ARCULUS FIXED INCOME FUND
MONTHLY REPORT – SEPTEMBER 2023

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 30 September 2023 (annualised)

	1M	3M	6M	1Y	2Y	3Y	5Y	Since inception
Total Return	**0.34%**	**1.41%**	**2.05%**	**4.79%**	**-0.12%**	**-0.14%**	**0.82%**	**1.01%**
Cash Distribution	1.16%	1.17%	2.21%	3.75%	2.39%	1.94%	1.93%	2.00%
+/- Growth	-0.82%	0.24%	-0.16%	1.04%	-2.51%	-2.08%	-1.11%	-0.99%
Index	0.34%	1.08%	1.99%	3.56%	2.03%	1.36%	1.28%	1.37%

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

Australian index returns 30 September 2023

Index	1M Return	3M Return	12M Return
Bloomberg Australia Bank Bill Index	0.34%	1.08%	3.56%
Bloomberg Australia Gov't 3-5 Year Index	-0.92%	0.58%	1.74%
Bloomberg Australia Composite 0-3 Year Index	-0.06%	1.21%	2.85%
Bloomberg Australia Composite 3-5 Year Index	-0.82%	0.81%	2.73%
Bloomberg Australia Composite All Maturities Index	-1.53%	-0.28%	1.61%

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 and reaffirmed in February 2023.

Fund Size

As at 30 September 2023, the Net Asset Value of the Fund was $71,546,666.11.

Portfolio characteristics 30 September 2023

Running Yield	4.98%
Yield to Maturity	5.01%
Average Margin	0.87%
Average Years to Maturity	2.21
Number of Securities Held	41
Floating	76.52%
Fixed	21.09%
Cash	2.39%
Modified Duration	0.46
Credit Duration	0.91

