# ARCULUS PREFERRED INCOME FUND
MONTHLY REPORT – SEPTEMBER 2023

DDH GRAHAM LIMITED | Arculus Funds Management

## 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 September 2023 (annualised)

| | 1M | 3M | 6M | 1Y | 2Y | 3Y | 5Y | Since Inception |
|---|---|---|---|---|---|---|---|---|
| **Total Return** | **0.43%** | **1.75%** | **2.50%** | **6.05%** | **1.90%** | **2.84%** | **3.12%** | **4.39%** |
| Cash Distribution | 1.43% | 1.45% | 2.76% | 4.98% | 4.15% | 3.80% | 3.70% | 5.35% |
| +/- Growth | -1.00% | 0.30% | -0.25% | 1.07% | -2.25% | -0.96% | -0.58% | -0.96% |
| **Index** | 0.34% | 1.08% | 1.99% | 3.56% | 2.03% | 1.36% | 1.28% | 3.35% |

*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% |
| ASX Bonds and Hybrids; All Issues incl. franking | 1.76% | 3.08% | 7.01% |

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 30 September 2023, the Net Asset Value of the Fund was $172,748,393.53.

## Portfolio characteristics 30 September 2023

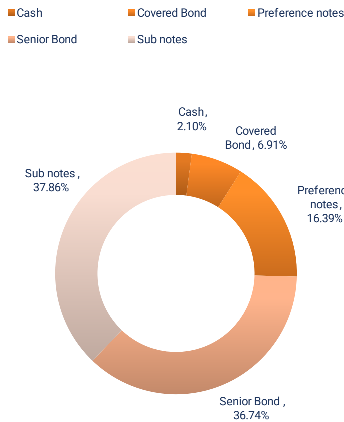
| | |
|---|---|
| Running Yield | 6.59% |
| Yield to Maturity | 9.53% |
| Average Margin | 5.39% |
| Average Years to Maturity | 3.14 |
| Number of Securities Held | 44 |
| Fixed | 24.42% |
| Floating | 73.49% |
| Cash | 2.10% |
| Modified Duration | 1.17 |
| Credit Duration | 2.17 |

## Fees

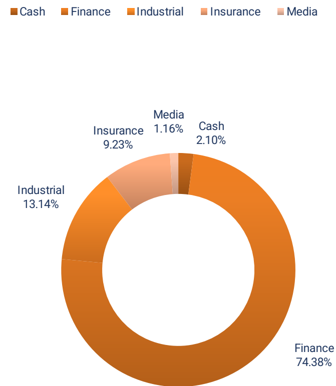
| | |
|---|---|
| MER | 0.82% |
| Buy/Sell Spread | +0.15% / -0.15% |
| Performance Fees | Nil |

