ActiveX

ARDEA Investment Management

ActiveX Ardea Real Outcome Bond Fund (Managed Fund) (ASX:XARO)

ARSN 629 403 925

Fund Facts – 30 April 2020

ASX Ticker	XARO		
Fund Inception Date	10 December 2018	**Fund Size**	$171.4 million
Underlying Fund Inception Date	20 July 2012	**Underlying Fund Size**	$3.5 billion
Distribution Frequency	Quarterly	**Unit Registry**	Link Market Services
Management Fee	0.50% p.a.	**Fund Issuer**	Fidante Partners Limited

Fund Overview

The ActiveX Ardea Real Outcome Bond Fund (Managed Fund) is a defensive fixed income solution that targets stable returns exceeding cash deposit rates and inflation, with a quarterly income distribution and daily liquidity.

The Fund does this by employing Ardea's 'relative value' investment approach, which combines the safety of high quality government bonds with proven risk management strategies to deliver low volatility returns, while protecting capital from interest rate fluctuations and general market volatility. (Note: neither the Fund nor the Underlying Fund are guaranteed).

Suits Investors Seeking

- a higher expected return than bank deposits[1]
- an alternative source of income, with low volatility
- a defensive fixed income anchor to diversify portfolio risk away from equities, property and credit investments
- investors who accept some risk and that their investment will include exposure to derivative strategies

1 Neither fund performance nor capital is guaranteed.

Monthly Performance Report – 30 April 2020

Fund Performance[2, 3]	1 month	3 months	FYTD	1 year	3 years	5 years	Since inception[4]
Fund	0.52%	1.04%	4.41%	6.44%	-	-	7.49%
Australian Consumer Price Index	0.00%	0.23%	1.57%	1.98%	-	-	1.66%
Excess Return	0.52%	0.81%	2.84%	4.45%	-	-	5.83%

2 Performance figures are based on the Fund's net asset value, 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 figures that are less than 12 months are for informational purposes only and are not to be relied upon when considering the likely future performance of the fund.

3 The performance of the Fund will not exactly replicate that of the Underlying Fund, for example, where cash is held by the Fund

4 The Fund's inception date is 10 December 2018.

Source: Fidante Partners Limited, 30 April 2020.

Underlying Fund

The Fund invests in Ardea Real Outcome Fund (Underlying Fund). In this report, where we refer to the Fund's investments we generally do so on a 'look-through' basis; that is, we are referring to the underlying assets that the Fund is exposed to through its investment in the Underlying Fund.

Underlying Fund Performance[5]	1 month	3 months	FYTD	1 year	3 years	5 years	Since inception[6]
Underlying Fund	0.52%	1.08%	4.43%	6.52%	5.27%	3.85%	4.23%
Australian Consumer Price Index	0.00%	0.23%	1.57%	1.98%	1.79%	1.73%	1.90%
Excess Return	0.52%	0.85%	2.86%	4.53%	3.49%	2.12%	2.32%

5 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 likely future performance.

6 The Underlying Fund's inception date is 20 July 2012.

Source: Fidante Partners Limited, 30 April 2020.

Underlying Fund Exposure

Sector Exposure	
Government – National	90%
Government - State	10%
Total	100%

Rating Exposure	
AAA	81%
AA	19%
Total	100%

Region Exposure*	
Australasia	24%
Europe	69%
North America	7%
Total	100%

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

* Australasia = Australia, New Zealand, Japan; Europe = France, Germany, UK; N. America = USA, Canada

Sources: Ardea Investment Management, S&P Ratings. Noting investors accept some risk and that their investment will include exposure to derivative strategies.

Fund Benefits
Higher expected returns than cash and term deposits[1] The Fund has a track record of delivering returns exceeding cash, term deposits and inflation since inception[2]. As these returns are independent of market direction, Ardea expects to maintain a level of outperformance in rising and falling markets irrespective of the level of cash or deposit rates.
An easier way to access your investment The Fund offers daily trading on the ASX, without break costs that can apply to term deposits.
Lower risk than many common investment income sources The Fund invests in high-quality government bonds and cash securities, which have lower credit risk, unlike bank hybrids and corporate bonds, while also using sophisticated risk management strategies to minimise volatility compared to dividend paying stocks.
Defensive fixed income anchor that helps diversify investment portfolio risk The Fund targets positive returns that are independent of interest rate fluctuations and general market volatility. Combining this with proven risk management strategies allows the Fund to help diversify your portfolio risk away from equities, property and credit investments.
Protect the purchasing power of your cash In addition to outperforming[3] bank deposits, the Fund targets returns exceeding inflation, which helps protect the long term purchasing power of your cash.
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 Risks
The Fund is exposed to a number of risks including interest rate risk, market risk, and collateral risk. Please refer to the Product Disclosure Statement for more information.

