

Ardea Real Outcome Fund

ARSN 158 996 699 APIR Code HOW0098AU

Quarterly Performance Report January 2021

Performance ¹	1 month	3 months	FYTD	1 year	3 year	5 year	7 year	Inception
Fund	0.13%	0.40%	2.79%	5.22%	5.55%	5.44%	4.55%	4.34%
Benchmark ²	0.33%	0.91%	2.79%	1.08%	1.56%	1.65%	1.63%	1.83%
Excess Return	-0.21%	-0.51%	0.00%	4.14%	3.99%	3.78%	2.92%	2.50%

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 January 2021.

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.
Inception Date	20 July 2012
Fund Size	\$6.9bn
Management Fee	0.50% p.a.
Buy/Sell Spread	+0.05% / -0.05%
Distribution Frequency	Quarterly

Sector Exposure	
Government – National	46%
Government - State	54%
Total	100%

Rating Exposure	
AAA	64%
AA	36%
Total	100%

Region Exposure*	
Australasia	55%
Europe	16%
N. America	29%
Total	100%

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

How are we positioned?

The portfolio return for the month was positive.

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

- Volatility

The portfolio is positioned long volatility through interest rate options. These trades are implemented to take advantage of the cheapness of implied relative to realised volatility and to provide risk balance to the portfolio. These trades benefited from a rise in implied volatility in January, which was driven by rising yields and increased hopes for a global recovery amid fiscal spending and the roll-out of a COVID vaccine programs.

- RV Bond vs Derivative

The portfolio targets relatively cheap bonds with hedges to manage duration risk expressed in interest rate derivatives. In January, gains were made in long positions in government and semi-government bonds relative to swaps, mostly in the AUD and NZD curves. These positions offset a small drag from similar types of trades in EUR and CAD curves.

There was a modest negative impact on performance 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, which underperformed as yields lifted.

- Micro Curve

These RV trades are exposed to curve movements, but with much lower volatility than macro-style yield

curve positions. These positions had a net small flattening exposure and underperformed slightly over January.

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.

Portfolio Commentary

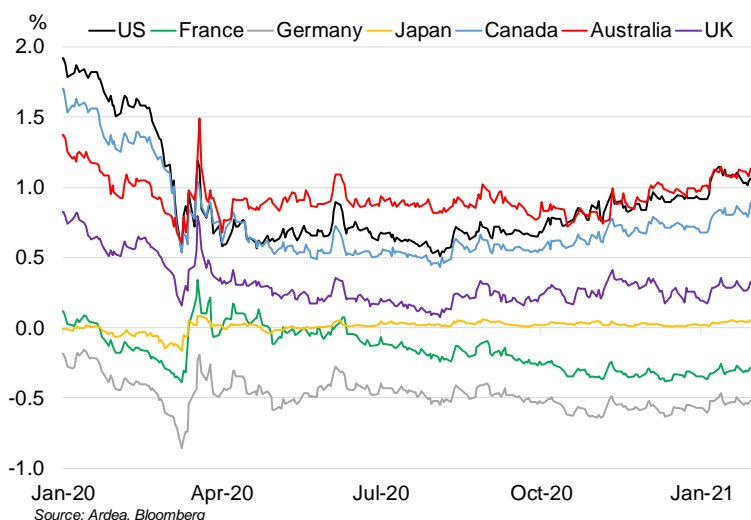
Notable events for the quarter are summarised below and more detailed discussions of topical market themes are available here - [Ardea's market insights](#).

What Happened?

Bond yields rise in January amid US fiscal spending bonanza

The reflation theme evident over the last few months received a boost in January after the Georgia senate runoff results handed senate control to the Democrats. The prospect of significantly higher fiscal spending and bond supply drove underperformance of US Treasuries, taking the 10y yield 17bp higher to 1.07% over the month, a high since March 2020. Inflation-linked bonds outperformed again, sustaining near-record low levels of real yields and maintaining the upward trend in breakeven inflation rates. Other bond markets sold-off in January in sympathy with the US, of note: 10y Bund yield +5bp to -0.57%, 10y ACGB yield +16bp to 1.13%, 10y Gilt yield +13bp to 0.33%.

