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

ARSN 629 403 925

Fund Facts – 31 March 2021

ASX Ticker	XARO		
Fund Inception Date	10 December 2018	**Fund Size**	$541.6 million
Underlying Fund Inception Date	20 July 2012	**Underlying Fund Size**	$7.8 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 March 2021

Fund Performance[2, 3]	1 month	3 months	FYTD	1 year	3 years	5 years	Since inception[4]
Fund	0.37%	0.63%	3.30%	5.14%	-	-	6.50%
Australian Consumer Price Index	0.23%	0.84%	3.30%	1.35%	-	-	1.59%
Excess Return	0.14%	-0.21%	0.00%	3.79%	-	-	4.91%

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 March 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	0.38%	0.64%	3.32%	5.18%	5.74%	5.56%	4.31%
Australian Consumer Price Index	0.23%	0.84%	3.30%	1.35%	1.63%	1.78%	1.86%
Excess Return	0.15%	-0.19%	0.02%	3.83%	4.11%	3.78%	2.45%

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 March 2021.

Underlying Fund Exposure

Sector Exposure	
Government – National	79%
Government - State	21%
Total	100%

Interest Rate Duration (years)	
12-month average	0.5
Since inception average	0.2

Rating Exposure	
AAA	71%
AA	29%
Total	100%

Region Exposure*	
Australia / NZ	58%
Europe	19%
North America	23%
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.

Quarterly 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.

How are we positioned?

The underlying Real Outcome fund delivered positive returns in March.

Many bond indices suffered historically large losses in Q1. While some markets saw less extreme moves in March compared with February, conditions remained challenging for traditional long-only portfolios. Against this backdrop, the underlying Real Outcome fund continued to deliver positive performance through a range of relative value positions.

The following strategy groups made a notable positive contribution to performance this month:

RV Bond vs Derivatives

The duration risk from many long government bond positions are hedged with interest rate derivatives. The spread between bonds and swaps (and other derivatives) is influenced by changes in bond supply/demand dynamics, issuance trends, derivative flows and many other drivers. Positions in Australian Commonwealth government bonds outperformed derivative hedges over the last month. Smaller gains were seen in similar positions in USD and NZD markets, which offset a small drag from AUD semi-government and CAD government bonds.

Volatility

The portfolio is positioned long volatility through interest rate options. These trades are implemented based on RV considerations such as the cheapness of implied relative to realised volatility and to provide risk balance to the portfolio. The value of these strategies increased as interest rate volatility remained elevated through the month. USD interest rate option positions benefited the most from the increase in volatility, as US rates experienced the largest moves over the last month.

The following strategy groups detracted from performance this month:

RV Rates

The portfolio holds a wide range of relative value long and short positions across multiple markets in bonds, swaps, futures and options. These positions require constant rebalancing as market conditions change. The delta hedging of positions in USD options were a modest drag on performance over the month.

RV Micro Curve

The micro curve category was a small drag on performance over the month. The largest detractor were positions targeting a steeper USD inflation curve, as shorter maturity swaps lifted relative to longer maturity swaps over the month. This strategy was designed to add protection in a risk-off move. Partly offsetting these positions were positive performance in nominal interest rate micro curve trades across the USD, AUD, JPY and NZD curves.

Underlying Ardea Real Outcome Fund RV attribution categories

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 minimise duration exposure, so that the portfolio is not overly exposed to general fluctuations in the level of market rates.

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.

Volatility: 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 increases (explained in more detail **here**).

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.

What Happened?

A quarter to forget for passive bond investors

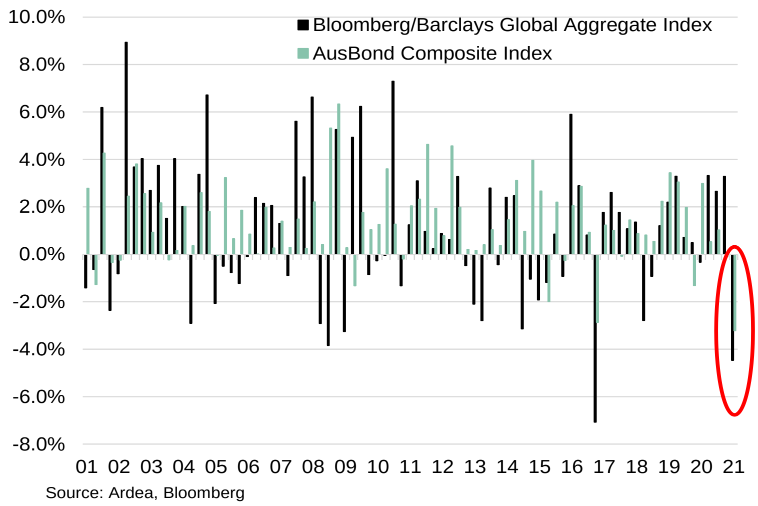
In March, government bonds generally remained under pressure, although price action was choppy and there were notable cross market differences. The US bond market underperformed significantly – the 10y yield finished the month 34bp higher at 1.74%. The 10y yields in Germany and the UK ended the month near flat and Australian 10y yields finished 13bp lower than the spike higher seen over the last few days of February.

