ARCULUS PREFERRED INCOME FUND
MONTHLY REPORT – JANUARY 2023

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 31 January 2023 (annualised)

	1M	3M	6M	1Y	2Y	3Y	5Y	Since Inception
Total Return	**0.89%**	**2.55%**	**3.51%**	**0.86%**	**1.81%**	**2.09%**	**3.06%**	**4.38%**
Cash Distribution	0.00%	0.85%	1.73%	3.44%	3.26%	3.12%	3.59%	5.32%
+/- Growth	0.89%	1.70%	1.78%	-2.59%	-1.45%	-1.03%	-0.54%	-0.94%
Index	0.27%	0.77%	1.31%	1.52%	0.77%	0.60%	1.03%	3.33%

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

Australian index returns 31 January 2023

Index	1m Return	3M Return	12M Return
Bloomberg Australia Bank Bill Index	0.27%	0.77%	1.52%
Bloomberg Australia Gov't 3-5 Year Index	1.74%	1.35%	-3.31%
Bloomberg Australia Composite 0-3 Year Index	0.78%	1.16%	-0.56%
Bloomberg Australia Composite 3-5 Year Index	1.88%	1.87%	-3.48%
Bloomberg Australia Composite All Maturities Index	2.76%	2.20%	-6.26%
ASX Bonds and Hybrids; All Issues incl. franking	0.01%	3.55%	4.83%

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 31 January 2023, the Net Asset Value of the Fund was $210,549,383.35.

Portfolio characteristics 31 January 2023

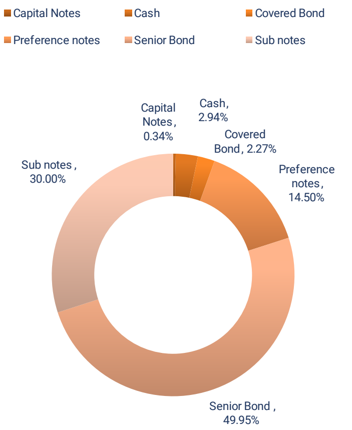
Running Yield	5.56%
Yield to Maturity	6.00%
Average Margin	2.63%
Average Years to Maturity	2.44
Number of Securities Held	49
Fixed	33.18%
Floating	63.88%
Cash	2.94%
Modified Duration	1.06
Credit Duration	1.61

Fees

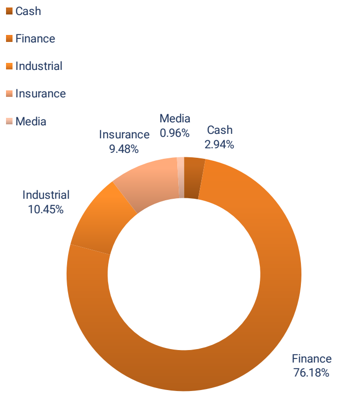
MER	0.82%
Buy/Sell Spread	+0.15% / -0.15%
Performance Fees	Nil

