

Ardea Real Outcome Fund

ARSN 158 996 699 APIR Code HOW0098AU

Monthly Performance Report August 2021

Performance ¹	1 month	3 months	FYTD	1 year	3 year	5 year	7 year	Inception
Fund	-0.27%	-0.82%	-0.27%	1.50%	5.28%	4.85%	3.94%	4.05%
Benchmark ²	0.30%	0.79%	0.53%	3.32%	1.76%	1.82%	1.69%	1.89%
Excess Return	-0.57%	-1.61%	-0.81%	-1.82%	3.51%	3.03%	2.25%	2.16%

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 August 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	\$9.7bn
Management Fee	0.50% p.a.
Buy/Sell Spread	+0.05% / -0.05%
Distribution Frequency	Quarterly

Sector Exposure	
Government – National	75%
Government - State	25%
Total	100%

Rating Exposure	
AAA	62%
AA	38%
Total	100%

Region Exposure*	
Australasia	67%
Europe	3%
N. America	30%
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

*Physical weights for sector and rating exposure

Source: Ardea Investment Management, S&P Ratings

How are we positioned?

Fund Performance

As at 31st August, the Fund's rolling 2 year return was 3.3% per annum (net of fees), which is tracking ahead of target. (return target = cash / CPI + 2% before fees).

Performance is evaluated over rolling 2 year periods for consistency with the recommend minimum investment horizon of 2 years. Performance for the month of August was -0.27% (net of fees), which is within the range of 'expected performance variability'.

Over short-term horizons it is entirely expected that portfolio performance will fluctuate in a range around the expected long-term investment outcome, including periods of negative returns. 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%.

Performance Drivers

The Fund's highly differentiated pure 'relative value' (RV) 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, the performance reported in any given period 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.

In order to provide portfolio commentary that is consistent with the Fund's highly differentiated investment approach, we provide examples of RV-specific themes that illustrate the types of opportunities the Fund accesses. Monthly performance is heavily influenced by short-term 'noise' and ordinarily offers little genuine information value.

RV-specific Themes

This month we discuss 3 examples of RV 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 and will continue to play out over the coming months.

- **RV theme 1:** An RV mispricing theme in the Canadian interest rate swap market has manifested via unusually high swap rates in the 3-5 year part of the curve, relative to surrounding points. This driven by temporary demand / supply imbalances caused by factors such as macro oriented market participants using this part of the swap curve to hedge their exposure to the risk of future rate hikes in Canada.

The Fund exploited this via RV trades that precisely isolate the specific curve anomaly from broader market fluctuations, in order to profit when that demand / supply imbalance eventually fades and the swap curve normalises. One such trade structure is known as a 'butterfly', as it has a 'body' trade leg cantered on the mispriced point of the curve, combined with two offsetting 'wing' trade legs either side of that point, which are intended to neutralise exposure to broader rate market fluctuations. The specific combination of 'wing' trades is chosen to optimise the risk / return characteristics of holding the trade, while waiting for it to play out as expected.

These trades are currently negative performance contributors because the demand / supply imbalance persists. However, we are comfortable holding these trades because the original rationale still holds and their marginal risk contribution to the overall portfolio remains modest.

- **RV theme 2:** In Australian interest rate markets, RV mispricing has emerged at a specific point on the interest rate swap curve that represents the swap rate for a 2 year swap starting in 1 years' time. This rate is unusually high relative to surrounding points on the swap curve due to temporary demand / supply imbalances that are partly caused by banks hedging interest rate risk on fixed rate home mortgages.

The Fund exploited this via RV trades that have the added advantage of being risk-reducing from a total portfolio perspective because of their diversification benefits relative to other positions currently in the portfolio.

These trades are currently negative performance contributors because the demand / supply imbalance persists. However, we are comfortable holding these trades because the original rationale still holds and the trades are risk diversifying for the portfolio as a whole. Potential catalysts for the demand / supply imbalance to eventually fade include reduced incentive for banks to target 3y fixed term lending, following changes to the RBA's funding facilities, and the attraction of this curve point for macro oriented investors seeking to express a directional view on AUD rates.

