Ardea Real Outcome Fund

ARSN 158 996 699 APIR Code HOW0098AU

Monthly Performance Report November 2020

Performance[1]	1 month	3 month	FYTD	1 year	3 year	5 year	7 year	Inception
Fund	0.39%	1.53%	2.78%	5.93%	5.88%	5.25%	4.62%	4.42%
Benchmark[2]	0.10%	0.65%	1.71%	0.36%	1.32%	1.45%	1.54%	1.74%
Excess Return	0.29%	0.88%	1.07%	5.57%	4.56%	3.80%	3.08%	2.68%

[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 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	
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	$6bn
Management Fee	0.50% p.a.
Buy/Sell Spread	+0.05% / -0.05%
Distribution Frequency	Quarterly

Sector Exposure	
Government – National	49%
Government - State	51%
Total	100%

Rating Exposure	
AAA	88%
AA	12%
Total	100%

Region Exposure*	
Australasia	49%
Europe	31%
N. America	19%
Total	100%

Interest Rate Duration (years)	
12 month average	0.5
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

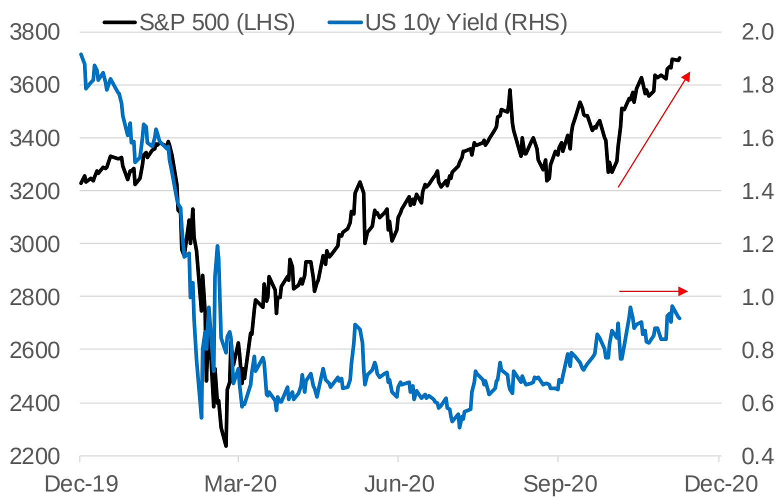
Portfolio Commentary

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?

In November, investor focus switched from votes to vaccines, which powered equities to new highs – most major indices posted double-digit gains and some made new monthly records. In contrast, the USD index and gold underperformed notably. The pro-risk backdrop had only modestly bearish implications for government bonds.

Chart 1: Equity melt-up vs bond yield containment



Source: Ardea, Bloomberg

We outline three key developments over the month.

1) The blue wave turned out to be more of a blue ripple for markets

The lead-up to the 2020 US election showed heightened investor focus on the prospects of a *Blue Wave* outcome, whereby Democrats take control of both houses of the US Congress. The upshot for markets was thought to be significantly more fiscal stimulus – bullish for stocks, but bearish for bonds. In the event, Biden claimed victory, although without a clear blue wave (at the time of writing some senate seats were still being contested). A transition process is underway for the Biden presidency.

The passing of this key event risk gives markets some confidence to the extent that political uncertainty has been reduced which is positive for sentiment. But markets have had to lower the probability of large-scale US fiscal spending, the clearest implication of which was a temporary sharp fall in long term US bond yields and a more sustained drop in measures of US rates volatility (Chart 2).

