

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 March 2023 (annualised)

	1M	3M	6M	1Y	2Y	3Y	5Y	Since Inception
Total Return	-0.01%	1.31%	3.46%	2.33%	1.57%	4.21%	3.13%	4.37%
Cash Distribution	1.24%	1.26%	2.14%	3.86%	3.44%	3.40%	3.64%	5.34%
+/- Growth	-1.26%	0.05%	1.33%	-1.53%	-1.87%	0.81%	-0.51%	-0.97%
Index	0.28%	0.79%	1.54%	2.04%	1.03%	0.73%	1.08%	3.33%

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

Australian index returns 31 March 2023

Index	1m Return	3M Return	12M Return
Bloomberg Australia Bank Bill Index	0.28%	0.79%	2.04%
Bloomberg Australia Gov't 3-5 Year Index	2.63%	3.16%	1.53%
Bloomberg Australia Composite 0-3 Year Index	1.17%	1.58%	1.41%
Bloomberg Australia Composite 3-5 Year Index	2.51%	3.30%	1.54%
Bloomberg Australia Composite All Maturities Index	3.16%	4.60%	0.35%
ASX Bonds and Hybrids; All Issues incl. franking	-0.55%	-0.68%	3.67%

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 and reaffirmed in February 2023.



Fund Size

As at 31 March 2023, the Net Asset Value of the Fund was \$186,036,423.33

Portfolio characteristics 31 March 2023

Running Yield	6.06%
Yield to Maturity	6.97%
Average Margin	3.26%
Average Years to Maturity	2.27
Number of Securities Held	49
Fixed	27.77%
Floating	69.90%
Cash	2.33%
Modified Duration	1.00
Credit Duration	1.71

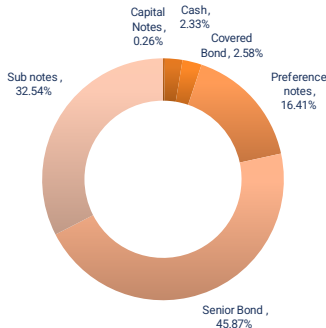
Fees

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

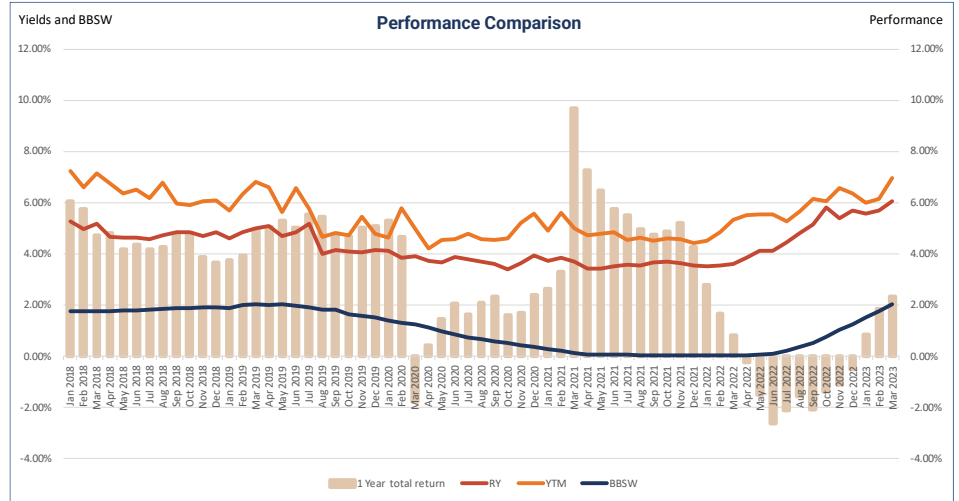
Asset breakdown

Sub Type Analysis

- Capital Notes
- Cash
- Covered Bond
- Preference notes
- Senior Bond
- Sub notes



Performance

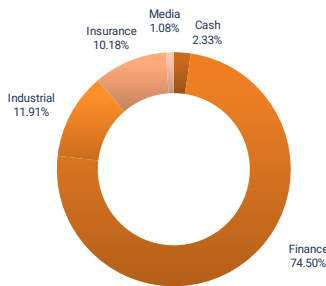


Source Arculus, DDH Graham data

Despite the volatility, driven by increased credit risk, in March the Fund produced a steady performance, losing just one basis point (bps). The year-to-date return this financial year is 4.78%. The March quarter distribution was 5.11%.