1 Neither fund performance nor capital is guaranteed.
2 Inception date is July 2012. Past performance is not an indicator of future performance.
3 Refers to the Fund's historical track record since inception

Monthly Commentary

Notable events for the month are summarised below and more detailed discussions of topical market themes are available here - **Ardea's market insights**.

A summary of Ardea's 'relative value' investment approach and portfolio construction process is provided at the end.

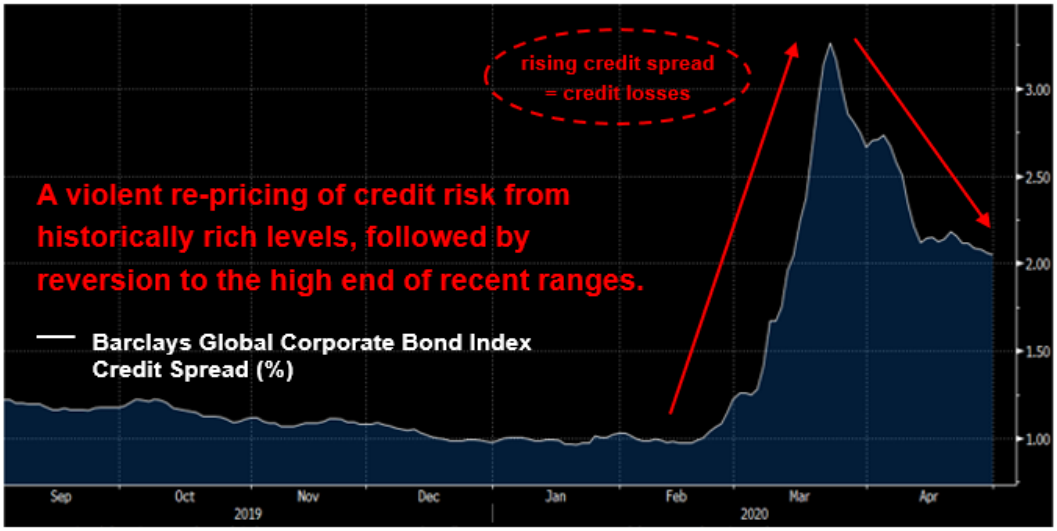
What happened?

Flattening virus curves and growing momentum toward re-opening economies were dominant themes in April.

This, combined with extraordinary policy intervention, led to a strong rebound in risk assets.

> *"The COVID-19 pandemic trajectory and recovery timeline is the key driver of financial markets, and our analyses suggest a significantly improved virus outlook. We saw an earlier-than-expected apex and lower peak of hospital resource use, broader-than-expected spread of the virus, and estimate a lower mortality rate than consensus models.*
>
> *This means economic activity could pick up sooner than most expected, and any potential future virus waves are likely to be less severe. Most regions are in the early stages of reopening their economies, and while the US is lagging this trend, it is likely to increasingly ease restrictions near term."*
>
> - JP Morgan, Global Asset Allocation, 7th May 2020

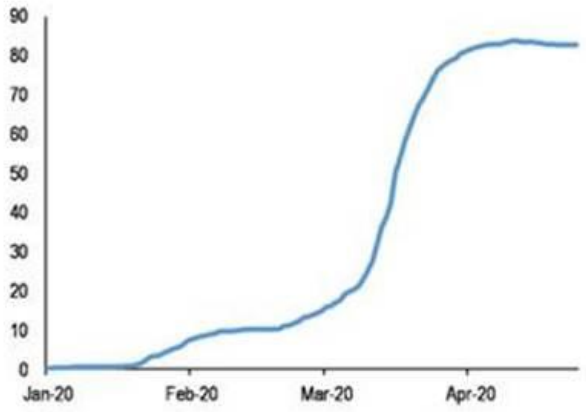
Source: Ardea Investment Management, Bloomberg



Source: Ardea Investment Management, Bloomberg

The chart below from JP Morgan, shows a plateau in global 'lockdown stringency', while the subsequent snippets give a flavour of the reopening theme progressing at varying speeds around the world.

Figure 3: Average score of lockdown stringency index across 147 countries as compiled by Oxford University



Source: Oxford University Research, J.P. Morgan

"Spain and France, two of the countries hardest hit by the coronavirus, are set to spell out plans to ease lockdowns as Europe moves to loosen restrictions despite concerns that such steps could backfire.

