ARCULUS FIXED INCOME FUND

MONTHLY REPORT – DECEMBER 2022

DDH GRAHAM LIMITED | Arculus Funds Management

Description/strategy

The investment strategy of the Arculus Fixed Income Fund (name changed from GCI Australian Capital Stable Fund on 29 November 2022) is to identify appropriate investments from the pool of Australian sovereign and Australian senior bank bonds that are expected to generate a sufficiently high yield, commensurate with the assumed risk, with minimum volatility of returns. The Fund is not benchmark aware so is without a duration target. It is focused on achieving an absolute return. The Fund is best suited to investors who seek a low to medium risk investment over a 1 to 3-year period.

Investment objectives

To provide income and capital stability and a high degree of liquidity in all market conditions. The total return will mainly comprise income from security income payments. The target rate of return is the Bank Bill Swap Rate plus 1.5% before fees.

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 DDH8305AU
ARSN 622 419 578

Fund availability

This Fund can be accessed by investing directly, or indirectly, using the BT Panorama, Allan Gray, HUB24, Netwealth and Macquarie Wrap platforms.

Performance to 31 December 2022 (annualised)

	1M	3M	6M	1Y	2Y	3Y	5Y	Since inception
Total Return	**-0.03%**	**0.94%**	**1.12%**	**-2.85%**	**-2.27%**	**-1.04%**	**0.37%**	**0.42%**
Cash Distribution	0.58%	0.59%	0.89%	1.44%	1.21%	1.22%	1.71%	1.68%
+/- Growth	-0.62%	0.35%	0.22%	-4.30%	-3.48%	-2.26%	-1.33%	-1.27%
Index	0.24%	0.74%	1.17%	1.25%	0.64%	0.54%	1.01%	1.02%

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

Australian index returns 31 December 2022

Index	1M Return	3M Return	12M Return
Bloomberg Australia Bank Bill Index	0.24%	0.74%	1.25%
Bloomberg Australia Gov't 3-5 Yr Index	-1.13%	0.91%	-5.60%
Bloomberg Australia Composite 0-3 Yr Index	-0.18%	0.90%	-1.56%
Bloomberg Australia Composite 3-5 Yr Index	-1.04%	1.03%	-5.91%
Bloomberg Australia All Maturities Composite Index	-2.06%	0.38%	-9.71%

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 2018, the Fund was upgraded to 'Superior' in December 2020.

Fund Size

As at 31 December 2022, the Net Asset Value of the Fund was $76,546,505.50.

Portfolio characteristics 31 December 2022

Running Yield	3.95%
Yield to Maturity	4.42%
Average Margin	1.20%
Average Years to Maturity	2.38
Number of Securities Held	42
Floating	37.43%
Fixed	60.12%
Cash	2.44%
Modified Duration	1.49
Credit Duration	0.57

