Ardea Australian Inflation Linked Bond Fund

ARSN 622 519 117 APIR Code HOW0062AU

Quarterly Performance Report December 2023

Performance (% p.a.)[1]	1 month	3 months	6 months	1 year	3 years	5 years	Since Inception[2]
Portfolio (net)	4.50	5.95	5.50	9.55	1.16	3.90	5.50
Bloomberg AusBond Inflation Government 0+ years Index	4.65	5.79	5.14	9.27	-0.41	2.77	4.77
Excess return	**-0.15**	**0.16**	**0.36**	**0.28**	**1.57**	**1.13**	**0.73**

[1] 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 future performance.
[2] The Fund's inception date is 18/03/2010.
Source: Fidante Partners Limited, 31 December 2023.

Strategy Overview

Ardea's pure relative value (RV) investment specialisation is fundamentally different to conventional fixed income investing and therefore we customise our quarterly portfolio commentaries accordingly.

As our portfolios are inherently high turnover, highly diversified and designed to generate uncorrelated returns from a repeated investment process averaged over time:

- *performance is the cumulative result of interactions between many of modestly sized trades that were entered, exited, and held over the preceding months*
- *performance is generally driven by many small gains / losses, rather than a few key contributors*
- *performance is not driven by broader bond / equity market fluctuations*
- *a single quarter is generally not enough time to draw meaningful conclusions about performance themes*

Therefore, we customise the quarterly portfolio commentary in the following ways:

- *Consider quarterly performance in isolation only when there is outsized performance volatility, unusually concentrated performance drivers and / or noteworthy portfolio changes.*
- *Consider quarterly performance in a longer-term context, with reference to the Fund's investment objectives and the roles it plays in the broader portfolio.*

Investment Objectives

The Fund's investment objectives encompass both the magnitude of returns generated ('size' of return) and the risk characteristics underlying those returns ('style' of return), resulting in a unique combination of risk / return attributes that cannot be obtained from conventional fixed income investments.

These attributes link to the underlying theme of defensive risk diversification.

Portfolio Commentary

Fund performance

Performance for the month of December was +4.5%, for the quarter the Fund returned +6.0% (before fees), 0.3% ahead of the benchmark.

Performance volatility

Based on the Fund's volatility target performance for every month this quarter was within the normal range of expected short-term performance variability.

Performance attribution

As usual, performance drivers for the quarter were diversified across many small gains / losses, with no unusually concentrated performance drivers.

31-Dec-23	1M	3M
Rates	0.0%	0.1%
Curve	0.0%	0.1%
Bond vs. Derivative	0.0%	0.0%
Options	0.0%	0.0%
Inflation	0.0%	0.0%
Semi Government	0.0%	0.0%
Excess Return	**-0.1%**	**0.3%**

The Fund's aggregate attribution categories of Rates and RV curve produced a positive outcome over the quarter.

Portfolio composition

While the Fund's individual trades change, there were no notable structural or thematic changes in portfolio composition over the quarter.

The table below conveys the Fund's current positioning by decomposing its risk utilisation across risk factors.

As examples of how to interpret these numbers:

> *19.9% of the Fund's risk is currently allocated to Micro Curve RV exposures. This is made up of combinations of trades (i.e. long/short positions in bonds, swaps, and futures) that seek to profit from pricing anomalies in the shapes of interest rate curves.*
>
> *53.4% of the Fund's risk is currently allocated to Bond vs Swap exposures. This is made up of long and short positions in government bonds that seek to profit from dispersion in the pricing of similar of bonds.*

Risk Budget Breakdown - Allocation by Risk Factor and Currency									
Currency	Bond vs Swap	Inflation Curve	Nominal Rates				SSA Spread	XCCY Basis	Total
			Macro Level	Macro Slope	Macro Curvature	RV Micro Curve			
AUD	53.4%	23.4%	1.9%	0.6%	0.3%	19.9%	0.5%	0.0%	**100.0%**

Longer term performance context

The Fund's 1-year return is +9.9% (before fees), ahead of the benchmark by +0.7%.

Performance was delivered against a challenging backdrop of rising interest rates, persistently high inflation and sometimes violent market swings. Prior to the third quarter of 2023, most major fixed income markets had suffered sizeable losses over the calendar year-to-date, with strong performance in November and December catapulting returns into positive territory as dovish rhetoric from the Federal Reserve prompted investors to reassess how long interest rates would remain at current levels.

Over the year to 31 December 2023:

- *AUD cash rates rose from 3.1% to 4.3% (AusBond Bank Bill Index yield)*
- *Australian inflation was 5.4% (AUD CPI index annual % as at Q3 2023)*
- *AUD bonds returned +5.1% (Q4 2023 +3.8%, CY 2022 -9.7%; AusBond Composite Bond Index)*
- *Global bonds returned +5.3% (Q4 2023 +5.4%, CY 2022 -12.3%; Bloomberg Global Aggregate Bond Index, AUD Hedged)*
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Market Themes & Fund Outlook

Fixed income market themes

On the surface, bond markets appear to have calmed considerably relative to the historically extreme turmoil of 2022, although a number of key markets would have declined over the 2023 calendar year had it not been for outsize returns as the year drew to a close.

