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

ARSN 629 403 925

Fund Facts – 31 August 2021

ASX Ticker	XARO		
Fund Inception Date	10 December 2018	**Fund Size**	$765.2 million
Underlying Fund Inception Date	20 July 2012	**Underlying Fund Size**	$9.7 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 cash[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 – 31 August 2021

Fund Performance[2, 3]	1 month	3 months	FYTD	1 year	3 years	5 years	Since inception[4]
Fund	-0.27%	-0.81%	-0.27%	1.48%	-	-	5.27%
Australian Consumer Price Index	0.30%	0.79%	0.53%	3.32%	-	-	1.74%
Excess Return	-0.57%	-1.59%	-0.80%	-1.83%	-	-	3.54%

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 is not a reliable indicator of likely future performance. All periods longer than 1 year are annualised.
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, 31 August 2021.

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	-0.27%	-0.82%	-0.27%	1.50%	5.28%	4.85%	4.05%
Australian Consumer Price Index	0.30%	0.79%	0.53%	3.32%	1.76%	1.82%	1.89%
Excess Return	-0.57%	-1.61%	-0.81%	-1.82%	3.51%	3.03%	2.16%

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. All periods longer than 1 year are annualised.
6 The Underlying Fund's inception date is 20 July 2012.
Source: Fidante Partners Limited, 31 August 2021.

Underlying Fund Exposure

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

Rating Exposure	
AAA	62%
AA	38%
Total	100%

Region Exposure*	
Australasia	67%
Europe	3%
North 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

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](#).

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.

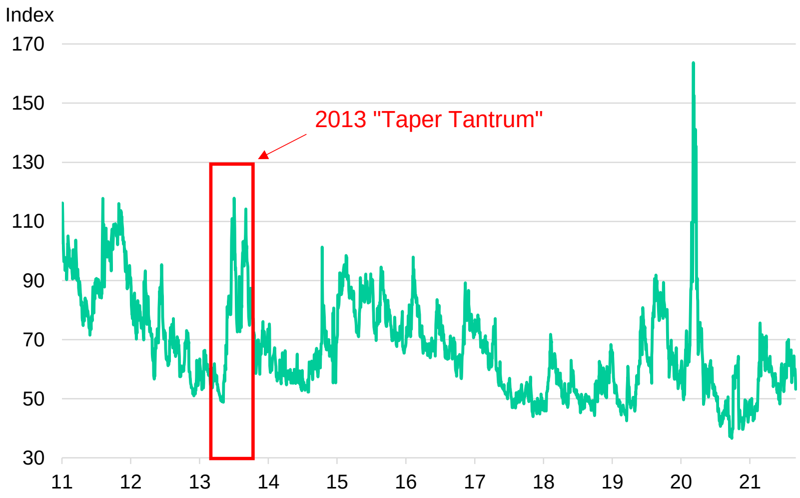
1) Why this time is different for the Fed's QE taper

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

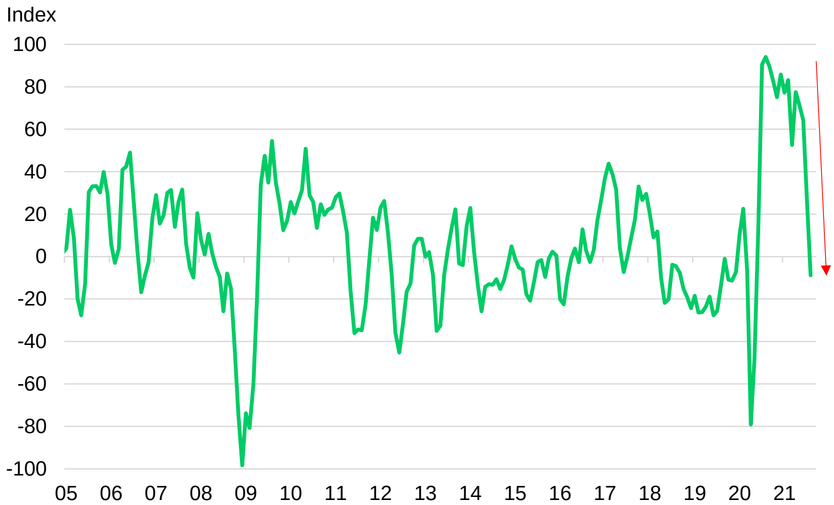


Source: Ardea, Bloomberg

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

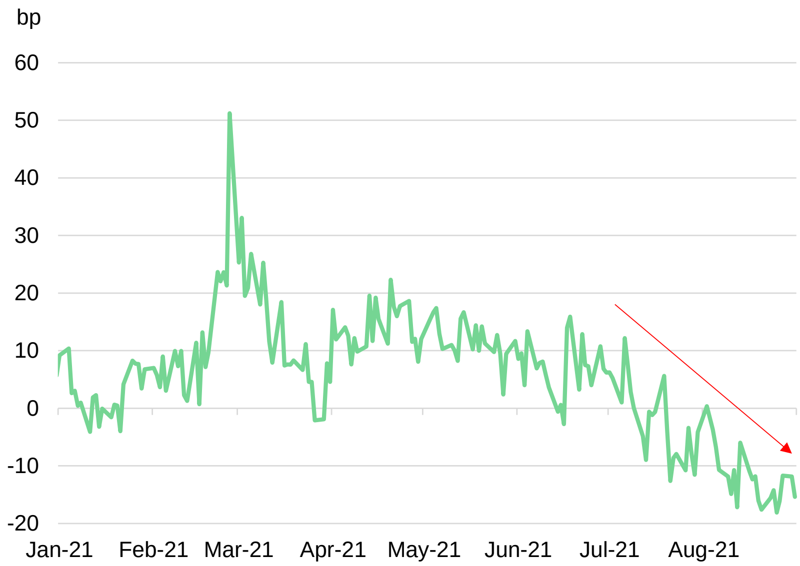


Source: Ardea, Bloomberg

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



Source: Ardea, Bloomberg

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Underlying Fund Ratings

Ardea Real Outcome Fund received a Morningstar Analyst Rating™ of 'Bronze' on 17 July 2021