

Ardea Real Outcome Fund

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Monthly Performance Report September 2022

Performance ¹	1 month	3 months	1 year	2 year	3 year	5 year	Inception
Fund	1.83%	0.33%	0.96%	0.68%	2.27%	3.76%	3.66%
Benchmark ²	0.40%	1.61%	7.04%	5.01%	3.55%	2.84%	2.39%
Excess Return	1.43%	-1.28%	-6.08%	-4.33%	-1.28%	0.92%	1.27%

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, 30 September 2022.

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	\$8.9bn
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	70%	AAA	56%	AUD	27%
Government - State	30%	AA	35%	CAD	20%
Total	100%	A	9%	EUR	10%
		Total	100%	JPY	0%
				NZD	1%
				GBP	9%
				USD	32%
				Total	100%

Source: Ardea Investment Management, S&P Ratings

Portfolio Commentary

Performance for the month of September was +1.83% (after fees).

An already tough year for markets worsened in September. The scale of drawdowns and level of volatility is the highest in decades in some asset classes. The Bloomberg Global Government Bond Index fell another 5% in September, taking year-to-date declines to 20% as major market yields hit the highest levels in a decade or longer. Global equity markets have experienced a similar sized correction, after registering 5-10% falls over the month. The global macro backdrop remains very challenging, as central banks aggressively tighten policy to fight historically high inflation into a slowing global economy. The Fed, ECB, BoE, BoC, RBA and other central banks all delivered outsized rate hikes in September. Further fuelling negative sentiment has been a crisis of market confidence in UK government policy, a continued major disruption to European energy supply and negative geopolitical headlines. Meanwhile, the extraordinary strength of the USD is causing headaches for other global central banks.

The UK has been a major driver of the September turmoil in global markets. GBP assets experienced EM-like volatility in the wake of the UK Government's budget update, which dramatically expanded fiscal policy at a time of high inflation and BoE quantitative tightening. Gilt yields experienced their largest ever daily and weekly increases in 30 years and the GBP fell sharply as markets questioned the credibility of the fiscal policy outlook. Subsequent BoE intervention and government statements aimed at easing market concerns saw only a very small retracement in yields late in the month (see this [note](#) for more detail on the UK market turmoil).

The UK situation highlights the risk of further policy-induced pressure on markets, as well as the limited flexibility of governments to respond to a rapid slow-down in growth, a constraint likely to worsen in 2023. The bullish and lower vol case for most assets requires a central bank policy pivot, which won't materialise without a convincing turn lower in inflation. As relative value investors, we see the opportunity set created by stressed bond markets as ultimately a positive for the outlook, as RV pricing relationships are stretched to extreme levels (see [here](#) for more detail).

The high volatility environment continues to benefit the Fund's net long position in interest rate options (+1.6%), which provide risk balance to the portfolio and are a source of RV opportunities. The increase in rates volatility was spread across curves and markets – AUD, USD, GBP and EUR positions added value in the month.

The Fund also benefited from changes in the shapes of yield curves (RV curve +0.5%). These positions are spread across global interest rate markets and are structured to minimise correlation with the broader macro themes that dominate conventional fixed income portfolios. For example, in the USD market, micro curve RV in the 0-5y sector – comprising long and short positions futures and swaps - were net contributors. Underlying RV themes vary but are typically targeting small mis-pricings in forward curves that arise due to flows and high uncertainty over the future path for interest rates. These trades require frequent rebalancing in volatile markets. Positions across the GBP curve also added value even through extreme volatility in this market. This outcome was mostly a function of positions in the long end of the Gilt and GBP swap curves. For example, in Gilts the Fund holds short positions in bonds that were trading relatively expensive on the curve and have subsequently underperformed in the wake of broader panicked selling and pressure on Liability Driven Investors (LDIs) to fund collateral calls in derivatives.

Performance was also supported by exposure to spreads between government bonds and derivatives (+0.3%). These gains were distributed across curves and markets. In general, the Fund is positioned around micro-RV in bonds, rather than broad up and down movements in the spread between bond and swap curves. Fiscal and bond supply concerns are starting to dominate price action in some markets, while other market technical factors are also influencing RV. For example, the big sell-off in the UK market, challenging liquidity conditions in bonds and subsequent BoE buying drove large under and then out performance of Gilts vs GBP swaps. In EUR, the front end of some bond curves is trading expensive vs swaps due to repo constraints and swap hedging flows, while long term bonds are comparatively cheaper on expectations of increased supply and the absence of ECB support.

The Fund's beta exposures were a detraction overall from performance. While the Fund benefits from a rising cash rate environment (+0.2% in the month), this was more than offset by a decline in the inflation beta component in September (-0.7%). Inflation beta exposures reflect modest-sized long positions in AUD inflation-linked securities. AUD market-based inflation expectations fell 30-40bp across most of the curve – the largest monthly decline since the onset of the Covid crisis in March 2020. While inflation is expected to remain near historically high levels in the near term, the scale of recent global monetary policy tightening and a slower growth outlook is projected to ultimately bring inflation lower. The market is pricing inflation readings to average near 5% over the next year, but less than 2.5% over the next decade (comfortably within the RBA's 2-3% target band).

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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