

ARCO Investment Management

ARCO Absolute Trust

Monthly report: December 2017

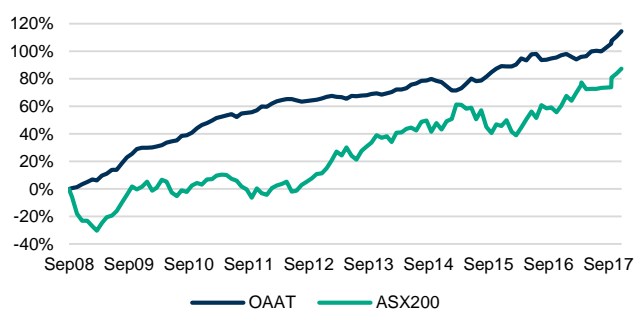
December capped a very strong quarter for the equity market, supported by significant M&A activity, rising commodity prices, US tax policy (again) and traditional festive cheer. The new year's party will likely flow into 2018, but so might the hangover!

| Performance | Month | Qtr | 1 Year | 3Yr(pa) | Life (pa) |
|-------------------|-------|-------|--------|---------|-----------|
| Fund return (net) | 1.76% | 4.47% | 8.45% | 7.06% | 8.55% |
| Positive months | | | 75% | 75% | 80% |
| Worst month | | | | | (2.3%) |
| Volatility | | | | | 3.8% |
| Sharpe ratio | | | | | 1.26 |

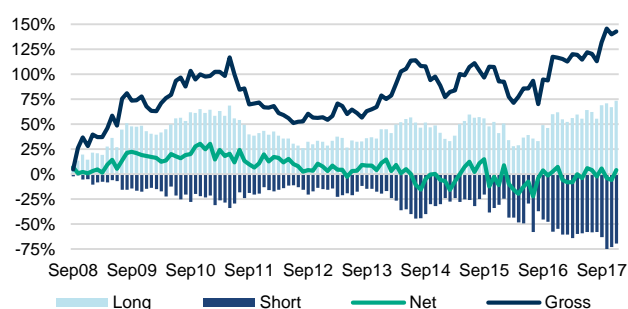
Monthly key contributors – by sector

| Longs | |
|----------|--------------------------------------|
| Positive | Resources, REITs, telecommunications |
| Negative | Retail, transport |
| Shorts | |
| Positive | Building materials, REITs |
| Negative | Insurance, industrials |

Cumulative performance



Fund investment profile (% NAV)



Portfolio settings

| % of NAV | Long | Short |
|----------------|-------|--------|
| Equities | 73.5% | -36.4% |
| Debt/ Hybrids | 0% | 0% |
| Derivatives | | -32.9% |
| Gross exposure | | 142.8% |
| Net exposure | | 4.2% |

| Concentration by position | Long | Short |
|---------------------------|-------|---------|
| Top 5 | 25.6% | (18.7%) |
| Top 10 | 43.5% | (31.3%) |
| Top 15 | 56.7% | (36.4%) |

Fund strategy and outlook

The Trust's objective is to steadily compound investor returns over time through stock alpha generation, with an overarching focus on capital preservation.

The Trust recorded a net return of +1.8% for the month, ending the calendar year up 8.45%, the 10th consecutive calendar year of positive returns since its inception in 2008.

Moving into 2018, the key themes that have driven markets may continue: better global growth and higher employment in developed economies prompting long-overdue household income growth, promising higher business investment in more tax-advantaged jurisdictions. This remains a solid backdrop for equities, but one that is substantially priced-in in our view, given very high valuations. What could derail this rosy picture? Watch bond yields carefully, and inflation indicators even more so, in view of the break-out in commodity prices and tightening in labour markets over the last six months. Watch geopolitics, which could again cut across the recovering Japan/China narrative.

Locally, commodities remain one of the very few bright spots. We remain mindful of little-to-no real wages growth for local households burdened by high debt levels, and now confronting a much weaker (or negative) wealth effect from softening property prices. The AUD-USD 10 year yield spread at c15bps signals investor expectations of continuing low inflation. If correct, this affords little room for companies to lift pricing, unless they produce retail energy. (Alternatively, a reversion in this spread reverts to more normalised levels will exacerbate the impact of a rising USD yield curve: an ugly outlook for the yield-based darlings of our equity market). Local employment numbers, while solid, point to a significant 'casualisation' of our workforce with the banking sector indicating around 20,000 job losses in their near-term plans which is hardly supportive of wage growth. RBA action (inaction) continues to be a balancing act between supporting a broad-based economic growth agenda and supporting inflated property (and equity) values.

