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

ARSN 629 403 925

Fund Facts – 31 July 2019

ASX Ticker	XARO		
Fund Inception Date	10 December 2018	**Fund Size**	$36.8 million
Underlying Fund Inception Date	20 July 2012	**Underlying Fund Size**	$1.2 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.

Quarterly Performance Report – 31 July 2019

Fund Performance[2, 3]	1 month	3 months	FYTD	1 year	3 years	5 years	Since inception[4]
Fund	0.59%	2.54%	0.59%	-	-	-	6.59%
Australian Consumer Price Index	0.10%	0.51%	0.10%	-	-	-	0.83%
Excess Return	0.49%	2.04%	0.49%	-	-	-	5.76%

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.

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	0.58%	2.59%	0.58%	7.89%	5.57%	4.02%	4.13%
Australian Consumer Price Index	0.10%	0.51%	0.10%	1.54%	1.82%	1.62%	1.90%
Excess Return	0.48%	2.08%	0.48%	6.35%	3.75%	2.41%	2.23%

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.

Underlying Fund Exposure

Sector Exposure	
Government	70%
Semi-Government	30%
Total	100%

Rating Exposure	
AAA	67%
AA	33%
Total	100%

Region Exposure	
Australia / NZ	64%
Europe	30%
USA / Canada	6%
Total	100%

Interest Rate Duration (years)	
12-month average	0.1
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.

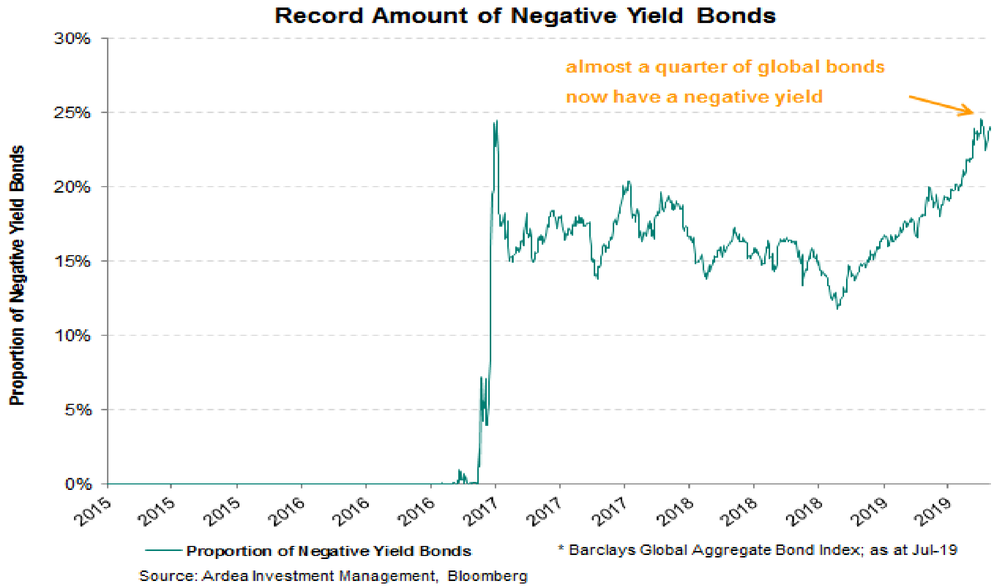
A summary of Ardea's 'relative value' investment approach and portfolio construction process is provided at the end.

What happened?

Against a backdrop of modest positive returns for global equity and credit markets, government bond markets were mixed (US -0.1%, AU +1.0%, EU +2.3%).

- With the notable exception of the US, government bond yields in most markets continued to collapse in July. E.g. AU yields reached a new record low of 1.2% for 10 year bonds, while German 10 year bonds hit an unprecedented negative yield of -0.4%.