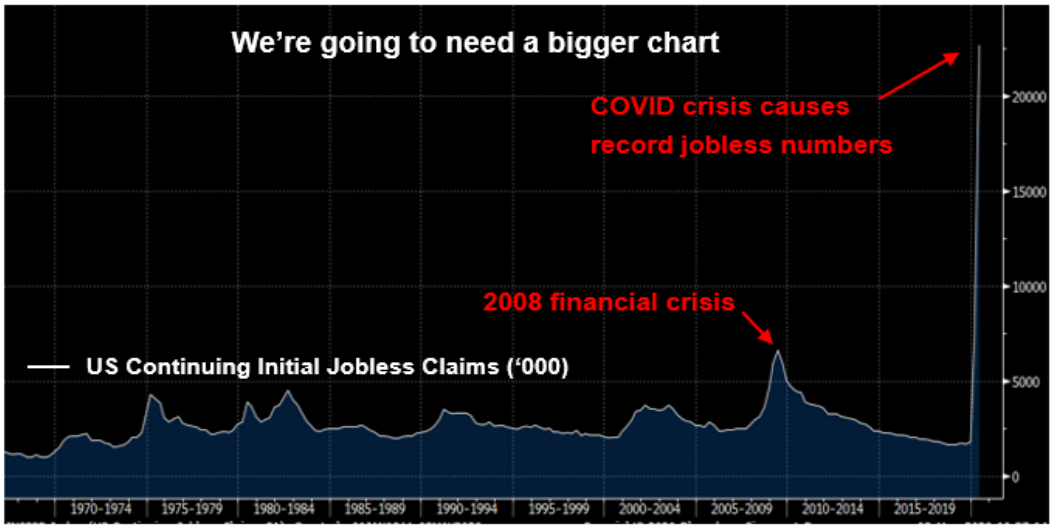
Spanish Prime Minister Pedro Sanchez has said he expects to announce loosening measures after Tuesday's weekly Cabinet meeting. France is preparing to ease its confinement after May 11, and Prime Minister Edouard Philippe will present the government's blueprint to the National Assembly on Tuesday afternoon."

- Bloomberg News, 28th April 2020

"The biggest mall owner in the U.S. is preparing to open a number of its properties across the country, as states such as South Carolina and Georgia start to reopen during the coronavirus pandemic, according to an internal memo that was obtained by CNBC. Simon Property Group is reopening 49 of its malls and outlet centers Friday through Monday …"

- CNBC, 28th April 2020

Despite all the positive sentiment in financial markets, economies are experiencing 'off-the-charts' weakness.



Source: Ardea Investment Management, Bloomberg

"The record-long U.S. economic expansion is over after almost 11 years, with what's likely to be the deepest recession in at least eight decades now under way. The world's largest economy shrank at a 4.8% annualized pace in the first quarter, the biggest slide since 2008 and the first contraction since 2014, as the need to fight the coronavirus forced businesses to close and consumers to stay home.

The current quarter is likely to be far worse, with analysts expecting the economy to tumble by a record amount in data going back to the 1940s."

- Bloomberg News, 29th April 2020

"The euro-area economy plunged into a record contraction, an outcome that will only add more urgency to controversial demands for joint government fiscal support. The gross domestic product of the eurozone fell by 3.8 per cent in the first quarter compared with the previous quarter, preliminary estimates from Eurostat found. This is the largest drop since the series began in 1995, and larger than seen in the worst of the financial crisis"

- Bloomberg News, 29th April 2020

"The coronavirus pushed China's economy into its first contraction in decades in the first quarter, with the spread of the disease around the world now leaving the nation reliant on fragile domestic demand to spur a recovery. Gross domestic product shrank 6.8% from a year ago, the worst performance since at least 1992 when official releases of quarterly GDP started and missing the median forecast of a 6% drop. China's economy hasn't contracted on a full-year basis since the end of the Mao era in the 1970s."

- Bloomberg News, 17th April 2020

First quarter bank earnings updates also gave us some insight into the expected economic damage from virus disruptions, particularly in relation to credit default losses.

Europe's largest lender HSBC reported Q1 earnings 13% below consensus estimates, largely driven by higher than expected provisions for credit losses, as Bloomberg News notes:

"HSBC Holdings Plc took its biggest charge for bad debt in almost nine years and warned of deepening loan losses as it pushes back parts of its restructuring program. Expected credit losses swelled to $3 billion in the first quarter, almost double estimates, and could rise to as high as $11 billion this year, the lender said on Tuesday."

Credit Suisse, one of the largest players in the leveraged loan space, also announced higher than expected loan loss provisions:

"Credit Suisse Group AG is taking more than $1 billion in write-downs and provisions for bad loans after the coronavirus, joining U.S. banks in taking an upfront hit as the outbreak pummels economic activity across the globe. The bank held back 568 million Swiss francs ($585 million) for credit losses, almost triple what analysts had expected, and said it may have to make further allowances in future quarters."

Credit rating downgrades also provided guidance on the severity of economic disruptions and the knock-on effects to credit default losses.