- **RV theme 3:** An RV mispricing theme in the Australian government bond market has manifested via bonds in the 20 year segment being priced anomalously cheap relative to closely related interest rate derivatives. This mispricing is driven by demand / supply imbalances caused by elevated government bond issuance on the supply side, combined with market segmentation on the demand side (more of the demand is concentrated in the sub-10 year sector where both the RBA's QE program and futures related buying is concentrated).

The Fund exploited this via RV trades that involved buying a number of bonds around the 20 year point, while neutralising duration risk using a combination of interest rate swaps and futures.

These trades are currently positive contributors to the Fund's performance as bonds have been outperforming relative to derivatives. We continue to hold these trades as the RV mispricing still has further to normalise.

Portfolio Commentary

Notable events for the month are summarised below and more detailed discussions of topical themes are available in the [Research](#) section of the Ardea website.

What Happened?

August was a fairly steady month for markets. Investors contended with mostly softer than expected economic data, asset purchase tapering signals from the Fed, signs of progress on a US infrastructure spending package and ongoing caution about the delta covid variant. Equities continue to rally in the face of substantial global economic uncertainty, reaching new record highs (S&P 500 +2.9%, MSCI World +2.4%). Bonds tracked sideways. The Bloomberg Global Aggregate (-0.42%) and US Treasury indices (-0.18%) posted their smallest respective moves in either direction since late 2020. Major market sovereign bond yields touched new lows since February intra-month before rebounding. For many bond investors, growth concerns are balanced by already expensive valuations. Australian bonds continued to outperform other developed markets amid ongoing lockdowns.

Why is it relevant?

We highlight 3 key market themes.

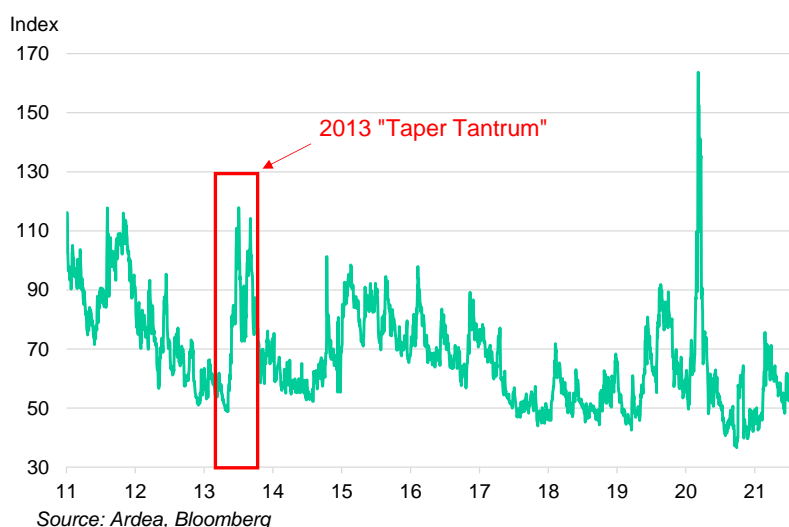
1) Why this time is different for the Fed's QE taper

The US Federal Reserve (Fed) is widely expected to begin the process of unwinding its Quantitative Easing (QE) program in the coming months. The "taper" will involve a gradual reduction in the pace of asset purchases from the current rate of \$120bn per month across treasuries and mortgage-backed securities. At the Fed's Jackson Hole conference at the end of August – traditionally watched by markets for important policy signals – Chair Powell said *"that if the economy evolved broadly as anticipated, it could be appropriate to start reducing the pace of asset purchases this year"*. A tapering of purchases in the coming months, alongside other cautiously optimistic comments about the economic outlook, are broadly consistent with earlier Fed comments and market expectations.

