

Ardea Real Outcome Fund

ARSN 158 996 699 APIR Code HOW0098AU

Monthly Performance Report October 2021

| Performance ¹ | 1 month | 3 months | 1 year | 2 year | 3 year | 5 year | Inception |
|--------------------------|---------|----------|--------|--------|--------|--------|-----------|
| Fund | -0.69% | -1.45% | -0.82% | 2.41% | 4.57% | 4.45% | 3.84% |
| Benchmark ² | 0.17% | 0.67% | 2.89% | 1.81% | 1.79% | 1.81% | 1.90% |
| Excess Return | -0.85% | -2.12% | -3.71% | 0.60% | 2.78% | 2.64% | 1.95% |

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 October 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 | \$10bn |
| Management Fee | 0.50% p.a. |
| Buy/Sell Spread | +0.05% / -0.05% |
| Distribution Frequency | Quarterly |

| Sector Exposure | |
|------------------------------|------|
| Government – National | 69% |
| Government - State | 31% |
| Total | 100% |

| Rating Exposure | |
|-----------------|-------------|
| AAA | 50% |
| AA | 41% |
| A | 9% |
| Total | 100% |

| Region Exposure* | |
|--------------------|------|
| Australasia | 36% |
| Europe | 14% |
| N. America | 50% |
| Total | 100% |

| Interest Rate Duration (years) | |
|--------------------------------|-----|
| 12 month average | 0.2 |
| 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 October was -0.69% (net of fees), which is modestly outside the range of expected performance variability (see the *Understanding Performance* section below for details).

The magnitude of negative return experienced this month is still consistent with the Fund's 2% p.a. volatility target and, as we explain below, is a strong validation of the Fund's risk management process, which is intended to maintain low performance volatility, even through periods of extreme market stress.

Relative value (RV) interest rate 'Curve' and 'Bond vs Derivative' exposures detracted from performance this month, while the Fund's exposures to 'Options' and 'Inflation Beta' were positive contributors. Some specific trade examples are provided further below.

Performance attribution to 'Curve' captures performance stemming from the Fund's exposure to changes in the shapes of interest rate curves, while attribution to 'Bond vs Derivative' captures performance stemming from exposure to changes in the relative pricing relationships between government bonds and closely related interest rate derivatives.

Both 'Curve' and 'Bond vs Derivative' exposures experienced extraordinary volatility this month, resulting in many RV-specific pricing relationships moving dramatically outside of their recent ranges. Due to the Fund's intentional approach of diversifying risk across a large number of modestly sized trades, the negative performance from these exposures was not driven by any key trades. Rather, it was the net result of some of the Fund's exposures profiting from these market moves, while many more were negatively impacted, resulting in a negative overall performance.

Some important nuances about October's bond market moves:

While government bond markets sold off dramatically in October, this in itself is not relevant for the Fund's performance because the portfolio is always managed to be 'duration neutral' and the Fund's pure RV investment approach is independent of general bond market fluctuations.

In fact, for most of the month, the Fund's performance remained positive even as bond markets were selling off. What actually was relevant for the Fund's performance was the highly uneven nature of October's violent moves across different sub-segments of rate markets that manifested over the last few days of the month.

While short-dated interest bond yields / rates rocketed higher, longer term rates remained stable (or even declined), resulting in violent changes in the shapes of interest rate curves and the pricing relationships between government bonds vs derivatives. Meanwhile, market pricing of long-term inflation moved substantially higher through the month, only to reverse half of that move on the last two days of the month.

For example in AU markets, 3Y bond yields rose by 0.9% over the month (a relative change of 290% ... an extreme move of the kind we haven't seen since the 1990's) but 30Y bond yields only rose by 0.4% (a modest change of just 17%). In US markets, 2Y bond yields rose by 0.2% over the month (a relative change of 80%) but 10Y bond yields barely moved and 30Y yields actually fell.

Therefore, as much as October was characterised by a general bond market sell-off, under the surface it was actually an RV-specific shock, meaning there were extreme dislocations across the kinds of RV pricing relationships on which the Fund focuses, and it was of a magnitude that we have only seen 2 other times in the past 20 years (Q4 2008 Lehman default, Q1 2020 COVID shock).

