Pure Relative Value: The Third Lever of Fixed Income

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"In a world that is constantly changing, there is no one subject or set of subjects that will serve you for the foreseeable future, let alone for the rest of your life."

So said the American author, John Naisbitt, whose analysis of social trends led to predictions regarding automation in the workplace, globalisation and even the rise of artificial intelligence. While it is fair to say that some of his predictions were a little wide of the mark, his quote about change can certainly be applied to the world of investing.

Investors have faced tremendous change over the past decade and perhaps an even more radical shift in recent years as ultra-low inflation and negative interest rates gave way to sky-high pricing and aggressive tightening by central banks in both the developed and emerging world. Rapidly rising interest rates have been particularly painful for fixed income investors but have also contributed to equity market uncertainty and created dislocations in the relationship between asset classes.

Central banks have suffered a great deal of criticism for their response to the challenge of rising inflation and dwindling economic growth and while some of this may be unfair, central banks have undeniably shifted from suppressors of market volatility to volatility amplifiers in fixed income markets.

Until recently, central banks were quick to intervene whenever there was some form of market stress, either in the shape of interest rate cuts or quantitative easing, and that intervention was easy to justify given their objectives of price stability and economic growth were perfectly aligned. Inflation was running well below target, so whatever policy makers did to facilitate stable prices was consistent with supporting growth. These objectives are now misaligned, with the options available to tame inflation undesirable from the perspective of economic prosperity.

WHY IS THIS RELEVANT?

These conflicting objectives, the associated policy uncertainty and central banks aggressively running down pandemic-era bond portfolios are why we consider the worlds' reserve banks to be amplifiers of volatility. This also means that interest rates and bond yields are in a structurally higher volatility regime than they have been for most of the post GFC[1] era. The escalated volatility presents a crucial consideration for multi-asset portfolio managers. Historically, their reliance on duration, predominantly achieved through government bonds, aimed to temper equity risk given the traditionally lower volatility of bonds compared to equities. Nevertheless, this reliance is not infallible, as historical instances demonstrate periods where government bond volatility exceeded that of equities, as depicted in the accompanying drawdown chart. Furthermore, uncertainty about inflation and the path of interest rates introduces a more variable correlation between bonds and equities. We do however note that, while better outcomes can be achieved under negative correlation, this is secondary to the impact of relative volatility.

[1] Global Financial Crisis of 2008.

ARDEA Investment Management

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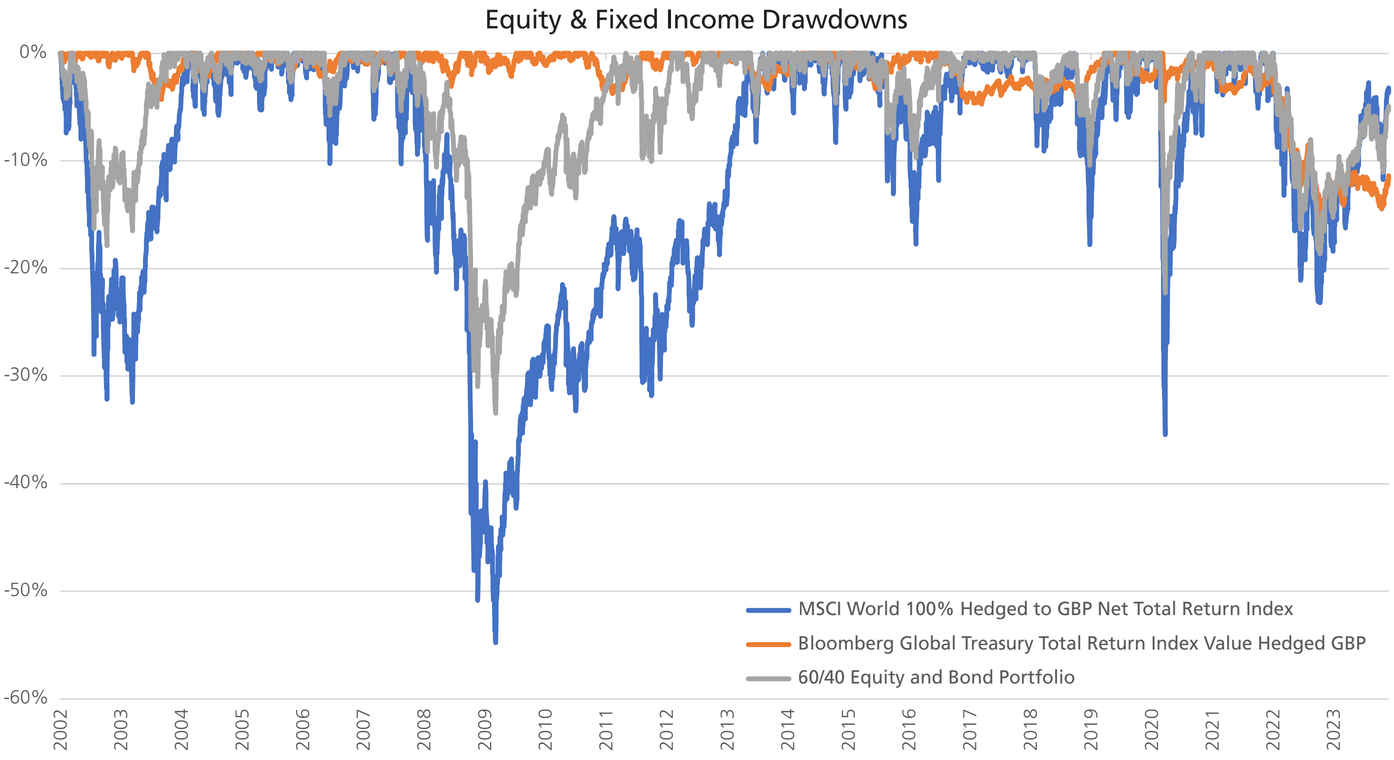