## Asset breakdown

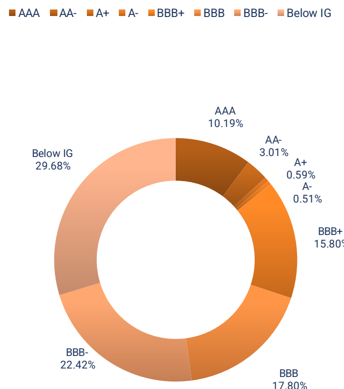
### Sub Type Analysis



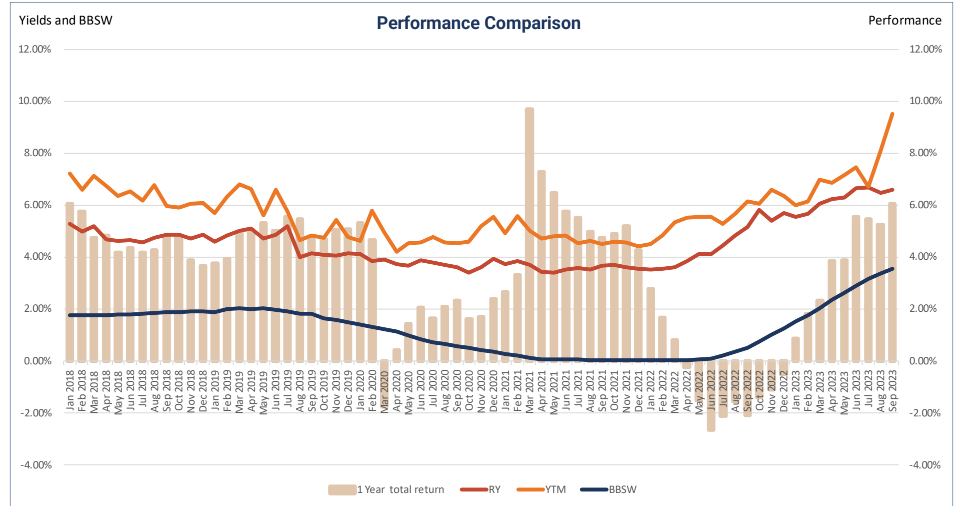

### Sector Allocation




### Credit Rating




## Performance




Source Arculus, DDH Graham data

The Fund had a solid September month with a net return of 43 basis points (bps) and 175bps over the September quarter. In a steady credit market, that we expect with an improved economic outlook, the Fund will derive all its performance from its coupon-driven running yield of 6.59% and the steady appreciation of capital value out to 2025 where the credit duration implies a YTM of 9.53%. This strong YTM is expected to deliver investors a more certain return outcome.

## Market review

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 have grown more distant. Australian senior credit margins, as represented by the 5-year Australian iTraxx index, widened modestly over the month.

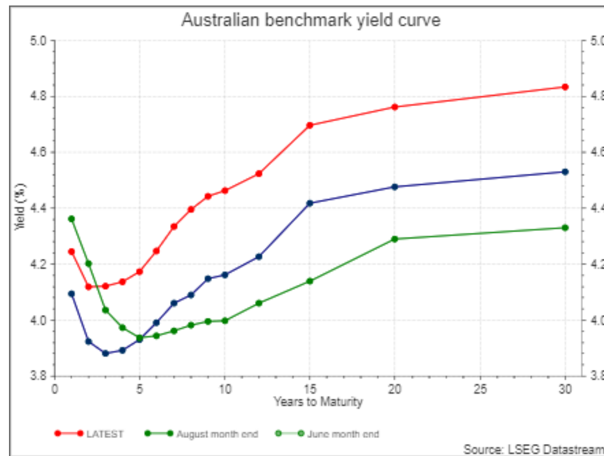
Major bank senior margins moved 2bps wider over the month.

| | |
|---|---|
| 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:

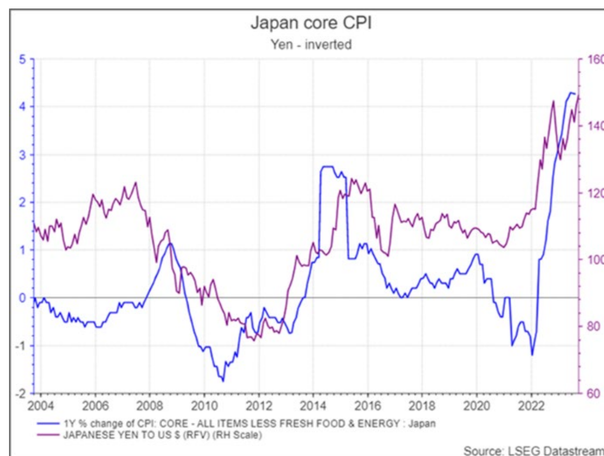
- Employment, government fiscal spending, and the trade surplus have kept the economic expansion intact.
- Wage growth has begun to increase and may grow faster than expected over the next few years under new industrial relations laws that will allow a degree of pattern bargaining. Wage growth not connected 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.

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

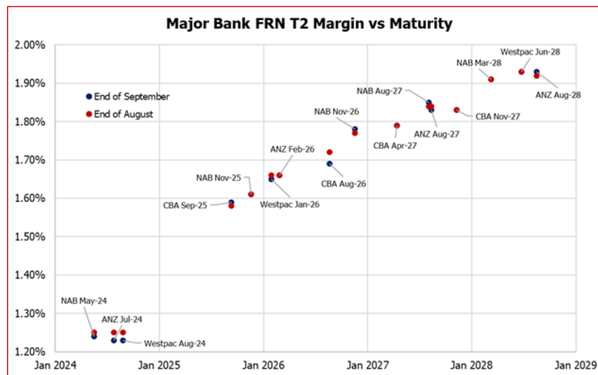
Increased US Treasury supply is putting pressure on all global bond markets. The US Treasury has a heavy program of bond issuance over the next few months, to maintain the government funding requirement, and has still not yet restored the $550bn balance to the General Account of the Treasury that was 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.*

**Subordinated bonds**

Tier 2 bond margins finished the month only slightly wider than August +189-190, however, during the month, margins moved out to +200bps in line with the rise in senior credit margins as depicted by the 5-year iTraxx index move. The only significant new supply of Tier 2 came from Suncorp, who issued $600m 10.75-year non call 5.75-year Tier 2 at a margin of 235bps that quickly traded into 225bps.