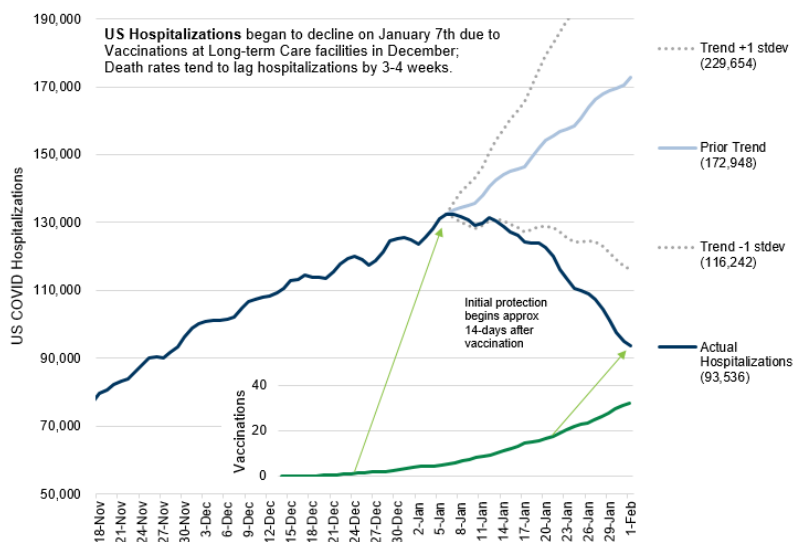
Chart 1: 10y bond yields



The race between COVID vaccines and infections

The vaccine roll-out gathered momentum, particularly in the US and UK, supporting confidence in the economy reopening narrative that had built-up over prior months. By late January, infection rates and hospitalisations had started to fall, although investors retained an underlying sense of caution about whether vaccines could offset the damage done by new COVID strains.

Chart 2: US Covid Hospitalisations drop as vaccinations rise

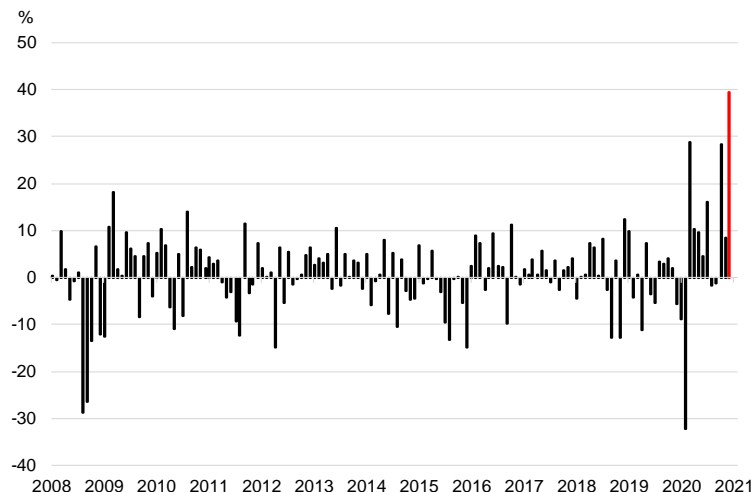


Source: Goldman Sachs

Massive short squeeze in US equities

Overall, most equity markets were stable to start the year. However, there has been significant volatility within some indices. A handful of US stocks saw extreme price moves. Heavily shorted stocks like GameStop, Blackberry, AMC and Express suddenly saw a surge in demand from retail traders following popular internet forums, resulting in a short squeeze. The GameStop price surged from under \$19 at the under of December to a high of \$347 in January before dropping to \$64 in early February. Over the course of January, baskets of the most shorted stocks posted their best monthly performance since at least 2008 (Chart 3).

Chart 3: Monthly move in basket of 50 most shorted stocks in the Russell 3000 index



Source: Ardea, Bloomberg, Goldman Sachs

What about the broader consequences of the retail-driven short squeeze? These developments did briefly dent broader equity investor confidence, but markets are quickly moving on. Consensus still heavily favours risky assets over bonds amid high hopes for a vaccine and debt-fuelled turnaround in the global economy in 2021. As is often the case, underlying concerns about lofty valuations persist and questions remain about whether the market is due for a decent correction.

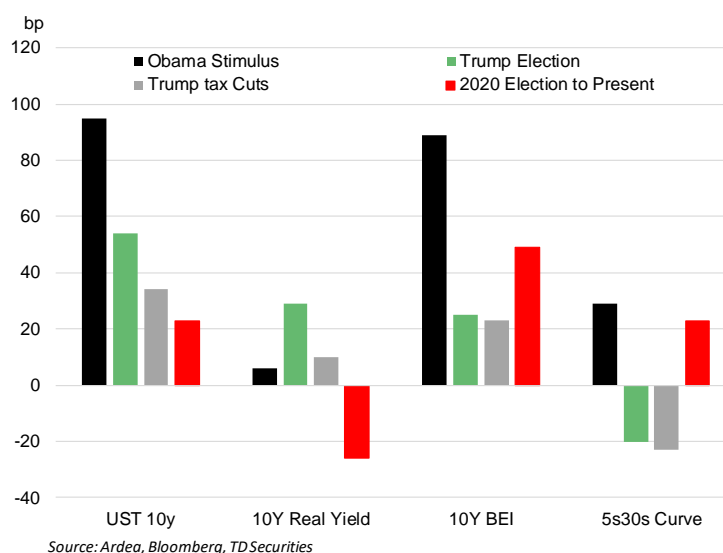
Why is it relevant?

Fiscal policy largesse and ongoing easy monetary policy underpin historically steep yield curve

Higher US fiscal spending has already flowed through to higher bond yields and steeper yield curves. We have discussed in previous reports the greater importance of fiscal spending for markets in an environment where monetary policy is already stretched (see [here](#)).

