

Ardea Real Outcome Fund

ARSN 158 996 699 APIR Code HOW0098AU

Quarterly Performance Report March 2021

Performance ¹	1 month	3 months	FYTD	1 year	3 year	5 year	7 year	Inception
Fund	0.38%	0.64%	3.32%	5.18%	5.74%	5.56%	4.46%	4.31%
Benchmark ²	0.23%	0.84%	3.30%	1.35%	1.63%	1.78%	1.65%	1.86%
Excess Return	0.15%	-0.19%	0.02%	3.83%	4.11%	3.78%	2.81%	2.45%

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 March 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	\$7.8bn
Management Fee	0.50% p.a.
Buy/Sell Spread	+0.05% / -0.05%
Distribution Frequency	Quarterly

Sector Exposure	
Government – National	79%
Government - State	21%
Total	100%

Rating Exposure	
AAA	71%
AA	29%
Total	100%

Region Exposure*	
Australasia	58%
Europe	19%
N. America	23%
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 March.

Many bond indices suffered historically large losses in Q1. While some markets saw less extreme moves in March compared with February, conditions remained challenging for traditional long-only portfolios. Against this backdrop, the Real Outcome fund continued to deliver positive performance through a range of relative value positions.

The following strategy groups made a notable positive contribution to performance this month:

RV Bond vs Derivatives

The duration risk from many long government bond positions are hedged with interest rate derivatives. The spread between bonds and swaps (and other derivatives) is influenced by changes in bond supply/demand dynamics, issuance trends, derivative flows and many other drivers. Positions in Australian Commonwealth government bonds outperformed derivative hedges over the last month. Smaller gains were seen in similar positions in USD and NZD markets, which offset a small drag from AUD semi-government and CAD government bonds.

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 these strategies increased as interest rate volatility remained elevated through the month. USD interest rate option positions benefited the most from the increase in volatility, as US rates experienced the largest moves over the last month.

The following strategy groups detracted from performance this month:

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. The delta hedging of positions in USD options were a modest drag on performance over the month.

RV Micro Curve

The micro curve category was a small drag on performance over the month. The largest detractor were positions targeting a steeper USD inflation curve, as shorter maturity swaps lifted relative to longer maturity swaps over the month. This strategy was designed to add protection in a risk-off move. Partly offsetting these positions were positive performance in nominal interest rate micro curve trades across the USD, AUD, JPY and NZD curves.

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](#).

What Happened?

A quarter to forget for passive bond investors

In March, government bonds generally remained under pressure, although price action was choppy and there were notable cross market differences. The US bond market underperformed significantly – the 10y yield finished the month 34bp higher at 1.74%. The 10y yields in Germany and the UK ended the month near flat and Australian 10y yields finished 13bp lower than the spike higher seen over the last few days of February.

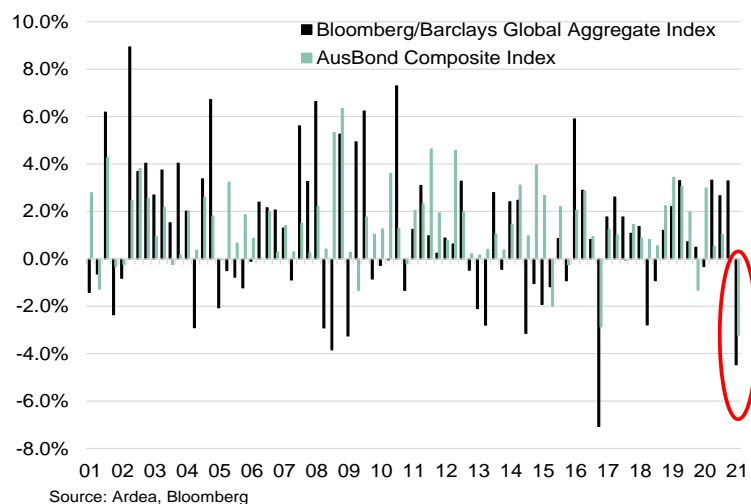
The March price action follows poor returns in sovereign bonds over the prior two months, leaving major bond indices historically weak in Q1. The AusBond Composite Index finished the quarter down 3.2% - the worst outcome since 1994. The Bloomberg/Barclays Global Aggregate Index fell 4.5% - the worst outcome since Q4 2016 (Chart 1).