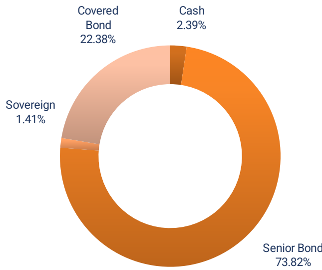
Fees

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

Asset breakdown

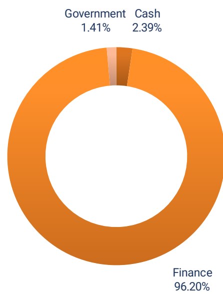
Sub Type Analysis

■ Cash ■ Senior Bond ■ Sovereign ■ Covered Bond



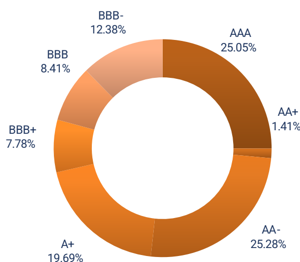
Sector Allocation

■ Cash ■ Finance ■ Government

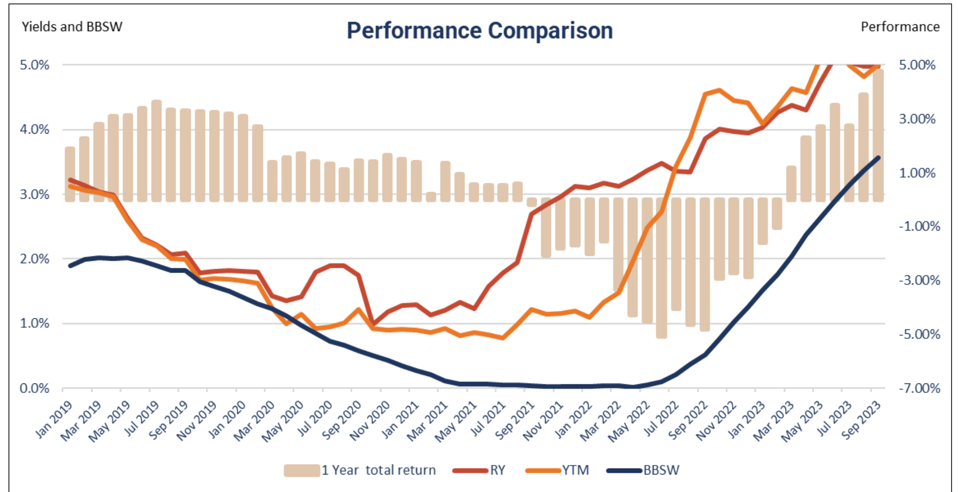


Credit Rating

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



Performance



Source Arculus, DDH Graham data

The Fund has returned a strong performance amidst the bond selloff since June 30 with its low duration approach to the current economic environment. Over the past month the net return for the fund has been 34 basis points (bps) in period where the All-Maturities bond index has fallen 153bps. Over the September quarter the Fund has a net return of 141bps. The focus has been on capital stability and providing investors with a consistent distributed yield.

Market review & outlook

The credit markets were eerily quiet in September given the rise in fixed bond yields, the pending US government shutdown and beat of the recession drums that notably has grown more distant. Australian senior credit margins as represented by the 5-year Australian iTraxx index widened modestly over the month.

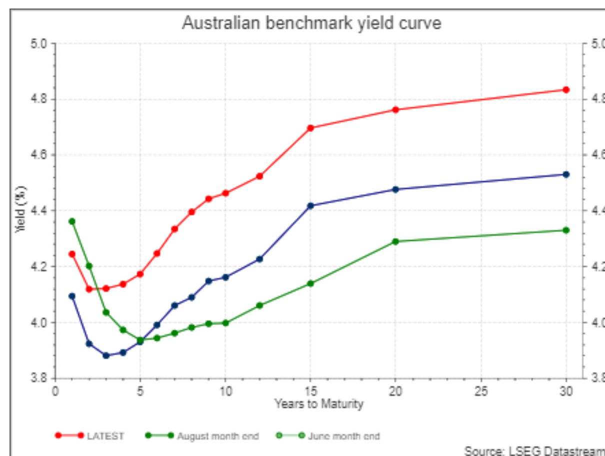
Major bank senior margins moved 2bps wider over the month.

1-year	+44bps
2-year	+63bps
3-year	+74bps
4-year	+85bps
5-year	+92bps

Fixed duration bond investors endured another sharp selloff since the end of August and more notably since June. The Australian benchmark yield curve was considerably flatter at June 30. The curve had turned inverse with the 2-year yield above the 10-year yield for the first time this economic cycle. This reflected the market consensus that the Australian economy would contract sharply in the second half of 2023. The yield curve did not remain inverted for very long because:

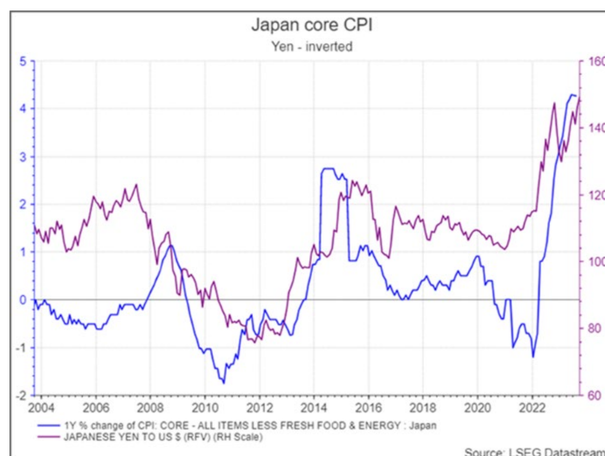
- Employment, government fiscal spending, and the trade surplus have kept the economic expansion intact.
- Wage growth has begun to increase and may grow faster than expected over the next few years under new industrial relations laws that will allow a degree of pattern bargaining. Wage growth not connected to increased productivity is inherently inflationary.
- The weaker Australian currency is a clear signal that monetary policy is not working.

The sharp steepening of the yield curve since June is signalling that inflation will be higher for longer. In the August monthly report, we explained this in more detail. Investors should refer to this report.



