

Ardea Real Outcome Fund

ARSN 158 996 699 APIR Code HOW0098AU

Monthly Performance Report July 2023

Performance ¹	1 month	3 months	1 year	2 year	3 year	5 year	Inception
Fund	0.88	0.86	5.82	1.71	1.76	3.87	3.68
Benchmark ²	0.60	1.15	6.02	6.27	5.36	3.52	2.66
Excess Return	0.28	-0.30	-0.20	-4.56	-3.60	0.36	1.02

¹ Performance figures are calculated after fees have been deducted and assume distributions have been reinvested. No allowance is made for tax when calculating these figures. Past performance is not a reliable indicator of future performance.

² The Fund benchmark is the Australian Consumer Price Index.

Source: Fidante Partners Limited, 31 July 2023.

Fund Features

Unique 'relative value' investment strategy: The Fund adopts a relative value investment strategy to access a range of fixed income return sources that are independent of interest rates.

Tight risk control: The Fund specifically targets low volatility returns by using a range of risk management strategies.

Diversification benefits: The Fund offers significant diversification benefits when combined with conventional bond, credit and equity investments in an investment portfolio.

Capital preservation: The Fund prioritises capital preservation by only investing in high quality government bonds, related derivatives and cash like investments. However, the Fund is not guaranteed.

Protect long term purchasing power: The Fund explicitly targets a return exceeding Australian inflation rates to protect long term purchasing power.

Daily liquidity: The Fund only invests in the most liquid segments of global fixed income markets.

Experienced and stable investment team: Ardea's investment team has decades of experience across global fixed income markets. Majority employee ownership of the Ardea business fosters team stability.

Fund Facts

Portfolio Manager	Ardea Investment Management
Investment Objective	The Fund targets low volatility returns exceeding cash rates and inflation, by investing in a global portfolio of high quality government bonds that prioritises capital preservation and liquidity.
Investment Horizon	Recommended min. 2 years
Inception Date	20 July 2012
Fund Size	\$6.8bn
Management Fee	0.50% p.a.
Buy/Sell Spread	+0.05% / -0.05%
Distribution Frequency	Quarterly

Sector Exposure		Rating Exposure		Risk Contribution by Currency	
Government – National	62%	AAA	58%	AUD	33%
Government - State	38%	AA	40%	CAD	7%
Total	100%	A	3%	EUR	16%
		Total	100%	JPY	1%
				NZD	0%
				GBP	14%
				USD	29%
				Total	100%

Source: Ardea Investment Management, S&P Ratings

Portfolio Commentary

Fund performance for the month of July was +0.9%.

July was a relatively quieter month for bonds markets, while risk assets continued to rally. Both US and Australian shares rose strongly, with a 3% increase. Year-to-date the S&P500 is up 19.5%. These gains were largely driven by softer-than-expected inflation data in the US and Australia, which led to the belief that the need for further rate hikes might be reduced. Consequently, the consensus macro narrative now revolves around the idea that rate hikes are nearing completion, and the risk of a recession has been averted. The risk to this 'goldilocks consensus' scenario is that central banks over tighten and then need to cut quicker as economies weaken.

The U.S. Federal Reserve indicated that it no longer expects a recession, and with slowing inflation, steady unemployment, GDP growth and consumer spending encourage investors that a soft landing was possible. In the bond market, 10-year Australian government bonds ended the month slightly higher at 4.06% and remained within the range observed since mid-last year (3.3%- 4.1%). In contrast, US 10-year yields increased 16bpts to 3.97%, nearing a 15-year high. The US Treasury is planning to issue more than USD 1 trillion of bonds and bills in the coming three months, while the supply of government bonds in the UK and Europe is also expected to increase dramatically in the near term. This situation is exasperated in the United Kingdom where the Bank of England is actively scaling back the size of its Gilt portfolio (UK government bonds).

The Federal Open Market Committee (FOMC) and European Central Bank (ECB) both raised rates by 25 basis points despite the improving outlook for inflation, the market is divided on whether there will a need for further rate increases. Any future rate increases will be driven by economic data, as the Fed and ECB closely monitor inflation to ensure it stays on track to reach their targets. The Bank of England (BOE) did not meet in July, but it is expected to increase rates at the early August meeting.

