ARDEA
Investment Management

Ardea Real Outcome Fund

ARSN 158 996 699 APIR Code HOW0098AU

Monthly Performance Report April 2021

Performance[1]	1 month	3 months	FYTD	1 year	3 year	5 year	7 year	Inception
Fund	0.14%	0.65%	3.46%	4.77%	5.70%	5.61%	4.39%	4.29%
Benchmark[2]	0.30%	0.70%	3.37%	2.06%	1.61%	1.77%	1.63%	1.85%
Excess Return	-0.16%	-0.05%	0.09%	2.71%	4.09%	3.84%	2.76%	2.44%

[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 April 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	$8.3bn
Management Fee	0.50% p.a.
Buy/Sell Spread	+0.05% / -0.05%
Distribution Frequency	Quarterly

Sector Exposure	
Government – National	60%
Government - State	40%
Total	100%

Rating Exposure	
AAA	74%
AA	26%
Total	100%

Region Exposure*	
Australasia	50%
Europe	28%
N. America	22%
Total	100%

Interest Rate Duration (years)	
12 month average	0.6
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 in April was positive.

Performance is driven by strategies that target specific 'relative value' (RV) mispricing between closely related fixed income securities. These strategies are implemented in a way that isolates the RV mispricing from broader market movements, maintaining minimal interest rate duration exposure and excluding all credit investments. For this reason, the performance of RV portfolios, over time, has a low correlation to broader bond market and macro themes.

The portfolio is constructed with many modestly sized and diverse RV strategies that collectively contribute to overall performance. We outline performance based on our broad attribution categories. As there are a large number of individual positions, the commentary below focuses on a small subset of noteworthy RV themes and examples of positions.

The strategy suggested investment horizon is two years. Over short periods of time, like one month, performance variability commensurate with the portfolio's volatility budget is to be expected.

Drivers

- **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 and limited exposure to macro events over time. The market backdrop for yield curves was generally tilted towards flattening over the month (ex-EUR), with a more pronounced move lower in the US 10-30y sector (see monthly market commentary). The portfolio holds mixed curve positions across markets and through April, various curve strategies in AUD, CAD and NZD added value and offset a small drag from positions in USD. For example, in the CAD market, the portfolio was positioned to take advantage of a micro mispricing in the forward interest rate swap curve that reflected a change in market flows, such as hedging against higher interest rates.
- **RV bond vs derivative.** These 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. AUD and EUR positions added value over the month. For example, long AUD semis across various points on the curve outperformed swap and

futures hedges. While AUD semi spread movements were fairly modest, there was a slight bias towards tighter spreads, reflecting continued demand and contained issuance expectations ahead of upcoming budgets. In EUR, ultra-long semi vs swap positions added value as the underperformance in EUR rate markets saw increased paying pressure in long end EUR swaps.

- **Inflation.** The portfolio maintains a structural inflation protection position through exposure to inflation-protected securities. As market-based measures of inflation rose through April, the portfolio benefited. These positions are in the AUD market and while the Australian Q1 CPI report underwhelmed market consensus late in the month, this was offset by the rise in longer term inflation expectations, which tracked global peer markets higher. The themes of strong growth, temporary price pressures and central banks determined to keep rates low all continue to support higher inflation pricing.

Detractors

- **Volatility.** The portfolio is positioned long interest rate volatility. These positions are implemented based on RV considerations and provide the portfolio with risk balance. After driving significant positive performance during a large sell-off in bonds in Q1, the subsequent fall in market volatility through April resulted in a modest drag on performance. Volatility fell amid stability in bond demand in the wake of cheaper valuations, market positioning and a higher bar for positive economic data surprises. The positions held are mostly in USD and are spread across a wide range of maturities.

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?

