ARCULUS PREFERRED INCOME FUND
MONTHLY REPORT – NOVEMBER 2022

Description/strategy

The investment strategy of the Arculus Preferred Income Fund (name changed from DDH Preferred Income Fund on 29 November 2022) is to identify appropriate investments to generate a sufficiently high yield, considering risk and minimum volatility of returns. The Fund is constructed with reference to macroeconomic factors and industry exposure. The Fund does not employ leverage either directly or using derivatives and has no offshore currency or market exposure. Up to 30% of the Fund can be invested in non-investment grade securities (S&P, Fitch rated below BBB-, Moodys rated below Baa3). The Fund is best suited to investors who seek a medium risk investment over a 3 to 5-year period.

Investment objectives

To provide unitholders with returns in excess of cash and bank deposits over the medium to long term by investing in Australian sovereign bonds, senior & subordinate debt issued by Australian financial institutions, senior & subordinate bonds issued by Australian corporates and ASX-listed hybrid and debt securities. The return is a combination of income distribution and capital growth. The target rate of return is the Bank Bill Swap Rate plus 350 basis points.

ESG

Environmental, Social and Governance issues form part of the risk analysis framework.

Fund details

DDH Graham Limited (DDH) is the responsible entity of the Fund. As responsible entity, DDH is responsible for the management and administration of the Fund, including the issue of the Fund's Product Disclosure Statement and all other public announcements concerning the Fund.

DDH has appointed GCI Australia Pty Ltd (one of Australia's leading Investment management businesses) ABN 68 140 364 576 (GCI) as the Fund's outsourced investment manager. Arculus Funds Management Pty Ltd (Arculus), a wholly owned subsidiary and Corporate Authorised Representative of GCI undertakes the investment management activities for the Fund.

APIR Code DDH0001AU
ARSN 108 161 575

Fund availability

This Fund can be accessed by investing directly, or indirectly, using the Wealth02, HUB24, Netwealth, OneVue, Praemium Investment, Ausmaq, BT Panorama, Macquarie Wrap and Australian Money Market platforms.

Performance to 30 November 2022 (annualised)

	1M	3M	6M	1Y	2Y	3Y	5Y	Since Inception
Total Return	**0.84%**	**0.98%**	**1.52%**	**-1.11%**	**2.00%**	**1.90%**	**2.91%**	**4.33%**
Cash Distribution	0.00%	0.85%	1.77%	3.40%	3.25%	3.15%	3.62%	5.32%
+/- Growth	0.84%	0.13%	-0.25%	-4.51%	-1.25%	-1.25%	-0.71%	-0.99%
Index	**0.26%**	**0.65%**	**0.98%**	**1.02%**	**0.52%**	**0.49%**	**1.00%**	**3.33%**

*Fund returns are net of all fees – may not sum due to rounding

Australian index returns 30 November 2022

Index	1m Return	3M Return	12M Return
Bloomberg Australia Bank Bill Index	0.26%	0.65%	1.02%
Bloomberg Australia Gov't 3-5 Year Index	0.75%	1.14%	-4.61%
Bloomberg Australia Composite 0-3 Year Index	0.56%	0.80%	-1.35%
Bloomberg Australia Composite 3-5 Year Index	1.05%	1.07%	-4.92%
Bloomberg Australia Composite All Maturities Index	1.55%	1.09%	-7.72%
ASX Bonds and Hybrids; All Issues incl. franking	1.22%	2.99%	3.03%

Returns are calculated using exit prices and are calculated after all fees and costs have been deducted, assumes any distributions are reinvested, and no allowance made for tax. The 'distribution' component represents the amount paid by way of distribution, including net realised capital gains. Numbers may not sum due to rounding. Past performance is not an indicator of future performance.

The benchmark is the Bloomberg Australian Bank Bill Index. The inception date of the Fund was 25 October 2004. E&P commenced as Investment Manager on 31 December 2010. Arculus commenced as Investment Manager on 01 July 2015.

Fund rating

Initially rated 'Favourable' by SQM Research in December 2016 the Fund was upgraded to 'Superior' in December 2020.

