

Ardea Real Outcome Fund

ARSN 158 996 699 APIR Code HOW0098AU

Monthly Performance Report August 2020

Performance ¹	1 month	3 month	FYTD	1 year	3 year	5 year	7 year	Inception
Fund	0.07%	2.12%	1.23%	5.20%	5.84%	4.64%	4.53%	4.37%
Benchmark ²	0.53%	-0.01%	0.63%	-0.06%	1.17%	1.32%	1.52%	1.66%
Excess Return	-0.46%	2.13%	0.60%	5.26%	4.66%	3.32%	3.01%	2.70%

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 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	\$5.5bn
Management Fee	0.50% p.a.
Buy/Sell Spread	+0.05% / -0.05%
Distribution Frequency	Quarterly

Sector Exposure	
Government – National	78%
Government - State	22%
Total	100%

Rating Exposure	
AAA	84%
AA	16%
Total	100%

Region Exposure*	
Australasia	58%
Europe	35%
N. America	6%
Total	100%

Interest Rate Duration (years)	
12 month average	0.2
Since inception average	0.1

* 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?

Following a period of virus resurgence globally, the virus news flow turned more positive in some places over August, while others continued to see accelerating case numbers.

“American hospitals are getting a reprieve as a spike of Covid-19 cases in the Sun Belt eases and the Northeast recovers, giving health-care workers a chance to prepare for what September and October may bring. For the first time in a month, fewer than 50,000 Americans are known to be hospitalized with Covid-19, according to data compiled by the Covid Tracking Project through Sunday.”

- Bloomberg, 'Hospitals in Some U.S. Hot Spots Finally Get Covid-19 Respite', 11th August 2020

“China reported the most number of domestic coronavirus infections in more than four months as it battles outbreaks in its western and northeastern regions, raising fears of a serious resurgence.”

- Bloomberg, 'China Reports Biggest Virus Spike Since End of Wuhan Outbreak', 27th July 2020

“Spain’s health ministry reported more than 920 new cases on both Thursday and Friday, the highest numbers since early May, when the government began easing one of Europe’s strictest lockdowns. Most of those were in the region of Catalonia in northeastern Spain, where authorities have been expanding restrictions to try to flatten the curve.”

- Bloomberg, 'Spain Second Virus Wave Swells, Fuels Concern Across Europe', 26th July 2020

“Covid-19 cases surpassed 24 million worldwide with India seeing a record spike and South Korea, Italy and France reporting the most new daily infections in months.”

- Bloomberg, 'Europe Keen To Avoid Lockdown; New India Record', 27th August 2020

Despite mixed virus news flow, the recovery in financial asset prices continued this month as economic growth indicators generally continued to improve, and (more importantly) policy stimulus kept flowing.

The COVID crash is fading into history as many stock markets now exceed their pre-COVID peaks. While the MSCI World equity index has managed to inch above its pre-COVID high, anything tech related has blown right past.

Similarly, other measures of risk asset pricing like credit spreads are almost back to pre-COVID levels as a classic 'risk-on' pattern is playing out across global financial markets.

