

### Description/strategy

The Arculus Preferred Income Fund is a domestic fixed income portfolio invested in Australian Government and Semi-Government Bonds, Corporate Senior & subordinated Bonds, and cash. The Fund aims to provide unitholders with returns higher than cash and traditional debt securities over the medium to long term with a target rate of return of the 90-day BBSW rate plus 350bps. The return is a combination of income distribution and capital growth. The Fund does not employ leverage either directly or using derivatives and has no offshore currency, structured credit or leveraged securities. 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 29 February 2024 (annualised)

	1M	3M	6M	1Y	2Y	3Y	5Y	Since Inception
<b>Total Return</b>	<b>0.44%</b>	<b>2.16%</b>	<b>3.58%</b>	<b>5.71%</b>	<b>3.75%</b>	<b>3.05%</b>	<b>3.42%</b>	<b>4.46%</b>
Cash Distribution	0.00%	1.44%	2.91%	5.55%	4.50%	4.01%	3.78%	5.31%
+/- Growth	0.44%	0.72%	0.67%	0.15%	-0.75%	-0.96%	-0.36%	-0.85%
<b>Index</b>	<b>0.34%</b>	<b>1.09%</b>	<b>2.12%</b>	<b>4.10%</b>	<b>2.92%</b>	<b>1.95%</b>	<b>1.47%</b>	<b>3.37%</b>

\*Fund returns are net of all fees. 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 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.

### Australian index returns 29 February 2024

Index	1m Return	3M Return	12M Return
Bloomberg Australia Bank Bill Index	0.34%	1.09%	4.10%
Bloomberg Australia Gov't 3-5 Year Index	-0.24%	2.17%	3.43%
Bloomberg Australia Composite 0-3 Year Index	0.15%	1.47%	3.76%
Bloomberg Australia Composite 3-5 Year Index	-0.20%	2.29%	4.19%
Bloomberg Australia Composite All Maturities Index	-0.30%	2.59%	3.51%

The benchmark is the Bloomberg Australian Bank Bill Index. Bloomberg Index data is sourced from Evans & Partners.

### Fund rating

Initially rated 'Favourable' by SQM Research in December 2016, the Fund was upgraded to 'Superior' in December 2020 and retained annually. Last updated February 2024.



### Fund size

As at 29 February 2024, the Net Asset Value of the Fund was \$172,404,285.70.

### Portfolio characteristics 29 February 2024

Running Yield	6.94%
Yield to Maturity	9.18%
Average Margin	4.84%
Average Years to Maturity	2.73
Number of Securities Held	51
Fixed	24.33%
Floating	73.83%
Cash	1.84%
Modified Duration	0.62
Credit Duration	1.59

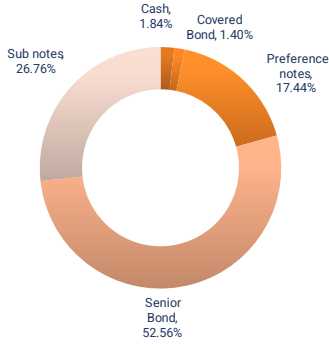
### Fees

MER	0.75% +GST
Buy/Sell Spread	+0.15% / -0.15%
Performance Fees	Nil

### Asset breakdown

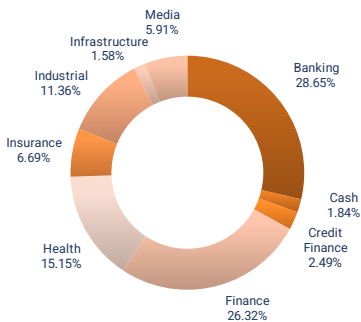
#### Sub Type Analysis

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



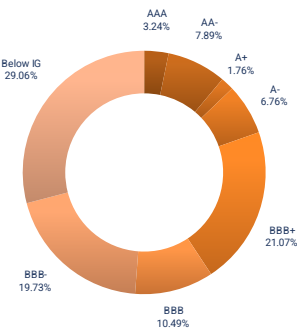
#### Sector Allocation

- Banking
- Cash
- Credit Finance
- Finance
- Health
- Insurance
- Industrial
- Infrastructure
- Media