Superior
SQM RESEARCH

Fund Size

As at 30 November 2022, the Net Asset Value of the Fund was $208,865,752.68.

Portfolio characteristics 30 November 2022

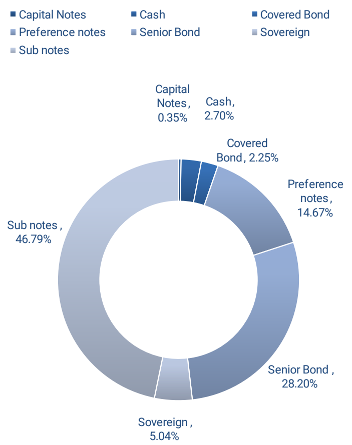
Running Yield	5.40%
Yield to Maturity	6.58%
Average Margin	3.53%
Average Years to Maturity	3.22
Number of Securities Held	41
Fixed	40.65%
Floating	56.65%
Cash	2.70%
Modified Duration	1.74
Credit Duration	1.57

Fees

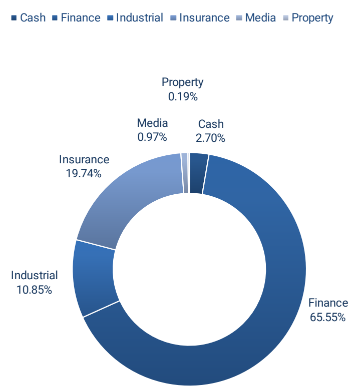
MER	0.82%
Buy/Sell Spread	+0.15% / -0.15%
Performance Fees	Nil

