

Ardea Real Outcome Fund

ARSN 158 996 699 APIR Code HOW0098AU

Monthly Performance Report February 2021

Performance ¹	1 month	3 months	FYTD	1 year	3 year	5 year	7 year	Inception
Fund	0.14%	0.15%	2.93%	4.06%	5.63%	5.64%	4.46%	4.31%
Benchmark ²	0.27%	0.89%	3.06%	1.23%	1.60%	1.72%	1.64%	1.85%
Excess Return	-0.13%	-0.74%	-0.13%	2.83%	4.03%	3.92%	2.82%	2.46%

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, 28 February 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.
Inception Date	20 July 2012
Fund Size	\$7.4bn
Management Fee	0.50% p.a.
Buy/Sell Spread	+0.05% / -0.05%
Distribution Frequency	Quarterly

Sector Exposure	
Government – National	81%
Government - State	19%
Total	100%

Rating Exposure	
AAA	59%
AA	41%
Total	100%

Region Exposure*	
Australasia	70%
Europe	16%
N. America	13%
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

How are we positioned?

The Real Outcome Fund delivered positive returns in February.

The market backdrop was one of extreme volatility in global rates markets, unseen since the height of the Covid panic in March 2020. The sharply higher yields and steeper curves delivered significant losses to traditional long-only government bond investments, particularly Australian benchmarks.

In this negative environment for bonds, the relative value strategies held by the portfolio delivered positive overall returns. The portfolio is constructed to be as well balanced as is practically possible to protect against abrupt changes in market conditions.

Volatility strategies delivered large gains, offsetting a drag in performance from the RV rates attribution category. Other types of RV strategies experienced modest overall gains and losses.

Volatility

The portfolio is positioned long volatility through interest rate options. These trades are implemented based on RV considerations such as the cheapness of implied relative to realised volatility and to provide risk balance to the portfolio. The value of long option strategies increased as interest rate volatility jumped dramatically, particularly over the second half of February.

RV Rates

The portfolio holds a wide range of relative value long and short positions across multiple markets in bonds, swaps, futures and options. These positions require constant rebalancing as market conditions change. This rebalancing of positions led to longer positioning in some sectors of curves than offsetting short positions, which underperformed as yields lifted. Long AUD positions in the 4-5y and 10-20y part of the curve underperformed short positions in the 7-10y part of the curve. Various net long positions across the NZD curve also underperformed. A partial offset to these positions were net short positions in USD, which benefited as yields lifted.

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.

Portfolio Commentary

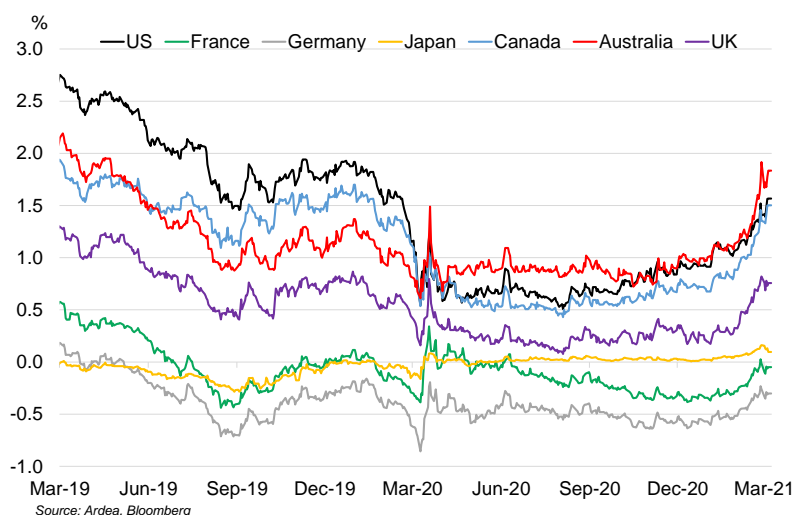
Notable events for the quarter are summarised below and more detailed discussions of topical market themes are available here - [Ardea's market insights](#). Ardea research is [available here](#).

What Happened?

A sharp rise in bond yields

Bonds sold-off sharply in February (Chart 1). Many developed market 10y government bond yields lifted by 30-40 basis points (bp). Moves were uneven across markets and fixed income benchmarks. For instance, the US 10y yield finished February 34bp higher, while the Australian 10y yield ended the month nearly 80bp higher (Australian bonds moved back closer to global peers in early March). The Bloomberg Barclays global aggregate index fell 1.7% in the month, while the Australian AusBond composite index fell 3.6%. The year-to-date losses on these benchmarks stands at 2.6% and 4.0% respectively.