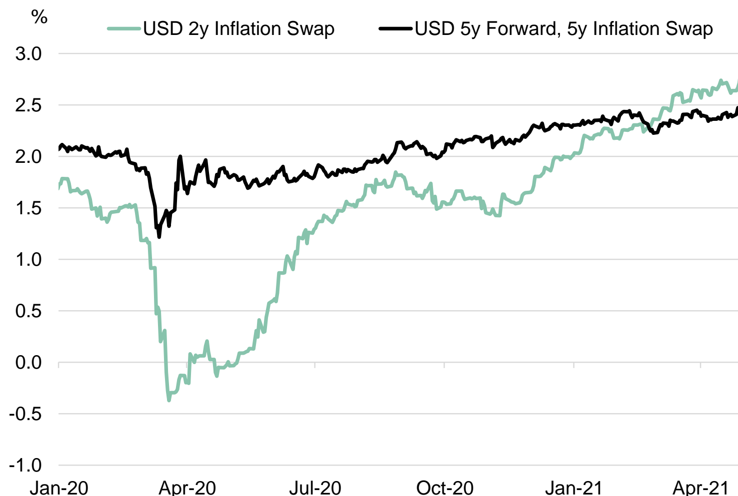
April was a relatively good month for most major asset classes. Investor sentiment remained buoyant and confidence strong in the unfolding global economic recovery amid very strong data. Many equity indices rallied to new all-time highs (S&P 500 +5.2%), while growth-sensitive commodity prices surged – copper jumped 12.1% m/m (the broader Bloomberg Commodity Index lifted 8.3%). Fixed income performance was mixed, but the asset class overall enjoyed much better support than in Q1. The Bloomberg-Barclays Global Aggregate Index gained 1.3% - the first monthly increase in 2021. The US Treasury Index gained 0.8% - the first monthly increase since November 2020 (more details on the underlying drivers of this rally in the following section). The benchmark US 10y yield fell 9bp to 1.63%.

Two broad developments within interest rate markets in April are worth highlighting:

1) US inflation pricing making new highs, but the curve shape reflects a temporary "shock"

The moderate rally in US Treasuries through April was led by gains in inflation-protected bonds (TIPS), taking the implied breakeven inflation (BEI) levels higher. The much watched 10y BEI lifted 3bp to 2.40% - a new high since 2013. Within 10y average inflation expectation measures there remains a significant difference between two-year pricing, which lifted nearly 30bp in April to 2.8%, and longer-term forward pricing, which has been broadly stable over the month around 2.4% (Chart 1). This flattening of the inflation curve shows the market is pricing some short-term inflation overshoot, but not an excessive structural inflation problem.

Chart 1: US market priced for a temporary, but not sustained inflation shock



Source: Ardea, Bloomberg

2) European and other major sovereign bond markets underperformed the US in April

The recovery in the US, augmented by fiscal stimulus, had been the epicentre of the reflation trade in Q1. Through April, however, US Treasuries outperformed equivalent bonds in GBP, CAD and AUD markets, where yields are broadly steady. CAD rates were well contained despite the Bank of Canada announcing a tapering of its asset purchase program. While this announcement was well flagged and not dramatic - purchases fell from $4bn per week to $3bn – for many investors the change foreshadows risk of a broader tapering of central bank support for markets later in the year or in 2022.

The EUR market underperformed notably. The 10y Bund yield was the mirror image of the US in April – rising by 9bp to -0.20% - a reversal of prior months outperformance. Markets have become more optimistic about the outlook for the vaccination roll-out in Europe, after earlier setbacks.

Why is it relevant?

The reflation road for bond markets is winding

The broad reflation theme that weighed on bonds in Q1 still has a long way to play out. Indeed, the consensus expects bond yields will rise further in 2021. In our last two monthly updates, we highlighted the underlying drivers of this reflation theme, notably:

- The massive US fiscal stimulus package driving faster growth and larger bond supply.
- The rapid roll-out of vaccines, allowing for reopening of major developed economies.
- Markets questioning central bank commitment to ultra-accommodative monetary policy.
- Rising inflation amid reopening effects.