The March price action follows poor returns in sovereign bonds over the prior two months, leaving major bond indices historically weak in Q1. The AusBond Composite Index finished the quarter down 3.2% - the worst outcome since 1994. The Bloomberg/Barclays Global Aggregate Index fell 4.5% - the worst outcome since Q4 2016 (Chart 1).

In contrast to sovereign bonds (and other safe-havens like gold, -10% in Q1), risk assets generally posted positive returns in Q1. In equities, the S&P 500 made new record highs and finished up 6% over the quarter. In contrast with 2020, European indices saw larger gains in Q1– the STOXX 600 rose 8%. Oil prices rallied a massive 22%.

The broad narrative driving markets is the rebound in global growth, following the severe COVID-induced contraction in 2020. The IMF upgraded its outlook for real GDP growth to 6% for 2021 (up from 5.5% in January). This outlook is being fuelled by massive US fiscal stimulus (including plans for more infrastructure spending in March), central banks sustaining highly accommodative policies and the ongoing roll-out of COVID-19 vaccines.

Chart 1: Quarterly returns in bond indices



Why is it relevant?

After many pundits saw one year and two year ahead forecasts for higher yields eclipsed in the space of a month or two, it's still too early to declare the worst is over for government bond returns. However, some consolidation is likely after the Q1 repricing leaves bonds incrementally less vulnerable to further positive surprises to the growth, inflation and COVID outlook.

In our last monthly market update, we outlined the macro and technical underpinnings of the bond sell-off and listed some catalysts for eventual stability in yields. We revisit some of these themes and highlight key risks for the next quarter.

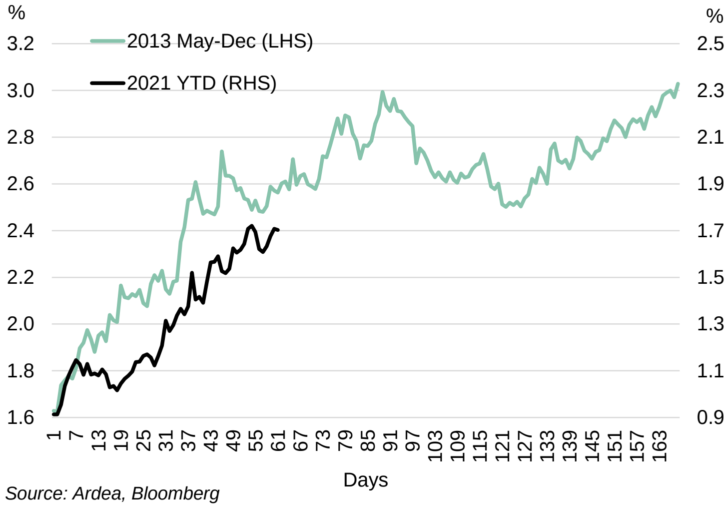
Shades of 2013, but without the US Federal Reserve (Fed) "taper" signal

The velocity of the year-to-date sell-off in bonds and US-led nature of the move is drawing comparisons with the 2013 bond rout – the "taper tantrum". Chart 2 compares the move higher in the US 10y yield in May to December 2013 with the year-to-date experience. The trajectory of the rise in yields is similar, albeit the last few months have been less volatile than in 2013. The underlying drivers of the recent bond sell-off are very different to the 2013 experience.

In May 2013, then Fed Chair Bernanke hinted that the pace of bond purchases under the quantitative easing (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.

This time around, there has been no direct signal of a "taper" in QE. In fact, in March the Fed maintained its policy settings and message that reducing accommodation remains a long way off. In this cycle, progress on unemployment and inflation needs to be realised, not just in the forecast profile. The uptrend in bond yields failed to reverse in the face of Fed rhetoric – a similar theme to February.