Additionally, the last 2 times rate markets experienced this type of RV shock, it was in the context of a broader "risk-off" move, meaning that equities / credit sold off materially as well. This time other segments of financial markets remained calm, which meant that market pricing of interest rate volatility (as reflected in option markets) did not move nearly as dramatically as it did in the prior 2 RV shocks.

Having long experience of managing these types of RV-specific shocks, we intentionally construct our portfolios to prioritise what Ardea refer to as risk balance, which means the Fund always maintains a balance of different types of trades that can perform well in different market environments, including periods of stress.

The Fund's risk balance worked as intended over the month, with the Fund's exposures from 'Options', 'Inflation Beta' and other trades providing material positive contributions that helped offset loss making exposures. It is precisely because of this risk balancing effect that the Fund did not experience an outsized negative return, despite the extreme nature of the RV shock in October.

The Fund always maintains a structural long exposure to interest rate options and inflation linked government bonds, which are implemented through an RV lens, and are managed in the broader context of maintaining 'risk balance' for the overall portfolio.

Some important nuances about the Fund's use of interest rate options:

One approach is to overlay options as a form of 'portfolio insurance' or a 'tail-risk hedge' and size them large enough to be dominant drivers of total portfolio performance. While this approach results in a high probability of such portfolios delivering positive performance in periods of market stress, it comes with the trade-off of material negative performance consequences in benign market environments.

The Fund uses options in a different way and for a different purpose. Rather than buying options as an overlay, the options are viewed through an RV lens and embedded into RV trades, which avoids material negative performance consequences in benign market environments. The purpose of using options in this way is not to seek large gains in periods of market stress, but to provide ‘risk balance’ for the portfolio at these times.

The use of options in this way is directly linked to the Fund’s objective of maintaining low performance volatility, even through periods of extreme market stress.

An additional nuance is that when rate markets become more volatile, the increase in volatility is rarely uniform. October was a perfect example of this, with extreme divergence in realised volatility of short-end vs long-end rates. The former experiencing 4-6 standard deviation moves while the latter remained relatively calm.

The practical implication is that we cannot predict in advance which sub-segments of rates markets will experience the most realised volatility. Therefore, our approach is to spread optionality across a range of currencies and curve segments to a) diversify the optionality and b) match the optionality to our RV exposures. While this approach works reliably over an investment horizon, there will always be discrete periods where the Fund happens to own more options in market segments that don’t move as much. For example, the Fund’s holdings of options on long-end rates provided little benefit in October.

As a direct result of the Fund’s strict performance volatility control, we are able to hold on to the loss making trades from October, in order to give enough time for RV pricing relationships to normalise again, and are therefore not forced to unwind these positions at the worst possible time.

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 – CAD interest rate swap curve

These trades contributed to ‘Curve’ attribution.

The Fund has been positioned over recent months with various trade structures targeting unusually high 2-3y swap rates in Canada relative to 1-2y and 3-5y rates. This anomaly in the curve has been driven by flows in the swap market related to hedging of interest rate risk by banks and positioning by macro-oriented investors expressing views on Bank of Canada policy rate trajectories.

An example of one type of trade structure targeting this RV theme is a “butterfly” spread, which allows the Fund to target the anomaly without exposure to the high level of macro risk that comes with long or short only positions. The Fund is long in forward starting swaps targeting 2-3y rates and simultaneously short both 1-2y and 3-5y sectors.

This type of position is much more tightly constrained than outright CAD swap rate level exposures, which have been very volatile. Nonetheless, the butterfly position underperformed in October as extreme trading conditions buffeted the short end of interest rate curves globally, with CAD, GBP and AUD markets the most affected. In particular, the shedding of interest rate risk by some participants has meant that the 2-3y point on the CAD curve has become even cheaper relative to shorter and longer points on the curve.

We are comfortable holding the position because the RV opportunity remains compelling and the risk contribution is modest.

RV Theme – Cross Currency Basis

These trades contributed to 'Bond vs Derivative' attribution.

The Fund is targeting RV opportunities in the AUD-USD cross-currency basis curve, by receiving between 5y and 10y maturities. This part of the curve has been excessively steep amid expectations of Australian bank offshore issuance (and other flows) that require hedging which pushes the basis spread higher. The shorter maturity basis swaps have been depressed by large RBA liquidity flows.

The last day of October saw an extreme increase in shorter dated spreads as banks and hedge funds stopped out of received strategies in basis spreads, mostly in the 1y part of the curve. The long end where the fund is positioned was better protected but these spreads still edged slightly wider in sympathy with the front-end dislocation and were a detractor from performance.

