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

ARSN 629 403 925

Fund Facts – 31 July 2020

ASX Ticker	XARO		
Fund Inception Date	10 December 2018	**Fund Size**	$219.8 million
Underlying Fund Inception Date	20 July 2012	**Underlying Fund Size**	$5.0 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 July 2020

Fund Performance[2, 3]	1 month	3 months	FYTD	1 year	3 years	5 years	Since inception[4]
Fund	1.16%	2.43%	1.16%	6.32%	-	-	7.87%
Australian Consumer Price Index	0.10%	-1.17%	0.10%	-0.42%	-	-	0.29%
Excess Return	1.06%	3.60%	1.06%	6.74%	-	-	7.58%

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 July 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	1.16%	2.45%	1.16%	6.37%	5.89%	4.68%	4.40%
Australian Consumer Price Index	0.10%	-1.17%	0.10%	-0.42%	1.07%	1.24%	1.61%
Excess Return	1.06%	3.61%	1.06%	6.79%	4.82%	3.44%	2.79%

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 July 2020.

Underlying Fund Exposure

Sector Exposure	
Government – National	63%
Government - State	37%
Total	100%

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

Rating Exposure	
AAA	89%
AA	11%
Total	100%

Region Exposure*	
Australasia	59%
Europe	31%
North America	10%
Total	100%

* 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?

The virus resurgence theme intensified globally this month.

"Almost 40 countries have reported record single-day increases in coronavirus infections over the past week, around double the number that did so the previous week, according to a Reuters tally showing a pick-up in the pandemic in every region of the world. The rate of cases has been increasing not only in countries like the United States, Brazil and India, which have dominated global headlines with large outbreaks, but in Australia, Japan, Hong Kong, Bolivia, Sudan, Ethiopia, Bulgaria, Belgium, Uzbekistan and Israel, among others. Many countries, especially those where officials eased earlier social distancing lockdowns, are experiencing a second peak more than a month after recording their first."

- Reuters, 'Record numbers of coronavirus cases in every global region', 25th July 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

"Hong Kong's new coronavirus outbreak has surpassed the magnitude of its previous waves of infection, in a cautionary tale that the worst may be yet to come in the global pandemic. …The former British colony is now one of the first places in the region to see a new wave dwarf previous outbreaks.

… A similar scenario is building in Japan and Australia, reflecting the challenge of containing the pathogen even in places that were widely lauded and emulated for their containment strategies. The new waves are a sobering reminder to other regions further behind on the pandemic timeline, like Europe, on challenges to come."

- Bloomberg, 'Hong Kong's New Outbreak Tops Earlier Waves in Cautionary Tale', 18th July 2020

Trying to control a 2nd wave, lockdown measures are being reinstated globally, to varying degrees. Even independent of lockdowns, there was evidence of consumer behaviour being impacted by virus resurgence.

"Hong Kong will ban all dine-in services at restaurants and public gatherings of more than two people not from the same family starting Wednesday, as the city's worst coronavirus outbreak shows no sign of abating."

- Bloomberg, 'Hong Kong to Ban Dining-in, Gatherings Of More Than Two', 27th July 2020

"California officials imposed sweeping new restrictions in response to a statewide surge of coronavirus cases, ordering indoor activities in a host of public places to be closed and declaring that students in the state's two largest school districts wouldn't return to in-person schooling in the fall."

- WSJ, 'California Pulls Back on Reopening Amid Surge in Coronavirus Cases', 13th July 2020

"Construction sites, manufacturing plants and the vast majority of retail stores have been ordered to operate under strict new operating conditions that limit the number of workers on-site and aim to cut the amount of customer facing time to nil."

- AFR, 'Lockdown revealed: Victoria goes into 'pilot light' mode', 3rd August 2020

"A few weeks ago we found that, even before official rollbacks of reopenings, states that were experiencing worse Covid-19 trends were underperforming economically across a broad set of indicators. The lesson was that behavioral changes in response to Covid trends can hinder the economic recovery even if states do not reimpose containment measures.

… These results reinforce our previous findings, suggesting that the confidence effects we found to be important across states are also operative across industries within states. As such, limiting the economic damage from Covid-19 to a few industries is likely to prove difficult as long as businesses and consumers

are not confident the virus is contained."