Asset breakdown

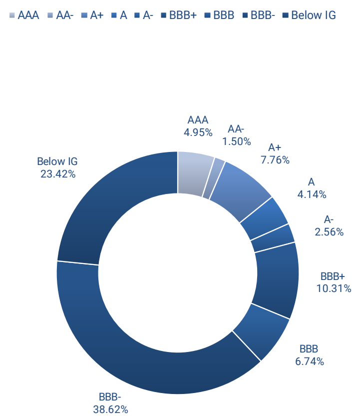
Sub Type Analysis



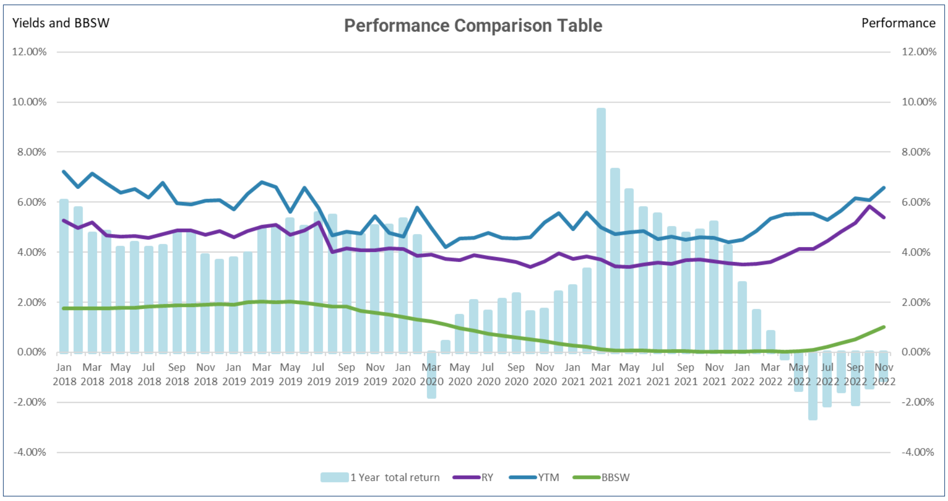
Sector Allocation



Credit Rating



Performance



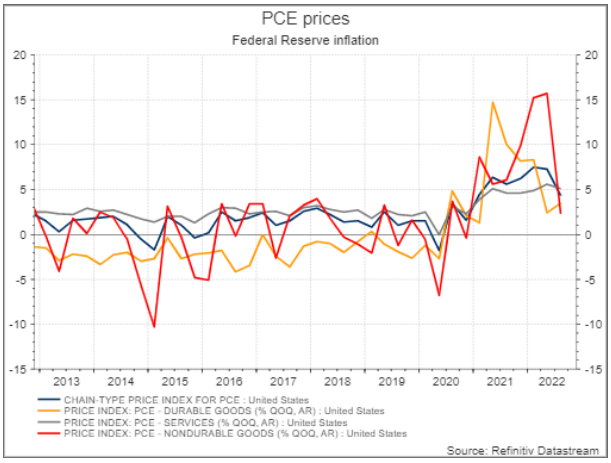
Source Arculus, DDH Graham data

The Fund is expected to continue to record strong performance numbers supported by the increasing running yield and yield to maturity (YTM) over the past few months. The current running yield of 5.40% and YTM of 6.58% is the highest the Fund has recorded for over four years. Although we now expect that the RBA will shortly leave rates on hold, we still expect that yields will continue to improve with tactical changes to fund positioning.

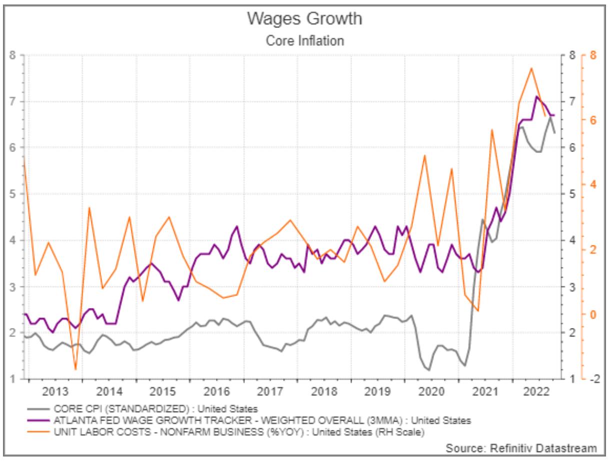
Market review

Right at the end of November (2pm on the 30th in NY) Governor Powell, in a speech, indicated for the first time that slower rate rises will be considered at the December FOMC meeting. This is seen as a clear pivot from the view he espoused repeatedly since the Jackson Hole statement, that the Federal Reserve had a simple goal of stamping out inflation and it would not waiver from this goal until it saw inflation in a clear retreat.

The market interpreted the more dovish speech from Powell as translating into only a 50-basis point (bps) hike in December and that the terminal rate may be lower than the 5.5% currently expected. Although too late for pricing of the November period in Australia, the incredible 18bps fall in US 2-year yields following the Powell speech may result in a strong bond rally in December, globally.

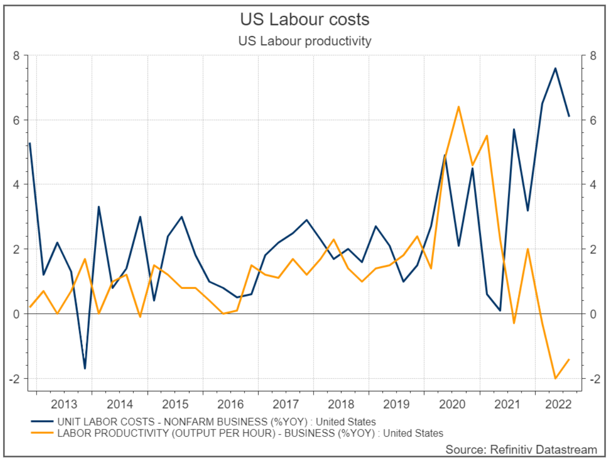


The shift in the interest rate outlook reflects the transitory price increases abating. This is evident at the key durable good price level – where durable goods prices led the increase in inflation due to the supply chain disruption from the pandemic. It is also clearly underway at the non-durable goods level and has commenced at even the services level. It may be too early to conclude that monetary policy, through a higher exchange rate, has begun to extinguish US inflation. The US economy is at risk of a wage price spiral. Wages growth and wage increase expectations have gained considerable momentum.



We have not seen US wages growth above 6% for many decades. This is the proverbial rolling stone gathering moss as it rolls down the hill. The stone now has so much momentum that only a brick wall – a severe economic contraction - can stop it.