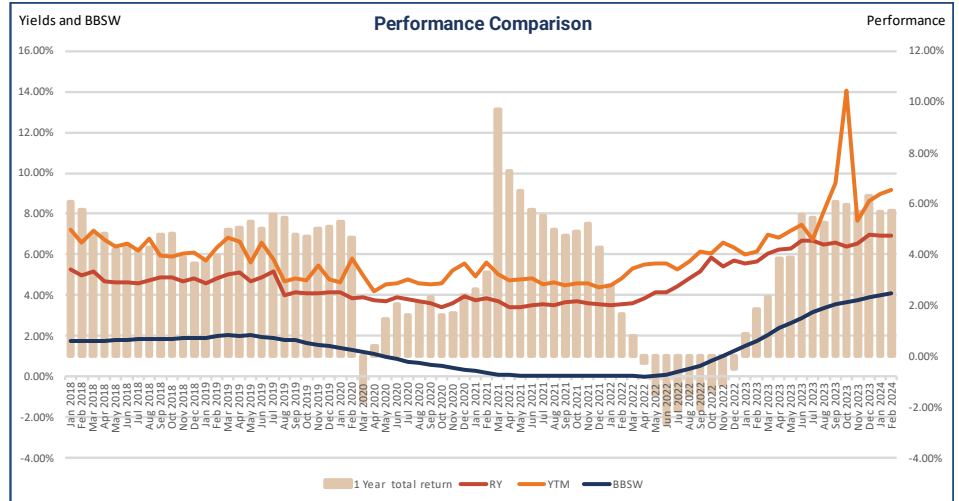


#### Credit Rating

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



### Performance

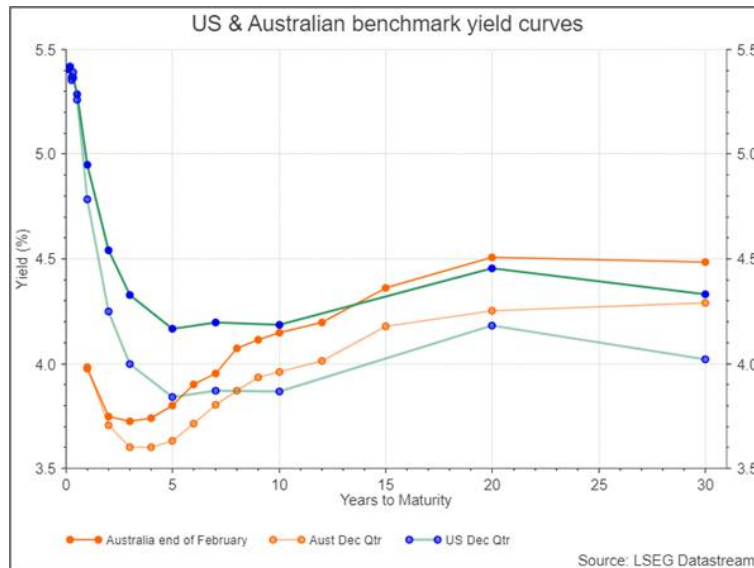


Source Arculus, DDH Graham data.

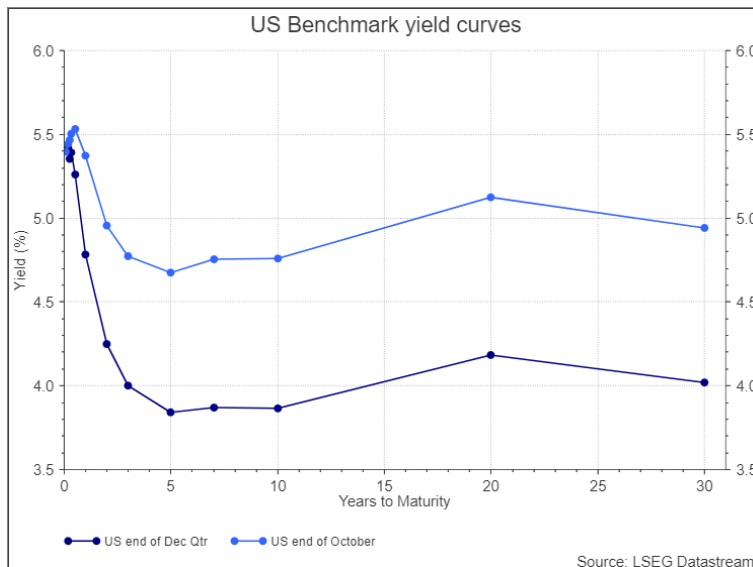
The Fund had a solid February with a net return of 44 basis points (bps) sourced mainly from coupons paid on holdings during the month. In a steady credit market, that we expect with an improving economic outlook, the Fund will derive all its performance from its coupon driven running yield of 6.94% and the steady appreciation of capital value out to 2025 where the credit duration implies a YTM of 9.18%. This strong YTM is expected to deliver investors a more certain return outcome. The investment management focus is to achieve this outcome with a lower level of volatility than the comparable peer group due to consistently applying our risk management framework to all investment decisions.