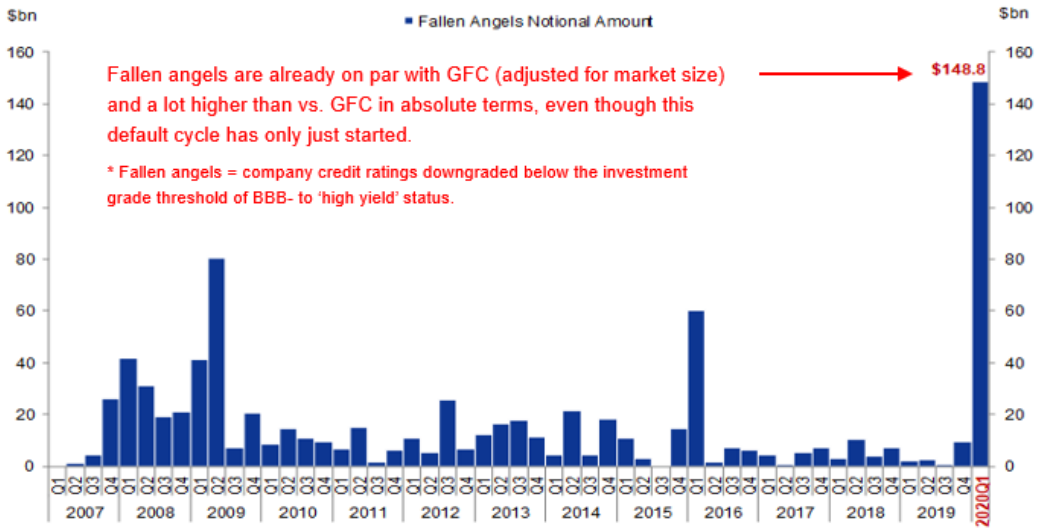
"Beyond default rates, another factor pointing to the health of the loan market is the ratio of downgrades to upgrades, especially those at the lower end of the credit quality spectrum. The downgrade/upgrade ratio hit an unprecedented 11.4:1 at the end of March. The next-closest figure, which is compiled on a rolling three-month basis, is from January 2009, as the loan market was still in the throes of the Great Financial Crisis, when the ratio was 8.45:1."

- Standard & Poor's, LCD News, 23rd April 2020

"The pace of rating downgrades has materially accelerated over the past few weeks. As shown in Exhibit 1 [see chart below], the amount outstanding of newly minted fallen angel bonds has jumped to $149 billion this quarter, a higher amount than the previous peak reached in the second quarter of 2009.

The pick-up in negative rating actions has also been visible within the broader IG and HY markets."

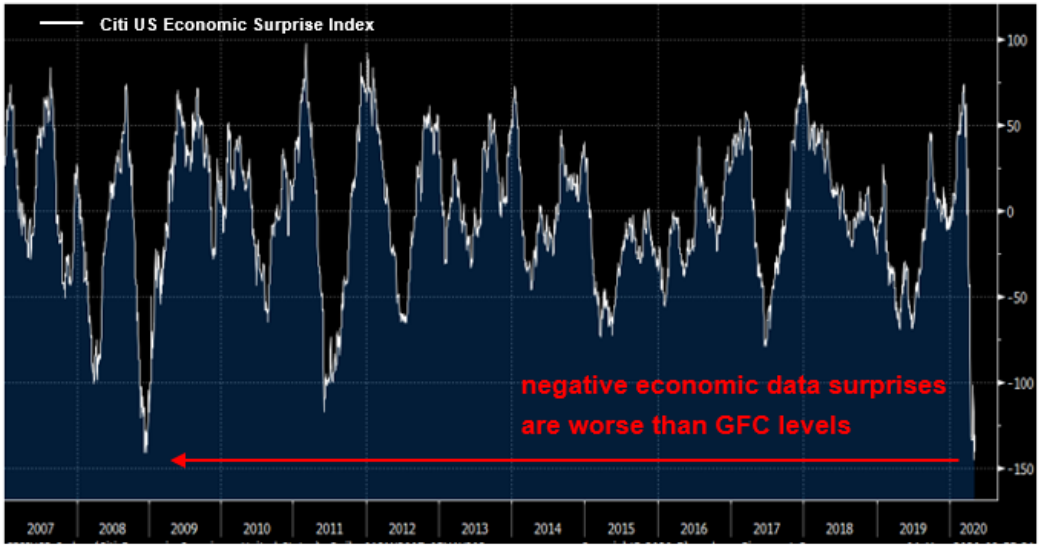
- Goldman Sachs, Credit Notes, 30th March 2020