Chart 1: 10Y nominal government bond yields



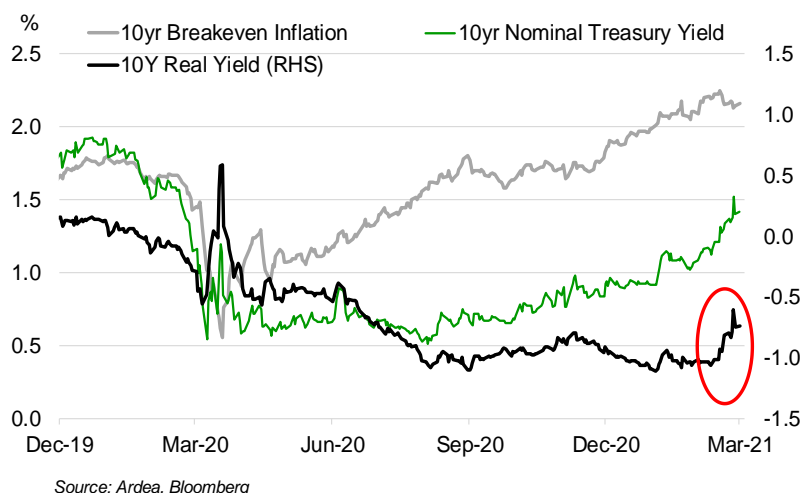
Bond yields had been steadily moving higher since late 2020, but there are three elements of the February move that differentiate it from that earlier period:

- 1) The velocity of the sell-off.** The February rise in the US 10y yield was the largest monthly move since the election of former US President Trump in 2016. Measures of rates volatility reached the highest levels since March 2020. The consensus expected higher bond yields in 2021, but not this quickly.
- 2) Front end repricing.** While yield curves steepened in the February sell-off, front end yields have

started to become unanchored and price a greater chance of central bank policy tightening over the next few years. At one point, US futures priced most of a Fed Funds hike by the end of 2022 and the curve out to 5 years steepened sharply.

- 3) Real yields rise sharply.** From mid-2020 until January, developed market real yields had been mostly confined to a tight range, even as nominal bond yields gradually lifted, pushing inflation expectations steadily higher. In February, real yields jumped sharply, matching the move in nominals in major markets. Higher real yields pose a greater threat to risk assets than the previously benign drift higher in nominal yields, although absolute levels are still low (Chart 2).

Chart 2: Breakdown of US 10y yield move – real and nominal



Why is it relevant?

The drivers of the February bond rout

1) New US fiscal package driving faster growth and larger bond supply

In a world where monetary policy is at its limits, fiscal policy is a powerful force in markets. US fiscal policy has been the most significant of late, following the announcement of a new \$1.9tn stimulus package. The massive fiscal spending program impacts bonds through the economic/US Federal Reserve (Fed) policy outlook channel, as well as through the supply/demand balance channel. The more important consequences of more fiscal spending are the growth and inflation outcomes in the near term – economists have been pushing forecasts for both higher recently – compounded by the success of vaccines and economies reopening. Some US economists now look for real GDP growth of 6.5% in 2021.

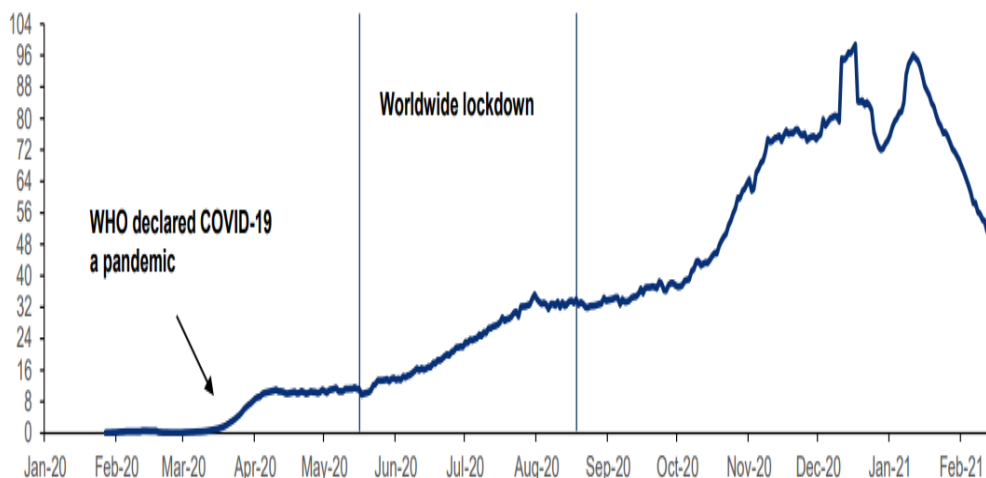
The supply of US Treasuries net of Fed purchases is growing. February showed some indigestion of this new supply, which added to negative bond sentiment. In the last week of February, a \$62bn US 7y auction recorded the weakest demand statistics in years (high auction clearing yield margin over pre-auction secondary levels, low indirect share and the lowest coverage ratio in at least a decade).

