

# Ardea Real Outcome Fund

ARSN 158 996 699 APIR Code HOW0098AU

## Quarterly Performance Report December 2020

Performance <sup>1</sup>	1 month	3 months	FYTD	1 year	3 year	5 year	7 year	Inception
Fund	-0.11%	0.81%	2.66%	5.82%	5.80%	5.23%	4.40%	4.36%
Benchmark <sup>2</sup>	0.23%	0.37%	1.95%	0.37%	1.33%	1.47%	1.54%	1.75%
Excess Return	-0.34%	0.44%	0.71%	5.45%	4.47%	3.76%	2.86%	2.61%

<sup>1</sup> 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.

<sup>2</sup> The Fund benchmark is the Australian Consumer Price Index.

Source: Fidante Partners Limited, 31 December 2020.

### 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

<b>Portfolio Manager</b>	Ardea Investment Management
<b>Investment Objective</b>	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.
<b>Inception Date</b>	20 July 2012
<b>Fund Size</b>	\$6.6bn
<b>Management Fee</b>	0.50% p.a.
<b>Buy/Sell Spread</b>	+0.05% / -0.05%
<b>Distribution Frequency</b>	Quarterly

Sector Exposure	
Government – National	61%
Government - State	39%
<b>Total</b>	<b>100%</b>

Rating Exposure	
AAA	86%
AA	14%
<b>Total</b>	<b>100%</b>

Region Exposure*	
Australasia	37%
Europe	48%
N. America	16%
<b>Total</b>	<b>100%</b>

Interest Rate Duration (years)	
12 month average	0.5
Since inception average	0.2

\* Australasia = Australia, New Zealand, Japan; Europe = France, Germany, UK ; N. America = USA, Canada

Source: Ardea Investment Management, S&P Ratings

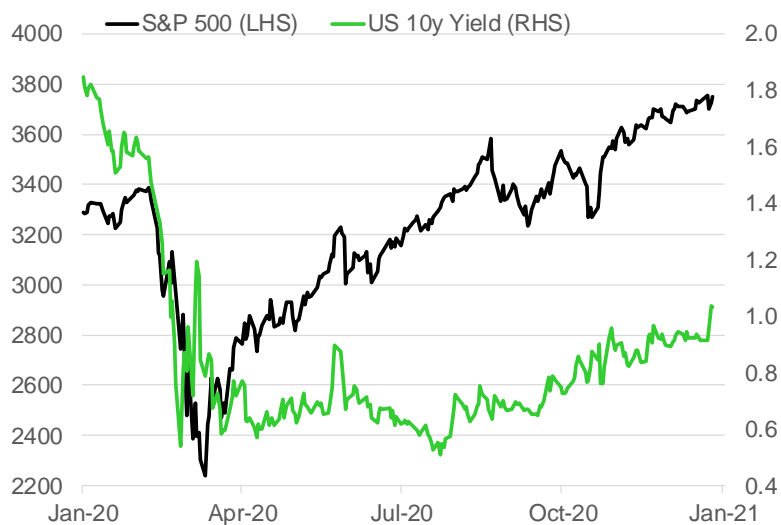
## Portfolio Commentary

Notable events for the quarter are summarised below and more detailed discussions of topical market themes are available here - [Ardea's market insights](#).

### What Happened?

In December, markets broadly continued down the positive risk and reflation path. Equities posted healthy monthly gains yet again (S&P 500 +3.7%, MSCI world +4.1%), sovereign bonds were mixed (US 10y yield +7bp, Bloomberg global treasuries index return +1.5%), credit spreads sustained tight ranges and the USD continued to fall (DXY -2.1%). These moves cap off an extraordinary year for markets, where a global pandemic drove one of the largest downturns in modern history, yet many asset prices rebounded sharply. Sovereign bonds also finished 2020 with solid gains, despite the weakness in some markets, such as US Treasuries, over the last month.

Chart 1: S&P 500 vs US 10y yield



Source: Ardea, Bloomberg

## Vaccine and fiscal policy optimism eclipses virus infection concerns

The dominant market narrative in December focused on the roll-out of COVID vaccines, which trials in November showed as highly effective. The massive task of delivering vaccinations got underway in the US, UK and Europe. There is a very long way to go before major economies see anything like herd immunity, but the fact the program has started before the end of 2020 supports the optimistic 2021 outlook underpinning current asset valuations.

So bright is this light at the end of the COVID tunnel that markets are willing to overlook rapidly rising case numbers in the northern hemisphere. Government mandated lockdowns and social distancing measures increased over the month in many countries, denting near term economic recovery prospects. Investor nerves were also tested by reports of new variants of COVID in the UK and South Africa.