- Deutsche Bank, US Economic Perspectives, 13th July 2020

While in the background, the immense stimulus safety net kept growing and economic data releases continued to surprise positively as global fiscal + monetary stimulus keeps gushing out at unprecedented rates.

"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."

- 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

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.

As shown in the chart below, economic data improved considerably over the quarter, relative to pessimistic forecasts. Although, the absolute levels of economic activity are still depressed.

Source: Ardea Investment Management, Bloomberg

Why is it relevant?

Despite the strong resurgence in virus cases and a shift back toward tightening lockdowns, risk assets have remained resilient. For example, the MSCI World equity index is holding at just 5% below its pre-COVID record high. Indulging in some hindsight based analysis, we can point to the following explanations.

- Global economic rebound

So far, the virus resurgence hasn't derailed the global economic recovery. Leading indicators point to a slowing rather than a reversal of growth momentum. (see Citi economic surprise index chart above)

– Political / social resistance to strict lockdowns

In the first wave there was strong political and social will to enforce and comply with strict lockdowns due to the fear of worst case tail risk scenarios (e.g. overwhelmed hospitals, mass fatalities). With those scenarios not having materialised (ironically, perhaps precisely because those strict lockdowns were so successful), there is now less political and social appetite to revert back to those strict measures. As the harsh economic consequences of those lockdowns is now more apparent, the balance has swung more towards maintaining the economic rebound.

"Shuttering businesses, grounding airlines and ordering people to stay home was hard enough the first time. The thought of having to do it all over again is something world leaders don't want to even contemplate. From Italy to New Zealand, irrespective of how well the virus was contained, governments acknowledge that fresh waves of the deadly coronavirus are likely and that the policy tools to mitigate the damage are limited. The hope is that localizing quarantines to towns, cities and regions will be enough to snuff out bouts of infections as they come.

… Nowhere is the disconnect between the health risk and reticence to lock down more pronounced than in the U.S., the worst-hit nation with more than 140,000 dead and the number of infections soaring in battleground states Trump needs to win. But as far back as May, the president made his priorities clear. "Will some people be affected? Yes. Will some people be affected badly? Yes," Trump said during a factory visit in Arizona, a crucial swing state, that month. "But we have to get our country open and we have to get it open soon."

- Bloomberg, 'Second Virus Wave Is Real, But Lockdown Is Now Nuclear Option', 25th July 2020

– Vaccine hope

Based on past experience with vaccine development, the initial consensus was that it would take years for a vaccine to be deployed. However, the sheer amount of resources being thrown at the problem, combined with a more flexible approach to vaccine development protocols, seems to be fast tracking progress.

"SK Bioscience, the South Korean pharmaceutical company backed by Bill Gates, may be capable of producing 200 million coronavirus vaccine kits by next June, the Microsoft Corp. co-founder said in a letter to South Korean President Moon Jae-in."

- Bloomberg, 'Gates Says Korean Firm Could Make 200 Million Vaccines by June', 26th July 2020

"A promising coronavirus vaccine candidate hit another milestone this week, when Moderna Therapeutics began phase three of clinical trials. The move signals the biotech company and the National Institutes of Health, which are collaborating on the trial, are one step away from bringing the drug to the public and commercial markets."

- National Geographic, 'Moderna's mRNA vaccine reaches its final phase', 27th July 2020

– Ongoing stimulus sugar hit / safety net

Perhaps most important of all, 2020 has seen an unprecedented, staggering, Brobdingnagian (we're running out adjectives) amount of 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.

As a side effect of this extreme central bank intervention, the price discovery process in financial markets has become severely distorted and conventional pricing relationships have lost their information value.

"$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.

- Bank of America, The Flow Show, 30th July 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."