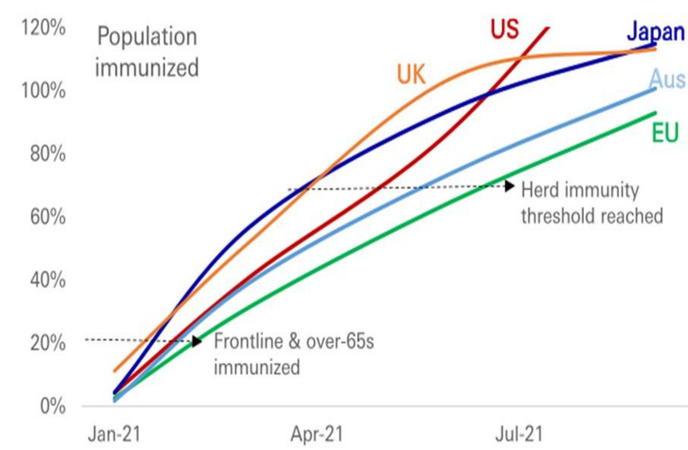
Chart 2: MOVE Index of US Treasury Volatility

Source: Ardea, Bloomberg

2) Vaccine test results offer investors hope

While November started with intense focus on politics, positive news on vaccines ultimately dominated sentiment and price action. Three vaccine candidates reported test results at the upper end of expectations, showing up to 95% effectiveness against COVID in trials. As a result, market participants are starting to imagine a return to a more normal world economy. Chart 3 shows an example of a bullish immunisation projection in November, which suggests herd immunity for many G10 countries could be reached as soon as mid-2021.

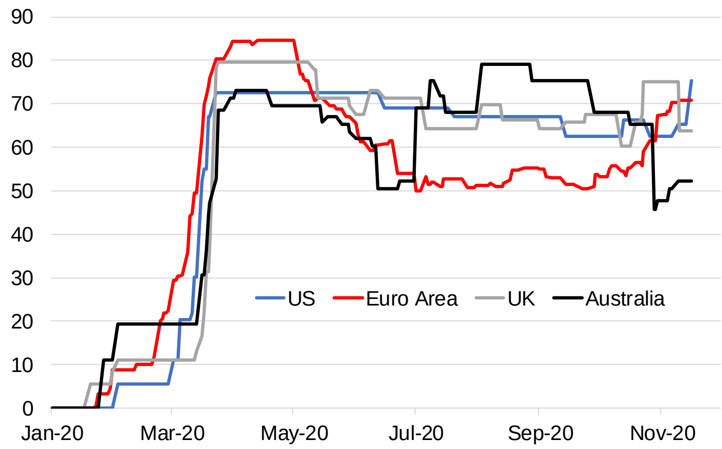
Chart 3: Population immunisation ratios



Deutsche Bank, Haver Analytics, World Bank company sources

The vaccine news was very timely for markets, which in early November were confronting high case numbers and renewed lockdowns in Europe and the US. This renewed COVID wave threatened to derail the recovery narrative that had taken hold over previous months. Chart 4 shows economic stringency indices – which measure the extent of lockdowns and social distancing measures – are still a very long way from normal.

Chart 4: Oxford Economic Stringency Indices



Source: Ardea, Bloomberg

3) Central banks keep low rate support in place

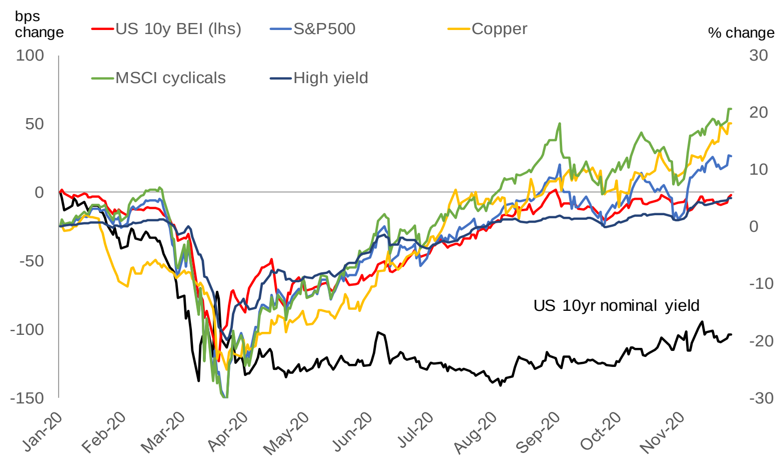
A key anchor holding bond yields down is the continued highly accommodative stance of central bank policy. November featured some notable policy signals from central banks:

- **US Federal Reserve:** The FOMC minutes revealed a lengthy discussion about potential changes to the pace and composition of asset purchases. Many market participants expect the Fed to extend the average maturity of asset purchases in December.
- **European Central Bank:** ECB President Lagarde indicated a preference to further easing via bond purchases, rather than an extension of negative rate policies. Further easing is expected by December.
- **Bank of England:** BoE announced a larger than expected £150bn increase in quantitative easing (QE).
- **Reserve Bank of Australia:** The RBA implemented rate cuts, extra cheap bank financing and a quantity-based QE program for the first time.
- **Reserve Bank of New Zealand:** The RBNZ added further stimulus via cheap loans to banks but hinted at a lower willingness for negative rates.

Why is it relevant?

In recent reports, we have discussed how prospects for a recovery from COVID and confidence in a structurally low inflation outlook have contributed to risk asset strength and well contained nominal bond yields. As Chart 5 shows, this divergence has extended in the last month, although the inflation expectation component of long-term yields has more closely tracked the path of risk assets than nominal yields (via steeply negative *real yields*).

Chart 5: Various asset class movements from January to end November



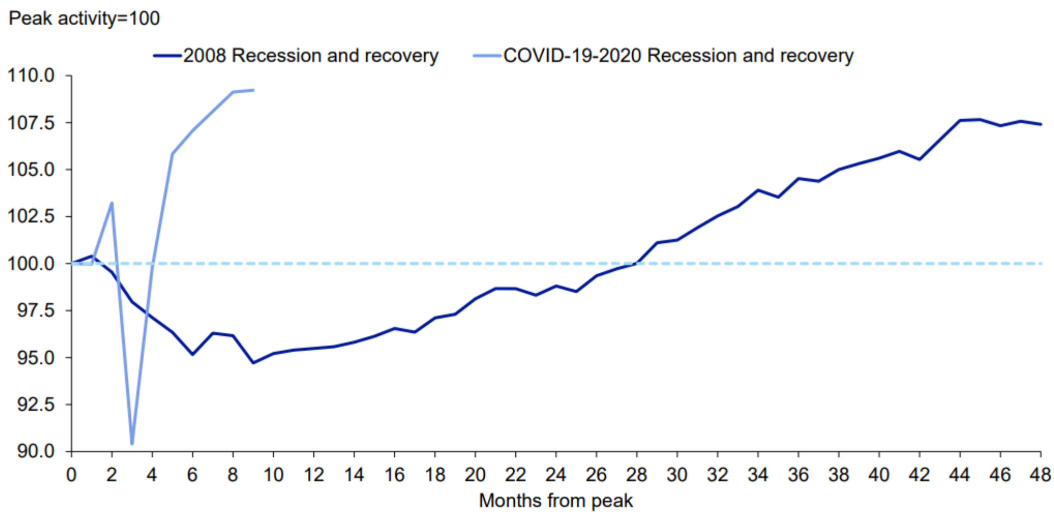
Source: Bloomberg Normalised to 0 on 1st January 2020. US 10y and BEI on LHS, others on RHS.

Underpinning the risk asset and bond yield divergence are assumptions about what 2021 holds for the global economy. We outline a few of these key themes.

1) Markets anticipate a remarkable turnaround in growth

2020 has seen the sharpest decline in global output in around 100 years by some estimates. The IMF expects global real GDP growth to finish the year down around 4.7%. For 2021, growth is forecast to rebound by 4.8%. Both the depth and speed of recovery in growth from the COVID recession stand in stark contrast with previous global recessions, such as in 2008. Indeed, as Deutsche Bank research recently pointed out, some facets of the global economy have shown very strong "V-shaped" rebounds, such as US retail spending (Chart 6). This kind of bounce in spending speaks to the huge volume of government support for households.