Chart 2: COVID cases per million (7d MA)



Source: Deutsche Bank Exit Strategy Policy Tracker, 5-Jan-21

Beyond vaccines, policymakers continue to support market confidence. After much debate in Congress and uncertainty, late in December, US lawmakers agreed on a \$900bn stimulus package in time to avert a government shutdown. While markets had started to price this outcome in ahead of time, the confirmation of the package supported risk sentiment. Investors also began to contemplate a January Georgia senate race which had the potential to hand senate control to the Democrats – the market implication is widely thought to be a much larger fiscal spending package.

## Central banks: European Central Bank increases quantitative easing, other central banks maintain status quo

Beyond the fiscal and vaccine tailwinds, huge central bank liquidity flows continue to buoy asset prices. At their December meeting, the ECB announced plans for a further €500bn of new bond purchases and an extension of the QE program until March 2022. The ECB's aggregate stimulus for 2020 has now reached over €3tn. As outlined in a December Ardea [research note](#) on negative rates, there are broader implications of the latest round of ECB policy easing:

- **European bonds are resilient.** Euro sovereign bond markets have sustained low yields or seen new record low yield levels over the last two months, even in the face of very positive vaccine news.

- **QE viewed as critical to the recovery.** The ECB expects to continue buying bonds through 2021 even as growth is anticipated to rebound sharply with vaccinations rolled out across populations. Elevated unemployment and long held deflation fears remain front of mind for the central bank.
- **ECB bond demand set to exceed supply.** Market participants expect ECB QE to exceed the net new supply of bonds being issued in 2021 – an extraordinary outlook considering the record volumes of fiscal stimulus being thrown at economies.
- **More negative yielding peripheral debt.** Spanish and Portuguese 10y bond yields traded at negative yields for the first time in December – a far cry from the over 7% and 14% respective peaks seen through the sovereign debt crisis earlier this decade.

The total global pile of negative yielding debt reached a new record high of US\$18tn in December.

Chart 3: The market value of the global pool of negative yielding debt



Source: Ardea, Bloomberg

The US Federal Reserve (The Fed), somewhat surprisingly for many market participants, kept policy settings on-hold. There was widespread speculation the Fed would increase the duration of their portfolio to guard against the risk of a steeper curve amid market hopes for a recovery. Instead, the Federal Open Market Committee (FOMC) tweaked their qualitative guidance, committing to the current pace of asset purchases “until substantial further progress has been made toward the Committee’s maximum employment and price stability goals”.

The Reserve Bank of Australia (RBA) made no changes to policy in December after committing to substantially larger QE purchases in November. The implications of RBA liquidity injections continue to be felt by the market. In December, a small allocation in 3 month T-note tender cleared at a negative yield – the first ever sale of negative yielding nominal debt. In a [recent note](#) we showed this outcome reflected both the high levels of excess liquidity from the RBA and cross-currency basis levels.

### Why is it relevant?

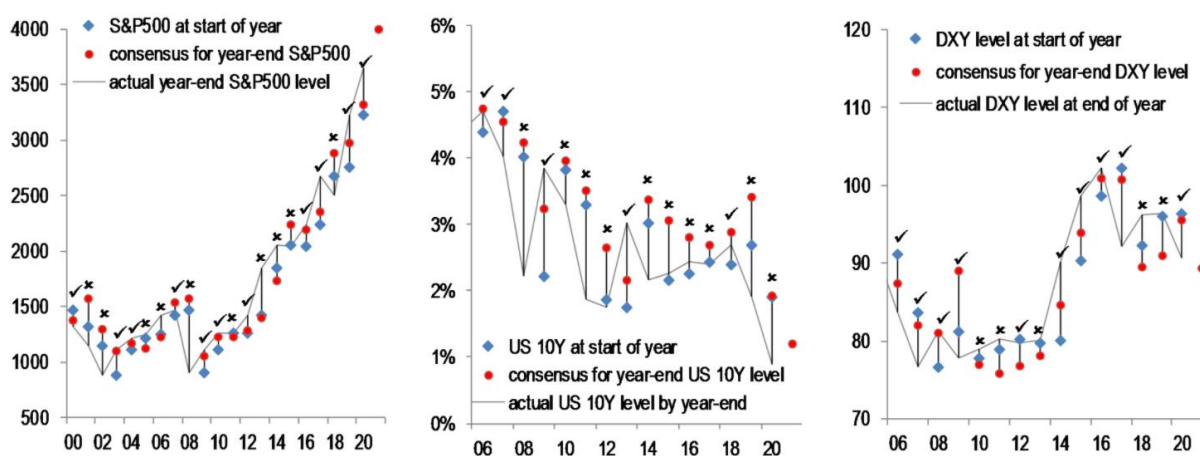
#### Risks to the positive 2021 consensus