2) Markets looking to the end of the pandemic

Alongside fiscal spending, reflation hopes are supported by the ongoing fall in global COVID case numbers (Chart 3), led by countries where vaccination programs have been ramped up. News on the effectiveness of vaccines has also been positive. Israel reported a 94% fall in symptomatic Covid-19 infections in 600,000

people that had received two doses of the Pfizer vaccine. On some estimates, major economies such as the US are on-track to vaccinate vulnerable populations by April and could achieve herd immunity in Q4 2021.

Chart 3: Global COVID cases per million (7d MA)

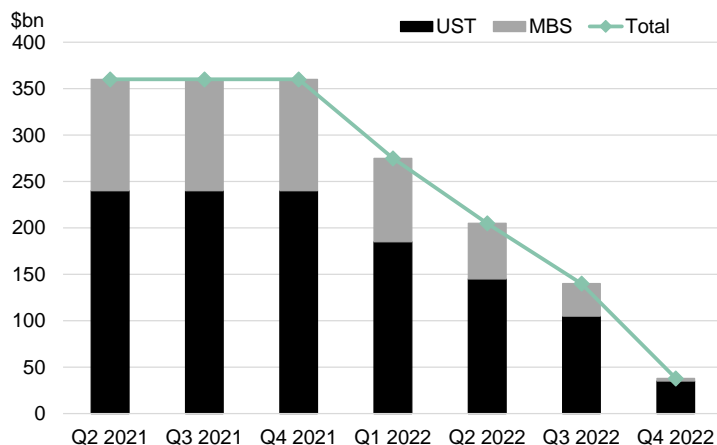


Source: Deutsche Bank Exit Strategy Policy Tracker, 16-Feb-21

3) Markets questioning central bank commitment to ultra-accommodative policy

The fact real yields have lifted sharply in the latter stages of the recent sell-off is also indicative of fears that policy will be tightened. Markets are questioning central bank resolve in maintaining large scale bond purchases and ultimately zero or negative rate policies well into the future. The timing of any shift is highly uncertain, but for some central banks commitments to bond buying could shift at year end or early 2022 if growth and inflation pick up strongly. A recent survey of US bond dealers shows expectations for significant tapering of quantitative easing (QE) in 2022 (Chart 4). In Australia, many market participants expect the Reserve Bank of Australia (RBA) to end its 3 year yield curve control policy at some point this year.

Chart 4: NY Fed Survey of Primary Dealers – median expected quarterly volume of Fed asset purchases



Source: Ardea, NY Fed

4) Technical factors, such as convexity hedging and positioning

Volatility in bond markets is often compounded by technical factors. One such impact is convexity hedging, which reflects the selling of US Treasuries to hedge mortgage-backed bond investments (and some other types of portfolios risk). When government bond yields rise suddenly there is reduced demand from mortgage holders to refinance. That fact, in turn, means mortgage bond investors have a delayed stream of

payments and their duration starts to lengthen. To manage this risk to their portfolios they sell bonds/shorten duration. These flows, when hitting a market already under pressure, can add to the velocity of the bond sell-off.

Positioning shifts by large investors is another technical factor that can add to volatility in a sell-off. This appeared to be one reason behind the significant underperformance of AUD rates relative to the US and other G10 markets (another key reason is the perceived lightness of the RBA's commitment to control longer term rates compared with other central banks). The AUD-USD 5y forward, 5y swap rate spread – a spread often targeted by global macro investors– widened as much 50bp in the space of two weeks in late February. Similar sharp widening in this spread has been observed in prior high rates volatility periods (such as 2013 and 2015) and is indicative of global investors cutting long exposures and refocusing on larger US and EUR markets.

Chart 4: Australia one of the worst performers - AUD-USD 5y forward, 5y swap rate jumps sharply



Source: Ardea, Bloomberg

Are there any supports for bonds?

After such a big sell-off and increase in volatility, it is worth considering what are the circuit breakers that could deliver some stability in bonds. We list a few key themes to watch.

1) Central bank guidance. The most important signal in the near term for the market is how central banks react to the unfolding sell-off in bonds. There have been numerous occasions in recent years where market participants have overestimated the sensitivity of central bankers to higher market yields. The call to arms for central banks to increase bond purchases or strengthen forward guidance is generally when one or a combination of the following conditions are met:

- government bond markets become illiquid or dysfunctional (such as in March 2020);
- broader financial conditions also tighten (such as widening credit spreads or higher bank funding costs);
- the level of yields rises to a point where the outlook for policy goals such as inflation or unemployment are starting to be compromised.

There is arguably further to go before these conditions generate a major shift in central bank thinking. The change will probably need to come from the Fed, given the size of the US market and initial drivers

of the February sell-off. Arguably the likes of the European Central Bank (ECB) could be quicker to act given the larger deflation tail risks in the Eurozone. The RBA recently stepped up its bond purchases, but yields have continued to climb in step with larger global bond markets.

