

# Ardea Real Outcome Fund

ARSN 158 996 699 APIR Code HOW0098AU

## Monthly Performance Report October 2020

Performance <sup>1</sup>	1 month	3 month	FYTD	1 year	3 year	5 year	7 year	Inception
Fund	0.54%	1.21%	2.38%	5.74%	5.85%	5.09%	4.64%	4.42%
Benchmark <sup>2</sup>	0.03%	1.08%	1.61%	0.49%	1.36%	1.46%	1.56%	1.75%
Excess Return	0.50%	0.13%	0.77%	5.24%	4.50%	3.63%	3.07%	2.67%

<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 October 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>	\$5.6bn
<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	64%
Government - State	36%
<b>Total</b>	<b>100%</b>

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

Region Exposure*	
Australasia	40%
Europe	55%
N. America	5%
<b>Total</b>	<b>100%</b>

Interest Rate Duration (years)	
12 month average	0.3
Since inception average	0.1

\* 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?

Pro-growth and risk-on themes that dominated for most of the September quarter weakened in October. For example, the MSCI World equity index, having reach a new all-time high in early September, subsequently dropped 8% by the end of October. The proximate causes were the two themes that dominated over the month – the US election and a global resurgence in COVID cases.

On the virus front, Europe led the way back into lockdown, while the US has so far been reluctant to reimpose wide scale lockdowns, despite also experiencing a spike in new COVID cases.

*“Germany and France were bracing for new lockdowns Wednesday, as governments sought to stop the fast-rising tide of coronavirus cases that are beginning to fill European hospitals.*

*French markets opened lower on expectations that President Emmanuel Macron will announce tough measures during a televised evening address to the nation. Doctors in France are calling on the government to impose a new nationwide lockdown, noting that more than half of the country's intensive care units are now occupied by COVID-19 patients and medical staff are under increasing strains.*

*... On Tuesday alone, the country had a big spike in the number of daily deaths from COVID-19, recording an additional 523 deaths and another 33,417 new infections. Belgium, the Netherlands, most of Spain and the Czech Republic are seeing similarly high rates of infection, while Germany was still colored in orange — indicating that the average number of new cases there is still under 120 per 100,000 over the last 14 days.*

*Still, German Chancellor Angela Merkel was pressing governors of the country's 16 states to quickly agree a partial lockdown Wednesday that could include further restrictions on public gatherings and the closure of bars and restaurants.”*

- Associated Press, ‘Germany, France gear up for new lockdowns as virus surges’, 28<sup>th</sup> October 2020

*“As New York officials on Thursday hurriedly launched a targeted lockdown to stamp out rising rates of positive coronavirus test results, chaos, confusion and tension erupted over restrictions that are closing schools and businesses and greatly limiting attendance at places of worship.”*

- NY Times, ‘New York City rushes to enact a new targeted lockdown, sowing chaos’, 8<sup>th</sup> October 2020

On the US election front, the main focus was on uncertainty relating to the next round of fiscal stimulus.

*“A blue sweep, in which Biden wins the presidency and Democrats take control of the Senate, appears the most likely outcome according to polls and model projections. This result would provide the most fiscal stimulus to the economy in 2021. While the Biden plan does detail about \$2.5tn of tax increases over the next decade, we assume these will not be implemented until the economy is on firmer footing, likely late 2021 or early 2022. Simulations of the Fed staff’s model show that an additional \$2tn stimulus package could significantly boost the economy next year, lifting real GDP growth by about 5 percentage points, adding 3 million jobs, and lowering the unemployment rate by nearly 2 percentage points.*

*... However, the second most likely outcome – a Biden win and a Republican Senate – is also the most negative for 2021 growth, in our view. Fiscal stimulus is likely to be far more marginal and other key elements of the Biden agenda that could be implemented through executive orders or guidance on regulation are likely to be negative for near-term growth prospects. With control of the Senate possibly not determined until January, there could be a prolonged period of uncertainty about fiscal policy prospects following the election.”*

- Deutsche Bank, Economic Research, 22<sup>nd</sup> October 2020

At the time of writing, although Joe Biden has won the election, the so-called ‘blue-wave’ scenario looks unlikely (i.e. Democrat control of the senate), which means less fiscal stimulus than hoped but also less tax hikes.