Asset breakdown

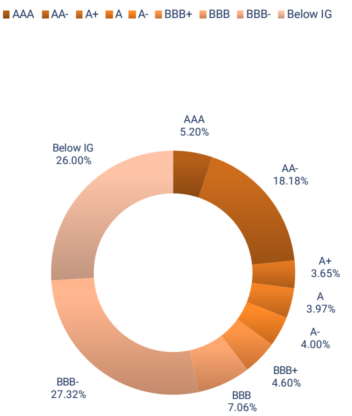
Sub Type Analysis



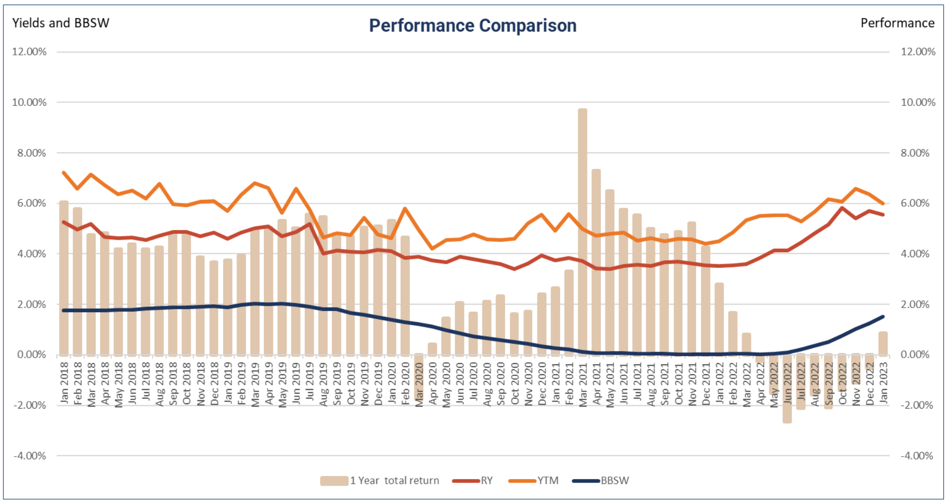
Sector Allocation



Credit Rating



Performance

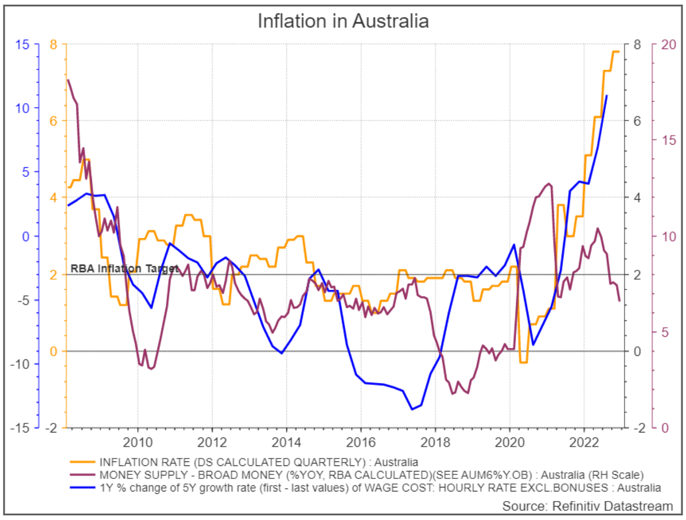


Source Arculus, DDH Graham data

The Fund performed well, lifting 89 basis points (bps) in January following an 80bps increase in December. Over the next 12 months, the performance will be supported by the strong underlying yield and the short-dated nature of the bonds.

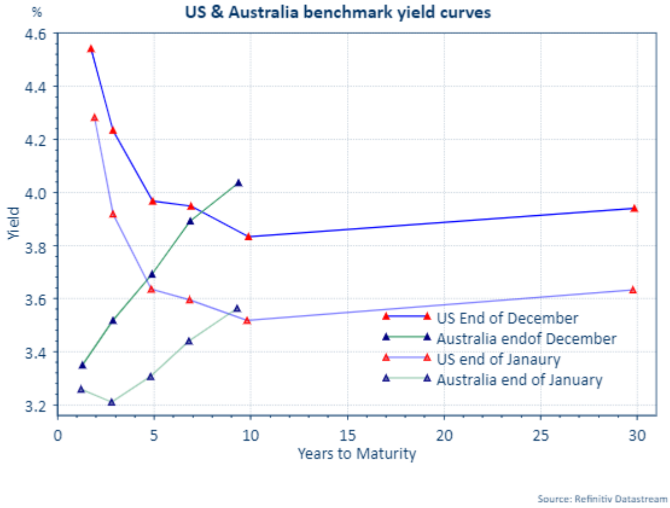
Market review

In spite of the worse than expected Australian inflation reading for December that shows Australia and the US may experience very different inflation outcomes, there has been a rally in fixed income bonds since the end of December in both markets. This is a good example of the power of the US market with its influence extending into all dollar block currencies.



