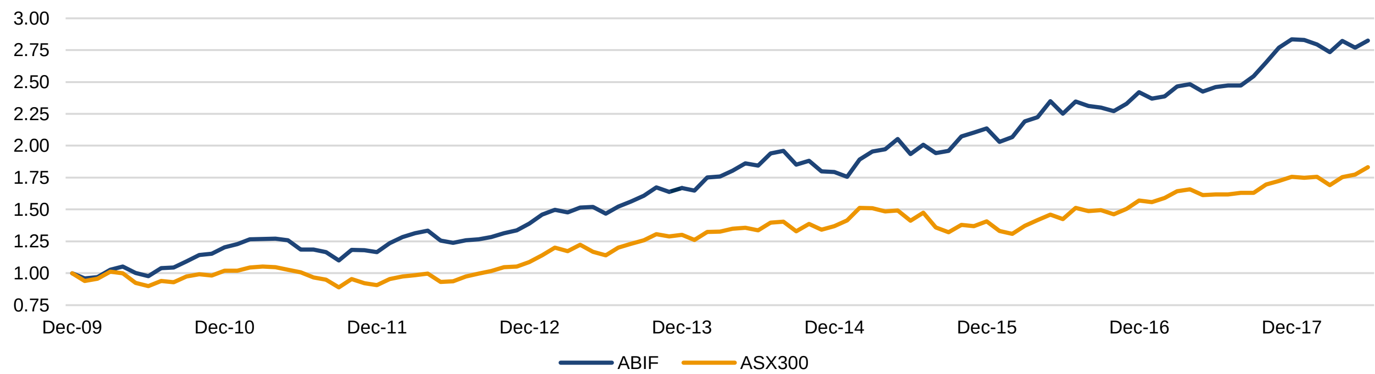
Key portfolio changes

Additions/up-weights
Additions
ANZ
Up-weights
TAH, MIN, CTX, BLD, FXJ

Deletions/down weights
Deletions
JBH, AGO
Down-weights
AHG, LNK, CYB, HT1

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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