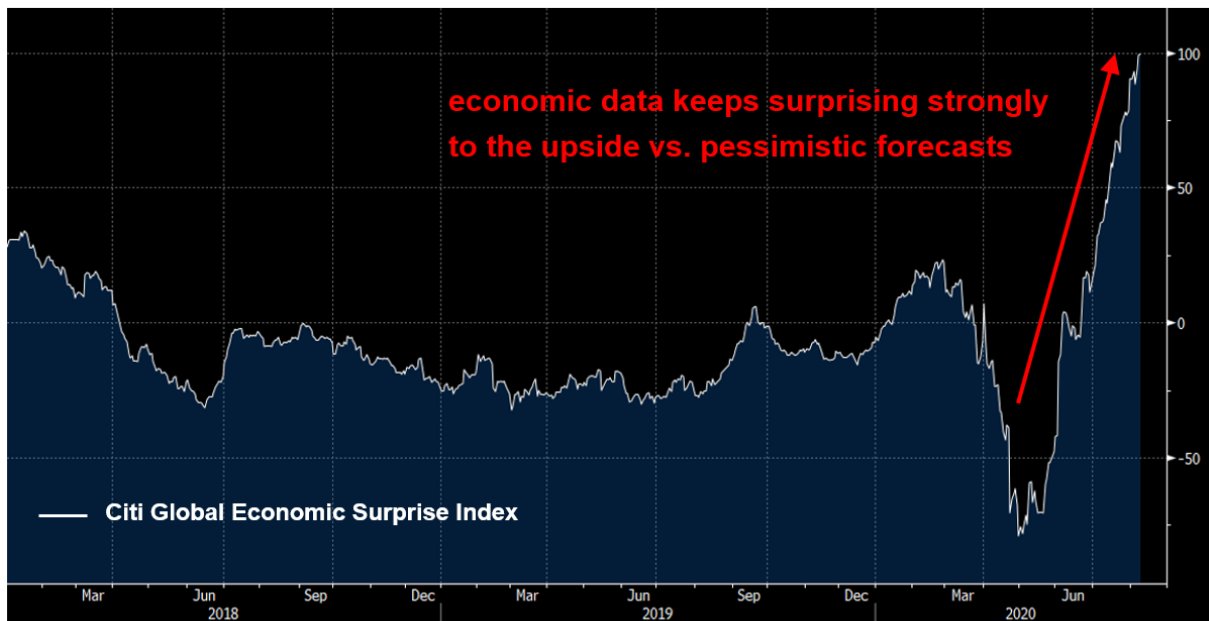
Rallying equity and credit markets, rising commodity prices, rising market pricing of inflation expectations and higher government bond yields are all consistent with risk-on, pro-growth, and reflation narratives.

These dynamics are strongly underpinned by central banks aggressively trying to reflate economies.



Source: Ardea Investment Management, Bloomberg

Economic surprise indices compiled by Citigroup show how economic data is tracking relative to economists' consensus expectations. Negative numbers indicate that the actual data is coming in below expectations and vice versa for positive numbers.



Source: Ardea Investment Management, Bloomberg

Perhaps most important of all, 2020 has seen a staggering amount of policy stimulus. The combination of massive fiscal stimulus + ultra-low rates + central bank asset purchases / liquidity injections is clearly helping risk asset prices defy the gravity of growing downside risks.

“\$20tn in 2020: global policy stimulus \$20tn, monetary \$8.5tn, fiscal \$11.4tn (doesn't include \$1tn Phase IV US fiscal stimulus); 164 global rate cuts in 147 trading days; policy & positioning key drivers of the Bull of 2020.”

“Macro vs market ‘disconnect’: resolved thus far as follows ... Markets rationally being “irrational”: government and corporate bonds have been fixed (“nationalized”) by central banks, so why would anyone expect markets to connect with macro, why should credit & stocks price rationally.”

- Bank of America, The Flow Show, 9th and 30th July 2020

“Senate Republicans presented their \$1 trillion plan to bolster the pandemic-ravaged U.S. economy in a series of bills that would trim extra unemployment benefits, send \$1,200 payments to most Americans and shield businesses, schools and other organizations from lawsuits stemming from coronavirus infections. The \$1 trillion package was pulled together after days of negotiations between Senate Republicans and President Donald Trump’s emissaries that didn’t completely settle differences within the GOP over the size and scope of additional federal spending in response to the pandemic.”

- Bloomberg, ‘GOP Rolls Out \$1 Trillion Stimulus to Start Talks With Democrats’, 27th July 2020

“After four days of intense discussions, EU leaders reached an agreement in the early hours of Tuesday, 21 June on the recovery fund (NGEU: New Generation EU) and next EU budget ... this week’s agreement marks an historic step for Europe given: 1) EU transfers will be financed by common issuance for the very first time, worth €390bn; 2) the amount: in total the NGEU equates to €750bn (5.4% of the EU’s 2019 nominal GDP, including €360bn of loans); 3) principles of a fiscal union have been kept with plans for increased new own resources”

- Barclays, Economics Research, 24th July 2020

Why is it relevant?

Coincidentally with the stimulus fuelled recovery in asset prices, a nascent 'reflation' narrative is building in the background.

For example, the chart below shows the market pricing of US inflation expectations, using 5 year inflation swaps as a proxy. This measure has fully retraced its March decline, despite economic activity and employment still remaining well below pre-COVID levels. While part of this rebound was just a recovery from the panic driven extremes of March, in some spots the market pricing of inflation expectations has pushed past pre-COVID levels.



