

ARCO Investment Management

ARCO Absolute Trust

Monthly report: May 2018

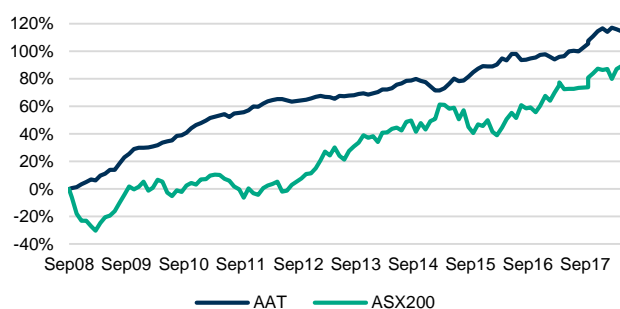
A consecutive positive month for equity markets though a bumpy ride for investors as volatility rose again, stirred by global geo-political events. Locally, credit constraints showed further evidence of economic impact which we think are more broadly-based than many realise.

Performance	Month	Qtr	1 Year	3Yr(pa)	Life (pa)
Fund return (net)	-0.65%	0.19%	9.26%	5.99%	8.17%
Positive months			67%	72%	79%
Worst month					(2.3%)
Volatility					3.8%
Sharpe ratio					1.2

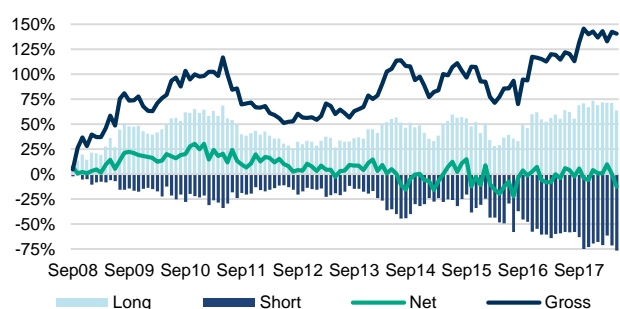
Monthly key contributors – by sector

Longs	25 positions
Positive	Resources, REITs
Negative	Retail, Diversified Financials, Teleco
Shorts	16 positions
Positive	Banks, building materials
Negative	Media, REITs

Cumulative performance



Fund investment profile (% NAV)



Portfolio settings

% of NAV	Long	Short
Equities	63.9%	-40.5%
Debt/ Hybrids	0%	0%
Derivatives		-36.1%
Gross exposure		140.4%
Net exposure		-12.7%
Concentration by position	Long	Short
Top 5	23.9%	(19.3%)
Top 10	39.0%	(32.2%)
Top 15	51.3%	(39.7%)

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 -0.65% for the month.

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-bunga 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 market headwinds are building again. Consistent with our objective to minimise investor downside risk, we moved the portfolio risk settings to a modest net short market exposure.

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Performance review

In a broadly positive month for the local equity market, the Fund's resource stocks were again the primary positive driver of returns and it was pleasing that the Fund's short portfolio finished close to square for the month.

BHP, NuFarm, Atlas Iron, Lynas (both since trimmed) and also Super Retail Group (since exited) were notable positive contributors to Fund performance during May, along with our continued short exposure to select banking and building material stocks.

Disappointingly, two of our long positions represented a significant drag on the portfolio's overall performance – Link and AHG. Ex these two stocks, the portfolio generated solid returns.

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.

Short positions in more interest rate sensitive stocks were a modest drag on the May result though we continue to see increasing downside risk to the price of these stocks and retain our short exposure.

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.

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%	0.91%	(1.16%)	1.39%	(0.54%)	(0.65%)		7.25%
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	\$11.298
Strategy	Long-short Australian equities
Objective	Positive returns in all market conditions. Overarching focus on capital protection
Firm AUM	\$145m

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)

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