It is worth noting that longer dated Tier 2 issues – 15-year non call 10-year – are trading 25-30bps tighter now to six months ago when these longer dated bonds were issued by NAB and ANZ. This may encourage one of the other major banks to bring a 15-year non call 10-year issue to market in the near future. CBA is the most likely candidate to being a new 15NC10-year Tier 2 as they are the only major bank not to have done so in 2023.

Tier 2 bonds are traded now entirely in the OTC market with the maturity of the NABPE listed Tier 2.

Tier 2 or under APRA guidelines lower Tier 2, for regulatory capital purposes, has the following characteristics:

- Minimum term of 5 years (where most are 10-year non call 5 years).
- Interest rate payments are conditional only on the entity remaining solvent.
- Interest payments can be deferred but are then cumulative.
- Subordinated to all bank term deposits which are subordinated to senior bonds.
- Amortised over 5 years.

### Tier 1 hybrids

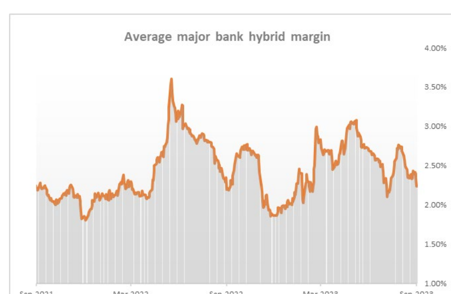
Most of September was characterised by a recovery in hybrid margins post the recent $1.25 billion NAB hybrid IPO in August. The average major bank hybrid margin contracted nearly 0.50% in September to finish at 2.24%. Below we examine this level vs the usual yardsticks of credit and equity markets. The Evans & Partners hybrid index closed up a huge 1.47%. However, towards month end APRA released a paper calling for submissions for a review they will be conducing into the role of hybrids (AT1 capital) in their role as providing capital support in banking crises. This review announcement has no immediate impact on secondary pricing except for currently unknown outcomes on which some participants of the market may be speculating, albeit way too early.

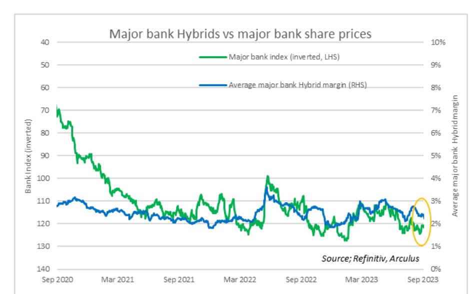
Of note is the contraction in margins in the week after the announcement. Of the 0.49% September contraction mentioned above, 0.19% occurred in the past week. Whether this was due to the APRA release or the $950m of NABPE redemption funds moving back into the market is unknown (note volumes were 10% above average from the redemption day September 20 - 25th, then 10% below average for the rest of the month!)

We discuss the APRA paper below; however, our conclusions are that there may be less hybrid issuance post the review. If there are changes to future hybrids that increase risks and restrict ownership, then new hybrids with higher dividends may force trading margins on current ASX hybrids higher. On the other hand, a scarcity factor may come into play if either the current crop of hybrids are the only ones retail investors can buy or if issuance going forward is reduced. Demand will keep prices up and trading margins low. Currently, secondary buyers should be careful jumping to a liquidity conclusion too quickly. If banks feel issuance will be more costly post the review, they will issue more of this cheap form of capital prior to the review being implemented.