We continue to favour this position as the original rationale still holds and we believe the short-term positioning related volatility is unlikely to persist.

RV Theme – USD Swaptions

These trades contributed to 'Options' attribution.

The Fund embeds options positions into RV strategies. These are RV trades in-and-of-themselves but they also improve the risk balance of the portfolio. Over prior months, the Fund targeted long swaption 'straddle' positions in USD short end rates. This strategy involves buying a receiver and a payer swaption at the same strike level, such that the Fund is net positioned for higher volatility without needing to pick whether it is an up or down directional move in rates. The RV rationale at the time of implementation reflected lower option implied volatility relative to realised volatility.

The position performed strongly in October as volatility in this part of the curve jumped sharply (see the market commentary for a detailed discussion on the drivers of this move).

Structural Exposure – AUD inflation

These trades contributed to 'Inflation Beta' attribution.

The Fund maintains a structural long position in Australian inflation-linked bonds with the interest rate duration risk associated with these positions hedged. The net effect is that the portfolio is exposed to higher inflation pricing. The size of the position is maintained at a steady level such that it tends not to be a dominant driver of returns over the medium to long run compared with RV alpha sources (although the precise composition of bonds and inflation swaps that comprise the beta exposure involves RV considerations).

Against the backdrop of rising global inflation pressures (see the market commentary for a more detailed discussion), Australian inflation breakeven levels rose throughout the month. A higher than expected CPI report on October 27 propelled these breakeven levels even higher, however much of that move reversed sharply over the final day of the month in what was an extraordinary period of volatility in the Australian market.

Market Commentary

What happened?

The month of October – particularly the last week – saw massive shifts in interest rate markets concentrated at the front end of yield curves. Central banks directly and indirectly backed away from dovish policy guidance, sparking a major regime shift in the pricing structure of interest rates and moves were exacerbated by positioning. Across most G10 markets, 2y yields finished the month between 20bp and over 70bp higher. Some measures of front-end rates volatility reached historically extreme levels (see the next section for details).

In contrast, movements in longer term rates were limited overall, but with notable increases in inflation expectations. The US 10y nominal yield finished the month just 6bp higher at 1.55% - a move comprised of a 21bp increase in the breakeven inflation rate and a 15bp decline in the real yield. Bond indices generally underperformed, but to varying degrees. The Bloomberg Global Aggregate (-0.2%) and Global Treasury (-0.5%) indices suffered modest declines, while the AusBond Composite Index (-3.6%) was impacted by significant underperformance in AUD bonds.

Elsewhere, equities recovered from September losses to make new highs – the S&P 500 rallied 6.9%, unaffected by the volatility in rates markets. Commodity prices continued to rise, further underpinning inflation concerns. The broad Bloomberg commodity index rose 2.6%, while energy prices surged further. Brent oil futures rallied 7.5% over the month to near a seven year high of \$84/bbl, bringing the year-to-date increase in the benchmark to +64%.

Why is it relevant?

We foreshadowed in our [previous note](#) that increasing growth and inflation forecast uncertainty will ultimately underpin higher rates volatility. That is playing out, but in a narrowly focused way at the front end, rather than at the long end of yield curves.

