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

ARSN 629 403 925

Fund Facts – 31 January 2020

ASX Ticker	XARO		
Fund Inception Date	10 December 2018	**Fund Size**	$151.9 million
Underlying Fund Inception Date	20 July 2012	**Underlying Fund Size**	$3.1 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 – 31 January 2020

Fund Performance[2, 3]	1 month	3 months	FYTD	1 year	3 years	5 years	Since inception[4]
Fund	0.69%	0.90%	3.34%	8.40%	-	-	8.19%
Australian Consumer Price Index	0.20%	0.66%	1.42%	2.04%	-	-	1.89%
Excess Return	0.49%	0.24%	1.92%	6.36%	-	-	6.30%

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, 31 January 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	0.69%	0.89%	3.31%	8.50%	5.61%	4.06%	4.22%
Australian Consumer Price Index	0.20%	0.66%	1.42%	2.04%	1.86%	1.77%	1.87%
Excess Return	0.49%	0.23%	1.89%	6.46%	3.75%	2.29%	2.35%

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, 31 January 2020.

Underlying Fund Exposure

Sector Exposure	
Government	60%
Semi-Government	40%
Total	100%

Rating Exposure	
AAA	45%
AA	55%
Total	100%

Region Exposure	
Australia / NZ	52%
Europe	12%
USA / Canada	36%
Total	100%

Interest Rate Duration (years)	
12-month average	0.3
Since inception average	0.1

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?

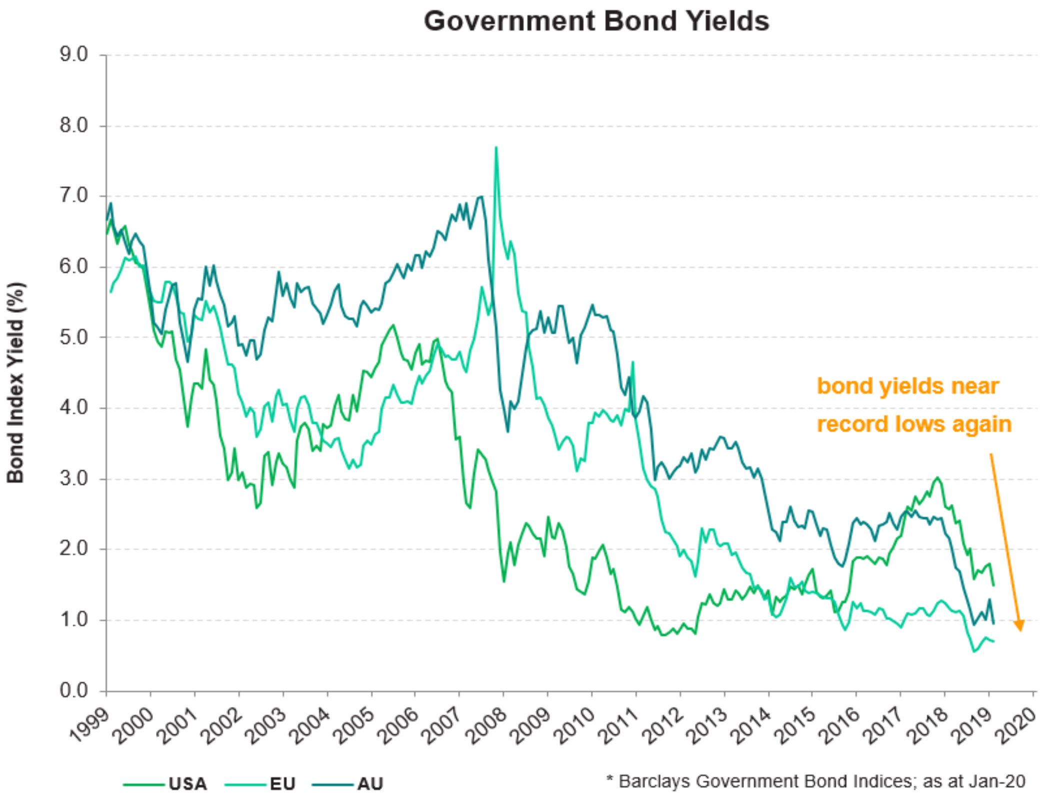
January was generally a risk-off month across global markets as coronavirus fears hit growth sensitive assets. Equities were down in most markets (Australia a notable exception) and commodities were hit particularly hard in anticipation of China's economic growth slowing due to virus related factors.

Growth sensitive assets hit

Asset Price Performance (as at 31-Jan-20)	1 Month Return
MSCI World Equity Index	-0.7%
iShares Emerging Markets Equity ETF	-4.7%
iShares High Yield Bond ETF	-0.4%
Oil	-15.7%
Iron Ore	-8.5%
Copper	-10.2%

Source: Ardea Investment Management, Bloomberg

Meanwhile, bonds played their traditional safe haven role, with most bond markets performing strongly over the month. As a result, bond yields are now back near record low levels.



