

# Ardea Real Outcome Fund

ARSN 158 996 699 APIR Code HOW0098AU

## Monthly Performance Report September 2021

Performance <sup>1</sup>	1 month	3 months	1 year	2 year	3 year	5 year	Inception
Fund	-0.50%	-0.77%	0.40%	2.93%	5.01%	4.72%	3.96%
Benchmark <sup>2</sup>	0.27%	0.80%	3.06%	1.87%	1.80%	1.83%	1.90%
Excess Return	-0.76%	-1.57%	-2.66%	1.06%	3.21%	2.89%	2.05%

<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, 30 September 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

<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>Investment Horizon</b>	Recommended min. 2 years
<b>Inception Date</b>	20 July 2012
<b>Fund Size</b>	\$10bn
<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	68%
Government - State	32%
<b>Total</b>	<b>100%</b>

Rating Exposure	
AAA	54%
AA	34%
A	12%
<b>Total</b>	<b>100%</b>

Region Exposure*	
Australasia	59%
Europe	3%
N. America	38%
<b>Total</b>	<b>100%</b>

Interest Rate Duration (years)	
12 month average	0.3
Since inception average	0.2

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

\*Physical weights for sector and rating exposure

Source: Ardea Investment Management, S&P Ratings

## Portfolio Commentary

Performance for the month of September was -0.5% (net of fees), which is marginally outside the range of 'expected performance variability'.

The relative value (RV) interest rate 'Curve' related exposures accounted for substantially all the negative return this month. This attribution bucket captures performance stemming from the Fund's exposure to changes in the shapes of interest rate curves. These exposures are driven by trades that exploit pricing inconsistencies between different points on interest rate curves by taking 'long' positions in some points vs. 'short' positions in others, with overall trade packages managed to remain duration neutral.

It is normal for any of the Fund's individual trades to experience short-term losses because we cannot precisely time the optimal entry point for every trade, nor can we control the timing of when a trade will play out as expected. While such timing effects occur all the time, their impact on total portfolio performance is usually smoothed out via portfolio diversification. However, sometimes many trades happen to be temporarily negative at the same time, while others take longer than average to play out, resulting in a larger negative performance at the total portfolio level, which is what happened with the Fund's 'Curve' related exposures this month.

Due to the Fund's intentional approach of diversifying risk across a large number of modestly sized trades, the negative 'Curve' performance was not driven by any 'key trades'. Rather, it was the net result of numerous positively and negatively performing trades that we entered, exited, and held in the normal course of trading activities. Two examples of such curve trades are discussed below.

As the Fund's performance is not driven by a few key trades, nor can it be mapped to broader market fluctuations or macro themes, we focus the commentary below on examples of RV-specific themes that the Fund is positioning around. The performance of many individual trades underlying these themes, combined with hundreds of others, has contributed to the Fund's performance this month.

### **RV Theme – AUD interest rate curves**

AUD government bonds in the 15-20Y segment are currently priced cheap relative to closely related derivatives. This RV opportunity is driven by temporary demand / supply imbalances caused by elevated bond issuance on the supply side vs market segmentation on the demand side (i.e. demand for bonds is currently more focused in 10Y and shorter segments, where the Reserve Bank of Australia (RBA) is also buying bonds).

The Fund is exploiting this via RV trades involving buying these bonds vs. entering short positions in derivatives, such as 10Y interest rate futures contracts, to neutralise duration exposure. These trades aim to profit as the pricing of these bonds eventually converges towards that of the derivatives. These trades combine both 'bond vs. derivative' and 'curve' exposures.

These trades were negative performance contributors for the month as their 'curve' exposure was negatively impacted by changes in the shape of the AUD interest rate curve between the 10 year and 15 year points. We are comfortable holding these trades because the original rationale still holds and their marginal risk contribution to the overall portfolio remains modest.

### **RV Theme – GBP interest rate curves**

The GBP interest rate swap market is currently pricing swap rates in the 2-4Y forward part of the curve at anomalously high levels, relative to rates in the 4-7Y forward part of the curve, resulting in excessive flatness between these curve segments. This RV opportunity is driven by a combination of macro oriented market participants using these swaps to express views on the timing for rate hikes and the trading activity of other market participants using these swaps for hedging purposes.

The Fund is exploiting this via RV trades that position for a re-steepening in this specific part of the curve, in order to profit when the swap curve normalises.

These trades are currently flat performance contributors as the shape of the curve remains unchanged. We are comfortable holding these trades because it will take time for the curve anomaly to normalise.

### **RV Theme – USD bonds vs derivatives**

USD government bonds around the 20Y segment are currently priced cheap relative to closely related derivatives. This RV opportunity is driven by temporary demand / supply imbalances caused by elevated bond issuance to fund fiscal stimulus vs lack of natural bond demand around the 20Y point due to market segmentation (macro oriented market participants focus more on the 10Y point, while structural demand for bond duration from liability managers is more focused on the 30Y point).

The Fund is exploiting this via RV trades involving buying the 20Y bonds vs shorting 20Y and 30Y futures contracts to neutralise duration exposure. These trades aim to profit as the pricing of these bonds eventually converges towards that of the derivatives. These trades combine both 'bond vs. derivative' and 'curve' exposures.

In this case the Fund has also embedded 'optionality' into the RV trade structure by expressing part of the 'long bond' leg of the trade using bond options, which are priced cheap on an RV basis when compared to their realised volatility, as well as to the pricing of comparable options on interest rate swaps.

A defining characteristic of Ardea's investment approach is the way in which we integrate interest rate options into the structuring of our RV strategies, as an efficient way of embedding a structural 'long volatility' and 'positive convexity' bias into portfolios. We intentionally embed this bias into our portfolios because it has proven effective in providing 'risk balance' to help our portfolios remain neutral to varying market / macro scenarios and also to provide the potential for additional performance upside in periods of market stress (e.g. Q1 2020).

These trades were negative performance contributors for the month because the demand / supply imbalance persists. We are comfortable holding these trades because the original rationale still holds and their marginal risk contribution to the overall portfolio remains modest.

## Market Commentary

Below is a summary of key points covered in this month's market commentary. The full article is available on Ardea's website [here](#).

### ***Tapering, Tightening and Rising Rates Uncertainty***

- Bond yields are rising again, and central banks have turned more hawkish.
- The US Federal Reserve (Fed) will soon commence quantitative easing (QE) tapering. The impact on bond yields is likely to be limited by the large absolute size of the Fed's balance sheet and offsetting issuance flow dynamics.
- Policy rate expectations have more room to move. Current Fed forecasts and market projections still represent a glacial pace of policy tightening by longer run historical standards.
- Global rates markets have moved to price more aggressive policy rate hike assumptions and greater divergence is evident between markets - a theme that is likely to continue.
- High levels of inflation and growth uncertainty point to higher rates volatility.

## Understanding Performance

Performance is evaluated over rolling 2 year periods for consistency with the recommend 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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