ARCO Investment Management
ARCO Benchmark Independent Fund

Monthly report: June 2019

June highlighted the market's fixation with bad is good – i.e. weakening economic fundamentals globally will result in central bankers cutting rates, leading to higher equity prices...really? We remain a bit more circumspect…

Bonds drag stocks higher

RBA cuts rates twice

Macro dominates markets

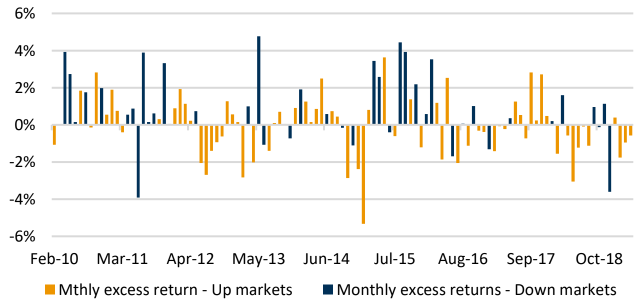
	Month	Qtr	1 Year	3 Year	Life (p.a.)
Price NAV					
Fund (a)	-1.0%	0.7%	-1.4%	7.3%	11.4%
ASX300 Accum	3.6%	8.1%	11.4%	12.7%	7.8%

(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	27 holdings
Positive	Energy, Consumer Services
Negative	Materials, Banks
Top Active	O/w – ALL, NEC, AMC SGR U/w – BHP, WBC, CSL, CBA

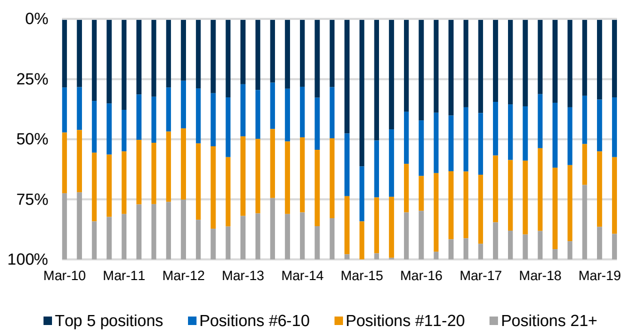
Performance: monthly excess returns



Sector weightings

	ASX300	ABIF	Active
Consumer discretionary	6.6%	18.5%	11.9%
Consumer staples	5.5%	5.5%	0.0%
Energy	5.3%	7.1%	1.8%
Financials	31.5%	16.5%	-14.9%
Healthcare	8.5%	0.0%	-8.5%
Industrials	8.1%	12.7%	4.5%
IT	2.5%	5.5%	3.0%
Materials	18.5%	20.5%	2.1%
Real Estate	7.8%	4.9%	-2.9%
Telecommunications	3.9%	8.8%	4.9%
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 –1.01% for the month.

It's been a huge year for the Australian market which, of course, is great for investors. Unfortunately, on a relative basis we haven't been able to keep up with the stellar rise. This begs the question: what's going on?

Not wanting to sound like a broken record, we'll let someone else do it for us, the Governor of the Reserve Bank: *"There are investors who think the outlook is sufficiently weak that they expect central banks right around the world to cut interest rates but they are not worried about corporate profits or credit risk," Dr Lowe said. "I don't really under-stand that." He pointed out the contradiction as central banks lower rates at the same time as equity markets "are very strong" and credit spreads are narrow. "So to me it's a strange world." (AFR – 25/6/19)*

We concur: it's a very strange world indeed. In June markets continued to take good news as good news and bad news as, well, good news! The Australian market advanced by another whopping 3.7% to set yet another record. To put this in perspective, from the market record peak in 2007 it took until 2013 to regain the losses occurring courtesy of the GFC. Since that time, the market (on an accumulation basis), is up over 60%. Additionally, since the low set in December, the market is up 24% in six months.

The market is now capitalising record low interest rates (usually associated with tough economic times) ***and*** increasing corporate profits. Like the RBA Governor, the logical inconsistency of this premise troubles us. It's similar to watching the crescendo of calls on Wall Street for rate cuts from a 50 year low in unemployment. Meanwhile, real world risks to company earnings seem to be rising, with evidence of disruption to global supply chains in the wake of the trade war on an almost daily basis, and with bombs exploding in the Straits of Hormuz.