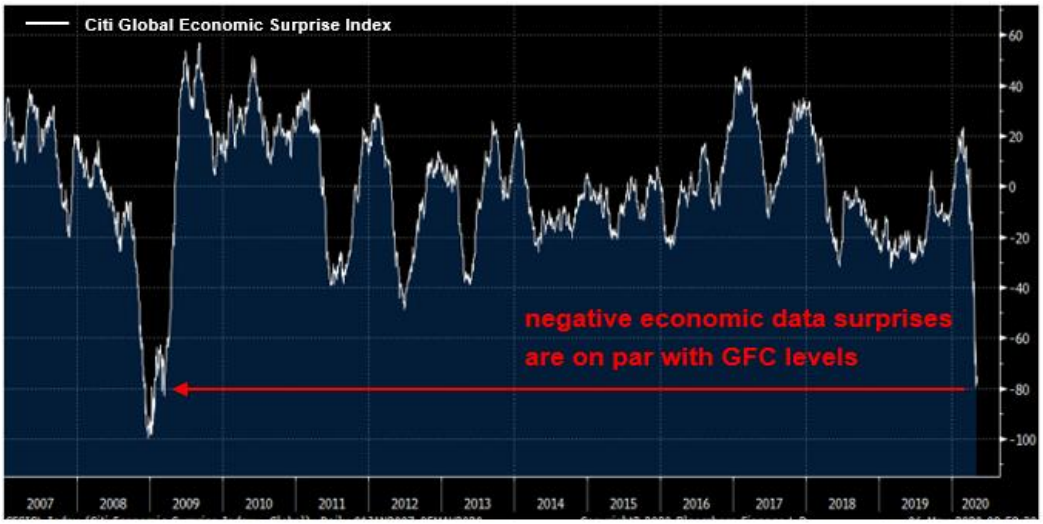
Source: Chart from Goldman Sachs, Comments from Ardea Investment Management

Even though expectations for near term economic growth are already very pessimistic, the actual data is still coming out even worse.

Citigroup's 'Economic Surprise' indices track economic data releases vs. economists' consensus forecasts. Negative numbers indicate that the actual data is below consensus expectations.

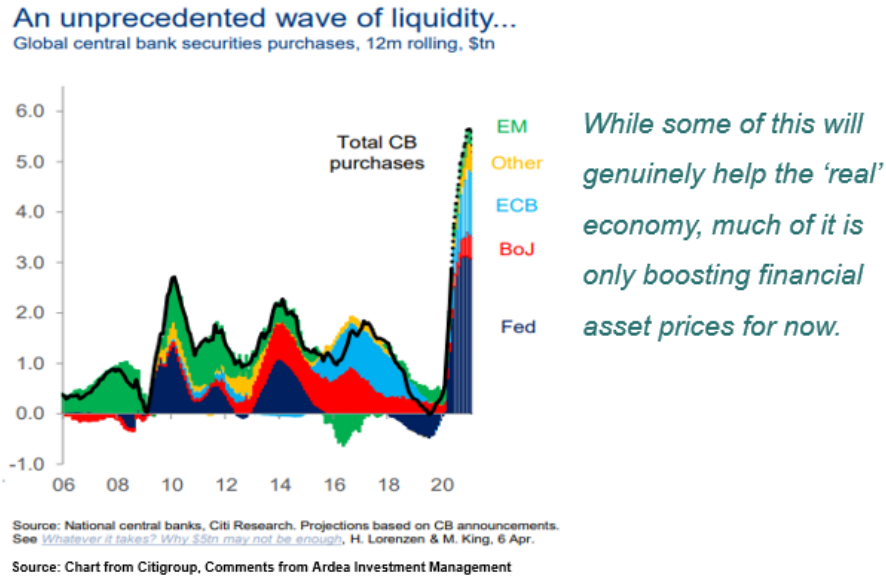


Source: Ardea Investment Management, Bloomberg



Source: Ardea Investment Management, Bloomberg

Trying to soften the economic downside and speed up the subsequent recovery, unprecedented fiscal and monetary stimulus has been unleashed. (details here)



Central banks are now boldly going where they have never gone before, as Deutsche Bank noted in relation to the US Federal Reserve's decision to buy high yield (HY) bonds.

> *"Today's update by the Federal Reserve with respect to the primary and secondary corporate credit facilities is unprecedented and should deliver a huge shot of confidence to the US credit market. In effect, the Fed has left almost no stone unturned and thrown the kitchen sink at the credit market. By expanding purchases to HY exchange traded funds and fallen angels, the Fed has gone beyond what any central bank has done before in venturing further down the credit spectrum."*

This is clearly aimed at addressing the substantial 'fallen angel' problem that many had warned about (see here) but is also prompting new warnings about moral hazard.

> *"When people get the feeling that the government will protect them from unpleasant financial consequences of their actions, it's called "moral hazard." People and institutions are protected from pain, but bad lessons are learned.*
>
> *… There's an old saying – variously attributed – to the effect that "capitalism without bankruptcy is like Catholicism without hell." It appeals to me strongly. Markets work best when participants have a healthy fear of loss. It shouldn't be the role of the Fed or the government to eradicate it."*
>
> - Oaktree Capital, Howard Marks Memo, 14th April 2020

Equally bold (and controversial) was the UK's decision to flirt with outright debt monetisation when the UK Treasury re-activated its dormant 'Ways and Means Facility', which is a mechanism for the Bank of England to help finance government spending. The idea of central banks directly financing government spending – i.e. monetising debt – is controversial, as we discussed here.