*“The resolution of most of the recent electoral uncertainties has a number of implications for the US economic outlook. The first and most important relates to fiscal policy. Barring a surprise Democratic sweep of the two Georgia Senate runoff elections in early January, the prospect of a Blue Wave surge in fiscal thrust is off the table.*

*That said, our DC experts believe that we are likely to see another spending package to support the economy and to address public health needs. While the uncertainty is high, something in the neighborhood of \$1 trillion late in the first quarter is a reasonable expectation.*

*While divided government after Inauguration Day promises less of a spending boost to aggregate demand than the Blue Wave scenario, it also presents less of a tax drag on growth. We expect no major changes in tax policies from the incoming 117th Congress. Looking beyond the near-term prospects for another COVID-19 relief spending package, we believe the prospects of divided government imply no further major changes in fiscal policy after the first quarter.”*

- JP Morgan, Economic Research, 10<sup>th</sup> November 2020

## Why is it relevant?

The events of the last few months – a nascent global economic recovery, central banks going more extreme with monetary policy and surging fiscal stimulus – all tie back to a key asset allocation theme that we have

discussed before, namely the interplay between inflation expectations and the 'lower for longer' interest rates theme that has been turbocharging asset prices everywhere.

Back in our December 2019 market commentary, we noted the following:

*"We now see more concern about the negative side effects of ultra-low interest rates and a growing consensus that when interest rates are already very low, the marginal benefit of further monetary stimulus reduces, while the costs increase. (details [here](#))*

*... The obvious alternative to stretched monetary tools is fiscal policy, which Reserve Bank of Australia Governor Philip Lowe has been vocal about. Commenting on a research report he oversaw, which assessed the efficacy on unconventional monetary policy tools such as negative rates and quantitative easing, he noted:*

*"One key lesson is that the tools are most effective when used together with a broader set of policies, like fiscal and prudential measures."*

*Dr Lowe's remarks amplify his recent warning that monetary policy can only do so much and his calls for the Coalition government to inject more infrastructure spending and structural economic reforms to boost the sluggish economy."*

- Australian Financial Review, 'QE most effective with broader fiscal policies', Oct 2019

Fast forward to today and fiscal stimulus of epic proportions has been unleashed globally, a theme we discussed in detail [here](#).

*"Global fiscal frenzy is real & big: \$10tn of announced fiscal stimulus in 2020 now greater than \$8tn of monetary stimulus; fiscal is more powerful direct stimulus for economy than monetary policy."*

- Bank of America, 'The Flow Show', 4<sup>th</sup> June 2020

*"The COVID-19 crisis has devastated people's lives, jobs, and businesses. Governments have taken forceful measures to cushion the blow, totaling a staggering \$12 trillion globally. These lifelines have saved lives and livelihoods. But they are costly and, together with sharp falls in tax revenues owing to the recession, they have pushed global public debt to an all-time high of close to 100 percent of GDP."*

- IMF, 'Fiscal Policy for an Unprecedented Crisis', 14<sup>th</sup> October 2020

While much of the fiscal stimulus commentary has focused on the risks of unsustainable government debt levels, there has been less on the implications for inflation. Currently, the overwhelming consensus view is that inflation will remain low for a very long time, but could fiscal stimulus change that?

Conventional economic theory suggests inflation is largely a monetary phenomenon and has less to do with fiscal policy. But that same conventional thinking has failed to explain why inflation has remained so stubbornly low for the past decade. Newer schools of thought suggest the relationships between monetary policy, fiscal policy and inflation are more complex than previously thought. (e.g. [How fiscal policy drives inflation.](#))

A research note from Morgan Stanley brought these two schools of thought together, arguing that what's really different this time is the unprecedented combination of large scale monetary + fiscal stimulus being engaged at the same time. They refer to the US case specifically, but similar dynamics are playing out globally.