In contrast to sovereign bonds (and other safe-havens like gold, -10% in Q1), risk assets generally posted positive returns in Q1. In equities, the S&P 500 made new record highs and finished up 6% over the

quarter. In contrast with 2020, European indices saw larger gains in Q1– the STOXX 600 rose 8%. Oil prices rallied a massive 22%.

The broad narrative driving markets is the rebound in global growth, following the severe COVID-induced contraction in 2020. The IMF upgraded its outlook for real GDP growth to 6% for 2021 (up from 5.5% in January). This outlook is being fuelled by massive US fiscal stimulus (including plans for more infrastructure spending in March), central banks sustaining highly accommodative policies and the ongoing roll-out of COVID-19 vaccines.

Chart 1: Quarterly returns in bond indices



Why is it relevant?

After many pundits saw one year and two year ahead forecasts for higher yields eclipsed in the space of a month or two, it's still too early to declare the worst is over for government bond returns. However, some consolidation is likely after the Q1 repricing leaves bonds incrementally less vulnerable to further positive surprises to the growth, inflation and COVID outlook.

In our last monthly market update, we outlined the macro and technical underpinnings of the bond sell-off and listed some catalysts for eventual stability in yields. We revisit some of these themes and highlight key risks for the next quarter.

Shades of 2013, but without the US Federal Reserve (Fed) “taper” signal

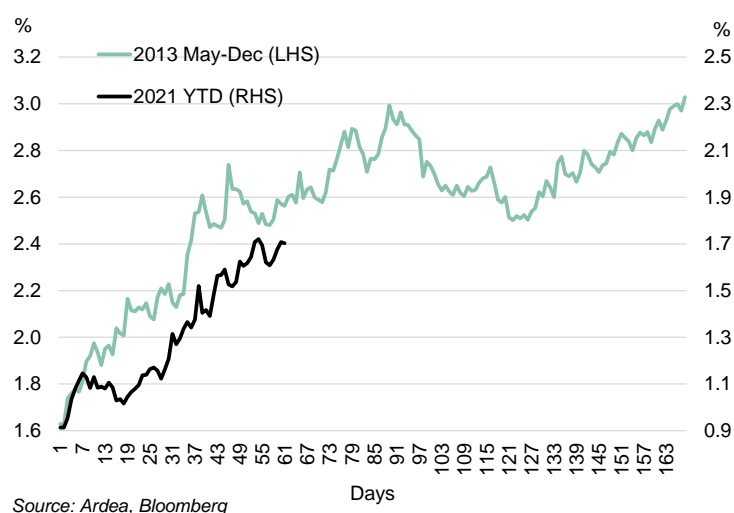
The velocity of the year-to-date sell-off in bonds and US-led nature of the move is drawing comparisons with the 2013 bond rout – the “taper tantrum”. Chart 2 compares the move higher in the US 10y yield in May to December 2013 with the year-to-date experience. The trajectory of the rise in yields is similar, albeit the last few months have been less volatile than in 2013. The underlying drivers of the recent bond sell-off are very different to the 2013 experience.

In May 2013, then Fed Chair Bernanke hinted that the pace of bond purchases under the quantitative easing (QE) program would need to be gradually tapered. While the start of the tapering process didn't take place until the end of the year, between May and September 2013 the US 10y nominal yield lifted over 100bp to a high of 3.05% and the 10y real yield lifted 130bp to a high of 0.92%. Other bond markets also suffered heavy losses at the time.

This time around, there has been no direct signal of a “taper” in QE. In fact, in March the Fed maintained

its policy settings and message that reducing accommodation remains a long way off. In this cycle, progress on unemployment and inflation needs to be realised, not just in the forecast profile. The uptrend in bond yields failed to reverse in the face of Fed rhetoric – a similar theme to February.