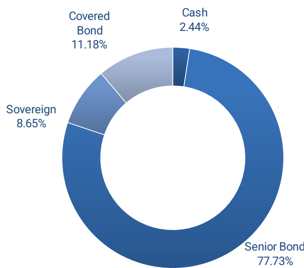
Fees

MER	0.40%
Buy/Sell Spread	+0.10%/-0.10%
Performance Fees	Nil

Asset breakdown

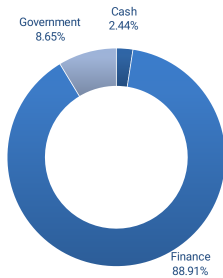
Sub Type Analysis

■ Cash ■ Senior Bond ■ Sovereign ■ Covered Bond



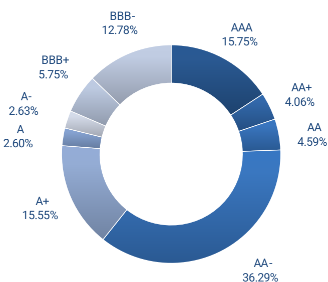
Sector Allocation

■ Cash ■ Finance ■ Government

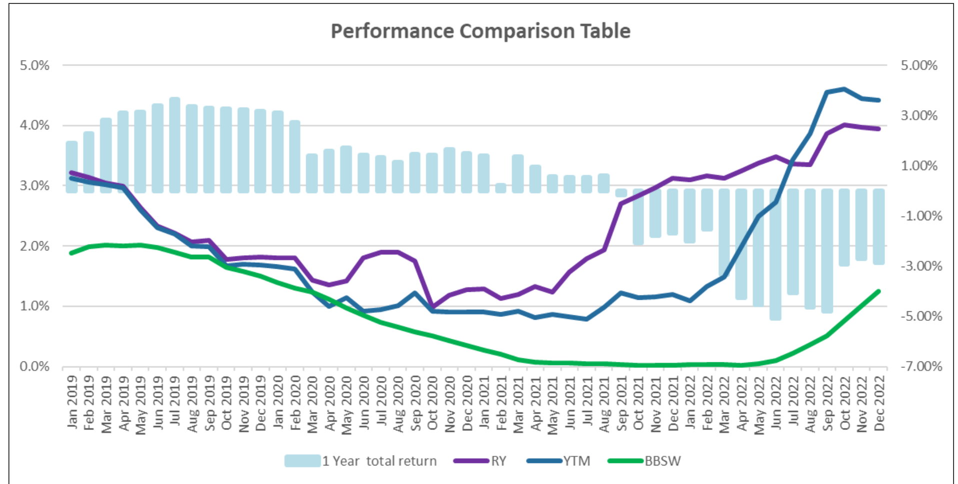


Credit Rating

■ AAA ■ AA+ ■ AA ■ AA- ■ A+
■ A ■ A- ■ BBB+ ■ BBB-



Performance



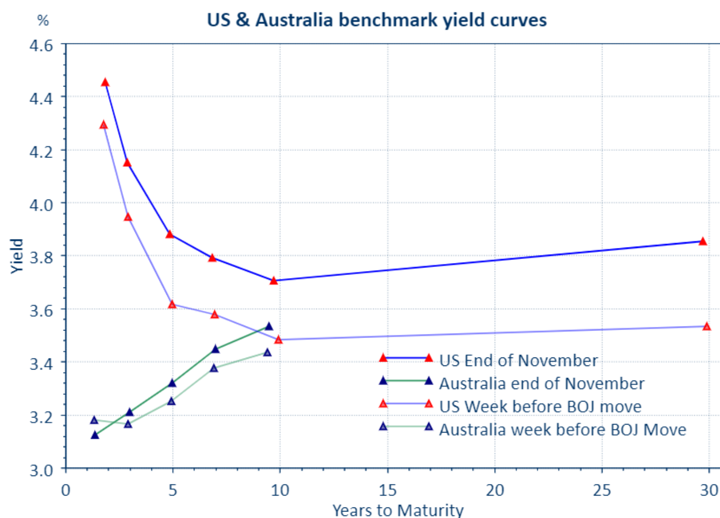
Source Arculus, DDH Graham data

The Fund produced a steady performance in December in what was yet another very bad month for bonds. The All Maturities Index fell 2.06%. Supported by the strong running and YTM of the portfolio the Fund's performance is expected to steadily improve over the next 12 months as many of the underlying holdings approach their maturity. As the Fund mandate only allows for investment in Australian sovereign and senior bank debt that meet the repo eligibility criteria (part of the HLQA APRA capital) there is no currency risk and a very low level of credit risk assumed for the current running yield of 3.95%.

Market review & outlook

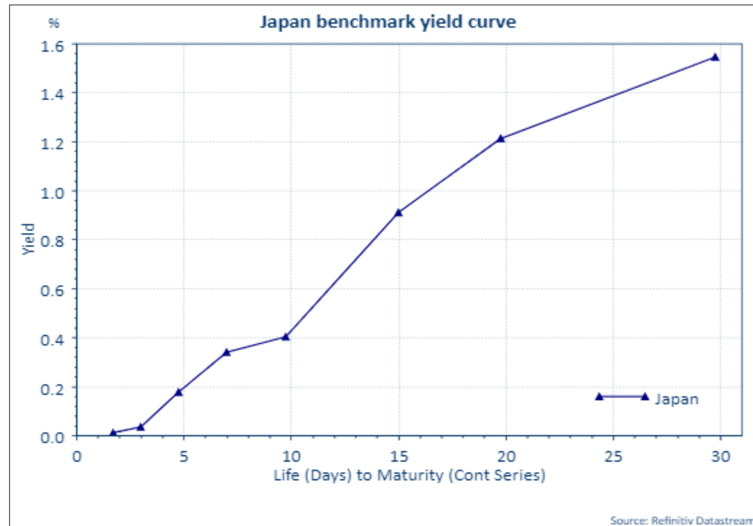
Global bond markets finished December on a weak note after the Bank of Japan (BOJ) adjusted its yield curve control policy to lift the 10-year yield target from 25 basis points (bps) to 50bps.