*“While we are likely to experience big imbalances in the real economy for several more quarters, if not years, the most powerful leading indicator for inflation has already shown its hand—money supply, or M2. As Milton Friedman famously said 50 years ago, ‘inflation is always and everywhere a monetary phenomenon.’ It’s fair to say we have never observed money supply growth as high as it is today.*

*Of course, money supply also grew rapidly after the Great Financial Crisis (GFC) and we never saw inflation appear in a meaningful way. This fact has emboldened the view that the Fed can print money at whatever rate they want, and it won’t lead to inflation, at least not enough inflation to cause nominal and real long term interest rates to rise much from here. Given the historically low levels of rates and crowdedness of long duration assets, that may prove to be a dangerous assumption.*

*We’ve argued for the past several months that the policy response to this crisis has been very different than what was used during the GFC. On the monetary front, the Fed reacted much more swiftly and aggressively with its immediate response and direct intervention in credit markets. In short, they went all-in from the beginning showing no hesitation to do whatever it takes to support markets and the economy. Part of that aggressiveness was also likely attributable to the fact that we didn’t get any meaningful inflation after \$4 trillion in Quantitative Easing following the GFC. However, it’s the fiscal response that’s really different this time.*

*First, the government has been sending money directly to both consumers and small businesses as a means of supporting the economy during the lock down and reopening—aka “helicopter money.” Second, they have directly intervened in the lending markets by making loans via the Paycheck Protection and Main Street Lending Programs. Finally, and perhaps most importantly for the inflation call, is the decision by Congress to guarantee loans made by commercial banks and to offer mortgage and other liability (rent) forbearance via the CARES Act.*

*... Congress is now in the driver’s seat when it comes to the money supply with its fiscal programs and as Milton Friedman also famously said, ‘Nothing is so permanent as a temporary government program.’ This is potentially more inflationary than appreciated which means back end rates can rise. Very few portfolios are prepared for such an outcome. Such shifts can happen quickly when they are so unexpected ...”*

- Morgan Stanley, US Equity Strategy, 13<sup>th</sup> August 2020

It is also well recognised that letting inflation ‘run hot’ for a while can be a tempting policy choice for governments struggling to get their elevated debt to GDP ratios back under control. This kind of convenient ‘solution’ is tempting for politicians, but comes with significant risk of unintended consequences and once unleashed can be hard to control.

*“... there’s another way that the government can shrink the mountain of debt weighing down the U.S. economy: inflation. Because most interest payments are fixed in nominal terms, inflation makes existing debt less important in real terms. Raising the long-term inflation target from the current 2% to a still-modest 4% would substantially increase the rate at which debt effectively vanishes.*

*The U.S. has used inflation this way before. Economists Joshua Aizenman and Nancy Marion wrote:*

*The average inflation rate over this period [from 1946 to 1955] was 4.2%...inflation reduced the 1946 [federal] debt/GDP ratio by almost 40% within a decade.*

*A decade of 4% inflation today would do the same for total debt, not just government debt.”*

- Bloomberg, ‘Inflation is the way to pay off Coronavirus debt’, 7<sup>th</sup> May 2020

*“The truth is that governments have an inherent bias towards inflation, especially under adverse conditions such as wars and revolutions. The Covid-19 lockdown is another such condition. Tomorrow’s inflation will alleviate some of today’s financial problems: debt levels will come down and inequalities of wealth will be mitigated. Once excessive debt has been inflated away, interest rates can return to normal. When that happens, homes should be more affordable and returns on savings will rise.*

*But the evils of inflation should not be overlooked. Economies do not function well when everyone is scrambling to keep pace with soaring prices. Inflation produces its own distributional pain. Workers whose incomes rise with inflation do better than retirees. Debtors will thrive at the expense of creditors. Profiteers arise, along with populists who feed on social discontents.”*

- Financial Times, ‘Can governments afford the debts they are piling up?’, 3<sup>rd</sup> May 2020

Given the difficulty central banks have had over the past decade in getting inflation up to their target levels it is naïve to simply assume they can precisely calibrate policy to deliver inflation that’s high enough to materially reduce real debt burdens, with no risk of spiralling much higher.