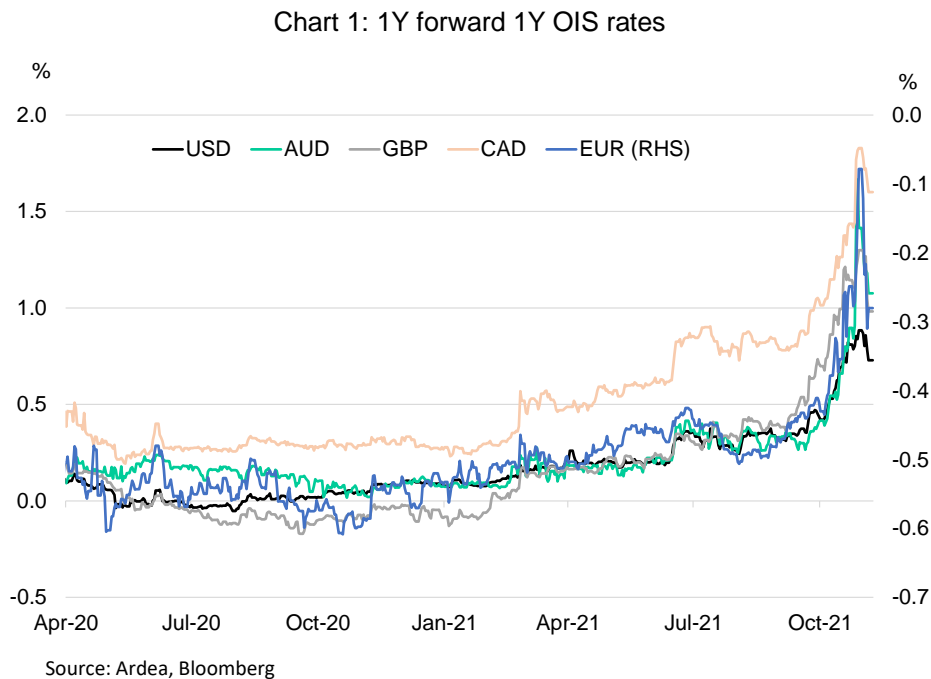
The moves in short end rates have been exacerbated by positioning shifts and a notable pull-back has started early in November. This consolidation phase could have further to run, to varying degrees across markets. But what is clearer is that central banks are already either tightening or preparing to tighten. The backdrop of an unanchored front end is likely to be an enduring theme into 2022, which has implications for fixed income portfolio construction and yield curve strategies.

Equities are taking comfort from well contained long end rates and a negative real policy rate outlook, while global growth momentum and earnings growth remain solid.

We discuss the implications of three key market themes from October.

1) Major shift in the front end of yield curves in October

The biggest moves over the last month have been at the front end of curves, where markets have repriced for significant global central bank policy tightening over the next 2-3 years (Chart 1).



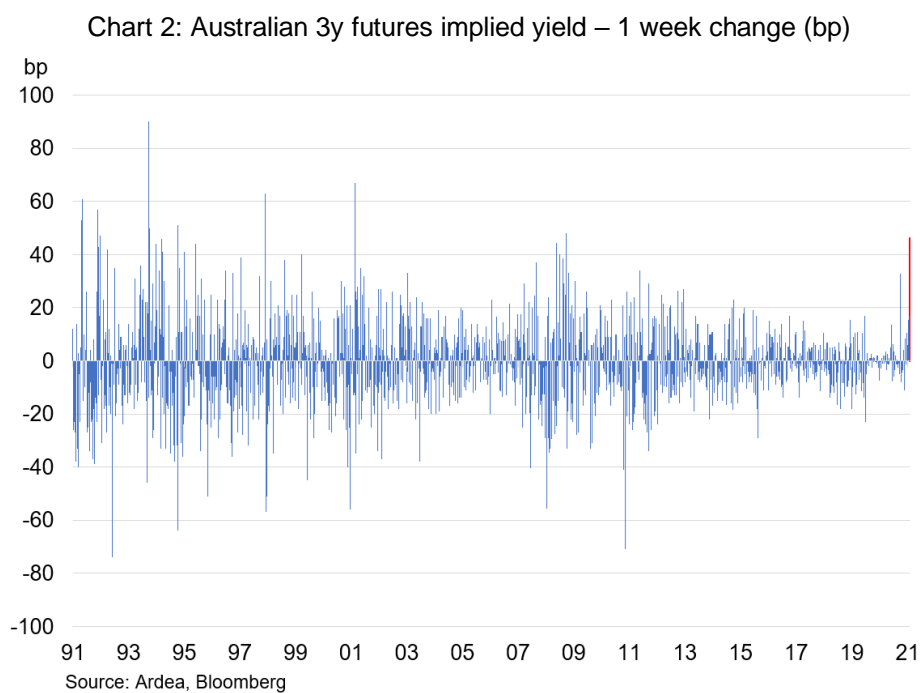
All markets were gripped by fears of tighter policy through October. The AUD, CAD and GBP curves saw the most significant repricing in reaction to higher inflation data and speculation of earlier policy tightening from respective central banks. Some notable developments contributing to these moves:

- **Global:** Rising global inflation fears, as commodity prices reached new multi-year highs and widespread supply pressures persisted.
- **GBP:** Key Bank of England policy committee members cited rising inflation expectations as a reason to soon begin tightening policy. The market repriced sharply for higher rates over the next few years, including pricing a hike for the November meeting. The Bank subsequently decided not to hike in November (sparking a reversal of some of October's moves in early November).
- **CAD:** The Bank of Canada announced an immediate end to quantitative easing (QE) purchases and brought forward rate hike guidance to the middle of 2022.
- **AUD:** Australian Q3 inflation data exceeded market expectations - the core measure lifted to 2.1%pa - the lower end of the RBA's 2-3% target band. The bigger impact on markets came from the RBA deciding not to defend the 0.10% Yield Curve Control (YCC) target on the ACGB Apr-24 bond, underpinning expectations the RBA would formally drop this target. This was subsequently confirmed at the November 2nd meeting.
- **EUR:** The European Central Bank (ECB) did not aggressively push back on market pricing at their October meeting, adding to the global policy exit fears gripping fixed income markets.

- **USD:** The US market was also caught up in the global repricing theme in October, but price action was a bit more orderly than in some other G10 markets. The US Federal Reserve's (Fed) QE tapering timeline and communication strategy have been viewed by markets as providing a bit more of a restraint on rate hike pricing. QE tapering was formally announced at the early November Federal Open Market Committee (FOMC) meeting.

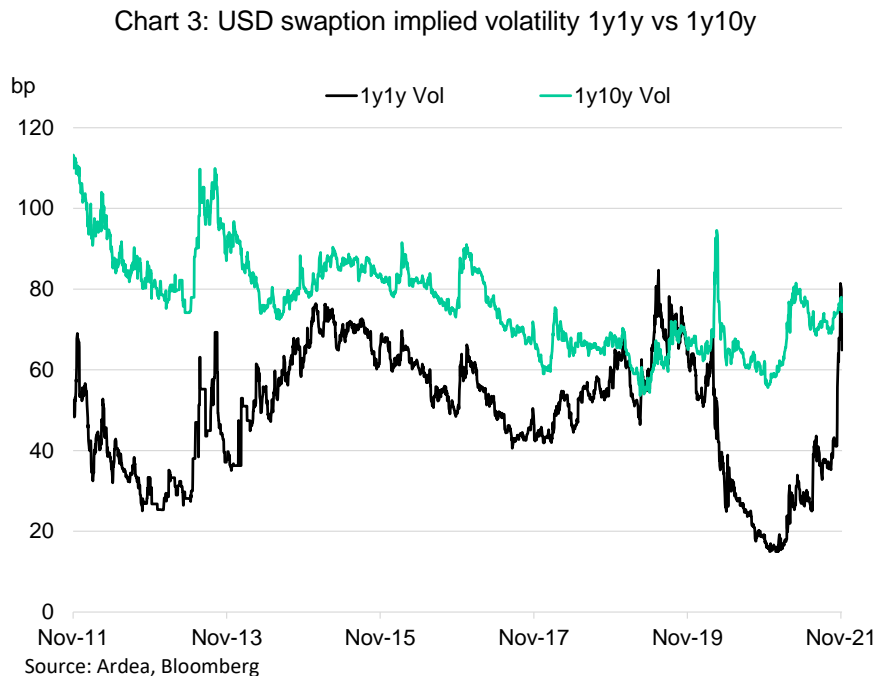
Significant positioning-related flows have extended the sell-off in most markets, as long positions in short end bonds and derivatives were jettisoned. This theme helps explain why the moves in short end rates markets were so violent in the last week of October (as shown in Chart 1). The wash-out of long positions meant that it didn't take as much of a dovish hint from central bankers to drive a significant correction in early November.

The moves in the sub-3y sector of the AUD market were among the most extreme in the world over this period. The yield on the 3m bank bill futures contract maturing in December 2022 lifted 1.22% to 1.60% in October and traded in a 92bp range over just the last week of the month. Year ahead AUD rates contracts had traded in just a 35bp range for the prior year. The AUD 3y futures contract implied yield lifted by 46bp over the last week of the month – the largest weekly increase since 2009 and among the largest increases since the 1990s (Chart 2).



2) Well contained long end rates and real yields a source of comfort for risk assets

Despite the extreme volatility in short term rates, movements at the long end of yield curves have been well contained. Chart 3 shows just how big the disconnect was in October for USD rates, where implied volatility for 1y rates exceeded 10y rates – a rare occurrence in the last decade (outside a brief period in 2019).