In addition to the inflation risk, fixed income investments may be impacted by a number of significant external events in the months ahead. The risks of these events unfolding needs to be appreciated when determining, firstly, the fixed duration of a portfolio, but then subsequently the impact on floating rate credit margins if a more severe economic contraction is triggered. Currently, we are following these known risks:

- Japanese inflation rising to a point where the Bank of Japan (BOJ) judges that it is sustainably above its 2% target. We view this as inevitable given the weakness of the Yen and the current reading above 4%, but the timing is less certain. If the **BOJ begins to tighten monetary policy and it abandons yield curve control** of its 10-year bond, then we are likely to see a selloff in all US dollar bloc bond markets as investors switch into Yen denominated Japanese bonds.



A sharp rise in Italian bond yields that will jeopardise the ability of Italy to remain part of the Euro currency scheme. Much like the UK budget under Truss, Italy is now forecasting a larger fiscal deficit of 5.3% this year from an earlier target of 4.5% (next year 4.3% versus 3.7%) set in April. Again, like the UK, part of the reason for the increased deficit is effectively a tax cut. In Italy the tax cut took the form of the super-bonus tax scheme, which was an ill-considered green incentive scheme, whereby renovations spent on improvements that made a property more energy efficient qualified for a tax deduction of 110%. Italy has a high debt level in a Euro zone context and given its GDP outlook. To date this has not been an issue for Italy but if the European Central Bank (ECB) needs to push the EU into a recession to bring inflation under control, Italy will then struggle to reduce its budget deficit or pay down its debt.

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Through September the margin between the Italian and German 10-year bond yields began to increase. Earlier this year the ECB had announced a policy of capping the margin between these bonds at 200bps, however, it has not been tested since by a market that has been focused elsewhere. The Italian budget outcome and increased borrowing requirements connected with it may push this margin above 200bps where there is a risk that the ECB does not follow through with its policy because of a conflict with its inflation fight at a Euro area wide level. Before a 14bps fall in the Italian 10-year bond yield on the last day of September the Italian-German bond yield spread was 198bps, and it still closed the month at 196.4bps. Just one month ago this spread was at 169bps.

Italian-German 10-year bond yield spread

Increased US Treasury supply is putting pressure on all global bond markets. The US Treasury has a heavy program of bond issuance over the next few months, to maintain the government funding requirement, and has still not yet restored the $550bn balance to the General Account of the Treasury that was run down during the debt ceiling negotiation period earlier this year. The rising tide of US Treasury issuance may at some point result in higher treasury bond volatility. One measure of US treasury bond volatility is the Move index.

US Treasury bond volatility needs to be monitored very closely at the moment. The Bank of England, the Bank of International Settlement, and the Federal Reserve have all recently highlighted that the short interest in Treasury futures has risen well above the level it reached in early 2020. The rise in short interest has occurred because hedge funds are deploying a strategy called the 'Basis Trade' whereby they buy a US Treasury at one price (e.g., $100), sell it in the futures market at a higher price (e.g., $100.50) and leverage this difference by also using the bought bond to borrow (e.g., $98) and again recycle this into the 'Basis Trade'. Hedge funds deploy this strategy ahead of downturn points in the economy where interest rates begin to fall and demand for fixed rate government bonds rises and causes the margin between the actual and futures price to contract. The problem the regulators are worried about is that if margins actually widen (don't contract) in line with increased Treasury market volatility, then unwinding the 'Basis Trade' will make the bond market dysfunctional in a similar way it did in March 2020 and briefly in 2008 after the Lehman's collapse. This is something that the Federal Reserve considered at the recent Jackson Hole Symposium with a paper written by Darrell Duffie, *'Resilience redux in the US Treasury market', Graduate School of Business, Stanford University, August 13, 2023*.

