ARCO Investment Management
ARCO Benchmark Independent Fund

Monthly report: May 2018

A consecutive positive month for equity markets though a bumpy ride for investors as volatility rose again, stirred by global geo-political events. Locally, credit constraints showed further evidence of economic impact which we think are more broadly-based than many realise.

Equities rally for 2nd month in a row | Elevated volatility levels return | Credit squeeze making an impact

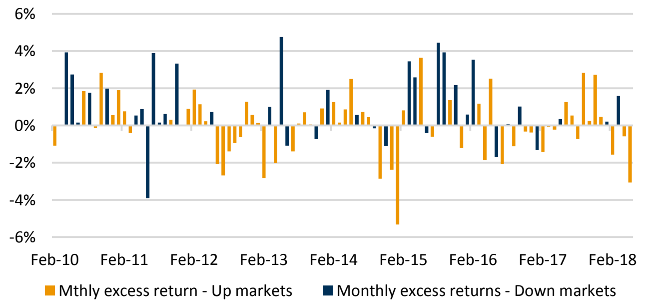
	Month	Qtr	1 Year	3 Year	Life (p.a.)
Price NAV	1.1694				
Fund (a)	-1.87%	-0.9%	14.2%	10.5%	12.9%
ASX300 Accum	1.19%	1.1%	9.6%	5.8%	7.2%

(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	Materials, banks, transport
Negative	Healthcare, energy, retail
Top Active	O/w – NUF, JHG, LNK, QUB U/w – CBA, WBC, ANZ, NAB

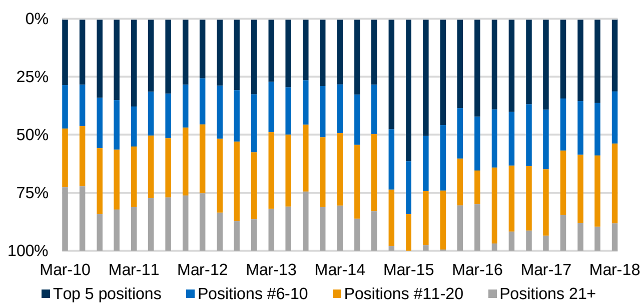
Performance: monthly excess returns



Sector weightings

	ASX300	ABIF	Active
Consumer discretionary	4.8%	16.5%	11.7%
Consumer staples	7.9%	6.1%	-1.8%
Energy	5.5%	5.4%	-0.1%
Financials	32.9%	11.0%	-21.9%
Healthcare	8.0%	0.0%	-8.0%
Industrials	7.4%	10.4%	3.0%
IT	2.4%	10.3%	7.9%
Materials	18.4%	40.3%	21.9%
Real Estate	8.0%	0.0%	-8.0%
Telecommunications	2.7%	0.0%	-2.7%
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 -1.87% for the month and is +14.2% for the year ending May.

May was another positive, though volatile, month for local equity markets. The Federal Budget had no real impact on local markets (again), the RBA maintained its cautious and accommodative position (for the 19th consecutive month) and the Royal Commission continued to shed light on the pain to come for the banking sector, its customers (through tighter credit) and shareholders – i.e. most of us.

Offshore events drove notable volatility in our markets during the month. The ongoing China/US trade squabbles and the US retreat from the Iran nuclear deal, (and resultant rise in oil prices to a 4 year high), drove the US 10yr bond yield through 3% and to its highest level since 2011. The bunga-bungle of Italian politics then increased market unease toward the end of the month and 'risk off' sentiment drove US yields lower, spreads on European debt wider and local equity markets turned softer.

We continue to spend a significant amount of time researching the impact of a much more difficult credit environment on the local economy and markets. This is not only to re-test our view on banks but also in recognition of the many multiplier effects on local stocks. It is difficult to imagine that property prices will not take a material hit. Corelogic noted during the month that national dwelling price growth fell for the year to April and to a six year low. Developers are highlighting project risks emanating from the credit squeeze on their buyers with elevated stridency. Home equity drawdowns have been a big part of consumer expenditure for a long time in Australia, and that cycle now seems set to reverse.