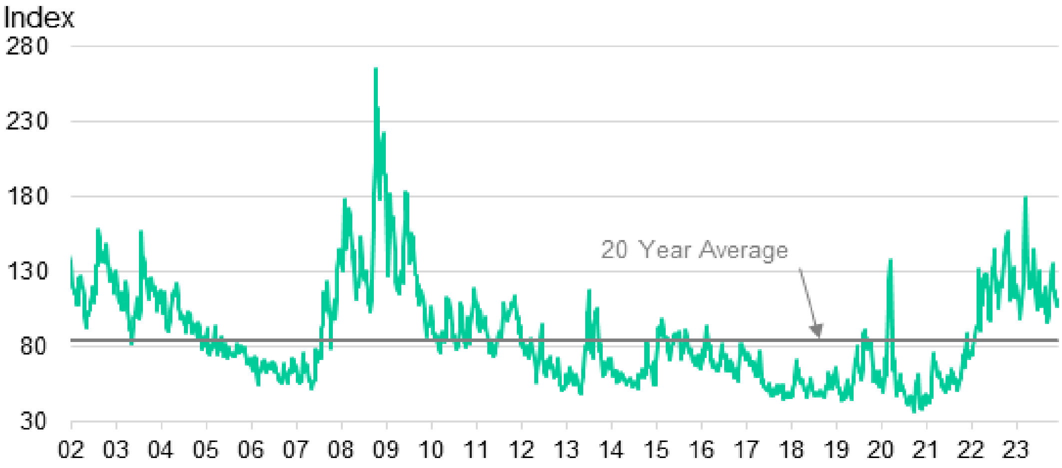
Longer dated fixed income assets, particularly US Treasury bonds generated the strongest returns in the final months of 2023 as dovish rhetoric from the Federal Reserve prompted investors to reassess how long interest rates would remain at current levels. The Fed left its target rate in the range of 5.25-5.50% for the third consecutive meeting, with Chairman Powell signalling the potential for rate cuts in the year ahead after headline inflation fell to 3.1% in November. Twelve months earlier, headline inflation in the United States exceeded 7%.

Government bonds remain highly volatile due to the macro uncertainty around inflation and slowing economies. A key theme is that central banks have transitioned from being suppressors of market volatility, which they had been since the GFC, to now acting as volatility amplifiers.

Central banks had previously been swift to intervene whenever market stress emerged, either in the shape of interest rate cuts or quantitative easing. However, with policy uncertainty and central banks aggressively running down their pandemic-era bond portfolios we consider the worlds' reserve banks to be amplifiers of volatility.

As a result, when combined with the increase in supply, government bond and interest rate markets are now in a regime of structurally higher volatility, which means that for any level of bond yields investors should now expect materially higher price volatility and therefore more variable returns.

Fixed income market volatility can be illustrated by the ICE BofA Move Index (below), which measures bond market volatility by tracking a basket of OTC options on US interest rate swaps and as the chart below shows, remains materially above the long-term average:



Source: Ardea, Bloomberg, December23

2024 is widely forecast to mark the end of one of the fastest and most aggressive central bank tightening cycles. Markets are now turning their attention to the timing and size of potential rate cuts however a return to the ultra-low rates environment appears remote. Investment banks and asset managers have varying calls for yields which reflects division over whether the U.S. economy in particular will enter the long-heralded recession dragging the world with it. This lack of consensus is in contrast to a year ago, when most incorrectly predicted a U.S. recession resulting in rapid rate cuts, in fact in the third quarter of this year the US economy expanded by over 5%.

Central banks have been successful in bringing inflation down from its peak, tackling the last leg of this battle can expect to be the hardest in the inflation fight. A multitude of challenges, from a transforming geopolitical landscape to the costs of the energy transition and infrastructure building amongst others lie ahead. Although inflation has seen a swift decline in many cases, reducing it from say 4% to 2% will be a tougher challenge than the journey from 9% to 4%.