Chart 2: Q1 2021 rise in 10y yield vs 2013 “Taper Tantrum”



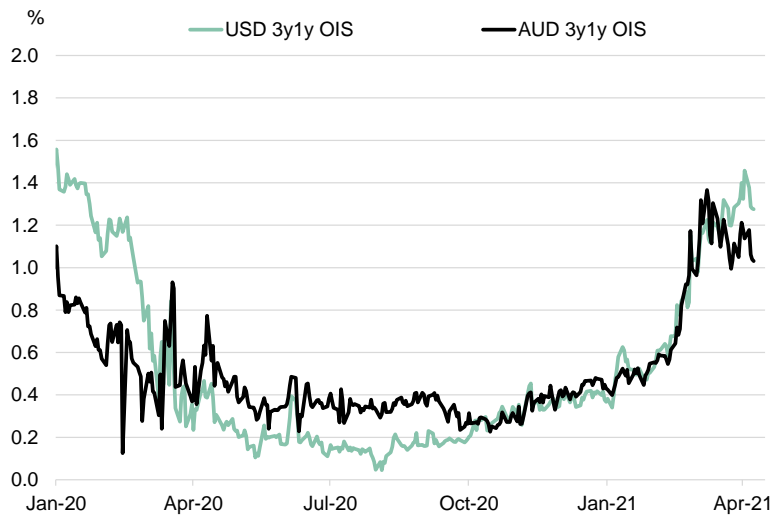
Gauging the repricing of bonds ahead of Q2

Yields are coming off much lower levels than in previous bear periods for bonds. But the adjustment has been substantial in such a short space of time. For example, US and Australian 10y yields have lifted over 80bp in Q1, nearly doubling the yield level available to an investor. Predicting in advance at what point yields reflect a “fair” value in the face of a recovery is extremely difficult, as the track record of forecasters shows (as we noted in our December update, the consensus has called the year ahead *direction* of bond yields correctly only about 40% of the time and has had much less success in calling the yield *level*). That said, a helpful starting point is to focus on what the market is currently telling us about future interest rate and inflation moves.

1) The next central bank policy tightening cycle

Even for investors focused on long term bonds, the path for cash rates over the next few years still provides an important anchor point. Interest rate swaps and futures contracts give an indication of just how much markets expect cash rates to rise in the next few years. The Fed and Reserve Bank of Australia (RBA) are telling markets rates will not move until 2024. Rates could well move higher sooner if the recovery accelerates meaningfully. But the real story is the amount that rates move up when the time comes. The market now thinks this process could unfold much more aggressively than previously thought. As Chart 3 shows, the average level of implied 1y USD and AUD cash rates 3 years forward has lifted nearly 100bp compared to Q1 to 1.2-1.4%.

Chart 3: Rapid rise in 3y ahead USD and AUD policy rate pricing (3y forward, 1y overnight indexed swaps)



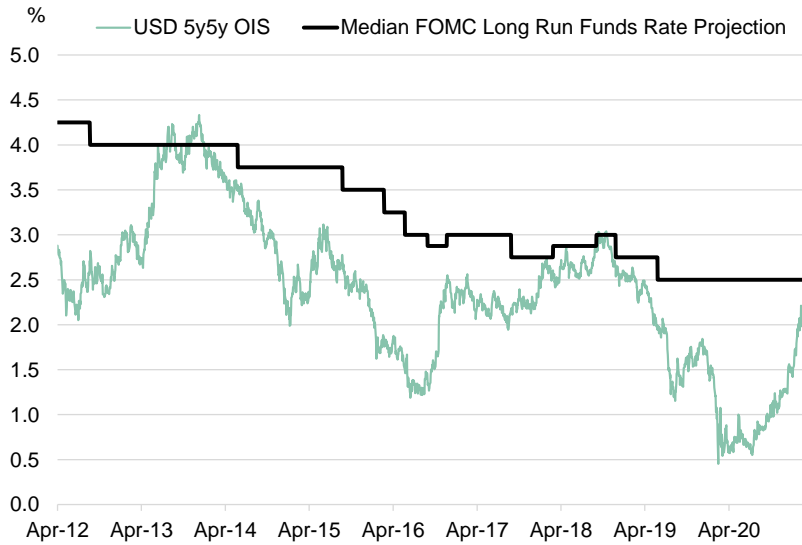
Source: Ardea, Bloomberg

2) Long term rates

A key driver of bond valuations is the expected long-term level of policy rates. A major difference between the Q1 bond sell-off and 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 4 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 enough 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.

