

# ARCO Investment Management

## ARCO Benchmark Independent Fund

Monthly report: September 2018

The local equity market finally takes a breather and rising bond yields demand more investor attention. Equity risks remain broadly elevated: high valuations set against slowing growth, rising term interest rates, tightening credit standards and unsettling local and geo-politics.

Local equity markets retreat

AUD-USD 10yr yield gap widens

Beware offshore capital flow risk

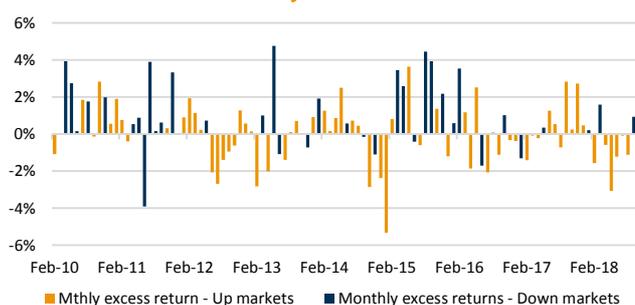
	Month	Qtr	1 Year	3 Year	Life (p.a.)
Price NAV	1.0570				
Fund (a)	-0.23%	1.2%	12.4%	13.4%	12.7%
ASX300 Accum	-1.19%	1.5%	14.0%	12.0%	7.5%

(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	Resources, energy, consumer services
Negative	Media, materials
Top Active	
	O/w – TAH, FXJ, CTX, MIN U/w – CBA, WBC, CSL, NAB

### Performance: monthly excess returns



### 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 -0.23% for the month, (ASX300A gross return of -1.19%).

The local equity market took a breather in September from its strong run over recent months, recording its first negative return since March. Australia was the worst performing of the developed equity markets, with a number of factors weighing on returns: interest rates, credit conditions, currency and valuation levels.

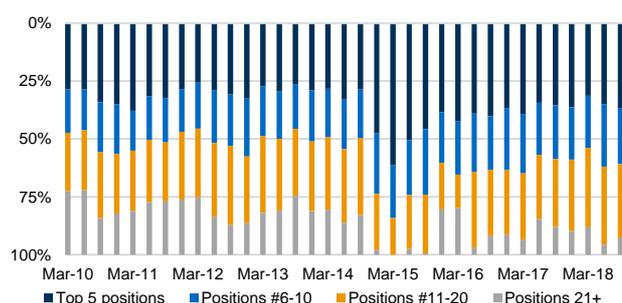
Rising bond yields, unless accompanied by rising earnings growth, are a problem for equities both directly (the discount rate) and indirectly, through attitudinal change in investor risk tolerance. USD term bond yields have broken out in a convincing manner. Local term yields have moved up in sympathy, but the AUD-USD 10-year bond spread has further inverted, to -50 bps: a post-1981 high. This speaks to continued weakness in the AUD, which is rapidly losing its status as a 'carry' currency in the eyes of fixed income investors. Offshore coupon-seeking money is a very big (and historically very unusual) part of our equity market as well, and this remains another risk factor, especially for high-PE stocks.

A steeper yield curve is usually interpreted as a signal of economic strength. In Australia's case, the curve seems pulled between term reversion in the US and the likelihood that the RBA remains pinned-down on short rates due to concerns over the property market and broader economic fragility. Financials are the obvious play from a steepening curve but still appear fraught with risk to us, commanding high multiples for very little growth, even prior to the impact of the Royal Commission on costs, credit creation, credit quality and potential liability risk.

### Sector weightings

	ASX300	ABIF	Active
Consumer discretionary	4.5%	8.3%	3.8%
Consumer staples	8.0%	4.7%	-3.3%
Energy	5.6%	7.4%	1.8%
Financials	32.3%	10.8%	-21.5%
Healthcare	9.3%	0.0%	-9.3%
Industrials	7.6%	12.5%	4.9%
IT	2.2%	9.0%	6.8%
Materials	17.1%	38.7%	21.6%
Real Estate	7.8%	0.0%	-7.8%
Telecommunications	3.7%	8.7%	5.0%
Utilities	1.9%	0.0%	-1.9%

### Stock concentration - % of equity exposure



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### Performance review

September was a healthy reminder that stock valuations matter and that relative value to other asset classes (esp bonds) does too.