- The extreme collapse in yields this year has now left global bond markets with a record amount of negative yielding bonds, a phenomenon that used to be considered an outlier limited to Japan. (details **here**)



- Collapsing bond yields haven driven stellar year-to-date (YTD) returns across global bond markets due to the inherent interest rate duration exposure of conventional bond investments. (details **here**)

E.g. even a simple passive exposure to the widely followed Barclays Global Aggregate Bond Index has delivered 5.3% YTD (9.3% annualised)

- Interest rate volatility remained elevated as central banks pressed on with rate cuts as a pre-emptive strike against downside economic risks (e.g. first US rate cut in 10 years, first AU back to back monthly rate cuts since the 2012 EU debt crisis).

Why is it relevant?

- The conventional narrative is that global bond yields are collapsing because investors fear a global recession, triggered by the US-China trade war, slowing economic momentum in Europe etc. Our take is more nuanced. Global bond yields are collapsing in anticipation of aggressive central bank action to save economic growth from the aforementioned risks, which is why we've only seen a small wobble so far in risky assets (i.e. equities, credit, emerging markets), rather than a material correction.

If economic growth really was to slow to levels that are consistent with the current levels of global bond yields, risky assets would have to fall a lot further. Instead, they are still holding up relatively well on the assumption that aggressive and pre-emptive central bank rate cuts will prevent the economic downside scenario from actually materialising.

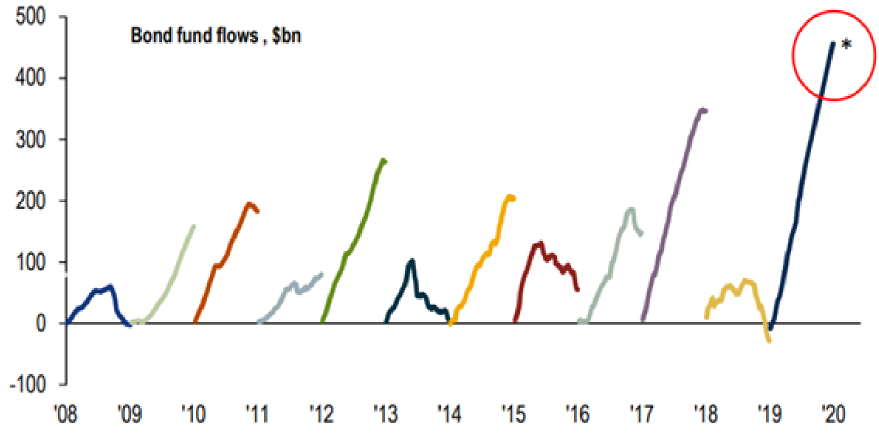
- Past 12 month returns show an unusual pattern of conventional safe havens like government bonds and risky assets performing strongly at the same time. (details **here**) This apparent inconsistency between bonds rallying fiercely, while risky assets remain near the highs, can be explained by one thing … the assumption that central banks will save the day.

- Lots of capital is flowing into bond markets in the expectation that yields will keep falling and therefore the interest rate duration exposure inherent in those bonds will provide capital gains to protect their portfolios if equities fall (lower bond yields = higher bond prices), making the 'long duration' trade a very crowded one despite its increasingly unfavorable asymmetry. (details **here**)

- On this point, the strategists from BofA Merrill Lynch produced the chart below and noted the following;

> *"The most important flow to know: annualized inflows to bond funds = staggering record $455bn in 2019; compares with $1.7tn inflows past 10-years; positioning danger is in bonds, not stocks or commodities"*
>
> – BofA Merrill Lynch, The Flow Show, July 2019

Chart 1: Positioning danger is in bonds, not stocks or commodities



Source: BofA Merrill Lynch Global Investment Strategy, EPFR global

- The combination of record inflows to bonds and the one way consensus bet that rates can only go lower, at a time when bond yields are already eye-wateringly low, leaves global bond markets in a precarious position. Anything that causes this consensus to be questioned, for example an unexpected uptick in inflation, could cascade into a violent bond market sell-off that then spills over into equity and credit markets, which in the latter case would be compounded by the structural deterioration in liquidity. (details **here**)

Looking at the earlier chart, note that the previous peak in bond inflows was late 2017 / early 2018 … just before the bond market sell-off that triggered 2018's global equity drawdown.