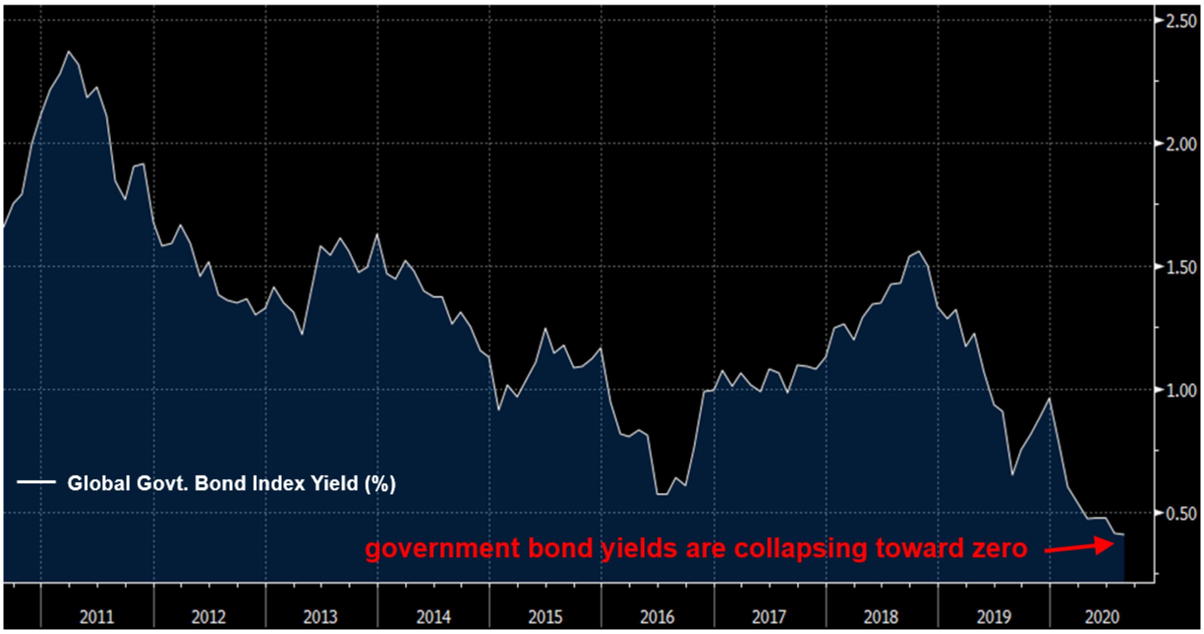
- Bank of America, The Flow Show, 9th July 2020

"The only thing that seems to matter is liquidity. Clients have told us to overlook underlying economic trends, beaten-down business and consumer confidence, plus potentially permanent job losses as smaller firms shutter their doors. They suggest following the old adage of 'Don't Fight the Fed' when we highlight caution. Pandemic fears also have been shunted to the sidelines as sentiment and cash follow the tape."

- Citigroup, US Equity Research, 12th June 2020

On the monetary policy side, pretty much every major central bank has cut interest rates aggressively over the past few months and strongly indicated they will stay there. Policy rates in all major economies, except China, are now hovering around 0%.

As a consequence, government bond yields in many places are already negative and the rest are fast approaching zero. We discussed the distortionary effects of negative rates here.



* Barclays Global Aggregate Treasuries Index

Source: Ardea Investment Management, Bloomberg

With government bond yield cushions collapsing toward zero, conventional government bond investments are now severely impaired in their ability to act as defensive anchors in multi-asset investment portfolios. When the starting point of yields is already near zero, government bonds simply cannot provide the same protective benefit against equity sell-offs that they used to.

We have previously covered this theme here and it is now getting more mainstream attention.

"The staple U.S. portfolio of 60% equities and 40% fixed income proved resilient this year, but strategists are now considering alternatives to government debt after some bond yields reached historic lows.

… 'I don't think bonds can provide the standard historical returns investors are used to," said Andrew Sheets, Morgan Stanley's chief of cross-asset strategy in London. 'The starting yield is at a point where that type of return is just not possible. Investors are going to have to lower expectations of 60-40 portfolios and will have to look elsewhere for what can be in the 40%.' Blending stocks and bonds, a decades-old investment staple to balance risk and reward, is being tested by ultra-low yields."

- Bloomberg, 'Investors Rethink '60/40' as Ultra-Low Yields Test Portfolios', 2nd August 2020

"Structural shifts are challenging the resilience of portfolios. With the policy revolution pushing yield curves close to their lower bounds, we see government bonds providing less diversification benefits in strategic allocations.