We noted through the August earnings season that we were in one of those market junctures where facts didn't seem to matter much to stock prices. It's under precisely those sort of conditions that prudent risk management requires maintaining a focus on applying a disciplined valuation lens to stock prices (and some cash reserve), with the expectation of stock reversion to more rational prices.

Despite the down-month for the broader market, the Fund had some notably

positive contributors in BHP, Mineral Resources and Tabcorp.

We also took advantage of weaker prices during September to further diversify our holdings. The portfolio now straddles two broad themes. First, we own a core group of stocks trading well under our view of fair value and which feature defensive cash flows. In this category are Fairfax, Tabcorp, Caltex, Downer, HT1 and Link.

We have supplemented these holdings with selective higher-beta stocks which have been smashed-up in price terms and which represent low multiples of strongly growing cash flows. Mineral Resources is in this category whereby

we believe its current equity valuation is attractive on the basis of the company's mining services cash flows alone, with a heavy discount applied to the company's Wodgina asset which is nearing a critical price discovery point.

Lynas Corp is a stock of similar interest to us. We have recently begun to rebuild our holding, having more than halved our investment at higher price levels on the initial news of the Malaysian Government review of the LAMP facility. Recent news on this risk exposure has improved and we find it very difficult to rationalise the company's loss of over half its capitalisation in terms of economic value risk.

### Performance summary

	Qtr	1 Yr	3 Yrs	5 Yrs
<b>Returns</b>				
Fund (1)	1.2%	12.4%	13.4%	12.2%
Market (ASX300)	1.5%	14.0%	12.0%	8.1%
- Excess return	-0.3%	-1.6%	1.4%	4.1%
- Correlation		-0.30	-0.24	-0.31
<b>Analytics</b>				
Information ratio – OBIF		-0.30	0.27	0.64
Tracking error		5.3%	5.2%	6.3%
Sharpe ratio – ABIF		1.8	2.1	1.5
Sharpe ratio – market		1.7	1.3	0.6

### Key portfolio changes

#### Additions/up-weights

##### Additions

PLS, TCL

##### Up-weights

LYC, HT1, ORE, RRL, LNK

#### Deletions/down weights

##### Deletions

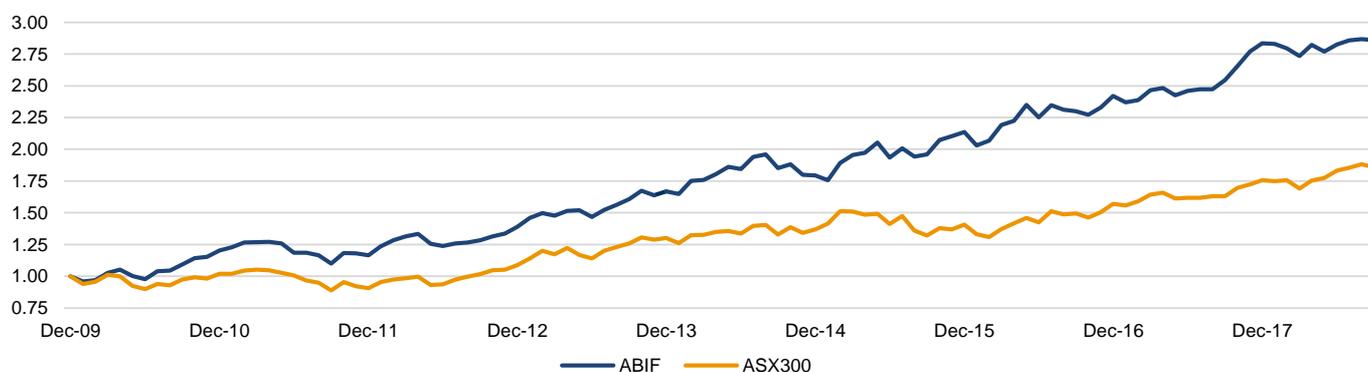
Nil

##### Down-weights

WES, BHP, JHG

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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