Chart 6: US retail sales after a recession - 2020 vs 2008



Note: Peak activity for 2008 recession defined as June 2008; Peak activity for 20202 recession defined as January 2020
Source: US Census Bureau, Deutsche Bank

There are big assumptions underlying bullish 2021 forecasts, especially around the effectiveness and pace of COVID vaccines, which are critical to economies opening back up. There are plenty of risks to the positive consensus outlook, such as logistical problems, population aversion to vaccines or the virus mutating. The emergence or not of these risks will be critical for risk appetite and demand for safe-haven sovereign bonds in the coming months.

2) Economic scars from COVID and low inflation

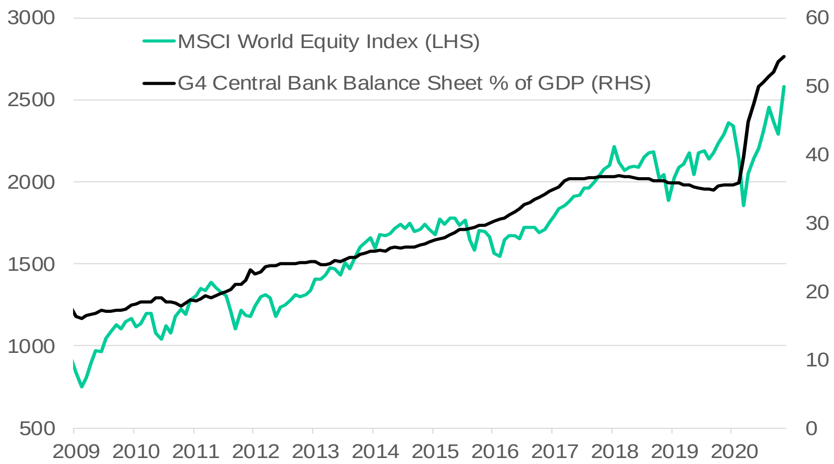
A strong prospective year-on-year rebound in GDP growth masks a lot of underlying weakness. Growth will remain well under the pre-COVID trend, while balance sheets and labour markets are generally not forecast to recover as quickly. International mobility will also be impacted for longer, which makes for a particularly difficult outlook in countries with higher dependence on tourism and immigration. This backdrop supports a low inflation consensus among economists. Even before COVID, many central banks were struggling to navigate structural forces driving a lower sensitivity of inflation to falling unemployment. These sorts of challenges haven't gone away, even if markets are focusing more on the bounce in headline growth.

3) Central banks will maintain highly accommodative policies

Central banks have gone all-in with policy measures this year, having taken rates to their respective effective lower bounds. Expectations of a lift in official cash rates have been pushed beyond the next year across markets. The Fed and RBA have recently said they will need to see inflation at or above target before considering any policy tightening. (See here for more detail on the RBA's latest policy changes and implications for investors).

Balance sheet growth has exploded in 2020, by over $8tn among the largest central banks. The near-term outlook is for more of the same, which is providing all assets with a big boost. Longer term, there is a risk any prospective pull-back in support could shake this cosy low yield and strong risk asset dynamic.