Chart 4: Fed long term funds rate projection vs 5y5y OIS rate

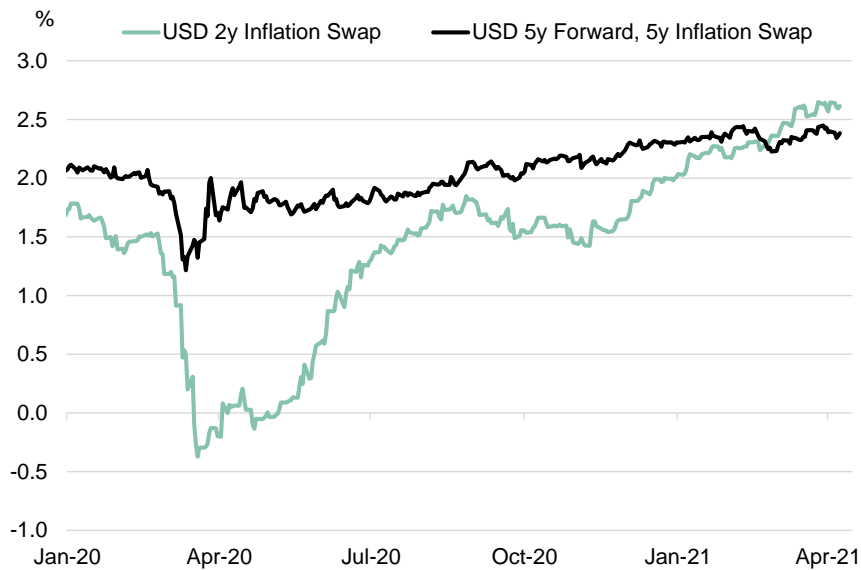


Source: Ardea, Bloomberg

3) Inflation

Shorter term market pricing for inflation has continued to accelerate as US growth picks up and maximum economy reopening velocity gets closer. As Chart 5 shows, longer term inflation pricing has also trended higher over time but is at a more moderate level. This suggests the market is pricing some short term inflation overshoot, but still not a structural rise in inflation well beyond the Fed’s 2% target (long run market pricing for headline CPI often exceeds forecasts for the Fed’s favoured core “PCE” inflation measure).

Chart 5: US 2y vs 5y forward, 5y inflation swap rates



Source: Ardea, Bloomberg

Q2 will see the arrival of the anticipated growth and inflation overshoots

Q1 was characterised by big positive surprises to the outlook in the form of vaccination progress, US fiscal stimulus that dwarfed already bullish expectations and upside surprises to actual activity data. From this perspective – and considering the repricing in yield curves – the bar to surprise the market has clearly lifted. It's possible that growth and inflation match very bullish expectations yet bond yields fail to rise meaningfully further and volatility eases.

Most forecasters are now looking for annual growth in US real GDP of 6-7% by the end of 2021, but the acceleration is expected to begin in earnest in the coming quarter and will continue to be led by the US. In Europe, recent COVID case increases and lock downs in some countries have raised the risk of a slower recovery. There are, however, hopes for a sharp improvement as vaccination progress continues. JP Morgan strategists recently made a bullish case for growth in Q2 (numbers are annualised):

“Q2 should deliver the surge (+7% globally), driven by +9% expansions in the US (mostly from stimulus), 9% in Europe (mostly from reopenings) but just 5% from China. The European view is obviously dependent on a major step-up in vaccinations that breaks the link between mobility and COVID-19 infections, but with vaccine delivering set to triple in Q2, a European catch-up is a reasonable baseline.”
(Source: *The JP Morgan View, 26-March-21*).

In terms of inflation, the outlook is less clear. Many economists and investors over the last decade have struggled to come to grips with structural trends restraining inflation and so will probably find the reverse short-term outlook just as challenging. As major economies reopen in Q2, consumers will be able to draw down on large accumulated savings buffers (thanks in part to government transfers), there will be a release of pent-up demand for services and probably supply bottlenecks. As outlined, the market-based inflation expectations have built-in some buffer for this rise in inflation. The bigger issue that won't be resolved so quickly is how sustainable the uplift in inflation is, given still significant slack in labour markets.

The resolve of central banks will be tested further in the coming quarter. As Ardea Portfolio Manager Tamar Hamlyn noted in a recent [AFR article](#), the yield and volatility bar for central banks to act remains quite high:

“The conclusion we are left with is that central banks still have considerable firepower that can be brought to bear should markets require this. The commitment and “whatever it takes” mentality of the world’s central banks still carries weight.

This support won't be given lightly, and perhaps not unless we see much higher volatility and even larger yield moves. And in a sharply rising yield environment, central bank prudence is to slow the move rather than stand against it.

But investors can take comfort that the backstop remains, though it's more distant than we might like.”

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