This unprecedented global policy stimulus response has been a key factor in stabilising financial markets and fuelling the rebound from March lows. When equity and credit markets were in freefall it was easier to push through giant stimulus measures as all the focus was on near term crisis control, with little bandwidth left to consider longer term side effects like moral hazard and future debt burdens. Now that markets have stabilised policy scrutiny and tensions are increasing.

> *"Activist protests in state capitals in favor of "reopening" the economy — and a growing backlash among congressional conservatives against the $3-trillion-and-growing tab for federal spending on economic assistance during the crisis — have increased the pressure from Mr. Trump's base to shift the government's focus, even as millions of Americans are applying for new unemployment benefits each week.*

'No more spending' has really become the rallying cry of the right' said Stephen Moore, an informal adviser to Mr. Trump who is the president of the Committee to Unleash Prosperity, which has pushed governors and other officials to ease restrictions on restaurants, bars and other businesses. 'We've done the spending, it didn't work, and now we need to try something else. There is going to be civil war in Congress over this.'"

- New York Times, 5th May 2020

"The European Central Bank's quantitative-easing program looks set to fight another day, even after German judges issued a three-month ultimatum to fix flaws in the controversial measure, a key weapon in the ECB's struggle against economic turmoil. In a 7-to-1 ruling, the judges said that the quantitative easing program isn't backed by European Union treaties. That's why German authorities acted unconstitutionally by not challenging the 2.7 trillion-euro ($2.95 trillion) plan."

- Bloomberg News, 5th May 2020

Why is it relevant?

For now, financial markets are optimistic that global progress on flattening virus curves will curtail the duration of economic disruptions, while the unprecedent monetary + fiscal stimulus blitz will support a quick rebound.

The first leg of the risk asset rally could be justified by relief that extraordinary policy stimulus, combined with flattening virus curves, had chopped off the worst-case tail risk economic scenarios (e.g. uncontrollable virus spreads, overwhelmed health systems, insufficient policy reaction etc.).

However, a continuation of the rally is contingent on the upside scenario of a V-shaped economic recovery actually being realised, while also overcoming the underlying contradiction that the lockdown measures which are successfully flattening virus curves, are the very same measures that are causing so much economic damage.

Will economic activity quickly revert to normal? Will easing lockdowns cause new virus flare ups? Will ongoing disruptions to global trade and migration be a lasting drag on economic growth?

The bull case rests on a relatively trouble free and sustainable exit from lockdowns, with policy stimulus being effective in buffering economic downside.

"We make no major changes to our model portfolio, retaining a pro-risk allocation given improving virus dynamics, extraordinary monetary and fiscal policy support, and defensive investor positioning.

… While the collapse in economic activity is historic, so too is the global policy response to cushion the impact and support a recovery as containment measures are relaxed. We estimate the impact of Fed easing in both rates and credit more than compensate for the temporary hit to corporate earnings when valuing the US market via discounted earnings."

- JP Morgan, Global Asset Allocation, 7th May 2020

Given the sharp rebound in risk asset prices, it appears that a V-shaped economic recovery is no longer an upside scenario but has actually become the new base case that is already being priced in. However, it is far from certain and some economic forecasters are now expecting a deeper downturn, with slower recovery.

"Since we last updated our outlook for the US economy a month ago, the extent of the economic damage wrought by Covid-19 and the related containment measures has become painfully evident. Recent developments, including first quarter GDP and our high-frequency tracker, suggest that the second quarter contraction could be more severe, and our recent analysis of state-by-state data indicate that the recovery from this lower base could prove to be very gradual.

This report updates our outlook to reflect these developments. We now see the economy plunging by nearly 40% annualized in the second quarter and expect a more muted rebound in the second half. On net, these forecasts leave real GDP down 8.0% this year, a contraction that is more than double our prior assumption of -3.2%."

- Deutsche Bank, US Economic Perspective, 5th May 2020

On the virus front, examples like Singapore show that it's not a straightforward path from virus peak to normality.

"In the early days of the coronavirus pandemic, Singapore was a global standard bearer for taming the deadly illness. Now it's home to Southeast Asia's largest recorded outbreak and is racing to regain control. One reason behind this reversal can likely be traced back to six days in February, when the earliest sign of

what would become an explosion in cases among migrant laborers first appeared."

- Bloomberg News, 21st April 2020

The fact that Singapore's new outbreak is centred on migrant workers, who are essential to Singapore's economy, shows how hard it is to manage the balance between virus containment and prolonged disruption of economic activity.

In Singapore and other places, a scenario with on-off rolling lockdowns to deal with periodic virus spikes may see the initial economic hit softened but the ongoing disruptions extending far longer than anticipated by bullish V-shaped forecasts.