Sector Allocation

- Cash
- Finance
- Industrial
- Insurance
- Media



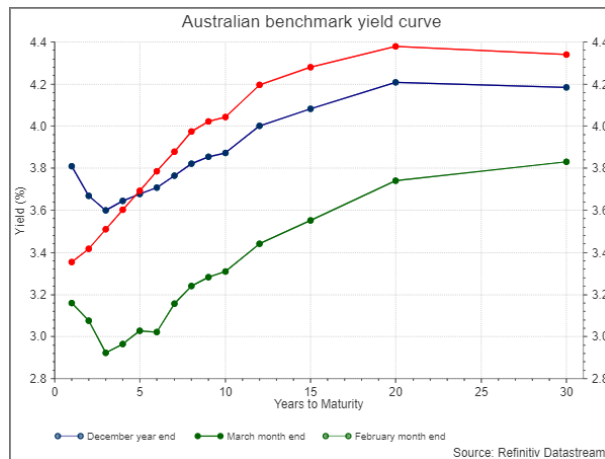
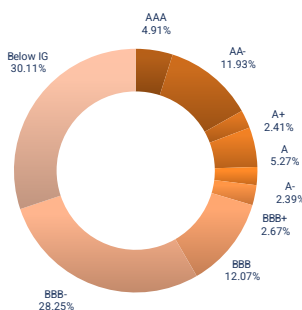
Over the next two quarters the running yield and the yield to maturity are expected to move higher in line with the 90-day BBSW rate (currently 3.71% from 3.56% at the end of December) and this will be the primary driver of performance. When the economic outlook becomes more certain there is scope to increase the yield on the portfolio by increasing either fixed duration or credit spread risk from the current low levels.

Market review

At the March meeting, the RBA raised rates by the expected 25bps and was less hawkish but in line with market expectations. Over the past three months there have been dramatic shifts in the Australian yield curve that mostly reflect shifts in the consensus outlook for the US economy and its bond market.

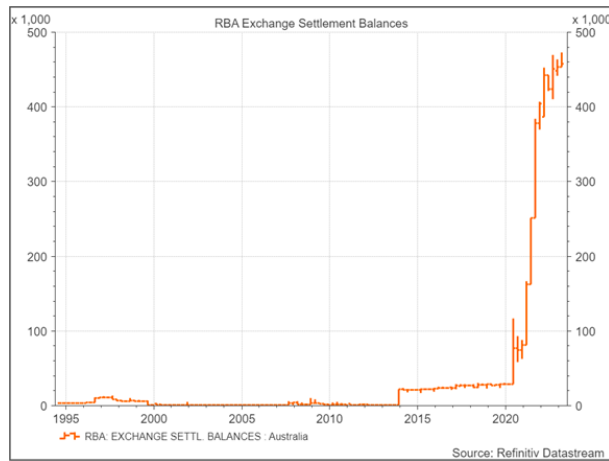
Credit Rating

- AAA
- AA-
- A+
- A
- A-
- BBB+
- BBB
- BBB-
- Below IG



The yield curve shift in March reflected the markets' view that the banking issues in the US and Europe will force the Central Banks to pause their rate hikes until their financial systems stabilise. It is not at all clear quite why the market then translates these offshore issues into a systemic problem for the Australian banking sector where:

- Australian banks are required by APRA to hold more Total Loss Absorbing Capital (Majors 11% versus US 7%) than any other developed economy.
- Australian banks are required to mark to market daily all their bond holdings while in the US banks have been allowed to self-determine a portion of their holds as hold to maturity and not marked to market.
- Australian banks have very large deposits into the RBA exchange settlement account.



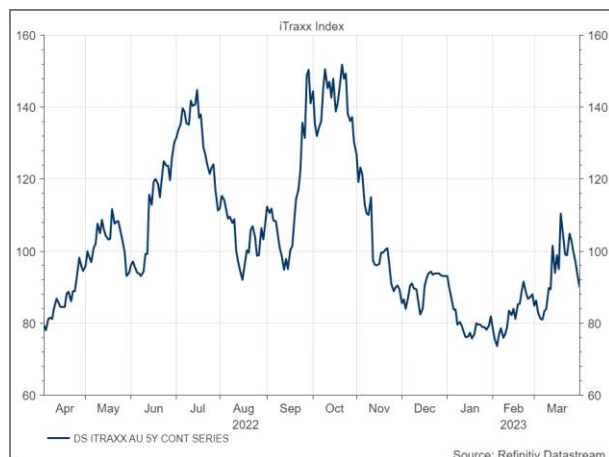
The lower yield level in the 3-year part of the curve is likely to reflect two factors:

- Natural bank demand for sovereign bonds of 3-year duration from banks that are required to hold them as part of their High Quality Liquid Asset requirements. This may be evident in fall in ES balances at the RBA in the months ahead.
- Forecasts that headline inflation will fall in the short term as the transitory factors abate. This may also push the RBA to pause rate increases until after the May Federal Budget.

Over the past month a lot has been written about the collapse of Silicon Valley Bank in the US and the ‘shotgun’ sale of Credit Suisse to UBS in Switzerland. In response to this and the increased recession risk later this year in Australia we expect credit margins will widen resulting in the price of the current crop of floating rate bonds, subordinated debt and hybrids falling.