Chart 2: Q1 2021 rise in 10y yield vs 2013 "Taper Tantrum"



Source: Ardea, Bloomberg

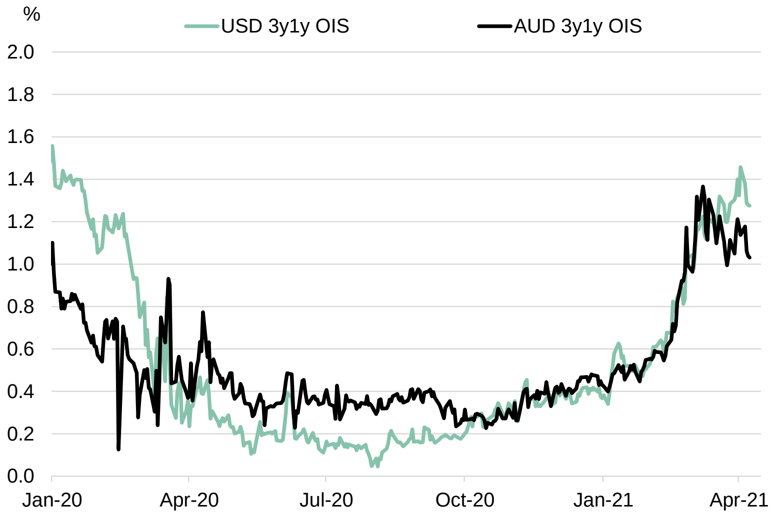
Gauging the repricing of bonds ahead of Q2

Yields are coming off much lower levels than in previous bear periods for bonds. But the adjustment has been substantial in such a short space of time. For example, US and Australian 10y yields have lifted over 80bp in Q1, nearly doubling the yield level available to an investor. Predicting in advance at what point yields reflect a "fair" value in the face of a recovery is extremely difficult, as the track record of forecasters shows (as we noted in our December update, the consensus has called the year ahead *direction* of bond yields correctly only about 40% of the time and has had much less success in calling the yield *level*). That said, a helpful starting point is to focus on what the market is currently telling us about future interest rate and inflation moves.

1) The next central bank policy tightening cycle

Even for investors focused on long term bonds, the path for cash rates over the next few years still provides an important anchor point. Interest rate swaps and futures contracts give an indication of just how much markets expect cash rates to rise in the next few years. The Fed and Reserve Bank of Australia (RBA) are telling markets rates will not move until 2024. Rates could well move higher sooner if the recovery accelerates meaningfully. But the real story is the amount that rates move up when the time comes. The market now thinks this process could unfold much more aggressively than previously thought. As Chart 3 shows, the average level of implied 1y USD and AUD cash rates 3 years forward has lifted nearly 100bp compared to Q1 to 1.2-1.4%.

Chart 3: Rapid rise in 3y ahead USD and AUD policy rate pricing (3y forward, 1y overnight indexed swaps)



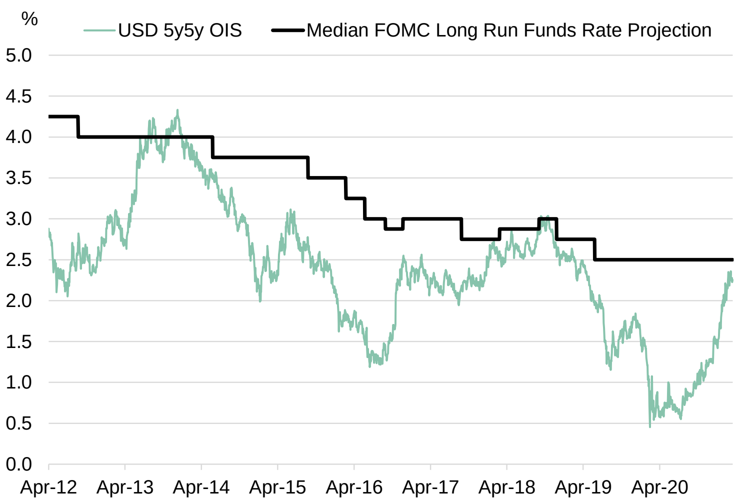
Source: Ardea, Bloomberg

2) Long term rates

A key driver of bond valuations is the expected long-term level of policy rates. A major difference between the Q1 bond sell-off and 2013 is that many investors now generally expect structurally lower real neutral policy interest rates (the level of rates where policy is neither expansionary nor contractionary). This is partly due to the experience of the last decade but also increased recognition of structural pressures such as demographics, debt levels and other limits to potential GDP growth. So if inflation is also contained in the long run, this simply means that nominal cash rates and also bond yields will struggle to return to longer run historical averages. The recent sell-off has dragged long term pricing for cash rates closer to the potential levels seen by some central banks and economic models.