The chart below compares the market impact of a few previous episodes of large increases in US fiscal spending with the moves seen in January. The size of the adjustment in nominal rates is clearly still small relative to prior episodes. What does look significant in an historical context is the fall in real yields, which continues to underpin a significant bounce in breakeven inflation levels. TD Securities research noted in January that previous fiscal spending episodes had ultimately boosted both real yields and breakeven inflation rates (BEIs).

Chart 4: Bond market reactions to previous US fiscal spending programs



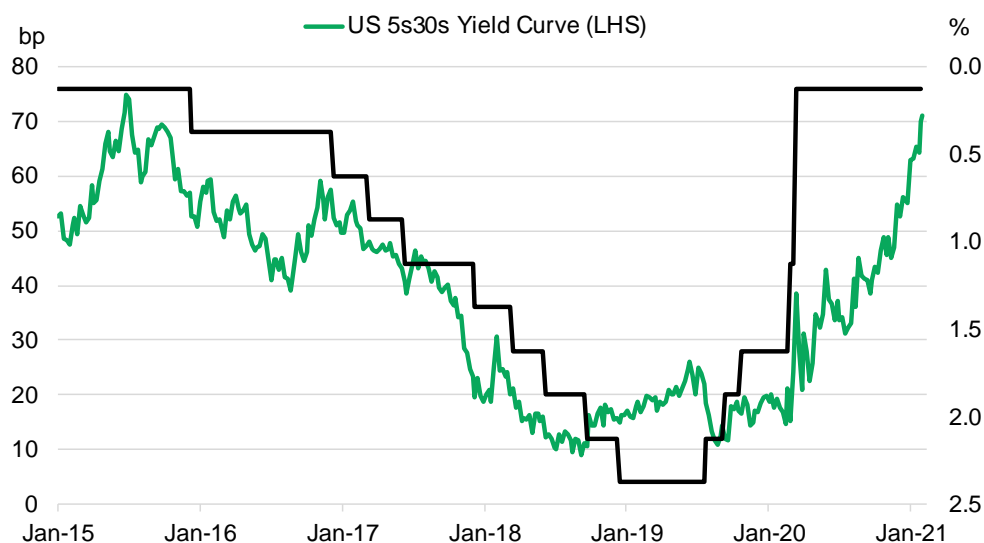
What continues to hold real yields lower is aggressive US Federal Reserve (Fed) policy, structurally lower expectations for the neutral policy rate and a pandemic recovery subject to setback. The Fed reiterated their highly accommodative stance in January by affirming two key policies:

- Asset purchases of \$120bn per month will continue until “substantial further progress” is made towards employment and inflation goals.
- Forward guidance on rates is tied to sustainably realising above 2% inflation – the Fed has reiterated that base effects and pent-up demand driven inflation in the wake of economies reopening will not drive rate hikes.

Pledges by the Fed and other central banks to sustain extreme policies in the face of the recovery means that further fiscal policy driven reflation will be concentrated at the long end of the yield curve. This stance marks a major point of difference with the more recent Trump fiscal policy expansion. The 5s30s curve had flattened through Trump-era fiscal spending because during much of that period the Fed was lifting the funds rate in anticipation of meeting its inflation targets. Now the 5s30s curve has steepened to levels last seen in 2015 before the Fed began tightening (Chart 5). The success or not of specific fiscal policy programs through

the US senate and the vaccination roll-out will be key determinants of how far this sell-off can run in the short term.

Chart 5: UST 5s30s curve vs Fed Funds Rate



Source: Ardea, Bloomberg

What are the implications of this fiscal and monetary regime being sustained for markets? One upshot for bond investors is that many macro-style curve trades are likely to remain highly correlated with outright yield levels (duration risk) as the bar to lifting short end policy rates will remain very high. There are also implications for interest rate volatility and the broader stability of markets. As Ardea Portfolio Manager Tamar Hamlyn noted in a recent [AFR article](#):

“Far distant outcomes are also inherently uncertain, no matter how much clarity is applied, so forming conviction around central banks’ commitment to navigate inflation well into the future will always be a difficult exercise.

The Fed’s inflation objectives appear even more finessed. The desire to deliver above-target inflation for a period, which then moderates at some far-distant point back to the desired long-term level of 2 per cent, requires conviction around a very long-term arc for inflation.

There will probably be periods where the blunt directionality of markets will struggle to price this accurately, creating volatility in yields. Clear and constant communication will provide the best shot at success for markets to navigate such a nuanced path.

The simple fact is that the commitment by central banks to keep rates low, and the benefits this brings to markets and the economy, carries with it the seeds of a more challenging policy exit in future. Whether this is the “right” approach is not at issue here, merely that the path is a more nuanced one for markets to follow, and as investors, we should form our expectations accordingly.”

Contact

For further information, please contact:

Fidante Partners Investor Services

P: 13 51 53

E: info@fidante.com.au

W: www.fidante.com.au

For Financial planner enquiries, please contact:

Your local **Business Development Manager** or

E: 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

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. 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 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. 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.