… The traditional approach to building financial resilience in multi-asset portfolios has been to rely on nominal government bonds as a cushion against risk asset selloffs. One consequence of the policy

revolution – bond yields tethered by central bank intervention – challenges this and forces investors to seek out alternatives.

We expect negative returns across developed market government bonds on a five-year horizon given low and negative yields today. Also, the inverse correlation between bonds and stocks decreases as yields near perceived lower bounds, compromising bonds' ballast role. The underperformance of German and Japanese bonds in recent equity selloffs illustrates this."

- Blackrock Investment Institute, '2020 Mid-Year Outlook', Investors Rethink '60, July 2020

As another side effect of the stimulus fueled economic recovery, a nascent 'rising inflation' narrative is building in the background.

For example, the market pricing of US inflation expectations has almost rebounded all the way back to pre-COVID levels, despite economic activity and employment remaining at low levels. Related to this, the US dollar has been weakening as growing conviction that ultra-loose US monetary policy will stay in place to spur inflation pushes real US yields more deeply negative. And then gold - the classic inflation hedge - is rocketing towards new highs.

For now this is a 'good inflation' narrative, meaning that higher inflation is perceived as 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. (details here)

How far and for how long this nascent inflation narrative pushes remains to be seen.

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 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 keep the overall portfolio duration neutral so that general fluctuations in the level of market interest rates don't materially impact the portfolio's risk and return.

This constant process of rebalancing can generate material positive returns in periods of heightened interest rate volatility because the portfolio is always structured to have 'positive convexity' via buying interest rate options. A positive convexity portfolio automatically profits from large interest rate moves, irrespective of their direction because the portfolio's duration automatically increases when market interest rates / bond yields fall and automatically decreases when they rise. Therefore, by definition, the duration exposure of a positively convex portfolio always changes in a favourable way.

These fluctuations in portfolio duration exposure are not caused by Ardea taking a view on the direction of interest rates, rather it automatically happens because of positive convexity inherent in the options we hold. The convexity related duration exposures in our portfolios are constantly neutralised to lock in the profits that accrue from interest rate fluctuations (i.e. portfolio duration rebalanced to neutral). This is done via a process known as 'delta hedging'. (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.

The positive performance for the month was driven by many different micro curve exposures across global interest rate markets, each contributing modest amounts to the total performance. A notable example this month was strong flows into the AU government bond market, which were taking advantage of the pronounced steepness of the AU yield curve relative to other markets. These flows caused some moderation of prior anomalies in the curve, resulting in profits for our positions that had been previously implemented to exploit them.

- Inflation Protection

These positions recovered most of their losses from the March quarter as inflation linked securities rebounded from the severely depressed levels they reached during the March turmoil. Back in March we noted that inflation securities offered a compelling profit opportunity with favourably asymmetric characteristics (i.e. limited downside risk vs. large profit potential) because they had fallen to levels that were already fully pricing in the ultra-low inflation scenario and therefore any challenge to this view could cause them to rebound sharply. (details **here**)

Indeed, as we noted in this month's market commentary, we are now seeing a nascent 'rising inflation' narrative building in the background.

As ARO has a dual objective of outperforming both cash and inflation, the portfolio always has a structural inflation protection component, which is implemented using inflation securities (i.e. government inflation linked bonds and inflation swaps). In simplified terms, these inflation securities reflect market expectations of future inflation. When these expectations rise, the prices of these securities also rise, generating profits. This is how ARO protects investor capital against rising inflation risk. The opposite happens when inflation expectations fall.

Noteworthy negative performance for the quarter 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. A specific subset of these strategies that focus on the RV pricing relationship between inflation linked bonds and inflation swaps incurred losses this month.

- Volatility Strategies

These strategies reversed some of the outsized gains they delivered in the March quarter, as financial markets continue to rally and market pricing of interest rate volatility has fallen back to record low levels. These strategies played their role in Q1 by providing risk balance vs. other RV strategies that incurred losses over that period. Subsequently, as markets have stabilised they reversed some of their prior gains, while those other RV strategies delivered larger profits. This is an example of how the fundamental principles of 'risk balance' and 'risk diversification', which underpin our portfolio construction process, can allow ARO to maintain performance volatility control even when extreme shifts in correlations, volatility or market themes occur.

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.

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.**

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