While yields could rise further over time, markets rarely move in orderly straight lines, since there also are many opposing forces at play. The price action in April, particularly in US Treasuries, is a good example. Consider the rally in US Treasuries occurred in the face of the following historically strong US economic data prints (released in April, but referencing March):

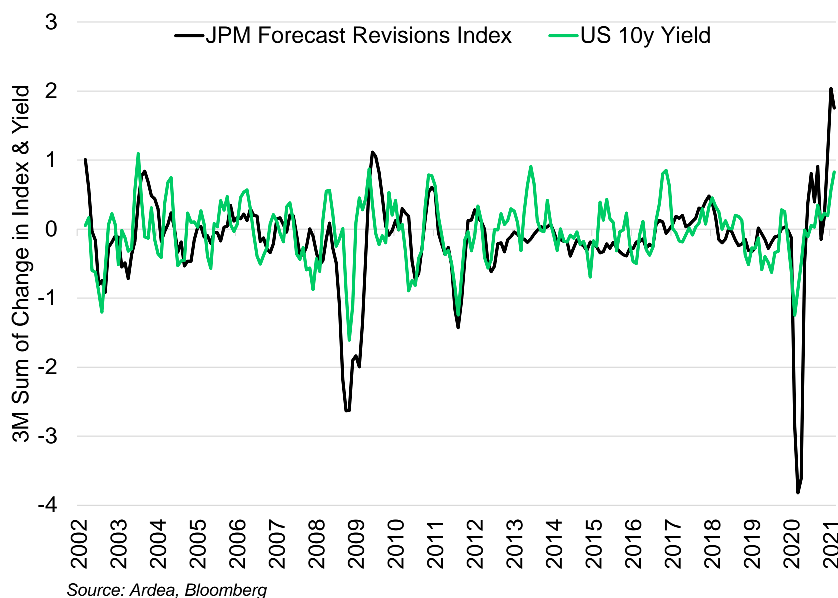
- The ISM Manufacturing survey headline index lifted to the highest ever level of 64.7 (above 50 indicates expansion) and the prices paid index held near the highest level since 2008 (both indices exceeded consensus).
- The US economy added 916k new jobs against market expectations of a 660k increase and the last two months figures were revised up by 156k.
- Headline and core inflation prints were 0.1% faster than expected at 2.6% y/y and 1.6% y/y, respectively.
- Retail sales jumped 9.8% m/m, against expectations for a 5.8% increase.

We list a few drivers of the recent rally below. These five supportive forces for bonds will remain relevant even as the global recovery continues to gather pace over the remainder of the year:

1) Q1 forecast revisions and repricing have set market expectations very high

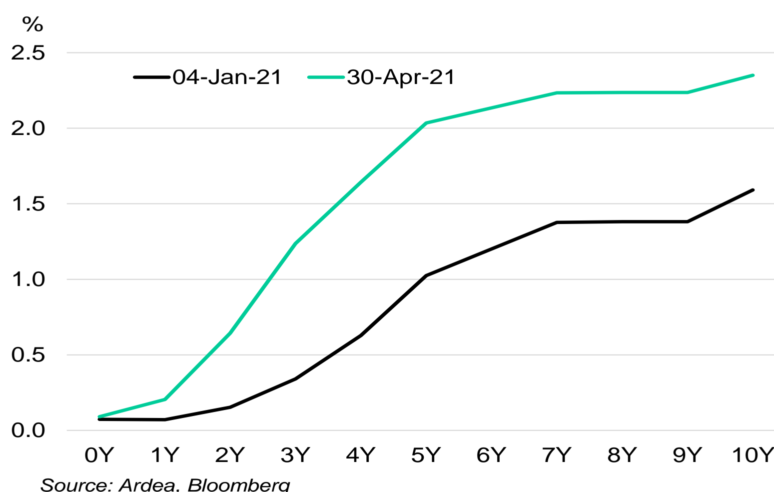
In our last monthly update, we concluded that the bar for news flow and economic data to keep surprising markets to the upside had clearly lifted. We detailed the wave of positive reflation catalysts confronting markets in Q1. Of note, the rapid acceleration of vaccination plans, big upside surprises to US fiscal stimulus packages and the improving trend in actual data. Chart 2 shows the first three months of the year saw an historically massive upward revision to economic forecasts, which already helped to propel yields higher. A temporary positive news fatigue appears to have set into the US market in recent weeks.