- 2) Risk asset spillovers.** Higher bond yields have started to rattle equity markets. The February peak to trough move for the S&P 500 was -3.1% and -3.6% for the MSCI World Index – still well contained compared with previous routs. However, there is evidence of a bigger impact from the bond sell-off at the higher risk spectrum of assets. As JP Morgan strategists recently noted:

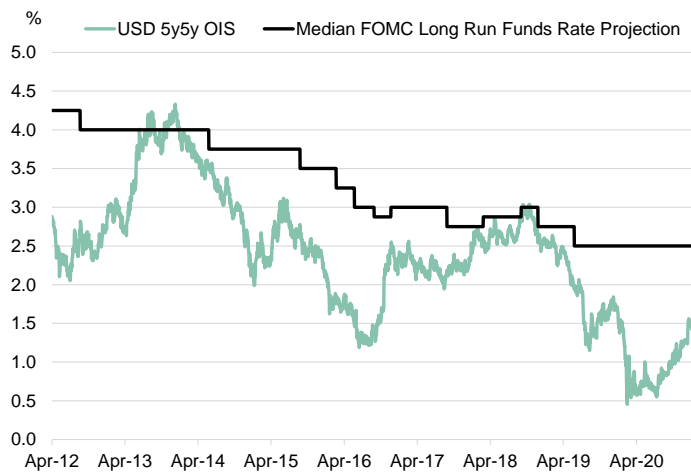
“A rates repricing this large and from such low starting levels also represents a regime change to anyone who has been valuing markets or allocating capital on the assumption that US rates would remain low for several years. Hence why the greatest casualties of the past month’s bond market sell-off have been the ones with the highest valuations, the most price momentum and the most imaginative investment thesis. Thus cryptocurrencies (XBT), innovation stocks (ARK), green energy (TAN), SPACS (IPO SPAC) and even traditional IPO (IPO) are all down 20% to 30% from their 2021 highs” (JP Morgan Cross-Asset Strategy, 5-Mar-21).

At some point, higher yields could drive a more significant and broader risk asset correction that ultimately feeds back into demand for bonds. One aspect of the current backdrop that is different from previous episodes is the extreme low starting point for real yields, which could mean that a broader portfolio of equities could potentially tolerate a larger sell-off than in the past. Even after the big rise over the last few weeks, the US 10y real yield is just -0.66% and the Australian 10y real yield is just -0.39% - both still extremely low by historical standards.

- 3) Inflation.** The last decade has seen an absence of significant inflationary pressure. There are reasons to think this long term trend is now changing – a point discussed in-depth in a recent Ardea article (see [here](#)). The tricky thing for investors is balancing the risks of higher inflation from fiscal spending and economies reopening with a more uncertain longer-term outlook. Central banks are embracing a more laid-back approach and are happy to wait and see inflation return well before lifting rates (instead of lifting rates in anticipation of inflation). The tension between improving economic data and central bank reluctance to act is a difficult place for investors to be. If inflation fails to rise sustainably beyond temporary effects, then yields ought not to keep rising sharply. This is of course a big risk to watch – as discussed in [this article](#). Market pricing for inflation is at levels broadly consistent with central banks achieving their targets but not sustainably overshooting. Central bank credibility is therefore important for the longer-term outlook for yields.
- 4) Valuations.** A key driver of bond valuations is the expected long-term level of policy rates. A major difference between the February bond sell-off and some previous large increases in bond yields, such as 2009 or 2013, is that many investors now generally expect structurally lower real neutral policy interest rates (the level of rates where policy is neither expansionary nor contractionary). This is partly due to the experience of the last decade but also increased recognition of structural pressures such as demographics, debt levels and other limits to potential GDP growth. So if inflation is also contained in the long run, this simply means that nominal cash rates and also bond yields will struggle to return to longer run historical averages. The recent sell-off has dragged long term pricing for cash rates closer to the potential levels seen by some central banks and economic models.

Chart 6 shows the Fed’s long run rate projection and the 5y5y OIS rate (the market expectation for the average 5y cash rate, 5 years forward). The Fed’s estimate of the long run rate has trended lower over time and the market has often struggled to price that down trending forecasted rate. Even with the strong cyclical recovery underway, eventually a large buffer will be priced into long term forward interest rates to entice demand for bonds. That point may be approaching for some investors with an over 2% funds rate priced into the curve ahead of the post-Covid recovery really getting underway. This is a very rough guide and there is plenty of scope for overshoot, as was seen during the 2018 Fed tightening and the 2013 so called “taper tantrum”.

Chart 6: Fed long term funds rate projection vs 5y5y OIS rate



Source: Ardea, Bloomberg

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

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