How are we positioned?

The portfolio's return for the month was positive as all three RV strategy categories performed well.

Compared to the previous month we reduced US and increased AU exposure, to take advantage of attractive RV mispricing between closely related AU semi-government bonds and interest rate swaps (RV Bond vs. Derivative category). We exploited this by buying a number of these bonds, while using the swaps to neutralise their inherent duration risk. A subsequent convergence in pricing between the relatively cheaper bonds and swaps contributed to performance this month.

As this type of RV trade can be negatively affected in adverse environments (i.e. bonds underperform relative to swaps), we also added more 'risk-off' strategies using AU and US interest rate options, to maintain the portfolio's risk balance. These option strategies profit if there are large moves in rate markets and are known as 'long gamma' strategies. (details **here**)

While conventional fixed income portfolios tend to rely on duration exposure for their defensiveness, this only works if bond yields / interest rates actually decline in the adverse market scenario. By contrast, long gamma strategies provide defensive protection irrespective of which way rates move and are therefore particularly useful in scenarios where duration doesn't work, for example as in early 2018.

Also within the RV Bond vs. Derivative category, our positions in long dated AU government bonds vs. swaps, detracted from returns as the bonds underperformed. However, the portfolio as a whole still performed strongly as these positions are sized modestly (as always) and were packaged together in the portfolio with a large and diverse range of other positively performing RV trades.

Our EU positions in the RV Rates category continue to perform well as rates volatility in French and German government bonds and related derivatives remains elevated. Even though these positions are still profitable, we have been reducing them to ensure they don't dominate the portfolio's performance, which is an important discipline that maintains risk diversification in the portfolio. The underlying market inefficiencies behind some of these EU strategies are explained **here**.

Ardea's 'Relative Value' Investment Approach

Conventional fixed income portfolios focus on accumulating portfolios of bonds to harvest yield. For these portfolios, the primary drivers of performance are broader market movements relating to the level of bond yields and fluctuations in the general level of interest rates or credit spreads (i.e. interest rate duration and credit risk). Portfolio construction is then based on the manager's views about these market themes.

By contrast, Ardea Real Outcome Fund (ARO) adopts a **'relative value'** investment approach, focusing on identifying and exploiting relative mispricing between closely related fixed income securities, in a way that isolates them from exposure to the broader market movements that drive conventional portfolios.

ARO's portfolio is intentionally constructed with many independent RV trades, each sized to contribute only modestly to the overall portfolio's risk and return, in order to maintain risk diversification in the portfolio. We then incrementally build up to the portfolio's return targets by doing lots of these trades repeatedly.

By constructing the portfolio this way, we aim to build up a more reliable stream of volatility controlled returns, while mitigating the risk of individual trades or market themes having a material negative impact on portfolio performance, particularly in extreme scenarios.

The many RV trades are packaged together such that the overall portfolio always has minimal interest rate duration, its performance remains independent of the prevailing market environment and its volatility remains low even in adverse environments.

The resulting portfolio consists of high quality liquid government bonds (min. 90% of portfolio Net Asset Value), together with cash and liquid interest rate derivatives (max. 10% of portfolio NAV), the latter being used to isolate RV mispricing, minimise unwanted interest rate duration risk and protect against market volatility.

Credit risk is also minimised by explicitly excluding all credit investments (including emerging market and lower rated government bonds), in order to prioritise liquidity and capital preservation.

For ARO's portfolio, the primary drivers of performance are not general market themes but rather the specific RV return sources we exploit, together with the protective volatility and inflation components of the portfolio. Additionally, it's uncommon for individual trades to materially drive performance as the portfolio is intentionally constructed to prioritise risk diversification, with many trades, each contributing a small amount to performance each month.

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Underlying Fund Ratings