In this market, there are almost as many short (expensive stocks) opportunities as there are long (cheap stocks) and we would not be surprised to see the ASX200 (price) Index repeat 2017's 50% negative performance months over 2018.

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Performance review

We extended the Trust's gross market exposure during December, and retained its overall neutral net market exposure.

Unsurprisingly, the portfolio's long positions dominated December's performance result.

We initiated a position in BHP, which has looked increasingly attractive on our fair value model for some time – despite our concern over spot iron ore pricing. In combination with our positions in LYC, ORE, and TAW, the Fund's resources exposure drove solid returns.

Our long-held exposure to WFD was rewarded by its price rally on the back of Westfield's announced sale to Unibail-Rodamco. TLS was also a notably positive contributor as the stock recovered some of its previous sell-off, which was well-overdone in our view, despite an indifferent medium-term outlook.

AHG and QUB were modest negative performers in our long portfolio though we retain our conviction in these stocks with a positive outlook fuelled by the relative strength of each in their respective sectors and earnings growth expected from both.

The Fund's short portfolio was a negative contributor to performance overall. However, 60% of our individual stock short positions were positive performers during December, with select insurance and industrial shorts being the principle detractors.

We retain our cautious view of the local banking sector which we expect to continue to struggle in 2018 with low earning growth, adverse credit quality, restructuring and political risks representing headwinds blowing strongly in the face of still attractive dividend yields.

ARCO Absolute Trust – monthly returns

| | Jul | Aug | Sep | Oct | Nov | Dec | Jan | Feb | Mar | Apr | May | Jun | FY |
|------|---------|---------|-------|---------|---------|---------|---------|---------|---------|---------|-------|---------|--------|
| FY18 | 0.24% | (0.29%) | 2.79% | 1.08% | 1.57% | 1.76% | | | | | | | 7.33% |
| FY17 | (2.28%) | 0.02% | 0.56% | 0.35% | 0.95% | 0.29% | (1.00%) | (0.98%) | 0.94% | 0.07% | 0.17% | 1.88% | 0.93% |
| FY16 | 0.31% | 1.52% | 1.79% | 1.42% | 1.01% | (0.11%) | 0.02% | 0.77% | 2.34% | (0.69%) | 2.29% | 0.11% | 11.21% |
| FY15 | 1.03% | 0.06% | 0.64% | (0.71%) | (0.53%) | (1.53%) | (1.88%) | (0.08%) | 0.98% | 1.96% | 2.04% | (1.09%) | 0.80% |
| FY14 | 0.36% | 0.14% | 0.43% | 0.32% | (0.52%) | 0.54% | 0.57% | 1.06% | 0.04% | 0.57% | 1.38% | 0.63% | 5.64% |
| FY13 | (0.54%) | 0.26% | 0.29% | 0.37% | 0.57% | 0.66% | 0.46% | (0.50%) | (0.06%) | (0.70%) | 1.22% | (0.18%) | 1.86% |
| FY12 | 1.69% | 0.29% | 0.29% | 0.97% | 1.63% | (0.09%) | 1.51% | 1.03% | 0.46% | 0.46% | 0.00% | (0.60%) | 7.88% |
| FY11 | 2.34% | 0.36% | 1.45% | 2.23% | 1.66% | 0.86% | 1.36% | 1.26% | 0.50% | 0.74% | 0.57% | (1.38%) | 12.57% |
| FY10 | 4.00% | 3.88% | 2.00% | 2.68% | 0.78% | 0.09% | 0.17% | 0.52% | 0.68% | 1.45% | 0.59% | 0.57% | 18.75% |
| FY09 | | | 0.67% | 0.59% | 2.19% | 1.47% | 1.81% | (0.56%) | 3.10% | 1.37% | 2.43% | 0.09% | 13.90% |

Note: returns are net of all fees and assume reinvestment of distributions. Fund inception date 15/09/08.

ARCO Absolute trust – distribution history

| Y/e June | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|----------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Series 1 units | \$1.23 | \$1.31 | \$2.03 | \$0.41 | \$0.12 | \$0.34 | \$0.46 | \$0.71 | \$0.43 |

Fund facts

| | |
|--------------------|---|
| Initial series NAV | \$11.306 |
| Strategy | Long-short Australian equities |
| Objective | Positive returns in all market conditions. Overarching focus on capital protection |
| Firm AUM | \$138m |

| | |
|------------------------|----------------------------------|
| Distribution frequency | Yearly (bi-yearly in FY 2016) |
| Minimum investment | Wholesale investors only, \$100k |
| APIR Code | OPT0001AU |
| ISIN | AU60OPT0014 |
| Fund Inception | 15/9/08 (@ \$10.00 per unit) |

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

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