The market reacted very little to the Fed’s comments in August, unlike the last time the Fed foreshadowed a major reduction of bond purchases. In May 2013, then Fed Chair Bernanke hinted that the pace of bond purchases under an earlier 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. A few of the key contrasts between 2013 and the current market comfort with tapering are: 1) experience since 2013 of very slow moving central bank policy shifts; 2) widespread investor acceptance of structural drivers of lower neutral policy rates; 3) low inflation, notwithstanding post-pandemic effects widely considered to be temporary (although this outlook is arguably much less certain than lower volatility pricing assumes, as we discussed in a recent research [note](#)).

Fed Chair Powell emphasised that tapering isn’t policy tightening in his Jackson Hole remarks to separate the decision about the reduction of bond purchases from interest rate increases, which require a “*substantially more stringent test*”. Market participants, however, cannot so easily separate the two, since yield curves reflect both interest rate expectations and QE risk premia. Moreover, both policy decisions are tied to the trajectory of the economy, which is expected to show ongoing recovery if the risks with the delta covid strain can continue to be managed.

Chart 1: MOVE index of US treasury volatility – 2013 vs 2021 approach to asset purchase taper

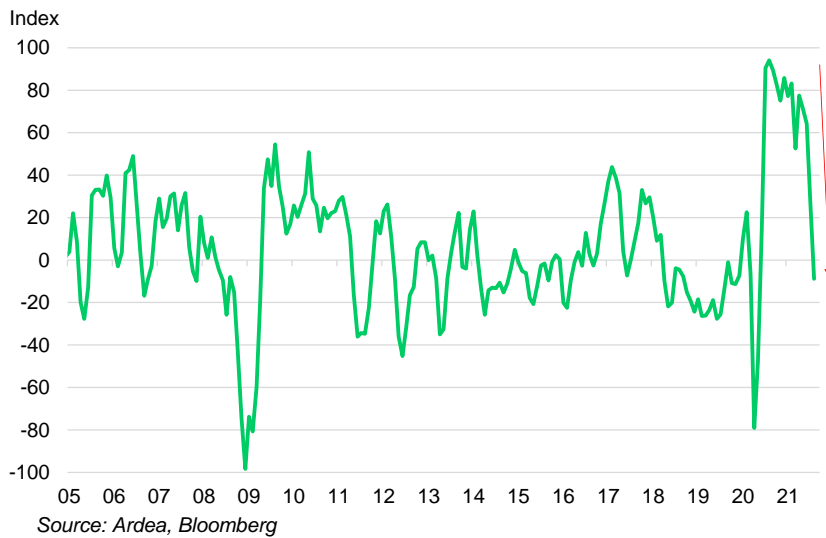


2) Investor concerns about the global growth outlook remain elevated amid negative data surprises

Investor concerns about “peak growth” have been a key driver of the trend lower in bond yields since the highs of Q1 (an issue we discussed in detail in a recent [note](#)). Inevitably, the US and China growth pulse had to slow from the unsustainably rapid pace seen earlier in the year. The magnitude of that slowing, limited nature of a pickup elsewhere and rise in covid cases has further exacerbated market anxiety about a weaker growth pulse. Actual economic data releases are now also significantly underwhelming consensus forecasts. While the July US payrolls report (released in early August) was notably strong, the broader recent trend in data from major economies has been soft. Chart 2 shows an index of global economic data results relative to investor forecasts has dropped sharply over the last two months (negative data “surprises”). There is a lot

of noise in economic data, but large moves lower in the broad index tend to be supportive of safe-haven bonds.

Chart 2: Citi global economic data surprise index



3) Australian bond outperformance continues

Australian bonds have outperformed global peer markets significantly over the last few months, as the majority of the country's population is in lockdown and the economy contracts sharply. Many economists look for a 3-4% contraction in growth in Q3, only a limited rebound in Q4 and a stronger recovery in 2022. The market is pricing a delay to RBA QE tapering and a more gradual rise in rates over the longer term relative to the US. Chart 3 shows the Aus-US 10y yield spread has tightened significantly through lockdowns and hit a low of -20bp in August.

Chart 3: Aus-US 10y yield spread



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