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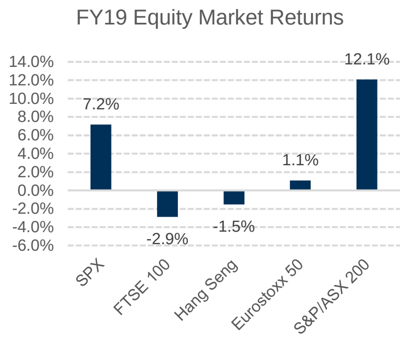
Performance review

June was a disappointing result for the Fund. The bond market's linear march higher has dragged the equity market with it, and the Fund was not positioned to benefit in terms of interest-rate sensitive sectors. More on that in a moment, but first a reflection on the last fiscal year.

The S&P/ASX 200 Accumulation ended FY19 with a 12.1% gain having been down almost that much in the first half; a 24% rally since Christmas Eve. The Australian market has the highest payout ratio in the world making it a favoured destination for global income funds. Perhaps in partial reflection of that factor, it's been a much bigger year for equity returns in Australia than for certain other markets:

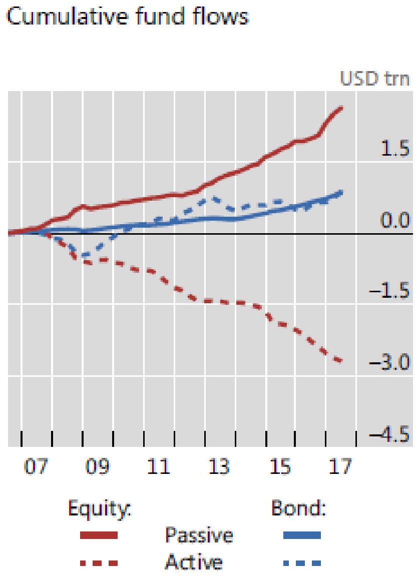


Bloomberg

Looking back on FY19 we'd make three general observations about equity markets and funds management:

1) The impact of passive funds (ETF's and index funds) became even bigger
2) In our experience, never have macroeconomic conditions and policy settings had such a huge impact on individual sectors and stocks (e.g. the thirst for yield)
3) The continued poor performance of active managers (long only and absolute return) only got worse, both in Australia and globally

Taken in turn, passive products are not price sensitive and are known to distort prices of stocks or sectors for long periods of time. Remember, flows into a passive fund simply buy a basket of stocks and are price- and valuation-indifferent. These funds have grown to be a very large part of the market with huge daily inflows:



Bank of International Settlements

Further, these funds have had a profound effect on the share registers of the majority of companies in the market. For example, Black Rock and Vanguard are among the top three shareholders in each of the top 20 companies in the Australian market. It doesn't stop there. The register of the bourse's 50th largest company by market capitalisation, Tabcorp, boasts Vanguard and Black Rock as its 3rd and 4th largest shareholder with quasi-passive fund, Australia Super, as its 2nd. The 100th largest company, Ansell, has Black Rock at #1 and Vanguard at #3.

The result of this trend is that sustained share price moves that are often related to index size and passive fund flows, are largely divorced from fundamentals. Inflows into passive funds have to be invested in the index or, in the case of ETF's, the underlying basket of stocks the fund is replicating. In many cases these flows can overwhelm the actions of active managers for sustained periods of time, although we believe that fundamentals eventually win out.

We can also see the effects of what we'll call YAAP: yield at any price. REIT's, infrastructure assets and a slew of other stocks are simply being priced on yield with only cursory attention to underlying risks to earnings and dividends. Of course, this is being fuelled by falling bond yields, liquidity creation and overall loose monetary policy, even as the real world efficacy of these policies seems to have reached a point of sharply diminishing returns.

Finally, we have seen aggregate active manager returns get progressively worse both here in Australia and globally. Thus the circular argument of poor performance and flows from active to passive has seen some once very large and successful firms leave the industry.

Sour grapes? Perhaps. But make no mistake, we are certainly not perennial bears actively searching for the next disaster. Nor will we be bucketed into the "growth" or "value" camps. We are simply bottom up stock pickers looking for solid risk/reward dynamics. Thus, while we are currently net short, over the journey it has been stock picking that has driven the vast majority of our returns. Therefore, currently, it is a sober look at the facts that drives our stock selection: economic data is deteriorating while equity markets hit record highs. *We simply cannot get on the growth at any price or yield at any price trains. We believe risk will eventually be priced, as it always has in the past.*

In the words of Ray Dalio founder of the $US150 billion dollar fund, Bridgewater.