Chart 2: A high bar set for the bond market – change in economic forecast revisions index and the US 10y yield (Rolling 3m sum, to 31-Mar-21)



The higher starting point for market pricing also supports the case for temporary consolidation in yields. As we showed in our last update, policy rate expectations, implied longer run neutral rate assumptions and inflation expectations have all lifted materially. For example, the US forward curve is now priced for around 100bp of further rate hikes over the next five years than was the case in January (Chart 3).

Chart 3: US Fed Funds forward curve (OIS 1y forwards) – January vs April



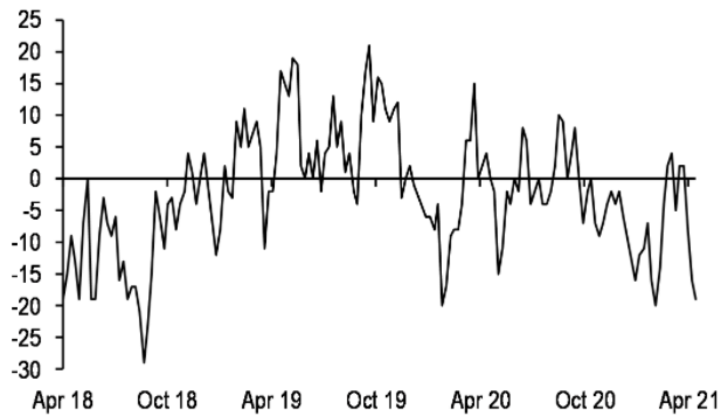
2) The Fed remains patient on tapering plans

The US Federal Reserve (Fed) remains very patient in its approach to reducing policy accommodation. Comments from Fed governors and statements after the Federal Open Market Committee (FOMC) meeting in April suggests they think it is too early to start talking about tapering asset purchases (unlike the Bank of Canada). The lack of a hawkish shift in rhetoric can be a restraint on the rise in nominal yields in the short term. But equally, the willingness of the Fed to sit behind the unfolding rise in inflation is contributing to the rise in market breakevens. As detailed last month, there is ultimately a risk that the market starts to see the approach taken by the Fed as unsustainable, driving a higher inflation risk premium. Further strong inflation data in the coming months from post-vaccine reopening effects will be a key test of how the market judges Fed credibility (as outlined above, so far the market only sees a temporary “overshoot” of the inflation target).

3) Positioning contributing to consolidation

Some indicators suggest the wave of US Treasury selling in Q1 has stretched positioning to the short-side, leaving the market incrementally more sensitive to buying flows. The JP Morgan Treasury investor survey suggests real money investors have reduced positioning to near the shortest levels since 2018, when the Fed was lifting rates. Meanwhile, primary dealer positions in US Treasuries are 40% lower than the recent peak in January (Chart 4).