*“Ironically, the greater the deflationary concerns that policymakers must fight today, the greater the debt build up and the higher the inflationary risks are in the future.*

*The deflationary shock caused by the pandemic drives the need to expand balance sheets to support demand today, as seen in the latest US \$1.0 trillion Phase 4 stimulus and the €750 billion pan-EU recovery fund. The resulting expanded balance sheets and vast money creation spurs debasement fears which, in turn, create a greater likelihood that at some time in the future, after economic activity has normalized, there will be incentives for central banks and governments to allow inflation to drift higher to reduce the accumulated debt burden.*

*Indeed, this has already been seen in recent FOMC minutes, as discussions of explicit outcome-based forward guidance raises the prospect for Fed-sanctioned overheating of the economy. Despite the longer-term nature of these risks, asset managers have real concerns today about persistent unanticipated shifts in inflation that can create large discrepancies between current expected real returns and actual realized returns.”*

- Goldman Sachs, Commodity Research, 28<sup>th</sup> July 2020

The consensus view from the economic forecasting community is still highly skewed to the low inflation scenario, as it has been for a long time now. The low inflation camp points to longstanding factors such as technology and globalisation, as well as more recently to economic weakness, slack in the labour market and depressed energy prices.

So far, officially reported inflation statistics in most developed economies remain consistent with the low inflation narrative. However, in the context of the severe economic shock that COVID has imposed, it’s worth noting that inflation data has rebounded faster than other economic activity indicators. For example, the New York Federal Reserve’s Underlying Inflation Gauge, which captures a broader range of prices than the narrow Consumer Price Index (CPI) basket, has already rebounded back to pre-COVID levels, even though US employment data remains stuck at depressed levels.



Source: Ardea Investment Management, Bloomberg

While most focus on the fact that inflation is still running below target levels, in this situation it is pertinent to apply the 'inversion' mental model popularised by the lesser known Berkshire billionaire, Charlie Munger. Rather than ask why inflation is low, it's more relevant to ask why inflation isn't even lower in the face of such severe economic disruptions.

Extending this inverted line of thinking, there is a growing minority now pointing to this resilience of inflation as a warning sign of future upside inflation risks that are building. They point to the unprecedented coordinated fiscal + monetary stimulus we're now seeing (including the creep toward explicit debt monetisation) on the demand pull side, together with cost push factors like rising anti-globalisation sentiment, populism giving more wage bargaining power to workers (despite elevated unemployment) and supply chain changes. (details [here](#))

We can't reliably predict whether inflation is headed higher or not. In fact, given all the variables involved and the complexity of their interactions, we'd argue nobody can. Reinforcing this point, back in May Deutsche Bank published a research piece on the post COVID outlook, in which one group of analysts made a compelling argument for inflation, immediately followed by another making an equally compelling case for deflation.

#### *"The case for inflation*

*As policymakers launch unprecedented stimulus packages, it seems the coronavirus will be inflationary. Add in the supply shock from retreating globalisation, the increase in labour's bargaining power, as well as the need to reduce large debt burdens, and it means inflation is back on the agenda.*

#### *The case for deflation*

*With the deepest recession in generations taking hold, it is remarkable that many dismiss the deflationary consequences. Deleveraging will be a feature of the landscape for years to come, any fiscal boost will ultimately prove temporary, while any reverse in globalisation would take decades to feed through."*

- Deutsche Bank, Konzept 'Life after COVID-19', 13<sup>th</sup> May 2020

While the consensus is still focused on the demand side (i.e. COVID induced unemployment causing a collapse in demand for goods and services), it is the supply side impacts that may turn out to be more important. Suppliers of goods and services were forced to close, not because of weak consumer demand, but because of government orders. Many of them will be slow to re-open (if they re-open at all) because there can be substantial costs involved in shutting down and then restarting production in many cases.

Given inflation ultimately comes from aggregate spending exceeding aggregate production capacity, COVID related supply chain disruptions, together with an acceleration of trends such as de-globalisation and populist focus on lifting wages, the potential cost push impact on inflation seems underappreciated.

*“... while we may be in the midst of a reduction in what mainstream economists call ‘aggregate demand,’ we are also seeing a significant supply-side shock. The former typically has deflationary tendencies, while the latter causes price inflation. A supply shock is simply an event which impedes the ability for supply chains, or the structure of production, to maintain the allocation of capital and labor so that they can produce a given level of output.”*

*What began as a reduced supply of imports to the US from China has developed into an even deeper supply-side issue, with government-enforced shutdowns for “nonessential” businesses, rising domestic unemployment, and reduced production as a record 6.6 million Americans filed for unemployment benefits in the last week of March.”*

- Mises Institute, ‘This isn't your usual demand-shock recession’, 15<sup>th</sup> April 2020