"The world now is leveraged long. Because interest rates were so low relative to return on equities, the world has borrowed a lot of money to buy financial assets. The defining time will be when asset prices don't do well. We're getting close to that point."

We are of the firm belief that current performance notwithstanding, these are quite extraordinary times and sticking to fundamentals is never so important as when they are being ignored. This does not necessarily mean a market crash, nor are we predicting one, but at some stage fundamentals will reassert themselves and the tyranny of passive flow will be a much less distortive factor.

Turning again to the month of June, bright spots in the portfolio were Worley, which benefitted from a rising oil price given its engineering exposure to the oil & gas industry; gaming company Aristocrat which continued its stellar run post its result in May; and pallet provider Brambles, benefitting from a reversal in cost inflation that hurt profits in the previous year.

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Two stocks that did huge work for the Fund in May, Nine Ent and Lynas Corp (up 19% and 54% respectively), gave some back in June, with no new material news. Our long position in battery materials (especially Pilbara and Galaxy) was a drag on performance. Lithium prices have been under pressure as we work through what we view as a short term oversupply situation.

The weakness in the domestic consumer caused an earnings downgrade for Star Entertainment and a sell-off in those shares, though we continue to be attracted to the longer term outlook for the company. We were also caught in a downgrade by Link, and have substantially sold that investment.

The about-face in global monetary policy settings from tightening to loosening has seen the usual suspects lead the market's charge: high yield and cyclical stocks with large materials stocks, banks, property trusts and infrastructure leading the way. We view this grouping of stocks as expensive (and risky), hence much of the damage was done by stocks not owned.

In portfolio moves, NZ telco **Spark** was added as we see it as one of very few high yield, low risk companies trading at a fair valuation. We also added a small position in **Webjet** as we are attracted to the long term outlook of its B2B hotel bed wholesaling business which has been going from strength to strength despite a somewhat soft travel market. Logistics provider Qube was exited on valuation grounds after a strong run while we added to positions in a handful of stocks, including the aforementioned Star. In addition to Link, positions in Aristocrat and Nine were trimmed due to strong share price performance.

Performance summary

	Qtr	1 Yr	3 Yrs	5 Yrs
Returns				
Fund (1)	0.6%	-1.5%	7.3%	8.6%
Market (ASX300)	8.1%	11.4%	12.7%	8.8%
– Excess return	-7.4%	-12.9%	-5.4%	-0.3%
– Correlation				
Analytics				
Information ratio – ABIF		-2.13	-1.01	-0.04
Tracking error		6.05%	5.37%	6.89%
Sharpe ratio – ABIF		-0.61	0.90	0.87
Sharpe ratio – market		0.84	1.13	0.56

Key portfolio changes

Additions/up-weights

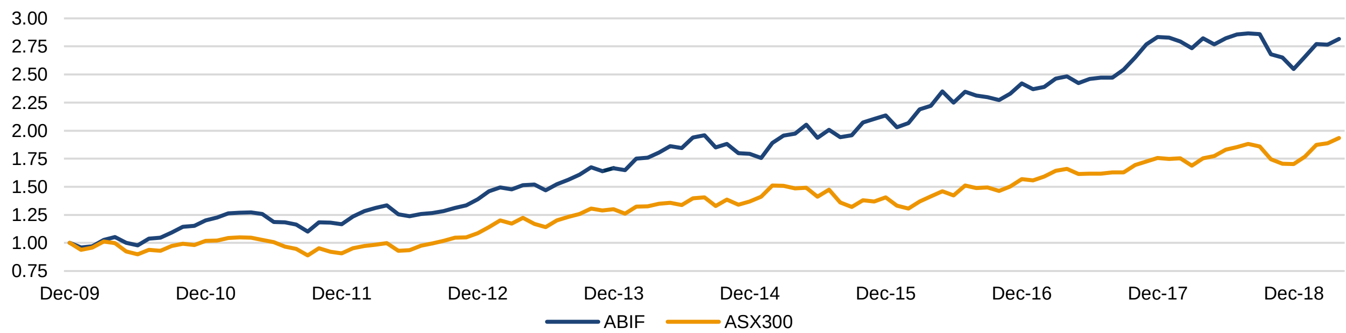
Additions
SPK, WEB
Up-weights
SCG, AMC, MQG, SGR, CYB

Deletions/down weights

Deletions
QUB
Down-weights
TAH, QBE, LNK, NEC, ALL

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

Cumulative returns since inception



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