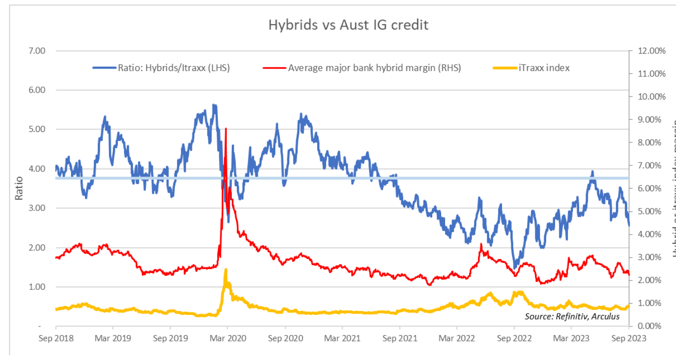
**Yardsticks**

Credit and equity markets wobbled in September with the iTraxx index rising by 0.10% to 0.876% and the Top 200 equity index falling by 3.5%. Equity market volatility rose overall, however bank implied volatilities have hardly moved. The chart at right shows recent weakness in bank stocks has been met with some strength in hybrid margins (see circle), however the relationship is not yet out of kilter. Nevertheless, if bank share prices fall with a weak equity market, hybrid margins will rise.



The third chart shows the ratio of hybrid margins to the iTraxx index has reversed in recent weeks; that is, hybrids are moving back into expensive territory versus general credit. The chart shows this trend can evolve further given the range this ratio displayed from March 2022 – March 2023. In September 2022 the ratio traded well under 2. Also shown in the chart are the individual time series components of this ratio. The iTraxx index in September 2022 traded well above 1% for many weeks with hybrid margins contracting. The point of this is to show that the opposite of what is expected to occur can prevail, usually driven by liquidity issues. Hence unless it's a violent move in credit wider, the iTraxx margin can rise and hybrids maintain their level.

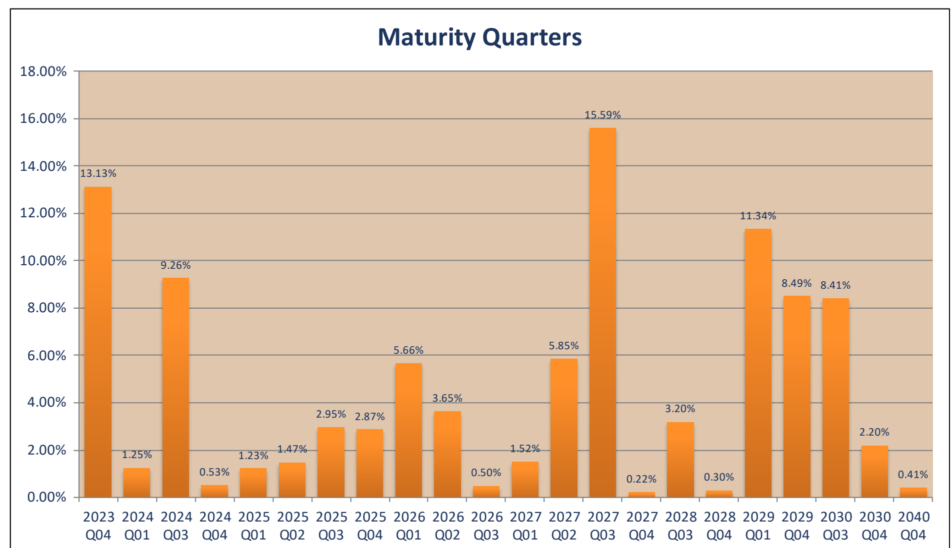



This brings us to the third driver of hybrid margin levels – liquidity and new issues. The recent NAB issue was an excellent example. In relatively steady equity and credit markets, the NAB issue with new paper at $1.25bn moved hybrid margins 0.40% wider within days, which then took five weeks to recover. Hence in the final quarter of 2023, the level of issuance will be critical to margin levels especially considering the APRA paper and discussion pieces from brokers and journalists. With margins looking reasonably tight right now and the recent NAB experience, issuance will be a vital price driver.

## Fund positioning

The Fund maintains a low fixed and credit spread duration. Consistent with this the cash weighting has been increased during the quarter in anticipation of new issues offering attractive yield in October. There is scope to derive a higher yield on the portfolio from shifting from AAA held bonds back into A rated senior or subordinated bank debt.

Profits have been taken on the ASX listed Tier 1 positions taken after the selloff that followed the recent NAB Tier 1 new issue. The release of an APRA discussion paper on the future structure of ASX listed Tier 1 securities has made investment in these types of securities less certain. Until this increase level of uncertainty is reflected in actual Tier 1 hybrid margins we will stand aside from the sector.



# 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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