The end of 2020, as with any other year, brings with it predictions and forecasts for the year ahead in markets. After such a tumultuous year, one might think the year ahead views would see a much greater than usual dispersion of views on asset returns and the global economy. Yet, generally investors and analysts seem to

have a broadly similar pro-growth/pro-risk narrative that extrapolates the last few months price action. Economies are expected to rebound strongly, stocks to post solid gains, while only a modest sell-off in developed market bonds ensues. Vaccines and stimulus from governments and central banks are expected to support asset prices.

Of course, it's worth having some healthy scepticism about consensus views. As the old market saying goes, "what is obvious is obviously wrong" – often referring to the risk of crowded investor positioning which can lead one to experience trading losses despite having the right macro or event call. Or perhaps some sort of new market driver or event risk emerging. JP Morgan strategists in December showed consensus forecasts have historically not been uniformly bad at predicting the direction of markets, but their track record varies considerably by asset. They showed that "consensus forecasts have correctly called the direction of US Treasury yields only 40% of the time, the S&P500 only 50% of the time, but the DXY (dollar) Index about 67% of the time". The historically less volatile bond market has been the harder call to get right!

Chart 4: Consensus vs actual outcomes for the S&P 500, the US 10y yield and DXY



Source: JP Morgan, 17-Dec-20

As for what could shake the optimistic 2021 market outlook, we suggest a few key risks:

- Virus mutates or vaccines don't work;
- Fiscal support is scaled back;
- Geopolitical volatility, such as trade wars, return to pre-covid ascendancy;
- Central banks foreshadow tighter policies.

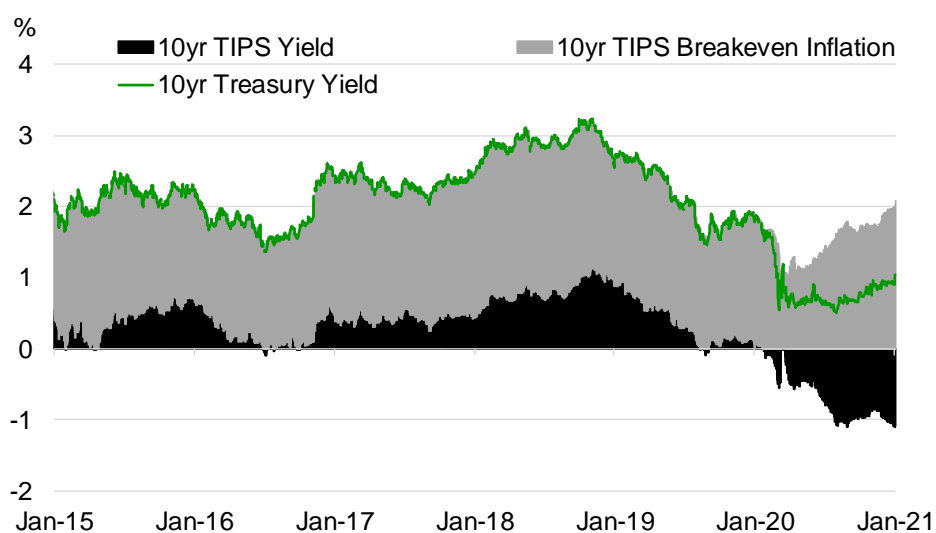
### Bond yields drifting higher and rising inflation expectations – a gathering storm?

Nominal bonds are starting to come under pressure, but at the time of writing in early January these moves remain modest by historical standards. The US 10y yield has drifted from 0.87% at the end of November to finally push over 1.0% in early January for the first time since March. The outlook for more fiscal policy and a vaccine-driven rebound in growth is supporting a repricing of long term rates.

Most investors and strategists see long term yields settling around 1.20-1.50% for US 10yrs in 2021 and a similar sized sell-off is envisaged in other developed markets (ECB actions make for a less bearish outlook in Europe, as discussed). These views are generally in line with or slightly above the forward curve. The reason for the conservatism is largely because of confidence that rate hikes are a very distant prospect, while Fed and central bank QE purchases should ultimately cap how much higher long term yields can go. Past experience suggests the Fed and other central banks will seek to lean against a destabilising sell-off, but the strike on this so-called Fed put is often much higher in yield than markets initially assume.