To measure credit spreads, we would use three indicators:

1. The 5-year iTraxx index that measures the margins on a range of corporate borrowers (banks and non-bank corporates such as Qantas, Woolworths etc). Last year the index peaked near 150 when the market was forecasting a recession in the US and Australia in the March quarter of this year. When it became apparent that a recession was not going to occur in the first half of 2023 the index (and the credit margins it represents) contracted back to 77bps. It is reasonable to expect that once our banks and corporates return to issuing new debt (ANZ late in March successfully raised floating rate senior at 106bps and we expect other to follow in April) the iTraxx index will jump significantly, possibly back to where it peaked after the UK budget crisis last year. The second reason we expect margins to rise is that we still see a risk of a recession in both the US and Australia commencing by the December quarter of 2023. In any economic contraction credit risk rises in line with the risk of defaults rising.
2. Australian major bank 5-year floating rate margins provide the base case for margins as they are liquidly traded daily as part of the APRA regulated Highly Liquid Asset Requirement. Here we have seen margins peak near 120bps in early November and since then contacted to near 90bps before the Credit Suisse merger pushed them back up to 105bps. In the short term we would expect new 5-year floating rate bonds to be issued near 120bps and this will pressure all major bank bonds margins wider. If a recession eventuates then the major bank bond margins are likely to move wider still;
3. Changes to credit margins implied by the futures markets



Hybrids

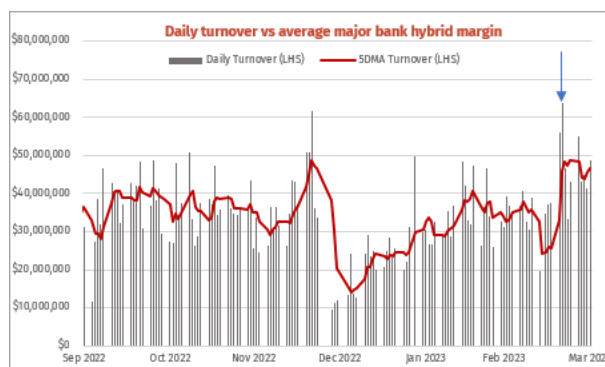
Banking crises are never good for hybrid securities no matter how much one argues that Australian banks are very secure. The quick insolvency of several US banks in early March rocked markets and impacted Australian bank share prices, which fell by 5% in the week after the news broke. Hybrid margins were mildly impacted, the average major bank hybrid margin rising by 0.20% to 2.50%. Hybrid margins has already risen off January lows, mainly due to anticipation of new issues.

However, the Credit Suisse (CS) crises struck at the heart of hybrids, with the CS's AT1 securities being evaporated and equity, albeit depressed, remaining. This news which unfolded over a weekend, shocked global hybrid markets and again, despite Australian banks being in a solid capital position, rocked the local hybrid market with the average spread jumping by 0.50% to near 3% in matter of days. Australian investors, rightly so, were examining the structure of our hybrids and whether such an event could unfold here. However, three factors prevented a large selloff:

1. Australian hybrids contain a conversion clause, which in the CS example would have resulted in CS hybrid holders being converted into equity. The CS hybrid did not.
2. Calming words from UK and European regulators regarding hybrids in a banking crisis, after being somewhat dismayed at how Swiss regulators had acted regarding the CS hybrid; and
3. The view that Australian banks are extremely well regulated and recently no suggestion of a rise in lending problems or large losses from activities, nor mismanagement of the balance sheet as apparent with the US banks. CS had suffered a trail of banking mishaps in recent years resulting in a string of large losses. Nevertheless, from an outsider's perspective, CS's capital position looked fine. The message is however, reported capital positions always lag reality especially in a banking crisis. We have seen this before.

The first chart below shows the average major bank hybrid margin over the past 12 months. The recent spike to near 3% as mentioned above was straight after the CS news (see arrow). Confidence quickly returned to the market once investors focussed on the reasons just outlined above. Chart 2 shows how turnover spiked in March, firstly as the situation unfolded and margins rose (see arrow), then the corrective phase where turnover was high with narrowing margins. The quick recovery was despite bank share prices lagging; however, they have since nearly caught up.

Nevertheless, Australian hybrid are not immune from bank stress and can ultimately be terminated if conversion cannot occur upon trigger events. Hybrids are fine for collecting income, however, will be strongly impacted at times of bank stress, whether this be from global factors as we have just seen, or a rise in debts that will affect balances sheets, profitability, and the ability to quickly raise capital. Hybrids are essentially a "peacetime" security. The payoff, like most debt, is asymmetric. But unlike a typical debt security, in liquidation, a hybrids terms may not allow an orderly extraction of residual value.



Sources: Arculus, Evans and Partners

Fund positioning

As we enter what we expect to be a highly volatile period for the Australian bond market, the Fund is positioned with a low fixed duration of 1 year and credit duration of 1.71 years. This low-risk approach reflects the enhanced interest rate and credit risk at this point in the monetary tightening cycle. Historically the Preferred Income Fund has had a credit duration of @3.5 years, however, even if we were optimistic about the economic outlook credit margins at current levels offer little value.

The Fund is positioned with the ability to increase either fixed duration if the forward outlook deteriorates or increase credit duration if the forward outlook improves.

The Fund has avoided bank Tier 1 securities over the past 12 months preferring Tier 2 debt that is trading near the same margins but with the certainty of the distribution being paid and a defined maturity date. Tier 1 securities need to be trading at least 70bps wider than Tier 2 securities given the fact they have more equity than debt characteristics when compared to Tier 2

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.

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