Source: Bloomberg and Ardea, January 2002 to November 2023.

Fixed income investors face a similar dilemma, with corporate bonds suffering the same upward pressure on yields (downward pressure on prices) as government issued debt, but with greater potential for default This means the traditional levers of fixed income portfolio management – duration and credit – could suffer further volatility. Potentially tarnishing their risk reducing benefits.

A lesser known, but nonetheless long-standing approach to fixed income is Pure Relative Value investing.

Pure Relative Value investing does not rely on conventional fixed income sources of return and is not impacted by the level of bond yields regardless of whether they are high, low, or even negative. Nor is it reliant on corporate credit risk or a fund managers' ability to forecast the direction of interest rates. Instead, a Pure Relative Value approach focuses on pricing inconsistencies between closely related securities – it offers investors a third lever.

The global fixed income market contains a very large array of securities that are explicitly linked to each other by well-defined relationships. In an efficient market, these securities would always be consistently priced with one another, but the fixed income market is not efficient. Underlying structural factors such as regulation, mandate restrictions and varying investor objectives cause market participants to transact for reasons other than profit maximisation.

As such, we continually observe pricing inconsistencies between closely related securities that have very similar risk characteristics. These pricing inconsistencies can be isolated using a wide range of risk management tools, including derivatives, which strip out unwanted market risk allowing the strategy to generate positive returns regardless of the level of bond yields, bond market volatility or the direction of interest rates.

The Ardea Global Alpha Fund focuses on pure relative value opportunities within the highest quality and most liquid government bond markets. As bond prices are less volatile and RV pricing relationships more constrained compared to stocks, these are low risk trades. To add additional stability to the return profile, the portfolio is then constructed to achieve volatility-controlled returns by combining many modestly sized and diverse RV trades, so that no single trade becomes a dominant driver of overall portfolio risk. As a result, our approach is duration neutral and excludes corporate credit, which provides investors a true alternative to traditional fixed income strategies – the abovementioned third lever.

Pure Relative Value: The Third Lever of Fixed Income

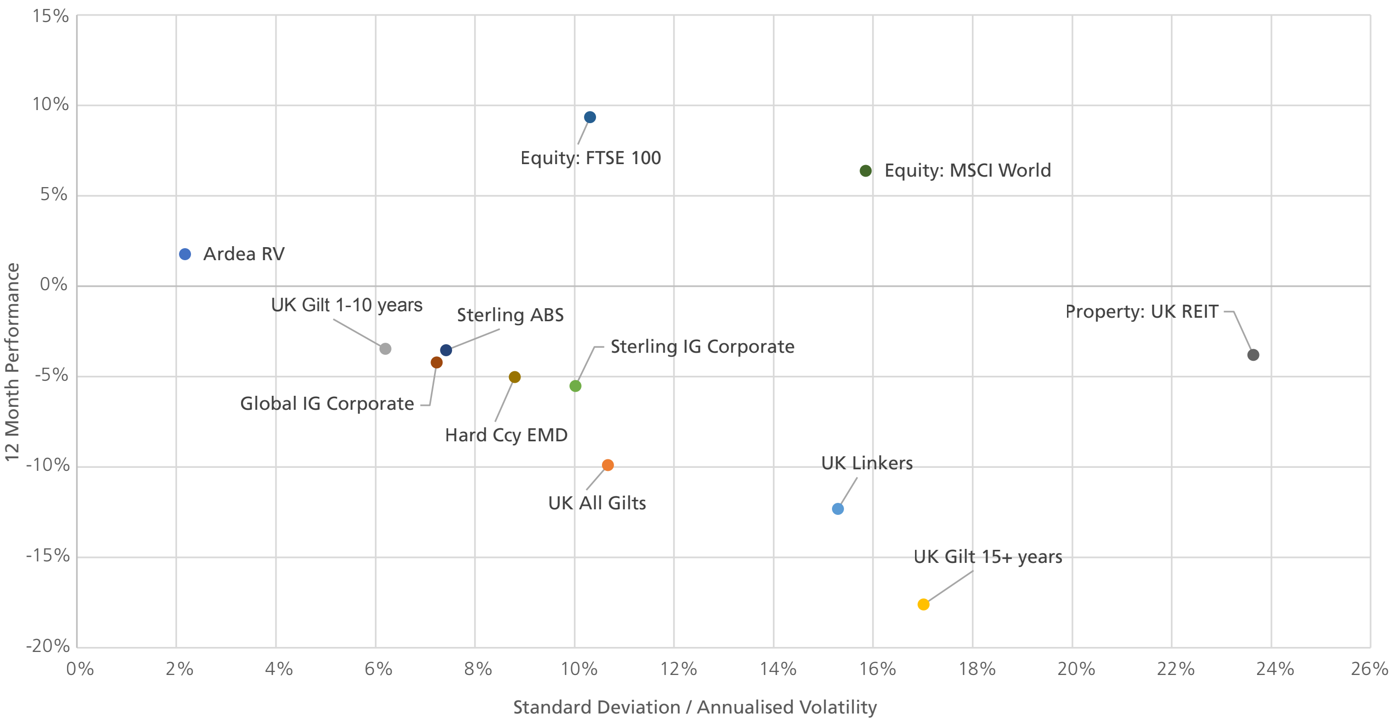
The Third Lever in Action	YTD Return	YTD Vol.	2022 Return	2022 Vol.
Ardea Global Alpha Fund: RV lever	3.9%	1.7%	3.1%	2.9%
Global Government Bonds: Duration lever	2.9%	5.1%	-11.7%	5.6%
Global Corporate Bonds: Credit lever	4.1%	7.5%	-15.3%	9.7%
Global Equities	17.5%	13.6%	-17.1%	20.6%