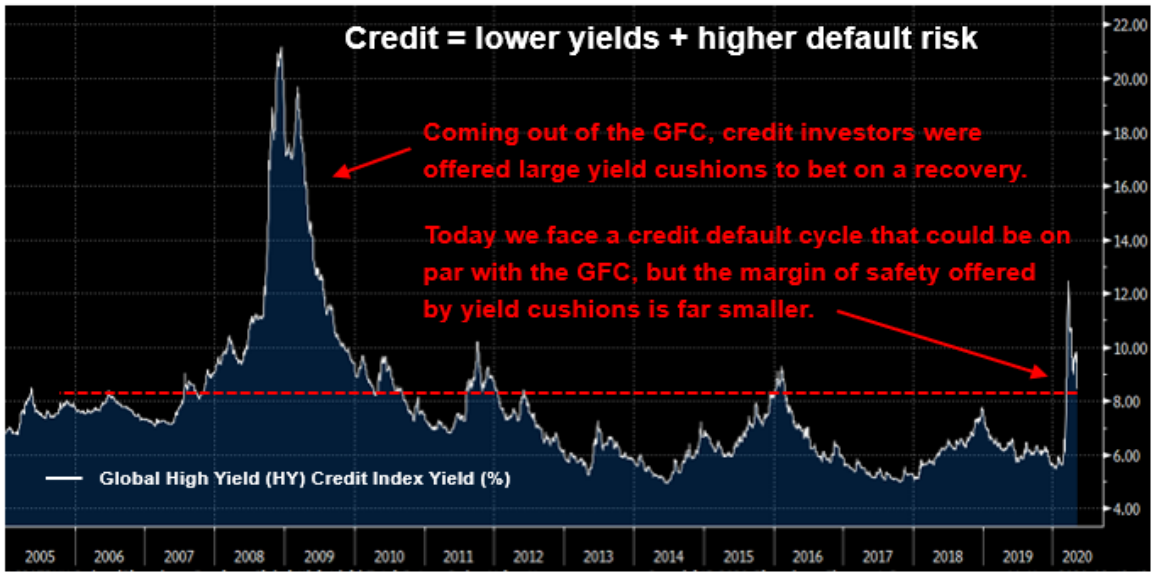
Trying to forecast the path of economic growth is a fraught exercise at the best of times (see here). A more useful approach is to understand the extent to which different scenarios are being reflected in current market prices. We can then think about how the current setup could be challenged and what the resulting impact on future market prices might be. Viewed through this lens, current risk asset pricing in many spots has been quick to discount scenarios with prolonged economic disruptions, while assigning high probabilities to scenarios in which things revert quickly to January levels.

In this context, the starting point matters. Heading into the first quarter (Q1) of 2020 drawdown some markets were at all-time record highs and many already had valuations toward historically expensive extremes. This rebound is therefore not taking prices from beaten up to average levels but arguably, from average levels back to the extremes of expensiveness, despite highly elevated forward-looking downside risks.

The current yields on offer in credit markets put this 'starting point' effect into perspective and we can use the Barclays Global High Yield Bond Index as an example.

Prior to the March turmoil, the index yield had dropped to near record low levels of c. 5.5% (record low yields = record high bond prices). This was driven by a combination of credit spreads declining and underlying government bond yields also falling. (credit spreads are explained here)

Following the March sell-off and subsequent rebound, the yield is now 8.4%, as shown in the chart below. On the surface this yield may look great but remember that the bonds in this index are 'high yield' for a reason. They carry material risk of default.



* Barclays Global High Yield Bond Index

Source: Ardea Investment Management, Bloomberg

For context, coming out of the 2008 crisis (GFC) this index offered a yield of c. 18% to cushion against default risk. This time the yield cushion is half as large, even though this default cycle could be just as bad.

Even though credit spreads have increased due to the Q1 credit sell-off, the decline in underlying government bond yields offset much of that, leaving yields far lower than they were in the post-GFC recovery. So, which matters more? The fact that credit spreads have increased or that total yields are still very low. It depends on how severe this default cycle will be.

Remember, when facing an actual default cycle, with the risk of permanent capital loss, it is the absolute level of yields that matter because that is the cushion that buffers against default losses. The fact that credit spreads are relatively higher or that credit yields are relatively higher than cash or government bonds is of little consolation when defaults cause permanent capital loss.

The timing of the economic recovery is crucial for corporate default rates. Whether the recovery is shaped like a V, a U, the dreaded L or a novel 'Nike swoosh' (explained here) will determine how many overleveraged corporates default as temporary liquidity problems morph into permanent solvency ones.

Credit rating firm Moody's offers three corporate default scenarios, depending on the severity and length of the economic downturn:

> *"Global HY default rate could rise to 6.8% for financial and non-financial companies over next 12 months in a sharp but short downturn.*
>
> *That could rise to 16.1% if economic and financial conditions were to weaken much more and turn similar to those seen during global financial crisis in 2008.*
>
> *In an extremely severe recession, worse than last crisis, the default rates could rise to 20.8% in a year."*

It's pretty clear that the current level of credit spreads and corporate bond yields is only 'cheap' if you have high conviction in Moody's first scenario. Credit markets currently offer very little margin of safety for anything worse than that.