Source: Ardea Investment Management, Bloomberg

How far and for how long the reflation narrative pushes remains to be seen. The consensus view from the research community is still highly skewed to the low inflation scenario, as it has been for a long time now.

The low inflation camp points to longstanding factors such as technology and globalisation, as well as more recently to economic weakness, slack in the labour market and depressed energy prices.

However, there is a growing minority now pointing to upside inflation risks stemming from the unprecedented co-ordinated fiscal + monetary stimulus we're now seeing (including the creep toward explicit debt monetisation), together with factors like rising anti-globalisation sentiment, populism giving more wage bargaining power to workers (despite elevated unemployment) and supply chain changes. (details [here](#))

Additionally, central bank talk is now more skewed to the idea of keeping rates near zero even if inflation runs a bit above target, in order to average out past below target inflation. (for example, see [here](#))

Combining all these factors, if a strong V-shaped economic rebound does in fact play out, time lag effects could cause the stimulus currently being implemented to become a highly pro-cyclical catalyst for higher future inflation.

"Data have continued to surprise on the upside: We have been confident on the prospects of a V-shaped recovery, highlighting that the global economy can get back on its feet quickly, given the exogenous nature of the Covid-19 shock plus the significant stimulus that has been implemented.

... The quick recovery since May has meant that the global economy is reflation faster than we initially expected. As the forces that drive inflation higher continue to align, we think that the case for DM inflation making a comeback in this cycle is now stronger than before.

... In the US, despite a dramatic spike in unemployment, personal income has remained above pre-Covid-19 levels since April due to large amounts of transfers. Policy efforts to address inequality will impart an inflationary impulse, particularly if the mix is skewed towards transfers to households.

... In sum, the speed of the recovery likely means that currently prevailing disinflationary shocks will be more short-lived than expected by many, and that a continued activity bounce back in 2021 is likely to be accompanied by upside inflation surprises.”

- Morgan Stanley, Global Macro Briefing, 7th September 2020

Given that inflation has been persistently running below central bank targets in most places, any increase from current levels would initially be perceived as ‘good inflation’ (i.e. a positive side effect of stronger economic growth). However, as we saw in 2018, it doesn’t take much to tip over into a ‘bad inflation’ narrative where risk asset prices are hit hard by the fear of too much inflation forcing central banks to hike rates.

This good vs bad inflation dynamic is now particularly relevant from an overall portfolio construction perspective because all asset prices have become so dependent on the ‘lower for longer’ interest rates narrative. Stretched valuations everywhere from equities to bonds to property have been justified to a large extent by the expectation for ultra-low rates to last for a long time.

Unexpectedly high inflation is the one thing that can really challenge this narrative because it could force central banks to hike rates, if the perception that they’re falling behind the curve takes hold. As we saw in 2018, we’re in a paradigm where risk asset prices can react very badly to even modest rate hikes. (details [here](#))

Central banks therefore face a tricky balance between stimulating economic growth and letting inflation run a bit hot (i.e. ‘good inflation’) vs. preventing runaway inflation expectations undermining central bank credibility and forcing rate hikes (i.e. ‘bad inflation’).

The tomato sauce bottle analogy comes to mind. As you keep banging on the upturned sauce bottle, you may get just the right amount of sauce coming out ... or you may get way too much. It’s hard to precisely control.



With consensus still strongly skewed to the low inflation scenario and most seeming pretty sure that substantially higher inflation isn’t coming any time soon, the following Mark Twain quote comes to mind:

“It Ain’t What You Don’t Know That Gets You Into Trouble.

It’s What You Know for Sure That Just Ain’t So”

While substantially higher inflation may not be a base case scenario for now, it is becoming an increasingly legitimate tail risk that is worth protecting against.

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 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. These trades added value over the last month, particularly long positions in Australian government bonds relative to swaps.

- 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. The positive performance for the month was driven by many different micro curve exposures across global interest rate markets, particularly trades in the AUD and JPY yield curves.

- 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](#)). The portfolio benefited from long positions in the EUR market over the last month, as global rates sold-off and curves steepened. The performance of these positions exceeded volatility losses on a US options strategy, underscoring the benefit of a global relative value strategy.

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

- 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. Over the last month, positions across the AUD curve underperformed hedges and offset gains made in other currencies.

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