Looking ahead, the second half of the year is unlikely to witness aggressive monetary policy increases like those seen in the first half, as the lag effects from the previous tightening measures are still to fully flow through. Inflation is likely to remain in the headlines into next year, as there is a risk that inflation may not retreat as quickly as the market expects, and core inflation could remain stubbornly higher. The expectation is rates will remain higher for longer as inflation remains above targeted bands.

The Reserve Bank of Australia (RBA) left rates unchanged at both the July and 2nd August meetings, to allow for further time to assess the impact of the interest rate increases to date and the economic outlook. The RBA noted that inflation is declining but remains too high and expects CPI inflation to be back within the 2–3 per cent target range in late 2025 (from mid-2025). Most economists are anticipating another 1 to 2 tightening's in the coming months. In Japan, the BOJ eased its yield curve control policy, which caps 10-year bond yields and is a form of tightening, resulting in yields reaching 9-year highs as the BOJ sees a higher risk to inflation in the nearer term.

The Fund's relative value strategies performed in July adding (0.6%) with bond verses derivative and relative value (RV) micro curve positions performing well. Bond basis trades were the primary drivers of performance over the month, with received basis swap in Australia (benefitting from a marginal swap spread widening) and paid (short) basis positions in Japan adding the most value. A short basis exposure to the long end of the US Treasury curve also added value. These bond verses derivative trades are designed to exploit changes in the price of physical (government) bonds relative to interest rate derivatives.

The lower than forecast US inflation print and the Federal Reserve's comments around avoiding recession was supportive of curve trades with a steepening bias and longer-dated paid (short) positions, most notably in Australia and the United States. Yield curves across many developed market economies remain inverted (AUD is flat), although less so, as front-end yields rallied on average in July as the prospect for further tightening's declined, while longer dated bond yields mostly rose over the month. Rates trades, which reflect performance related to neutralising bond duration exposure also added value to performance. Option positions (used for RV and risk balance) detracted over the month as volatility levels moved lower with position in USD and EUR the main detractors. Inflation beta positions detracted slightly while the funds beta exposure to cash continued to add to returns.

Looking ahead, we view interest rate curves as now being unanchored (not bound by zero rates or impacted by quantitative easing), as central banks, who were previously volatility suppressors, become volatility amplifiers during their quantitative tightening implementation. Increased government bond issuance, particularly in Europe and the UK is also adding to price volatility, leading us to anticipate structurally higher volatility levels over coming periods. The Fund's structurally long volatility positions, with the favourable asymmetric payoff profile, should provide significant upside potential against modest downside risk in this environment. The RV (relative value) environment although erratic over shorter time frames remains very fertile, particularly Bond RV in Europe and the UK, with numerous opportunities at stretched levels available for the fund to benefit from across markets.

Market Commentary

Please see the Insights section of the [Ardea website](#) for our latest thoughts on markets and investment themes.

Understanding Performance

Performance is evaluated over rolling 2 year periods for consistency with the recommended minimum investment horizon of 2 years. Over short-term horizons it is expected that portfolio performance will fluctuate in a range around the expected long-term investment outcome, including periods of negative returns. This is because the Fund's targeted return is not expected to materialise evenly over the investment horizon.

We use the concept of 'expected performance variability' to objectively define a range of short-term performance fluctuation that is consistent with the investment strategy operating as expected. This range is based on the Fund's volatility target of 2% p.a. and translates to an expectation for monthly performance to commonly fluctuate in a range of -0.4% to +0.7%.

The Fund's highly differentiated investment approach generates returns exclusively from capturing RV mispricing opportunities across global interest rate markets. This approach is intentionally independent of the level of bond yields, the direction of interest rates and broader bond market themes.

The Fund's portfolio construction process intentionally diversifies risk across many different types of independent and modestly sized RV trades. Therefore, performance is the cumulative result of interactions between hundreds of trades entered, exited, and held over the preceding months.

For these reasons, the Fund's performance is ordinarily not driven by a few key trades, nor can it be mapped to broader market fluctuations or macro themes. This is intentional, because the Fund aims to deliver volatility controlled returns that exhibit low correlation to the performance of government bond, credit, and equity markets. This is precisely why the Fund can offer compelling diversification benefits when combined with conventional investments.

Please note that monthly performance attribution is heavily influenced by short-term 'noise' and ordinarily offers little genuine information value.

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