Perhaps more importantly for the outlook for core inflation, is that labour costs are rising while labour productivity is falling. Fundamentally, wages growth without a commensurate increase in labour productivity is inflationary.



Our view is that the Federal Reserve will very shortly cease raising rates but will leave rates on hold for a considerable period – at least 12 months – even if the economy contracts sharply, because it will take time to choke the inflation genie, which is wages growth. We expect the same approach from the RBA and for Australian bonds yields to trade near the current margin to US bond yields.

Fund positioning

The repayment at the first call date of both the AMP and Challenger Tier 2 securities has provided a very good opportunity to shift towards sectors and security types that enhance the portfolio's yield. A great deal of care is being taken to minimise credit risk whilst also improving the yield to maturity (YTM) of the portfolio. Over the past month the portfolio's yield has increased while the 90-day BBSW rate has been steady through the careful selection of senior fixed bonds issued by Commonwealth corporation (CAC Act issuers).

Returns in the sector over the next 12 months will not be driven by chasing higher yields, but by avoiding credit risk and market price risk connected with the APRA requirement to increase hybrid issuance by $70bn in 2023. Initially, this increased capital was expected to be sourced entirely from Tier 2 securities. In expectation of this the market moved Tier 2 margins out to the widest level seen for many years. A typical example is the CBA 10-year, non-call 5-year Tier 2, issued at 2.80%. We were able to take advantage of this move in yields by purchasing the fixed yield bond version of this issue at 6.8% early in the month and taking profits at 6.06% near the end of the month.

In the new year, we expect that the recent APRA re-assertion of the Tier 2 and Tier 1 conditions for approval, and terms for redemption, will result in the banks increasing Tier 1 issuance rather than Tier 2. In the past month CBA has issued Tier 2 at 2.80% but Tier 1 at only 2.85%. Given the fact that Tier 2 is an actual debt security where capital repayment and the distributions are not discretionary, while Tier 1 distributions are discretionary and potentially perpetual, it seems only logical that the banks will make a series of unscheduled new Tier 1 issues, rather than Tier 2 next year, in order to fulfil the APRA requirement of $70bn of new subordinated capital.

ESG

Arculus Funds Management believes that integrating Environmental, Social and Governance (ESG) factors into our investment decision-making and ownership practices is fundamental to delivering the results our clients seek.

Investing demands active and ongoing engagement and we are committed to maintaining a focus on long-term sustainability and returns. We also recognise that the ESG investment world is constantly evolving, and we seek to partner with clients and ensure our principles align with theirs on this journey.

At a corporate level, ESG principles influence our people, our culture, and our choices, helping to make us better investors. At an investment level, we consider ESG in our analysis and processes, helping us identify opportunities and risks. Recognising that there is a lack of consistency in ESG implementation and articulation across the industry, we seek to be clear in our communication as well as providing insight for our clients. Arculus does not explicitly exclude any industry, rather we aim to invest only in what we consider to be the best company within an industry group that displays industry leading ESG principles.

Arculus Funds Management's policy is to integrate sustainability risks in their investment solutions across all our products by identifying, evaluating, and managing relevant risks in our investment decisions. We believe sustainability risks are most relevant to investment outcomes when they exhibit financial materiality, and, like all investment risks, are incorporated by balancing expected risk with expected reward. In managing investment solutions, Arculus consider financially-material sustainability risks in the context of expected rewards using a blend of inputs from sources including, but not limited to, our own portfolio managers and external third-party data sources.

Our focus is primarily on investigating the governance structures of each issuer as this is central to understanding the underlying business risks. Attention is also given to the level of equality and diversity because we have found that in the long term, businesses that employ the best people regardless of their gender, racial background or age tend to outperform.

We do not chase higher short-term returns by investing in offshore company securities because of the increased risks that include currency but also regulatory differences that protect the Australian financial system. Identifying inadequate governance practices is much more difficult offshore when we are not able to fully understand the cultural practices of that country or verify that the regulatory and governance framework of that country meets our standards.