Chart 7: Massive central bank balance sheet growth has supported asset prices



Source: Ardea, Bloomberg

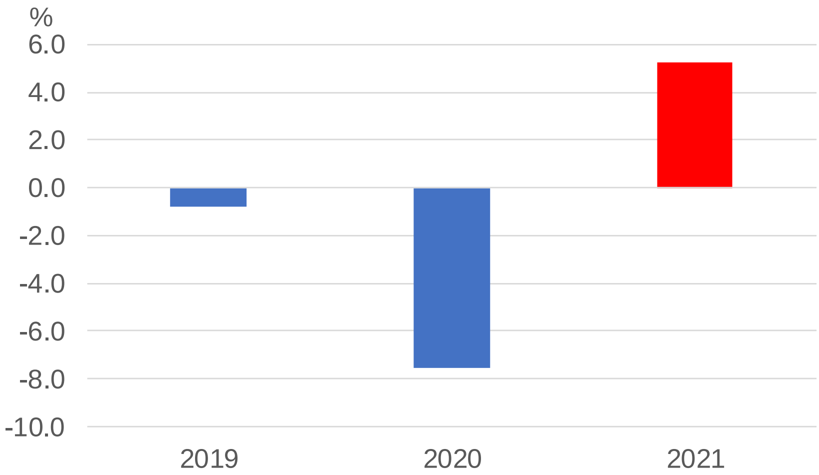
4) Fiscal policy support is a big potential swing factor

At the height of the global crisis in March, we wrote about the shift in market importance from monetary to fiscal policy (see here for more details). Governments have significantly supported economies in the wake of the massive drag from COVID shutdowns through a mix of direct payments to households and businesses and guarantee structures. The recession would undoubtedly be much more severe if aggressive action hadn't been taken (some estimates put the contraction at as much as double what has been experienced).

Through 2021, the prospects of economies re-opening also raise the risk of fiscal support being removed too early. Fiscal tightening through 2011 to 2015 hindered the recovery from the global financial crisis. The stakes this time around are massive and so is the risk of a policy mistake. Chart 8 shows the IMF's estimate of a turn in the fiscal thrust next year if enacted policies across the world are allowed to roll-off. But the IMF also point out the ample room for upside surprises to growth if policies are extended.

Fiscal policy is especially critical for the bond market, where a massive rise in issuance in 2020 contributed to steepening pressure at the long end of yield curves (see here for a more detailed discussion). With deficits still massive, the volume of issuance will still be large in 2021 (even if incrementally it's less than this year). Central bank purchases are set to eclipse issuance in some countries, but not others, while the distribution of purchases compared to issuance varies greatly across markets. These mismatches create cross-market and within market relative value distortions – a theme that is set to remain in place for the foreseeable future (outlined in more detail here).

Chart 8: IMF estimate of change in structural fiscal balance (% of GDP)



Source: IMF, Ardea

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**

  Long positions in semis, particularly in maturities slightly longer than 10y, outperformed duration hedges. These trades benefited from the improved demand from RBA QE and the lower yield outlook at the front end of the AUD curve supported reach for extra yield in semis over government bonds. The improved demand from the RBA and investors offset some modest underperformance following state budget results, which confirmed significant fiscal deterioration and increased bond supply.

  Long positions in ultra-long maturity EUR semis, implemented via options, outperformed paid swap hedges. The generally positive global risk backdrop and expectation of further central bank stimulus supported demand for EUR semis.

  Ultra-long maturity Australian government bonds outperformed swaps. The move in this spread was helped by non-government issuance hedging flows which pushed long term swap rates higher relative to equivalent maturity bond yields.

- **RV Curve**

  The AUD curve steepened through the month as the positive risk and economic news from the COVID vaccine trials drove an underperformance in long-dated vs shorter dated bonds and swaps. The portfolio held long positions in the 3-5 year part of the curve, relative to short positions in longer dated maturities.

The portfolio benefited from paying longer tenor AUD 6m vs 3m domestic swap basis and these spreads lifted through the month.

UK inflation swap steepeners were implemented beyond 10y to take advantage of unusual inversion in the curve. These trades benefited in November from a correction higher in long-dated inflation pricing as liability-driven investment demand re-emerged after the government released consultation on the Retail Prices Index (RPI) reform.

The portfolio held US inflation curve relative value trades in less than 10y maturities, across inflation-linked bonds and swaps. These positions benefited from a steepening in the inflation curve.

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

- **Volatility**

  Long volatility positions in AUD and EUR options underperformed through the month. Despite the emergence of significant positive and negative risks to the macro outlook, implied rates volatility fell as central bank policy expectations constrained trading ranges across yield curves with low rate guidance and QE.

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