Meanwhile, those on the front lines think this default cycle could be on par of even worse than the GFC. For example, despite 76% of credit managers surveyed expecting the global economy to be 'back to normal' by mid next year at the latest, they still expect a default cycle on par with the GFC.

> *"Global debt managers have the most pessimistic outlook on defaults since the 2008 financial crisis, according to a new report from the International Association of Credit Portfolio Managers.*
>
> *In a March survey of over 100 member institutions in more than 20 countries, 90% of respondents said they expect defaults to rise over the next 12 months, up from 48% in December. IACPM's credit default index was at -90.3 -- the worst reading since the survey began at the end of 2008, when it was -96.6.*
>
> *This comes as 38% of respondents said the global economy will be "mostly back to normal" by the end of 2020, following the disruption caused by the coronavirus pandemic. Another 38% said it would be business as usual by the end of June 2021."*
>
> - Bloomberg News, 'Global credit managers give bleakest default outlook since 2008', Apr-2020

And what happens if we don't get a quick V-Shaped economic rebound?

> *"One of the world's top restructuring bankers sees an economic crisis looming that will be worse than the last recession.*
>
> *'In some ways, it's much more severe than what we experienced in '08 and '09,' Irwin Gold, executive chairman of Houlihan Lokey Inc., said in a Bloomberg Television interview Tuesday. 'You saw that in the incredible volatility and revenue destruction we saw, which will lead to cash-flow destruction, liquidity destruction and knock-on effects,' he said, adding that the coronavirus pandemic and shocks in oil prices have 'revealed excesses in corporate credit and direct lending.'"*
>
> - Bloomberg News, 'Houlihan Lokey Expects Default Surge in a Crisis Worse Than 2008', 1st Apr-2020

The last material sell-off in risk assets (Q4 2018) was about rising interest rates challenging stretched valuations. Back then, the cause of the sell-off was within policymakers' control and as soon as the US Federal Reserve cut rates, markets rallied again. This time we have real recession risk and real default risk. It's no longer just about short-term volatility.

Serious large-scale default risk (i.e. permanent loss of capital) is not something credit investors have had to deal with for a long time, if ever in their careers to date. This is particularly true for Australia, which hasn't been tested by a proper default cycle since the early 1990's.

Central bank buying of credit can artificially support bond prices, but it can't prevent fundamental credit quality deterioration and defaults. This is the biggest risk to the 'buy what central banks are buying' strategy.

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 a large number of 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 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 quarter came from the following strategy groups:

- RV Rates

Volatility in bond yields and market interest rates contributed to performance this month as the portfolio always has 'positive convexity' via buying interest rate options.

A positive convexity portfolio automatically profits from large interest rate movements, irrespective of the direction of those movements. This is because the portfolio's duration automatically increases when market interest rates / bond yields fall and automatically decreases when they rise. The profits from this volatility is locked in via a process known as 'delta hedging', as the portfolio's duration is constantly rebalanced back to zero. (details **here**)

- 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.

A notable example this month was AU curve anomalies created by the demand / supply tension between central bank bond buying pinning the 3 year point at 0.25% vs. new government bond supply pushing 4 years rates higher, causing anomalous curve steepness.

- RV Bond vs. Derivatives

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 has zero net interest rate duration.

In March, our strategies exploiting RV mispricing between long dated government bonds and interest rate swaps incurred losses as governments around the world announced extraordinarily large fiscal stimulus packages to help offset virus related economic disruptions. The expectation of outsized new government bond issuance to fund this fiscal stimulus caused government bonds generally to underperform relative to their closely related interest rate derivatives. This dynamic was most pronounced in +15 year maturity bonds because these have not benefitted as much from central bank bond buying.

The losses reversed this month as the demand / supply imbalances moderated somewhat.

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

- Volatility Strategies

These strategies reversed some of the outsized gains they delivered in Q1, as financial markets stabilised in April. These strategies played their role in Q1 by providing risk balance vs. other RV strategies that incurred losses over that period. Subsequently, as the market stabilised in April the volatility strategies incurred losses, while those other RV strategies (e.g. bond vs. derivatives) delivered gains.

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 (known as 'implied volatility') increases.

Being 'long volatility' is a key advantage for portfolios with defensive objectives because interest rate volatility tends to rise in adverse market environments and therefore 'long volatility' strategies can provide additional performance upside at times when conventional investments will likely incur losses. It's important to note that these strategies are RV strategies in their own right, rather than 'protection' or 'insurance' trades, which means they can continue generating profits even in positive market environments, as they have over the past year.

They are particularly useful in maintaining ARO's risk balance because they have a strong 'risk-off' bias, meaning they tend to outperform in adverse market scenarios, and can therefore help offset expected losses on other strategies that can underperform at these times.

ARO's use of volatility strategies is explained in more detail **here** and **here**.

CONTACT US

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Lonsec

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