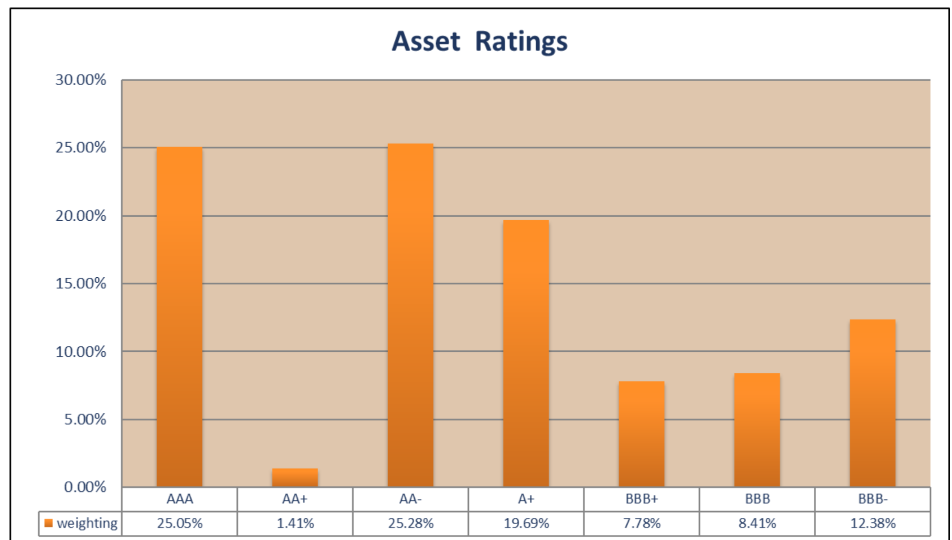
Fund positioning

The portfolio has been positioned for some time with a very low fixed duration of 0.46 years and a very low credit duration of 0.91. This has meant that portfolio returns have been mostly sourced from the coupon driven running yield. The focus has been on making consistent distributions to investors and minimising the capital risks wherever possible.

The Australian outlook for interest rates remains clouded by the uncertainty connected with the RBA mandate, interest setting decisions, and leadership, but more importantly by an uncertain economic outlook. It is by no means clear that an economic contraction sufficient to bring inflation back under control will occur sometime in the next 6-9 months and so, there is the potential for inflation to stay higher for longer and, in fact, begin to rise again with rising wages, not linked to productivity, feeding into services prices and final goods prices.

Prior to the breakout of the 5-year benchmark yield (see chart below) several of the fixed rate short duration holdings were sold and the fixed rate weighting of the portfolio reduced from 35% to 21%. This was a tactical move that resulted in the YTM dropping from 5.3% to near 5% and the running yield falling from 5.12% to 4.98% since the end of June. The aim would be to re-purchase these types of fixed bonds and lock in a YTM closer to 7%.

If inflation and official rates are going to remain higher for longer, and the economy continues to expand, then there is scope to increase the credit spread duration of the portfolio and with it the coupon driven running yield - increased credit spread duration will come from buying longer-dated floating rate bonds that have wider margins than shorter dated. There is also scope to increase the weighting towards "A-rated" securities and reduce the AAA holdings which also has the potential to increase the portfolio yield.



	AAA	AA+	AA-	A+	BBB+	BBB	BBB-
weighting	25.05%	1.41%	25.28%	19.69%	7.78%	8.41%	12.38%

Environmental Social and Corporate Governance

Our approach to ESG

Our ESG policy underpins Arculus' activities across all jurisdictions where we operate. It sets out our approach to sustainable purpose and forms the basis of our decisions by focusing on business ethics and compliance, people and culture.

Business ethics and compliance framework

At the core of this framework is strong governance and a robust risk and compliance framework.

This framework is supported by procedures and systems to ensure that we apply, at all times, high levels of personal and professional integrity. With the support of our risk and compliance functions we have put in place the necessary policies and procedures including a code of conduct and an initial assessment of the reputation of potential clients, identification and monitoring of our clients (through initial and ongoing screening of clients, ongoing reviews and transaction monitoring) as well as ongoing training of our employees, to ensure that the highest standards of compliance are embedded in the firm.