Both curves are likely to flatten further over the next few months for different reasons:

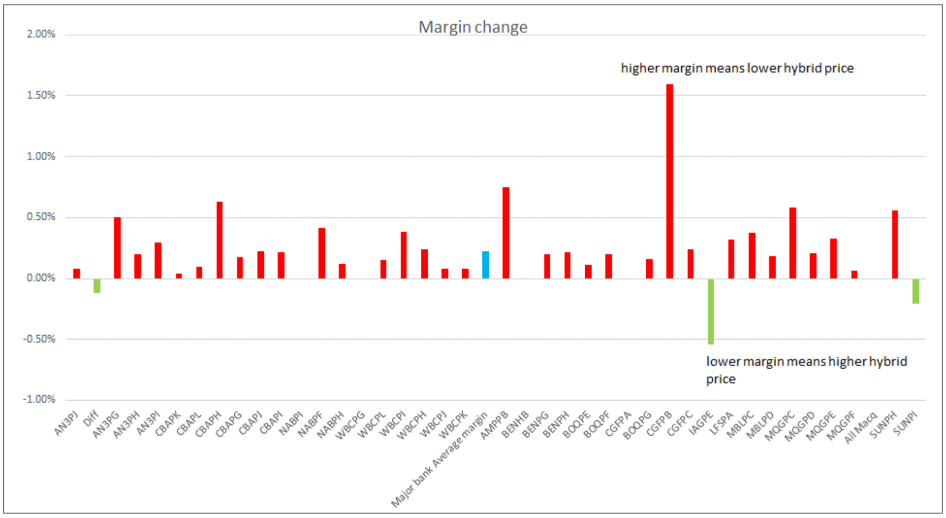
- **Australia.** The short-end yield at 3.21% now looks too low given the market is shifting into expecting the RBA terminal rate to be 3.75% from 3.5% previously. The market also does not seem to be appreciating that, due to the structural nature of the Australian economy, the RBA is more likely to keep rates on hold at this level for weeks/months, adding up to years, in order to get inflation back below its 3% target. The Australian curve then needs to have a shape more like the US curve with the short-end much higher than the long-end.
- **US.** The yield curve is steeply inverse (2 to 10-year spread near - 70bps) that will prove hard to justify if the US economy averts a recession in the first half of 2023. Given that the FOMC seems determined to keep short rates higher for longer, we should expect that 10-year yields will increase substantially over the next month to reflect the stronger than expected economic outlook. A yield curve inversion of 70bpsseems difficult to justify even if a recession occurs before June 30 given the strength in the US jobs market.



The second reason we expect a sharp rise in the US 10-year yield is the Debt Ceiling. The US is barrelling towards its riskiest debt ceiling clash since 2011, with a danger that America could default on its payments for the first time in its history after a very close brush with that scenario 12 years ago. The US hit its debt ceiling on the 19th of January and by June the Treasury will have exhausted all items it can defer and still avoid a default. The newly elected Republican majority in Congress is demanding deep spending cuts that at least wind back the pandemic spending. The need for this is something the Democrats (who still control the Senate) do not believe is necessary and so will not entertain any cuts to their spending programs.

The Hybrid market rally in December petered out in January with nearly all hybrid margins rising. The average major bank hybrid margin actually rose for the month to finish at 2.02%, a rise from 1.86% on 30 December. The Macquarie hybrid complex also widened in margin to 2.34% from 2.07%. The remaining non-major bank hybrid margins widened ever further. The chart below shows the change in margins from 30 December to 01 February. Only two hybrids rallied, the new IAGPE and SUNPI. IAGPE was still catching up to market after its IPO margin was set in early December when margins were wider. IAGPE was issued at 3.50% and now trades under 3%.

Hybrid volumes are typically lighter in January. This often fuels margin contractions as buyers get aggressive to secure volume. As soon as volume returns, margins equilibrate. This was the case in January. The daily volume in the first week was under $15m. The average daily volume in 2022 was $33m. After week one, the volume has gradually increased to be at $30m a day at month end. Hence normal market conditions are returning, accompanied by widening margins.



Source: Arculus

Fund positioning

The running yield has been pulled back from 5.69% in December to 5.56% and the YTM from 6.36% to 6.00%. This reflects a tactical de-risking with funds switched out of Tier 2 and fixed yield into a range of major bank short-dated FRNs that have a lower yield and lower duration risk. The decision to take this lower risk approach to investment over the end of year holiday period reflected the following:

- Fixed bond yields are expected to rise from the recent lows.
- Floating rate credit margins have contracted too far and too quickly over the past 45 days. By investing in short-dated floating rate bonds, the capital risk of widening credit margins is minimized.
- Liquidity over the holiday period is normally very light and this has the potential to increase bond volatility.

When the outlook becomes more certain the Fund is well positioned to increase credit or fixed duration and enhance the underlying yield.

Environmental Social and 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.