*“To summarise our arguments: First, we believe that the Great Covid-19 Recession (GCR) will be a sharper but shorter recession than the global financial crisis (GFC). Second, the public health crisis has galvanised policy-makers to respond swiftly. The timing, scale and coordinated policy easing will lift us out of the low-growth, low-inflation loop. Third, the economic shock is driving an even deeper wedge between low- and high-income workers. We therefore expect increased scrutiny of trade, tech and titans, given their role in driving the wage share of GDP lower and widening the income divide. Disturbing this trio will also mean disrupting the key structural disinflationary forces of the past 30 years.*

*... Addressing the pushback from investors: Just as we thought, the consensus remains firmly anchored in the disinflation camp. Most of our discussions were centred on the pace of the cyclical recovery and whether policy easing will be effective. While investors heard us out on the disruption to tech, trade and titans, they are generally downplaying its impact on inflation and believe that weaker demand conditions will persist, keeping inflation at relatively low levels.”*

- Morgan Stanley, Global Macro Briefing, 21<sup>st</sup> May 2020

History shows that inflation expectations are sticky ... until they're not. Which is to say that once a prevailing inflation narrative becomes entrenched – as ‘low inflation forever’ has become over the past decade – it takes more than just a single catalyst to change it, but once it does start to change, it can gain rapid momentum.

*“Inflation regime shifts tend to have several consecutive or simultaneous drivers. They tend not to have a single explanation such as ‘high debts levels’ or ‘money printing’. They often reflect broader contemporaneous social, political and economic dynamics (e.g. social upheavals, demographics, wars and their aftermath). The common drivers of inflation regime shifts are, therefore, a combination of: supply-side constraints or reforms, FX shocks, fiscal issues, institutional reforms, event-driven shifts in expectations, food/commodity shocks and demand shocks exogenous to all previous categories.*

*... In the late 1960s/early 1970s social pressures led to higher fiscal spending and increased labour bargaining power. A series of country-specific shocks also facilitated the inflationary push but policymakers were generally reluctant to tighten policy enough, allowing a permanent shift in inflation. The 1970s oil shock reinforced the inflationary issues and it was only in the late 1970s/early 1980s that credible committed policy efforts could break the inflationary spiral.*

- Deutsche Bank, Economics Research, 15<sup>th</sup> July 2020

*“Big picture lessons from '60s: late-60s, early 70s period of social & civil unrest, bigger government / budget deficits, end of globalization (end of Bretton Woods), rising yields & inflation after long period of calm, start of stagflation; lessons:*

*- Fed policy remained the dominant driver of asset prices.*

*- Initial period (1966 to 1969) of transition to stagflation, higher yields, higher inflation, higher volatility was characterized by small cap and value stock outperformance*

*- Markets discounted the end of hegemony of the US dollar; non-US assets significantly outperformed US equities (despite Nifty 50) in late-60s.*

*The transition from the 60s to the 70s (stagflation, monetary & fiscal instability, breakdown in global cooperation, civil disobedience) coincided with 3 big simple trends: Rising bond yields, Falling US dollar, Volatile, sideways stock markets”*

- Bank of America, The Flow Show, 4<sup>th</sup> June 2020

Linking all these factors to the current backdrop, it's not hard to envisage a scenario in which a confluence of factors leads to much higher inflation than currently anticipated by the consensus.

For example, imagine a scenario in which the nascent rebound in global economic activity, potentially turbocharged by vaccine progress, collides with the fastest money supply growth on record and the lagged effects of unprecedented monetary + fiscal stimulus flipping from their intended anti-cyclical objective to becoming highly pro-cyclical on the demand side.

Added to this, we can have cost push pressures from accelerating structural changes like de-globalisation and populist political pressure to raise wages for those at the bottom of the income spectrum, while COVID induced supply side disruptions continue to hold back production capacity.

Finally, we have central banks more openly talking about letting inflation overshoot to the upside and governments more concerned about the risk of doing too little rather than too much in mitigating the COVID shock. We know from the past decade's experience that once stimulus is hard to wind back once unleashed, given financial markets' pavlovian conditioning to panic at the slightest sign of stimulus withdrawal – recall the 2018 global equity market drawdown that was triggered by a withdrawal of stimulus by the US Federal Reserve. (details [here](#))

Combine all this and you have the makings of an inflationary regime shift.