We will not enter into, or maintain, relationships with individuals or organisations engaged in, or suspected of having engaged in, illegal activities or activities that go against our code of ethics. The following is a list of considerations that we consider:

- **Environmental:** Population impact & Sustainability
- **Social Concerns:** Diversity, Human Rights, Consumer Protection, Animal Welfare
- **Corporate Governance Concerns:** Management Structure, Employee Relations, Executive Compensation, Employee Compensation
- **Business Continuity Concerns:** Short-term Strategies, Unknown Uncertainties.
- **Socially Responsible Investing:** Investment Strategies, Inward Investors, Principles for Responsible Investment.

People and culture

Fostering openness, sustainability, and respect are our key objectives. We value everyone and strive to work as one team. We invest significantly in our people and their working environment by creating and maintaining a safe and healthy working environment and ensuring their ongoing professional and personal development.

We strive to create workplaces in which there is mutual trust and respect and where every person feels responsible for the performance and reputation of our firm. We respect one another and each other's individual rights and customs. We work towards achieving a diverse workforce, recruiting, employing and promoting people only on the basis of objective criteria and the qualifications and abilities needed for the job to be performed.

We promote integrity and professionalism throughout the firm and pride ourselves in leading by example which we do by setting the right tone right from the top of our organisation. We consider ourselves to be personable and approachable and hold these attributes up as being key when putting our core values into actions.

Our approach to identifying, managing, and rectifying ESG risks within our business and supply chain.

Arculus is an investment manager that strongly believes and complies with the compliance principal of 4 eyes on every transaction conducted under all our discretionary mandates. As such its operations do not extend beyond being appointed as an investment manager by an external Trustee/Responsible Entity, person or corporation. Every transaction conducted under a mandate is externally viewed by Arculus as the Investment Manager, the Trustee/RE, Fund Administration and the Custodian. Mark to market valuations are done and reported to investors external to Arculus by Fund Administration.

We continuously engage with our people to translate our core values into action. We do this through communications and engagement, information, and consultation to assist them in realising their full potential.

As part of our continuous disclosure requirements as an AFSL to ASIC we identify and rectify all potential and actual ESG risks swiftly.

The pandemic has changed the way we work as a team. We now actively encourage work from home to minimise environmental impact via travel, meetings are held through online platforms where possible and all marketing materials are distributed online, avoiding all printing where possible. We do not have a glossy brochure, nor do we print reems of paper and where possible any materials; paper, ink, etc., are all sourced locally. We continue to push individual accountability to all our staff and associates.

We do not commit to any international standards, reporting frameworks, or initiatives that promote responsible investment/ESG practices.

Although we do not belong or pay for inclusion in an association that monitors ESG standards or frameworks we apply a framework that is consistent with many international bodies that monitor ESG standards. As we don't invest in the following industries our focus is on adherence to international labour use standards and workers' rights:

- Gambling.
- The Australian Power sector at both generation and distribution levels.
- Fossil Fuel mining (Coal, Gas, Oil, Uranium).

Policy and resourcing

Firm-wide investment policy that incorporates responsible investment/ESG considerations.

As an Investment Manager we employ the same ESG policies across all our mandates. We recognize that certain industries represent increased risk from not meeting prescribed ESG principles. This risk can be at a few levels:

- Government Regulatory changes.
- Access to capital markets.
- Market pricing reflecting community perceptions.

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 longer term businesses that employ the best people regardless of their gender, racial background or age tend to outperform. As part of this we would exclude any business that relies on a supply chain that utilises modern slavery.

Across all the discretionary mandates of Arculus there is no exposure to the following industries:

- Gambling.
- The Australian Power sector at both generation and distribution levels.
- Fossil Fuel mining (Coal, Gas, Oil, Uranium).

We do not chase higher short term returns by investing in offshore securities because of the increased risks that include currency but also regulatory differences that protect the Australian Financial System. Identifying inadequate governance practices is more difficult offshore when we don't fully understand the cultural practices. At an ESG level this means we don't consider sectors like Weapons, Tobacco, or Drugs.

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