Source: Bloomberg and Ardea, March 2021 to November 2023. Index performance is hedged to GBP. Ardea Global Alpha Fund performance is shown for the GBP X distributing share class gross of fees and assuming distributions have been reinvested. Inception date: 1 March 2021.

The Fund targets a return of Cash +2% net of fees, and seeks to deliver uncorrelated investment performance while maintaining a modest level of volatility (between 2% and 3% per annum) and a high degree of liquidity. As such, Ardea consider the style of our returns every bit as important as the size of our returns.

This 'style of returns' is illustrated in the below scatter chart, which plots cumulative performance against annualised volatility for the Ardea Global Alpha Fund and a number of core asset classes since the Fund's inception in March 2021. Since the Fund's launch, the Ardea relative value strategy has not only outperformed all the fixed income indices included within this analysis, but it has done so with a significantly lower degree of volatility.

Performance vs. Volatility: March 2021 to November 2023



Source: Bloomberg and Ardea, March 2021 to November 2023. The performance of non-UK indices is hedged to GBP. Ardea Global Alpha Fund performance is shown for the GBP X distributing share class gross of fees and assuming distributions have been reinvested. Inception date: 1 March 2021.

Finally, the absence of duration, corporate credit and foreign exchange risk means the Ardea Global Alpha Fund can work well for insurers subject to the Solvency II regime and has been proven to improve risk-adjusted returns, while providing important downside protection during periods of market stress.

The tables below have been constructed using Ardea's proprietary Capital Management Tool and illustrate how a conventional multi-asset portfolio, in this case a typical UK insurance company's investment portfolio, can be enhanced via a modest 10% allocation to the Ardea Global Alpha Fund during times of stress, in this case the twelve-month period encapsulating the LDI crisis and pseudo banking crisis of 2023.

In the first instance, funding this 10% allocation out of the existing fixed income assets results in performance increase of one percentage point, while the Conditional Value-at-Risk falls from 21% to 19% and the Solvency Capital Ratio falls from 11% to 10%. Modest, but material improvements.

A similar result is achieved when the 10% allocation is funded from the original portfolio's exposure to UK gilts. In this instance, the Conditional Value-at-Risk falls from 21% to 18% and fund performance improves from -11% to -9.5%. For investors funding a similar exposure from longer-dated gilts or a more capital-intensive equity allocation, the impact on return, value-at-risk and the SCR capital charge has the potential to be far more significant.

April 2022 to April 2023: U.K. LDI Crisis and SVB / Credit Suisse Banking Crisis

UK Insurance Portfolio	Weight
U.K. Gilts	36%
UK Corporate Bonds	30%
Global Government Bonds	24%
U.K. Equities	5%
U.K. Property	3%
Global Equities	2%
Ardea Global Alpha Fund	-

Return	CVaR	SCR
-11%	21%	11%

10% Allocation via F.I.	Weight
U.K. Gilts	32.67%
UK Corporate Bonds	26.67%
Global Government Bonds	20.67%
U.K. Equities	5%
U.K. Property	3%
Global Equities	2%
Ardea Global Alpha Fund	10%

Return	CVaR	SCR
-10%	19%	10%

10% Allocation via Gilts	Weight
U.K. Gilts	26%
UK Corporate Bonds	30%
Global Government Bonds	24%
U.K. Equities	5%
U.K. Property	3%
Global Equities	2%
Ardea Global Alpha Fund	10%

Return	CVaR	SCR
-10%	18%	10%

Source: Bloomberg and Ardea, March 2021 to November 2023.
The performance of non-GBP indices has been hedged to GBP.
Fund performance is gross of fees.

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