Chart 4 shows the Fed's long run rate projection and the 5y5y OIS rate (the market expectation for the average 5y cash rate, 5 years forward). The Fed's estimate of the long run rate has trended lower over time and the market has often struggled to price that down trending forecasted rate. Even with the strong cyclical recovery underway, eventually a large enough buffer will be priced into long term forward interest rates to entice demand for bonds. That point may be approaching for some investors with an over 2% funds rate priced into the curve ahead of the post-Covid recovery really getting underway.

Chart 4: Fed long term funds rate projection vs 5y5y OIS rate

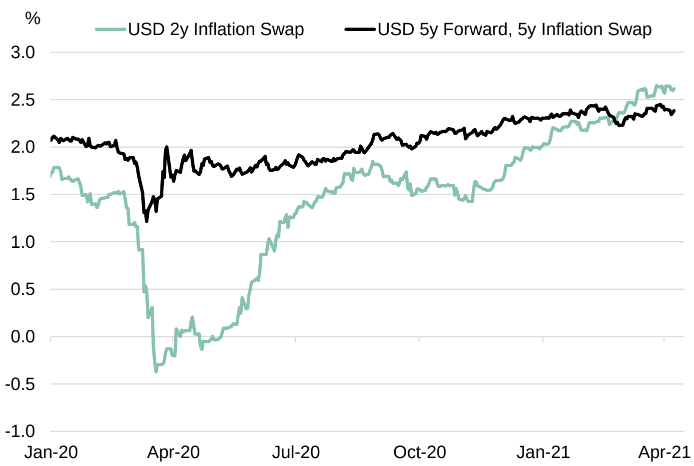


Source: Ardea, Bloomberg

3) Inflation

Shorter term market pricing for inflation has continued to accelerate as US growth picks up and maximum economy reopening velocity gets closer. As Chart 5 shows, longer term inflation pricing has also trended higher over time but is at a more moderate level. This suggests the market is pricing some short term inflation overshoot, but still not a structural rise in inflation well beyond the Fed's 2% target (long run market pricing for headline CPI often exceeds forecasts for the Fed's favoured core "PCE" inflation measure).

Chart 5: US 2y vs 5y forward, 5y inflation swap rates



Source: Ardea, Bloomberg

Q2 will see the arrival of the anticipated growth and inflation overshoots

Q1 was characterised by big positive surprises to the outlook in the form of vaccination progress, US fiscal stimulus that dwarfed already bullish expectations and upside surprises to actual activity data. From this perspective – and considering the repricing in yield curves – the bar to surprise the market has clearly lifted. It's possible that growth and inflation match very bullish expectations yet bond yields fail to rise meaningfully further and volatility eases.

Most forecasters are now looking for annual growth in US real GDP of 6-7% by the end of 2021, but the acceleration is expected to begin in earnest in the coming quarter and will continue to be led by the US. In Europe, recent COVID case increases and lock downs in some countries have raised the risk of a slower recovery. There are, however, hopes for a sharp improvement as vaccination progress continues. JP Morgan strategists recently made a bullish case for growth in Q2 (numbers are annualised):

"Q2 should deliver the surge (+7% globally), driven by +9% expansions in the US (mostly from stimulus), 9% in Europe (mostly from reopenings) but just 5% from China. The European view is obviously dependent on a major step-up in vaccinations that breaks the link between mobility and COVID-19 infections, but with vaccine delivering set to triple in Q2, a European catch-up is a reasonable baseline." (Source: The JP Morgan View, 26-March-21).

In terms of inflation, the outlook is less clear. Many economists and investors over the last decade have struggled to come to grips with structural trends restraining inflation and so will probably find the reverse short-term outlook just as challenging. As major economies reopen in Q2, consumers will be able to draw down on large accumulated savings buffers (thanks in part to government transfers), there will be a release of pent-up demand for services and probably supply bottlenecks. As outlined, the market-based inflation expectations have built-in some buffer for this rise in inflation. The bigger issue that won't be resolved so quickly is how sustainable the uplift in inflation is, given still significant slack in labour markets.

The resolve of central banks will be tested further in the coming quarter. As Ardea Portfolio Manager Tamar Hamlyn noted in a recent AFR article, the yield and volatility bar for central banks to act remains quite high:

"The conclusion we are left with is that central banks still have considerable firepower that can be brought to bear should markets require this. The commitment and "whatever it takes" mentality of the world's central banks still carries weight.

This support won't be given lightly, and perhaps not unless we see much higher volatility and even larger yield moves. And in a sharply rising yield environment, central bank prudence is to slow the move rather than stand against it.

But investors can take comfort that the backstop remains, though it's more distant than we might like."

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Underlying Fund Ratings

Ardea Real Outcome Fund received a Morningstar Analyst Rating™ of 'Bronze' on 27 May 2020

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