Source: Ardea Investment Management, Bloomberg

Why is it relevant?

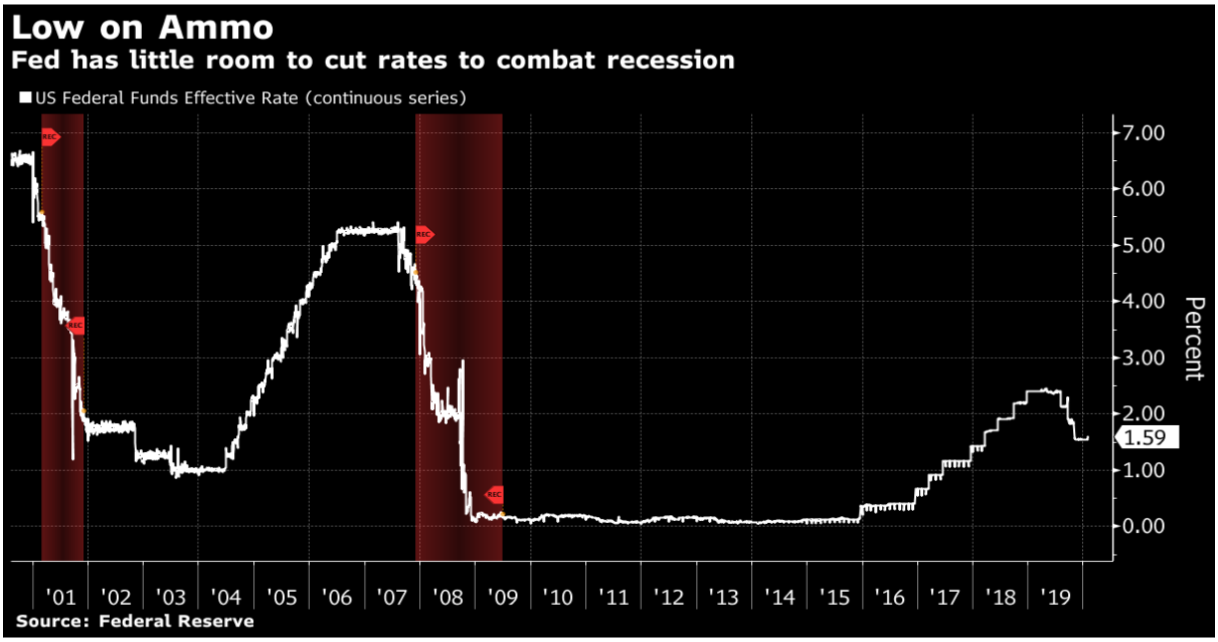
Since the 2008 financial crisis, policymakers have become increasingly reliant on monetary stimulus – interest rate cuts, quantitative easing – as the policy tool of choice to mitigate economic growth risks.

However, with interest rates already near or even below zero in most of the western world, there is growing concern that when interest rates are already very low to begin with, the marginal benefits of further monetary stimulus decrease, while the negative side effects increase. (details here)

This raises doubt as to whether monetary policy alone can continue carrying the burden of fighting economic growth risks, with fiscal policy being the obvious reinforcement. The Financial Times explained it this way:

> *"For four decades, monetary policy has been the dominant instrument of macroeconomic policy and central banks the queens of macroeconomic policy.*
>
> *…Today, however, even unconventional monetary policy looks exhausted. Short-term central bank interest rates are close to zero in the eurozone and Japan and a mere 0.75 per cent in the UK. In the US, the Federal Reserve was unable to get rates above 2.5 per cent in the upswing and is now back down to 1.75 per cent.*
>
> *… Room for action in response to a significant downturn is limited. Historically, the Fed has cut rates by as much as 5 percentage points in response to a recession. That would bring US rates to minus 3.25 per cent. This would only work if depositors could be charged for leaving money in banks. "*
>
> - **Financial Times, 'Active fiscal policy must be part of a new normal', Jan 2020**

This chart from Bloomberg News demonstrates the dilemma of central banks running out of policy ammunition. Referencing the US experience, the chart shows the last two recessions (shaded red), when the US Federal Reserve (FED) responded by cutting the official interest rate (white line) by up to 5%. There is now less room to repeat that kind of strong stimulus response, given the starting point of rates is much lower.



At least the FED was able to exploit the window of strengthening US economic growth through 2017/18 to modestly raise interest rates, thereby replenishing at least some of their ammunition to be able to cut rates in the future. Other central banks haven't been willing or able to follow the FED's lead.