Our broad view by month end was that equity market headwinds are building again.

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Performance review

In a broadly positive month for the local equity market, the Fund's resource and material stocks were the primary positive driver of returns.

BHP, NuFarm, Atlas Iron, Lynas (both since trimmed) and also Super Retail Group (since exited) were notable positive contributors to Fund performance during May.

Disappointingly, two of our long-held positions represented a significant drag on the portfolio's overall performance – Link and AHG.

Link had annoyed shareholders (us among them) with an equity raise in April, without any immediate investment need. With this backdrop, the reaction to an unexpected earnings hit flowing from the changes to low-balance and inactive super accounts in the Govt's 2018-19 budget was severe, with the stock down 17% for the month. We continue to hold Link as the stock trades below our view of fair value, with little credit for the solidly accretive purchase of Capita.

We have held an investment in AHG for several months, attracted by a much improved management dynamic under new-ish CEO McConnell in terms of improved capital allocation and cost-out, overlaid by early signs of a recovery in WA vehicle sales, which have long been depressed. AHG's earnings downgrade during the month was certainly not part of our thesis, although we think the stock price at these re-based levels has overly discounted this development.

We initiated positions in Fairfax Media and JB Hi-Fi during the month, attracted to each by the recent retracement of its share price compared to our fair value assessment for the company.

Performance summary

	Qtr	1 Yr	3 Yrs	5 Yrs
Returns				
Fund (1)	-0.9%	14.2%	10.5%	12.8%
Market (ASX300)	1.1%	9.6%	5.8%	8.7%
– Excess return	-2.0%	4.6%	4.7%	4.1%
– Correlation		-0.25	-0.37	-0.30
Analytics				
Information ratio – OBIF		0.79	0.77	0.64
Tracking error		5.9%	6.0%	6.3%
Sharpe ratio – ABIF		2.0	1.3	1.6
Sharpe ratio – market		1.0	0.4	0.5

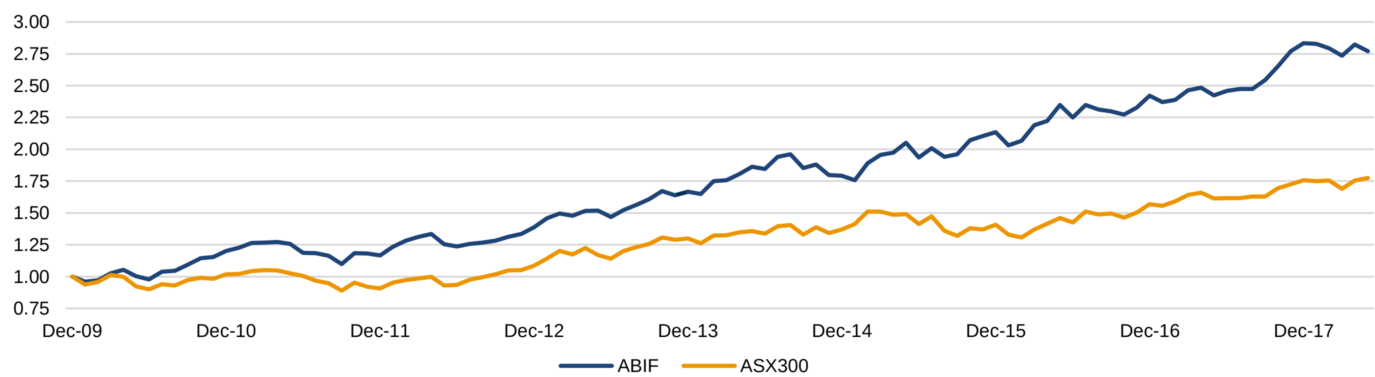
Note (1): Returns from the long portfolio of the ARCO Absolute Trust to Jun16, actual Fund returns thereafter.

Key portfolio changes

Additions/up-weights
Additions
TAH, FXJ, JBH
Up-weights
JHX, AHG, CTX, NUF, LNK

Deletions/down weights
Deletions
TLS, WFD, TCL, SUL, WPL
Down-weights
CYB, AGO, ORE, LYC

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