In October markets essentially moved to front-load the entire rates tightening cycle into the next few years without materially lifting the end point in the rates cycle. In some markets, 2y and 3y ahead forward rates have traded higher than 4y and 5y ahead forward rates. One interpretation of this pricing structure is that some kind of policy mistake is being priced. That is, rate hikes may go too far and will have to be quickly stabilised and perhaps partly reversed.

Generally, interest rate markets are sceptical that economies can handle a much higher peak in rates in the cycle because of debt levels and/or long-term inflation and growth dynamics. Or put another way, the market expectation for the neutral policy rate (the rate at which monetary policy is neither expansionary nor contractionary) has not increased. (Note that these constrained long-term rates are also impacted by non-economic flows from pension funds and other investors into long term bonds).

Well contained long term yields help explain the resilience of equities to the short end rates volatility in October (after all, equities are long duration assets). Moreover, most of the brief increase in long term rates is reflected in nominal yields and higher inflation expectations. Long term real yields remain historically low – the US 10y real yield at -1.10% is not far from an all-time low (Chart 4).

Chart 4: US 10y real yield

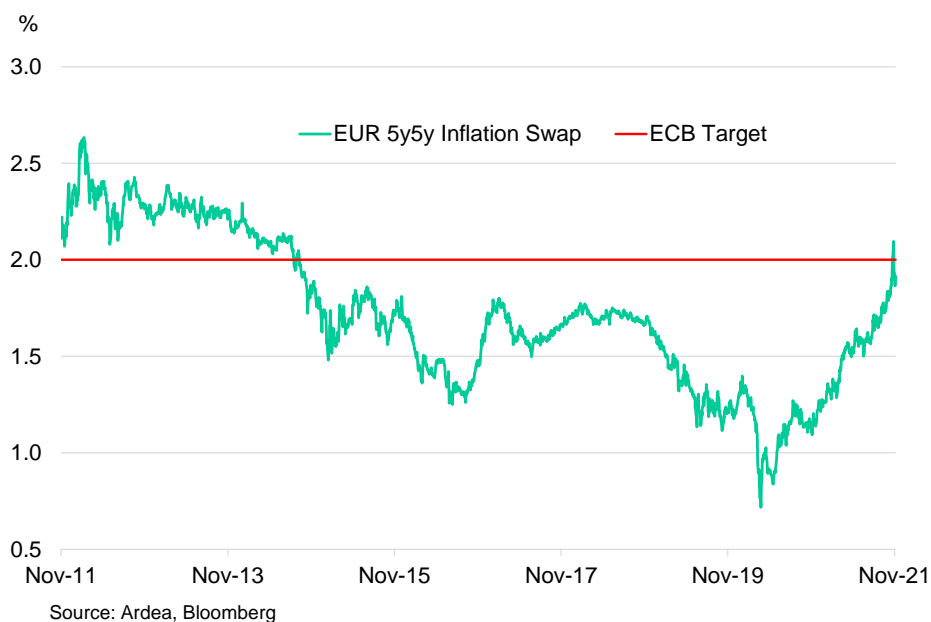


At the face of it, there might be nothing for stocks to fear from sharply higher short-term yields. However, the recent yield curve flattening could ultimately signal some risks for equities and markets more generally. If the reason for flatter curves are low neutral policy rates, then the point of genuinely tighter monetary policies and slower growth could be reached sooner. As we noted in previous research (see [here](#) and [here](#)), longer term rates can track much wider trading ranges with policy normalisation cycles still in the early stages.

3) Inflation risks continuing to challenge the central bank “transitory” narrative

Inflation dynamics are also proving to be very difficult to gauge. The “transitory” inflation view expressed by most central banks is undefined in length and there have been signs that it could take longer to ease (a risk we have flagged previously [here](#) and [here](#)). A case in point is the Eurozone. For many years the ECB’s favoured inflation expectations gauge – the 5y5y inflation swap – had tracked well under the 2.0% policy target (Chart 5). In moving to negative rates and implementing multiple rounds of QE over the last 7 years, the ECB frequently cited 5y5y inflation swaps as a key gauge for inflation expectations. The ECB used to fear that lower inflation expectations could become entrenched (as is the case in Japan). However, the opposite risk is now emerging. In October, the EUR 5y5y inflation swap traded over 2% for the first time since 2014 (Chart 5). In effect, the market sees higher inflation as less likely to be transitory.

Chart 5: EUR 5y forward, 5y inflation swap rate



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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