Between the end of November and the week ending before the BOJ adjustment to its Yield Curve Control (YCC) policy, the US yield curve had shifted down by 20bps at the long end to reflect weaker forward-looking data that had been released. The rally in bonds may also have reflected a theme amongst leading market strategists that because the US (and Australian) central bank is likely to make its last tightening move in March, it was time to begin buying duration bonds again. We maintain that it is still too early to meaningfully increase fixed duration as the economic outlook remains too uncertain.



Source: Refinitiv Datastream

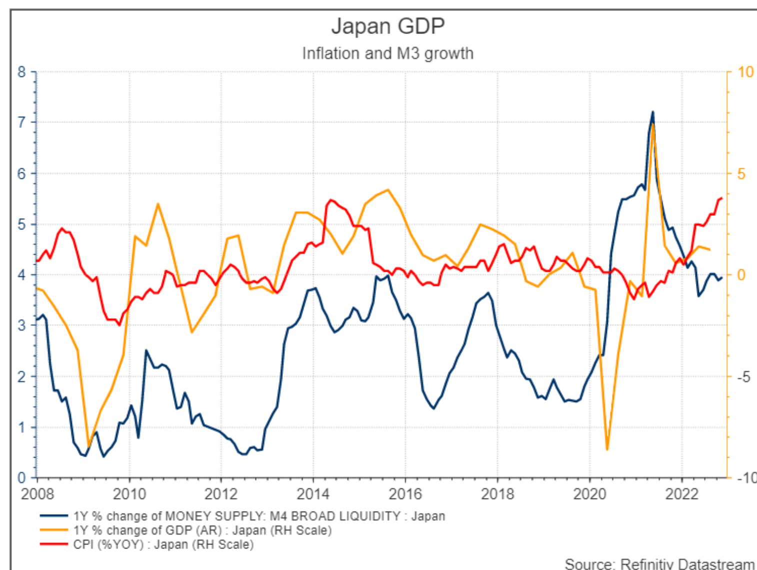
In the second half of December the bond yield curve began to steepen that was then compounded by the BOJ in the week before Christmas making an adjustment to its yield curve control (YCC) policy. At this stage, the change in policy to move the target 10-year Japanese sovereign bond yield from 25 bps to 50bps, is not a material change in policy that can be linked to a change in the BOJ's economic outlook. The BOJ explained the need for a policy change as just removing the kink in the yield curve depicted in the chart below.



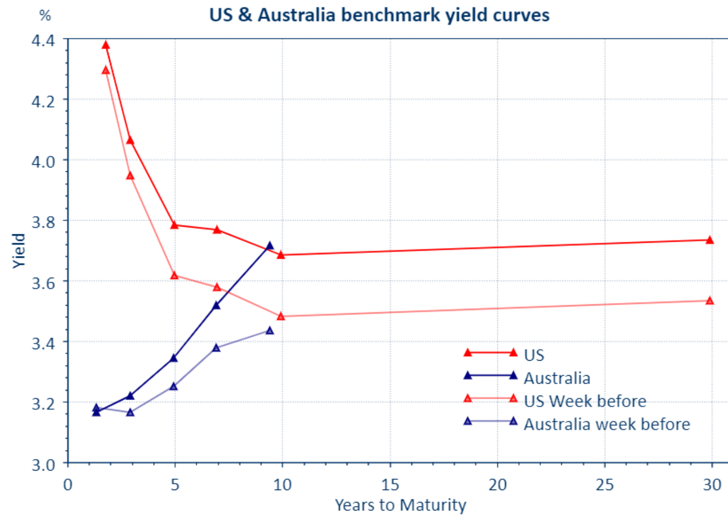
Clearly the markets don't believe that monetary policy has been materially changed. The shift in the yield curve control from 25bps to 50bps resulted in the 10-year yield rising only to 41bps before settling near 39bps and the 7-year bond yield rose from 22bps to 35bps. It is, however, likely that the BOJ has begun the process of withdrawing the extraordinary monetary stimulus that it has had in place for many years. A few years from now we might look back on how Japan has handled the withdrawal of extraordinary monetary policy with some admiration. The initial change to yield curve control is only a marginal adjustment at this stage (by comparison the RBA abandoned YCC overnight) and done at a time when many Japanese companies are not actively trading and very few of the international banks have a full desk operating. This at least explains the lack of Japanese bank activity - that did not spike - following the announcement.