For example, in Japan and Europe, the official central bank interest rate is still stuck in negative territory. The UK only managed a marginal replenishment by raising rates to 0.75%, having been mired in Brexit uncertainty. Meanwhile, Australia actually used up more of its monetary ammunition, having cut rates through 2019 to a record low of 0.75%.

With interest rates and bond yields in many parts of the world now near record low levels there is a growing consensus that fiscal policy needs to be re-engaged as part of the policy armoury to fight future growth risks.

If fiscal stimulus is indeed engaged in this way, a concern for bond investors is the potential for a large demand vs. supply imbalance across bond markets, as governments issue new debt to fund fiscal spending. Lots of new government bonds being issued at record high prices isn't an ideal combination and has the potential to push bond yields higher / prices lower.

On this point, central banks are already exploring ideas to more closely co-ordinate fiscal and monetary policies.

One option is yield curve control, as already practiced in Japan. This requires central bank intervention to intentionally cap bond yields so that borrowing costs (i.e. bond yields) don't increase, even as governments issue lots of new bonds to fund fiscal spending.

More controversial is the idea of central banks explicitly financing government spending by effectively printing money to absorb extreme levels of government bond issuance that markets wouldn't be able to digest (at least not without yields rocketing higher). Called debt monetisation, this is controversial because of the fear that it could eventually lead to economic carnage via hyperinflation, sky high interest rates and loss of confidence in currencies a la Venezuela and Zimbabwe.

Debt monetisation: Will one lead to the other?

Image credit: Cartoon Movement

A recent paper co-authored by former FED vice chair Stanley Fischer argues that 'unprecedented policy co-ordination' will be needed to fight the next economic downturn. Recognising the risks of outright debt monetisation, they advocate a middle path of fiscal and monetary policy co-ordination that mitigates these risks. While that sounds fine in theory, in practice it requires policymakers to manage an extremely delicate balance in engaging extraordinary stimulus measures, while still maintaining credibility around inflation / budget control.

This renewed focus on fiscal policy has direct implications for bond investors, particularly given the record amounts that have flooded into bonds betting on the low rates status quo to continue.

More generally, ultra-low rates, growing policy uncertainty and extreme yield chasing behaviour all combine to make conventional assumptions about bond behaviour and the diversification role they are expected to play in portfolios less reliable than in the past. (details here)

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 each month. 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 this month.

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:

- Bond vs. Derivative

In Dec-2019 the Reserve Bank of New Zealand surprised the market by not cutting interest rates despite markets forecasting a 75% chance of rate cuts at that time. This triggered a large sell-off in NZD rates (i.e. rates / bond yields moved higher), which was exacerbated by crowded consensus positions that had been positioned for a rate cut being forced to unwind their positions. As often happens in these kinds of situations, the sell-off was inconsistent, meaning that pricing across different parts of the NZD bond and interest rate derivative markets moved inconsistently, creating RV opportunities. We took advantage of this to implement a number of strategies to exploit these pricing inconsistencies between bonds, interest rate swaps and futures. As buying and selling flows across these instruments normalised this month, some of the RV mispricing corrected and generated profits for these positions. This is a good example of how those whose investment strategies are based on trying to predict market direction (i.e. the forecasting crowd) can create RV opportunities. Another such example we have previously exploited is detailed **here**.

- Rates

As the portfolio always buys interest rate options as part of RV strategies that have a 'risk-off' bias, it tends to outperform in adverse market environments when interest rate volatility rises. Just such a scenario played out in the latter half of this month when escalating coronavirus fears caused most equity and credit markets to sell off, while market interest rates and bond yields moved sharply lower. The portfolio's option positions benefited from this elevated volatility via a process known as 'delta hedging' (details **here**), with the resulting profits being recorded in the 'RV Rates' component of the performance attribution.

This is a good example of how the portfolios 'risk-off' biased RV strategies generally and the option positions specifically, provide additional performance upside potential in adverse market environments. Further detail is available **here**.

- Micro Curve

The portfolio holds positions to profit from a normalisation of interest rate swap curve anomalies that are present across various points at the short end of the AU curve due to demand / supply imbalances created by domestic and global investors betting on the strong consensus view of further rate cuts. While these positions incurred losses over the prior quarter as buying flows from these investor groups remained strong, the flows reversed in January, generating profits for these positions as the RV mispricing started to correct.

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

- Volatility

Unusually, even though the actual day to day movements in bond yields / market interest rates over the month were elevated (known as 'realised volatility') due to the global 'risk-off' tone, the market pricing of option volatility (known as 'implied volatility') declined in AU, which resulted in losses for some of our option holdings.

This kind of divergence between realised and implied volatility tends to create profitable new opportunities in the future. (details **here**)

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Underlying Fund Ratings

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