

Ardea Real Outcome Fund

ARSN 158 996 699 APIR Code HOW0098AU

Monthly Performance Report November 2021

Performance ¹	1 month	3 months	1 year	2 year	3 year	5 year	Inception
Fund	0.08%	-1.11%	-1.13%	2.33%	4.43%	4.43%	3.82%
Benchmark ²	0.27%	0.69%	2.87%	1.83%	1.82%	1.83%	1.91%
Excess Return	-0.19%	-1.79%	-4.00%	0.50%	2.61%	2.60%	1.91%

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 November 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.
Investment Horizon	Recommended min. 2 years
Inception Date	20 July 2012
Fund Size	\$11bn
Management Fee	0.50% p.a.
Buy/Sell Spread	+0.05% / -0.05%
Distribution Frequency	Quarterly

Sector Exposure	
Government – National	73%
Government - State	27%
Total	100%

Rating Exposure	
AAA	50%
AA	37%
A	13%
Total	100%

Region Exposure*	
Australasia	31%
Europe	14%
N. America	55%
Total	100%

Interest Rate Duration (years)	
12 month average	0.1
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 November was +0.08% (net of fees), which is within the range of expected performance variability (see the *Understanding Performance* section below for details).

The performance attribution refers to risk-factor level exposure for the Fund overall, rather than individual trades. The following themes impacting risk factor exposures were notable in November:

- The Fund benefited from **Options** and related **RV Rates** exposures as interest rate markets were moderately volatile over the month. Following a large increase in October, implied volatility in options with shorter underlying maturities remained elevated as central bank policy uncertainty persisted. Further out the curve, longer term rates volatility picked up a bit as markets grappled with uncertainty over the Omicron COVID variant. These moves, however, were not extreme by historical standards. The Fund buys options based on RV considerations and to provide risk balance to the portfolio.
- **RV Curve** exposures were a modest detractor from performance. This exposure represents a large number of underlying trades – some were contributors in the month, while others were detractors. A general theme is that interest rate markets recovered somewhat from the extreme disfunction of late October. However, many RV relationships targeted by the Fund across yield curves remained distorted. Over short-term periods, there is substantial noise associated with the behaviour of these constrained RV relationships.
- **Inflation Beta** exposure - expressed via AUD inflation-linked bonds - was near flat overall. Intra-month, however, there was significant volatility in inflation pricing levels. Market-based inflation expectations lifted sharply over the first half of the month in the wake of stronger global CPI data. But over the second half of the month, inflation expectations retreated as focus switched to more hawkish central banks and COVID risks. High levels of inflation uncertainty are driving higher than normal volatility in these exposures.

The Fund's performance is not driven by a few key trades or broader macro themes, so 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 and a large number of other themes, has contributed to the Fund's performance this month.

RV Theme – AUD swaptions

These trades contributed to the Options attribution.

The Fund holds options as RV trades and to provide the portfolio with risk balance. These positions are held in multiple currencies. The Fund recently added long “swaption straddle” positions in the AUD market – a structure that benefits from higher interest rate swap volatility without the need to pick whether swap rates go up or down (the main risk to the trade is falling volatility). Hedging related to structured bond issuance by banks has resulted in larger selling flows in AUD swaptions with underlying maturities at long tenors. These flows have cheapened these options to attractive levels to buy.

These trades are relatively flat over the last month (other similar style swaption positions in shorter maturities outperformed).

RV Theme – AUD bonds vs derivatives

These trades contributed to the Bonds vs Derivative and Curve attribution.

AUD government bonds in the 10-20Y segment have been priced cheap relative to closely related derivatives. This RV opportunity is driven by demand / supply imbalances caused by 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 RBA is also buying bonds).

These trades added value over the month and further outperformance is expected.

RV Theme – EUR long maturity bonds vs swap

These trades contributed to the Bond vs Derivative attribution.

The Fund has been positioned in ultra-long maturity EUR bonds with offsetting duration hedges in long-dated swaps. These bonds were targeted as relatively cheap to comparable maturity bonds, reflecting temporary supply/demand imbalances. The swap curve is inverted at longer dated maturities and large flows from other funds closing steepening trades in this part of the curve have led the swaps to recently outperform the bonds, leading this position to be a detractor from performance.

The underlying rationale for this position remains intact and is expected to outperform over time.

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](#).

5 Key Themes for 2022

As each year draws to a close, it's common for investment managers and banks to publish predictions for the year-ahead. In fixed income, these notes tend to be heavily focused on the macroeconomic and central bank policy forecasts that drive yield predictions. Forecasting is a tough gig. Even seasoned market professionals have a patchy record in accurately predicting key variables like growth, inflation, and the level of bond yields.

At Ardea Investment Management, macro forecasting is not part of our investment process because we adopt a pure [relative value](#) investment approach that aims to be independent of the level of bond yields, the direction of interest rates and the macroeconomic factors that dominate the performance of conventional investments. Therefore, instead of the traditional year-ahead forecasts, in this note we highlight 5 key themes that will impact the risk/reward balance for fixed income in 2022: 1) high expectations and risks to global growth; 2) peak inflation; 3) peak quantitative easing (QE) and bond supply/demand dynamics; 4) rate hikes to further un-anchor yield curves; 5) cross-market rates divergence and volatility.

A common link among these broader market themes is the rising level of macro uncertainty (as also outlined in a [recent note](#) on central bank policy tightening). For relative value, this uncertainty is likely to manifest in further distortions in yield curve shapes, interest rate volatility and changes in the relationship between bond and interest rate derivative curves.

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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