We have been for some time optimistic that the weak Yen will ignite export growth and, with it, break Japan out of the period of secular stagnation it has been trapped in since the early 1990's, however, it is our view that it's still too early for the BOJ to be withdrawing stimulus in a meaningful way for three reasons:

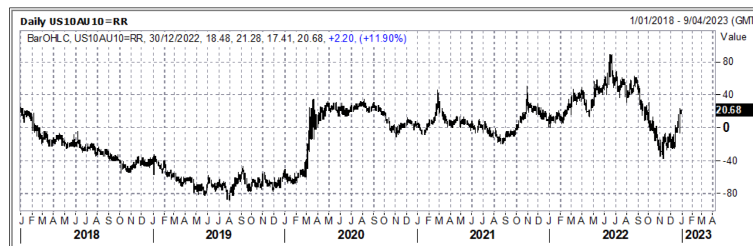
- GDP growth annualised remains lacklustre.
- Broad money growth - without any actions by the BOJ - has been falling since 2021.
- Japanese inflation readings (CPI) have clearly broken out of the range seen since the early 1990's, however, once the transitory price factors abate, we may see inflation fall back into the pre-COVID range.



The reaction to the BOJ policy change was much more significant in dollar bloc countries. In Asian trading the US 10-year rose 10bps and the Australian 10-year moved 21bps. It is instructive here to note that the day before the BOJ changed YCC policy, both the Australian and US curves had begun to steepen with 10-year yields rising. In a US context the BOJ move may then have only accelerated a move out of the USD that was already underway.



The Australian yield curve has steepened by more than the US curve over the past month. Since mid-October the Australian 10-year bond had been trading at discount to the US curve. This may have been reflecting the market beginning to price the risks of a US recession in early 2023 and a belief by some that given Australia's current high household debt, state debt and federal debt that our economy is more vulnerable to any economic contraction.



An alternative view is that Australia is less likely than the US to suffer an economic contraction in 2023 and this justifies Australian 10-year yield being higher than US 10-year yield. This view is also consistent with the contraction in floating rate debt margins since mid-October. Credit spread margins widen with increased credit risk ahead of an economic contraction and contract when the economy recovers.

Over the next few months, we expect a greater degree of clarity to be found from the economic data for the December quarter 2022, however, Australia faces a number of challengers in 2023. Chief among these will be the outlook for China where the rapid spread of the COVID virus has already begun to impact supply chains in much the same way the lockdowns in 2020 created a global shortage of durable goods. The new Federal Australian government has also embarked on a bold approach to both fair wage determination and energy pricing that risks a range of unintended consequences at a time when the economy is rapidly transitioning from fossil fuel-based power generation to renewable energy.

Fund positioning

A strong rally in the fixed rate bond curve in the early part of December provided an opportunity to take profits on some of the longer dated fixed rate bonds in the portfolio. This resulted in the modified duration of the portfolio reducing from 1.91 in November to 1.49 in December. At this stage, the proceeds from the sale of fixed rate bonds have been invested in major bank senior floating rate bonds which are at both low fixed duration and low spread risk. This switch from fixed to floating insulated the portfolio from the sharp, significant rise in the fixed rate curve in the second half of December.

Environmental Social and Corporate Governance

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.

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