Chart 4: Net US Treasury longs in JP Morgan client survey

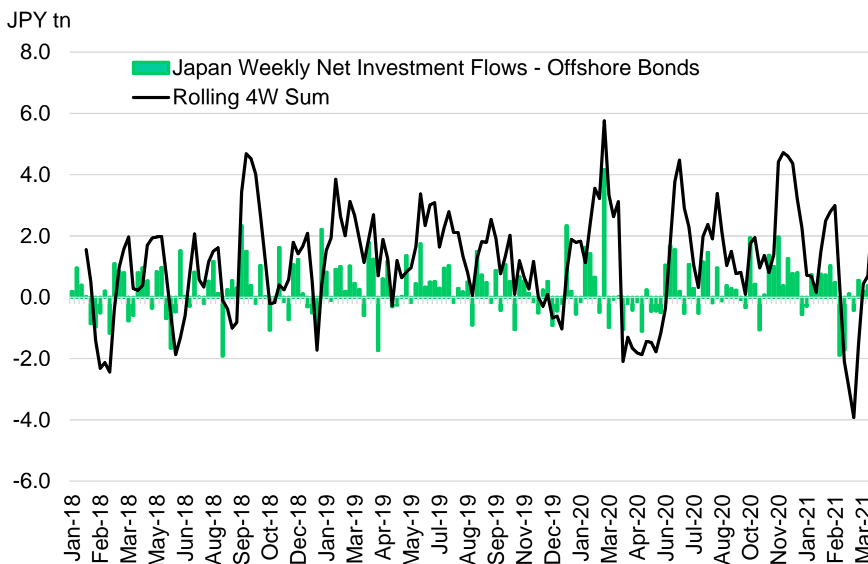


Source: J.P. Morgan

4) Japanese demand for global fixed income rebounds

Through 2020, Japanese investors were large net buyers of offshore fixed income assets. However, these flows turned temporarily sharply negative amid the bond rout in February and as the end of Japan's financial year in March approached (-¥3.9tn in 4 weeks to March 12). Through April, these flows have turned positive again – Japanese investors purchased ¥3.2tn of over the 4 weeks to April 23. Favourable FX-hedged yield pickup for these investors, especially in USD and AUD bonds, suggests demand could remain robust. *Note for our general discussion we focus on total Japan offshore investment. The more granular split of this data by country of investment destination is only available with a two-month lag – selling of AUD denominated bonds was especially heavy in February and contributed to the AUD market underperformance vs peers in the month.*

Chart 5: Japan net flows into global bonds



Source: Ardea, Bloomberg

5) Pension fund demand for the long end of the curve

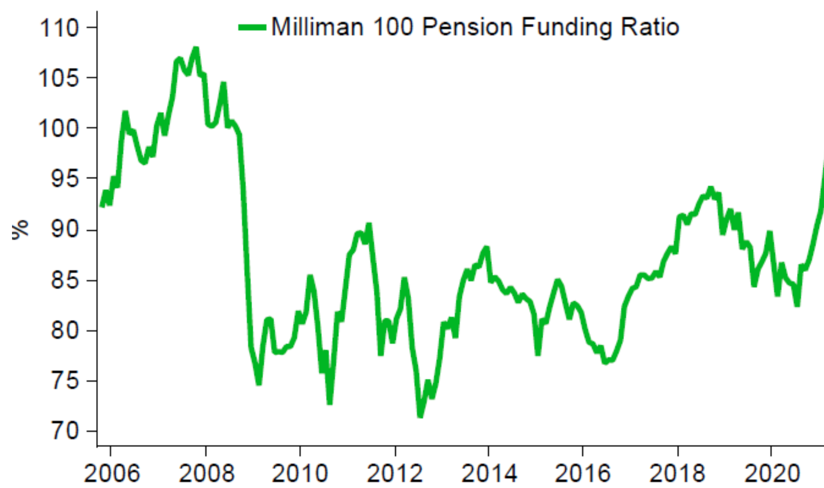
Pension funds are a major source of demand for US Treasuries and other global sovereign markets. These funds have long-dated liabilities to meet, which are best matched with longer duration bonds such as the 30y part of the curve. Demand from this investor base has recently picked up and provided support to the

very long end of yield curves, notably in the US.

US pension funds are big drivers of demand for Separate Trading of Registered Interest and Principal of Securities (STRIPS). These instruments are not issued directly but are constructed by separating out coupons from principal payments from existing long-dated bonds. This process allows investors with long-dated liabilities to invest in a 30 year zero coupon bond – a longer duration security than a standard, coupon paying 30y bond. In April, STRIPS demand lifted at the fastest monthly pace since October 2018 (these instruments also provide relative value opportunities vs standard whole bonds).

Pension funding ratios have reached 98% - the highest level in over a decade – after the big rally in equities and higher discount rates (funding ratio = pension assets/present value of future liabilities). Ratios nearer to 100% tend to encourage demand for long-dated bonds (or P-STRIPS) to hedge funding risk. This source of demand should therefore continue to provide some support for the long end of yield curves.

Chart 6: US Pension Funding Ratio



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

Ardea Real Outcome Fund received a Morningstar Analyst Rating™ of 'Bronze' on 27 May 2020

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 'regulated financial advice' under New Zealand law has 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. For more information refer to our Financial Services Guide (AU) or Financial Advice Provider Disclosure Statement (NZ) at www.morningstar.com.au/s/fsg.pdf and www.morningstar.au/s/fapds.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.