What could really damage confidence in this benign drift higher in rates is the re-emergence of inflationary pressure, a risk that is not being discounted heavily by economists but which the market is increasingly wary of. As we have discussed in recent market updates, the path for long term market implied inflation expectations has more closely tracked the rally in risk assets. As nominal rates have drifted slightly higher, real yields plummeted to near all-time lows at the end of December, propelling breakeven inflation rates higher (Chart 5). The entire US inflation curve is now above 2% and the 10yr breakeven level is at the highest level since 2018.

Chart 5: Decomposition of US 10y yield



Source: Ardea, Bloomberg

The inflation repricing speaks to the risk that massive monetary and particularly fiscal stimulus packages will counterbalance structural disinflationary forces. Actual inflation data remains very benign, which demonstrates how allocations to inflation-linked bonds only require a positive shift in the balance of risks to outperform significantly. Even at two year highs, market expectations for inflation of a bit over 2% are not yet at levels that materially threaten multi-asset portfolios. But if this rising “inflation risk premia” continues at its recent pace, then it could soon start to shake entrenched low levels of interest rate volatility and assumptions about the durability of central bank support for all asset prices.

In our [December market insights](#) note, we examine the risk of inflation and the implications for broader markets in much greater detail.

### How are we positioned?

The portfolio’s return for the month was negative.

Performance is driven by strategies that exploit specific ‘relative value’ (RV) mispricing between closely related fixed income securities. This is done in a way that isolates the RV mispricing from broader market movements, while maintaining minimal interest rate duration exposure and excluding all credit investments.

The portfolio is intentionally constructed with many modestly sized and diverse RV strategies that collectively contribute to overall portfolio performance. As the portfolio contains hundreds of individual positions, the commentary below focuses on just a few of the more noteworthy RV themes that contributed to performance over the period. (Further detail on the Fund’s pure ‘relative value’ investment approach is available [here](#).)

The main drivers of negative performance for the month came from the following strategy groups:

## - **RV Rates**

The portfolio holds a wide range of relative value long and short positions across multiple markets in bonds, swaps, futures and options. These positions require constant rebalancing as market conditions change. This rebalancing of positions led to longer positioning in some sectors of curves, notably in the 3-7y and 10-20y AUD bond and swap curves. These positions generated larger losses as yields lifted in December than gains from other short positions within the portfolio.

Noteworthy positive performance for the month came from the following strategy groups:

## - **Inflation**

The portfolio maintains a structural long exposure to inflation markets. As nominal rates have drifted slightly higher, real yields plummeted to near all-time lows at the end of December, propelling breakeven inflation rates (market-implied inflation expectations) higher. Actual inflation data remains historically subdued. The inflation repricing speaks to the risk that massive monetary and particularly fiscal stimulus packages will counterbalance structural disinflationary forces, as realised inflation levels remain low. Exposure to a level shift higher in inflation offset small losses from a relative value steepening position in the USD inflation curve.

## - **Volatility**

Implied volatility lifted modestly in December, which benefited long option positions mostly in AUD and EUR, which were implemented to take advantage of cheapness compared to realised volatility and to provide risk balance to the portfolio. The rise in rates volatility followed a broader bond sell-off, which was driven by expectations that vaccines and fiscal stimulus will outweigh near term virus concerns.

## **Ardea Real Outcome Fund RV attribution categories**

**RV Rates:** The portfolio consists of hundreds of individual long / short bond and derivatives positions, each with their own interest rate duration exposure. These positions are designed to offset each other and are constantly rebalanced to minimise duration exposure, so that the portfolio is not overly exposed to general fluctuations in the level of market rates.

**RV Micro Curve:** These RV strategies exploit pricing inconsistencies between different points on interest rate curves by taking a 'long' position in one point vs. a 'short' position in another, such that the overall trade has zero net interest rate duration. We focus specifically on curve points that are highly correlated with each other, which typically means they are close to each other.

**Volatility:** ARO's portfolio is always positioned structurally 'long volatility', which is expressed via buying interest options. This means the portfolio benefits when the market pricing of interest rate volatility increases (explained in more detail [here](#)).

**RV Bond vs Derivative:** These RV strategies exploit pricing inconsistencies between government bonds and closely related interest rate derivatives by taking a 'long' position in one vs. a 'short' position in the other, such that the overall trade is duration neutral.