Given that inflation has been persistently running below central bank targets in most places, any increase from current levels would initially be perceived as 'good inflation' (i.e. a positive side effect of stronger economic growth). However, as we saw in 2018, it doesn't take much to tip over into a 'bad inflation' narrative where risk asset prices are hit hard by the fear of too much inflation forcing central banks to hike rates.

This good vs bad inflation dynamic is now particularly relevant from an overall portfolio construction perspective because all asset prices have become so dependent on the 'lower for longer' interest rates narrative. Stretched valuations everywhere from equities to bonds to property have been justified to a large extent by the expectation for ultra-low interest rates to last for a long time.

Unexpectedly high inflation is the one thing that can really challenge this narrative because it could force

central banks to hike rates, if the perception that they're falling behind the curve takes hold. As we saw in 2018, we're in a paradigm where both risk asset prices, and traditional safe haven government bonds can react very badly to even modest rate hikes. (details [here](#))

Of course this is only one of many possible scenarios that can play out and maybe it turns out that inflation remains low. However, the narrow focus on whether inflation will or won't rise misses the bigger picture risks and opportunities for multi-asset portfolios.

It is often the case that when investor consensus has been heavily skewed in one direction for a long time, resulting in entrenched narratives, strategies that position for opposing scenarios can offer favourably asymmetric risk vs reward opportunities, meaning they offer disproportionate upside potential if the non-consensus scenario plays out.

Looking through short term performance volatility potential and thinking more about medium term portfolio construction and strategic asset allocation, we can see the makings of asymmetric opportunities when it comes to inflation.

We can certainly point to narratives that have become entrenched over the past decade - 'low inflation forever' and by extension, 'lower for longer interest rates'. We can also see a growing lists of catalysts that could conspire to challenge these entrenched narratives and we can also see how this could trigger a potentially violent disruption to the status quo pricing across pretty much all asset classes. This would cause substantial damage to multi-asset investment portfolios that appeared to be diversified but in reality, contained lots of investments that turned out to be highly correlated to the low inflation + low rates theme.

That takes us to the asymmetric opportunity, which stems from the combination of two underlying thematic:

- Having been entrenched in the low inflation narrative for so long, many large pools of institutional capital have materially down weighted (or even abandoned entirely) their strategic asset allocations to inflation linked assets.
- The supply of explicitly inflation linked assets has remained modest relative to the global investment universe. For example, inflation linked bonds only represent a small portion of the total fixed income universe.

Given these underlying thematic, even a modest shift in the prevailing inflation narrative could trigger a rush to rebalance the accumulated underweight inflation positions that have built up over many years. This in turn would cause an aggregate demand spike for inflation linked assets that is disproportionately large relative to their modest supply, in turn triggering an outsized price reaction in niche segments like inflation linked bonds. Related to this, we would likely see a spike in the market pricing of interest rate volatility, which is currently priced near all-time lows.

## How are we positioned?

The portfolio's 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. Consequently, the portfolio's performance is not driven by the macroeconomic factors or market movements that dominate conventional fixed income strategies and therefore exhibits minimal correlation to broader government bond, credit and equity markets.

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](#).)

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

- **RV Bonds vs Derivatives**

The portfolio held long positions in Australian government and semi-government bonds relative to swaps and futures. These positions, which had previously stood out as relatively cheap on respective yield curves, performed well as the market began to price an expected increase in RBA quantitative easing to 5-10y bonds at the November meeting. In EUR, RV trades in semi-government bonds also outperformed derivative hedges.

- **RV Rates**

The portfolio benefited from the rebalancing of duration positions, which reflected "delta hedging" (details [here](#)) of options in EUR.

- **Inflation**

The portfolio benefited from the outperformance of very short-dated ACGB inflation linked bonds amid the recovery in CPI reported for Q3. Modest gains also reflected positioning for a steeper USD inflation curve.

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

- **Volatility**

The portfolio is positioned long volatility through interest rate option positions in AUD, EUR and USD markets. A small drag on performance came from falling implied volatility on long option trades. Expectations for further central bank policy support generally weighed volatility across global rates markets.

**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.

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