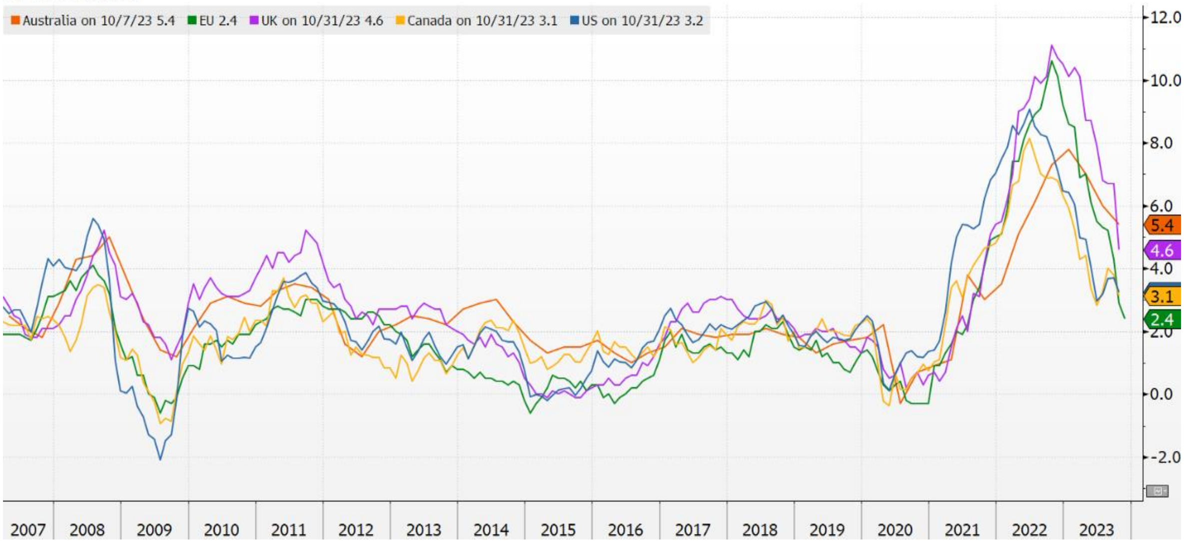
How central banks navigate these stubborn last percentage points of inflation will significantly impact whether we experience an economic soft landing or a harder one, the trajectory of bond yields will be influenced by this outcome. Globally, economic activity appears to be tapering, notably in Europe, evident in declining indicators such as capacity utilisation and the purchasing manager's index. It is reasonable to anticipate that bond volatility will remain high in this environment.

While the markets see central banks as having concluded their upward rate adjustments, central banks themselves are not ruling out the possibility of further rate hikes if inflation persists and economies remain strong and view speculation around near-term rate cuts as premature. Despite this market attention has shifted to the potential timing of rate cuts through 2024, with more aggressive cuts, both timing and size, anticipated in the US and EUR markets.

Looking at Australia in 2024, ongoing policy uncertainty prevails. The consensus on RBA monetary policy suggests it will likely remain unchanged for some time, with a potential easing cycle beginning later in 2024. There is, however, the possibility of a nearer-term rate hike if inflation surprises positively in the upcoming CPI releases and if labour market resilience endures. The RBA has signalled a data-dependent approach for any rate moves, particularly with inflation.

Current interest rate policies across developed markets are viewed as restrictive. However, if the last leg of the inflation battle persists, bond yields have the potential to again move higher and be volatile as the anticipated easing's of monetary policies the market has priced are potentially delayed and less aggressive through 2024.

CPI Headline



Source Bloomberg, most recent headline quarterly CPI releases, Dec 23

Fund performance outlook

With rate market volatility subsiding from the 2022 extremes, but still remaining elevated, we are in a good environment for RV investing; volatility is high enough to create lots of new RV mispricing from which to profit, but not so extreme as to cause violent dislocations in the behaviour of RV pricing relationships.

The Fund's performance in volatile environments is driven by a balancing act between the following factors:

- *more volatility = more fertile opportunity set for RV mispricing = positive for performance*
- *more volatility = more upside from the Fund's options exposures = positive for performance*
- *extreme volatility = violent dislocations in the behaviour of RV pricing relationships = can be temporarily negative for performance*

Generally, this balancing act skews toward positive performance, but sometimes results in modest negative performance.

ESG Commentary

The long-awaited Australian Government Green Bond Framework was finally released in December, ahead of the proposed inaugural Federal green bond issuance touted for mid-2024.

Key observations from Ardea about the framework include:

- This is specifically a green bond program, i.e., not a broader sustainable bond program which is the approach some Australian states have taken. Only climate and environmental initiatives are considered eligible.
- Federal tax rebates to encourage green activity or investment are considered an eligible use under the program. Therefore, the government can borrow using green bonds to fund the cost of these incentives which will go some way towards countering the shortage of viable green tangible infrastructure projects at the Federal level.
- Nuclear energy, arms manufacturing, and the fossil fuel industry are all explicitly excluded. This provides clarity that green bond proceeds would not be allocated to funding for nuclear subs via AUKUS or for the SA defence industry.
- The government is committed to spending to support clean energy investments with less emphasis on negative regulation to influence behaviour via market forces. Generally, the cost of allocating funding to direct specific economic activity is higher than the cost of a prohibition via regulation approach, which aims to shape incentives rather than activity. The former can still be warranted however if managed well, and if there are genuine risks that the private sector is unable to bridge.

This is a comprehensive framework which clearly addresses investor expectations towards meeting Australia's net zero policy goals. We expect the framework will be well-received by investors.

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