## Contact

For further information, please contact:

### Fidante Partners Investor Services

P: 13 51 53

E: [info@fidante.com.au](mailto:info@fidante.com.au)

W: [www.fidante.com.au](http://www.fidante.com.au)

For Financial planner enquiries, please contact:

Your local **Business Development Manager** or

E: [bdm@fidante.com.au](mailto:bdm@fidante.com.au)

For institutional enquiries, please contact:

### Jeremy Gordon

Senior Institutional Business Development Manager

Fidante Partners

P: 02 9994 7189

E: [jgordon@fidante.com.au](mailto:jgordon@fidante.com.au)

[www.ardea.com.au](http://www.ardea.com.au)



Unless otherwise specified, any information contained in this publication is current as at the date of this report and is provided by Ardea Investment Management Pty Ltd ABN 50 132 902 722 AFSL 329 828 (**Ardea**), the investment manager of the Ardea Real Outcome Fund ARSN 158 996 699 (**Fund**). Fidante Partners Limited ABN 94 002 835 592 AFSL 234668 (**Fidante Partners**) is the responsible entity and issuer of interests in the Fund. The information in this publication should be regarded as general information and not financial product advice, and has been prepared without taking into account of any person's objectives, financial situation or needs. Because of that, each person should, before acting on any such information, consider its appropriateness, having regard to their objectives, financial situation and needs. Each person should obtain and consider the Product Disclosure Statement (**PDS**) and any additional information booklet (**AIB**) for the Fund before deciding whether to acquire or continue to hold an interest in the Fund. A copy of the PDS and any AIB can be obtained from your financial adviser, our Investor Services team on 13 51 53, or on our website [www.fidante.com.au](http://www.fidante.com.au). Please also refer to the Financial Services Guide on the Fidante Partners website. Past performance is not a reliable indicator of future performance. Neither your investment nor any particular rate of return is guaranteed. The information contained in this document is not intended to be relied upon as a forecast and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy, nor is it investment advice. If you acquire or hold the product, we, Fidante Partners or a related company will receive fees and other benefits which are generally disclosed in the PDS or other disclosure document for the Fund. Neither Fidante Partners nor a Fidante Partners related company and its respective employees receive any specific remuneration for any advice provided to you. However, financial advisers (including some Fidante Partners related companies) may receive fees or commissions if they provide advice to you or arrange for you to invest in the Fund. Ardea, some or all Fidante Partners related companies and directors of those companies may benefit from fees, commissions and other benefits received by another group company.

The Zenith Investment Partners (ABN 27 103 132 672, AFS Licence 226872) ("Zenith") rating (assigned May 2018) referred to in this document is limited to "General Advice" (s766B Corporations Act 2001) for Wholesale clients only. This advice has been prepared without taking into account the objectives, financial situation or needs of any individual and is subject to change at any time without prior notice. It is not a specific recommendation to purchase, sell or hold the relevant product(s). Investors should seek independent financial advice before making an investment decision and should consider the appropriateness of this advice in light of their own objectives, financial situation and needs. Investors should obtain a copy of, and consider the PDS or offer document before making any decision and refer to the full Zenith Product Assessment available on the Zenith website. Past performance is not an indication of future performance. Zenith usually charges the product issuer, fund manager or related party to conduct Product Assessments. Full details regarding Zenith's methodology, ratings definitions and regulatory compliance are available on our Product Assessments and at <http://www.zenithpartners.com.au/RegulatoryGuidelines>

The rating issued 10/2020 is published by Lonsec Research Pty Ltd ABN 11 151 658 561 AFSL 421 445 (Lonsec). Ratings are general advice only, and have been prepared without taking account of your objectives, financial situation or needs. Consider your personal circumstances, read the product disclosure statement and seek independent financial advice before investing. The rating is not a recommendation to purchase, sell or hold any product. Past performance information is not indicative of future performance. Ratings are subject to change without notice and Lonsec assumes no obligation to update. Lonsec uses objective criteria and receives a fee from the Fund Manager. Visit [lonsec.com.au](http://lonsec.com.au) for ratings information and to access the full report. © 2020 Lonsec. All rights reserved.

© 2021 Morningstar, Inc. All rights reserved. Neither Morningstar, its affiliates, nor the content providers guarantee the data or content contained herein to be accurate, complete or timely nor will they have any liability for its use or distribution. Any general advice or 'class service' have been prepared by Morningstar Australasia Pty Ltd (ABN: 95 090 665 544, AFSL: 240892) and/or Morningstar Research Ltd, subsidiaries of Morningstar, Inc, without reference to your objectives, financial situation or needs. Refer to our Financial Services Guide (FSG) for more information at [www.morningstar.com.au/s/fsg.pdf](http://www.morningstar.com.au/s/fsg.pdf). You should consider the advice in light of these matters and if applicable, the relevant Product Disclosure Statement before making any decision to invest. Our publications, ratings and products should be viewed as an additional investment resource, not as your sole source of information. Past performance does not necessarily indicate a financial product's future performance. To obtain advice tailored to your situation, contact a professional financial adviser.