### Market review

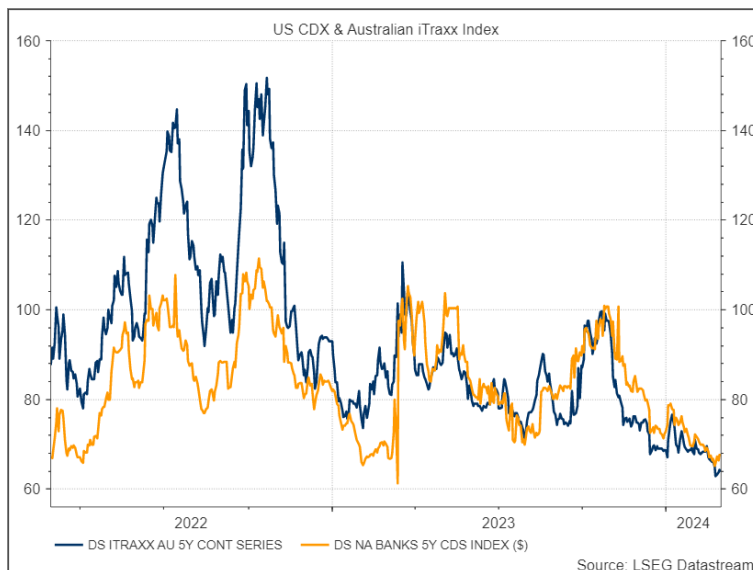
Since the end of the December quarter the Australian benchmark yield curve has moved in line with the ongoing shift higher of the US benchmark curve. This has been primarily driven by the fact that the robust US economic data continues to surprise the market and also increasingly by the increase in bond supply from the US Treasury that is responsible for the financing of the US debt program. The US money markets are still pricing six rate cuts this year, but the timing of them has been gradually shifting towards the second half.



As can be seen in the chart above the Australian benchmark Commonwealth 10-year yield has moved from trading at a 10bps premium to the US 10-year, to a 10bps discount in February. This shift in sentiment towards Australian 10-year may have been primarily driven by the increased supply of US longer dated bonds after the US Treasury shifted back to auctioning bonds after several months (November & December) of preferring the issue of short-dated treasury bills. The deliberate shift by the US Treasury from issuing bonds to bills in early November is seen by some market participants as the main reason for the fall in the US 5 & 10-year bond yield from near 4.76% in late October to near 3.87% at the end of December. This shift in the US yield curve between the end of October and the end of December can be seen in the following chart.



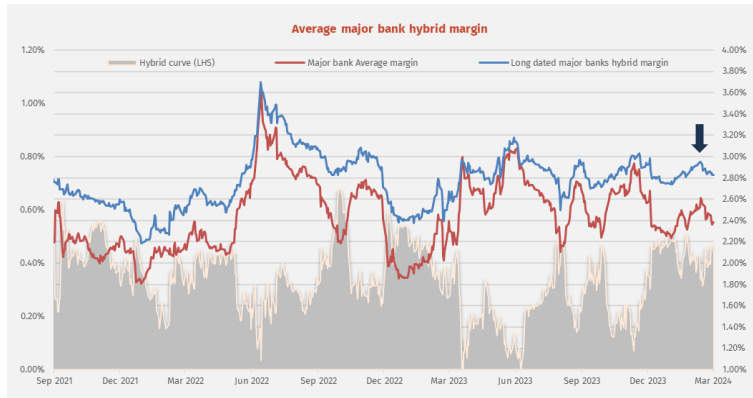
In line with the surging US equity market, credit default swap rates in the US contracted to the tightest levels seen in many years in February. Equally, the Australian 5-year iTraxx index declined to near lows last seen in early 2023 when strong buying emerged for credit when the economy had not contracted as forecast by most economists throughout most of 2022. The current margin levels in the US and Australia do not reflect market expectations that US or Australian economic activity is going to contract in the near to medium term. It is also worth noting that the credit margin contraction has occurred during a period where the market has absorbed a sharp increase in senior and subordinated bond issuance by the financial sector in both the US and Australia. In February there has been a record level of corporate bond issuance in the US and well above average issuance in Australia with the return to the market of mutual banks issuing senior repo bonds and the major banks being large issuers of subordinated Tier 2.



**Hybrids**

In February, Tier 1 hybrid issuance returned after the summer holiday period. Primary issuance was the dominating driver of margins in the month. ANZ flagged an issue in late January and finally announced the offer on Wednesday, 14 February. The ANZ offer was to replace the upcoming AN3PG (\$1.65bn) with a 22 March optional call date for ANZ. ANZ announced the offer size at \$1bn+, however the final volume was dependent on ANZ gaining a court win against the ACCC to buy Suncorp Bank. This approval was granted on Tuesday, 20 February and ANZ increased the offer size to \$1.70bn.

The chart below shows the average margin for long-dated major bank hybrids (to directly compare the new issues) and the average margin for all major bank hybrids. The arrow shows the timing of the ANZ issue and indicates the margin rise which we now regularly see at major banks' issue times. Both Westpac and ANZ pre-announced their intention to launch a new Tier 1, which resulted in the margins on the existing hybrid scheduled to be called contracting into the date at which it still qualified to roll into the new issue. After the ANZ issue, margins contracted, and the longer-dated hybrids moved almost back to January levels. This is a pattern we see regularly in the relatively illiquid ASX listed hybrid market where investment demand conspicuously tends to rise and fall around new issue dates.



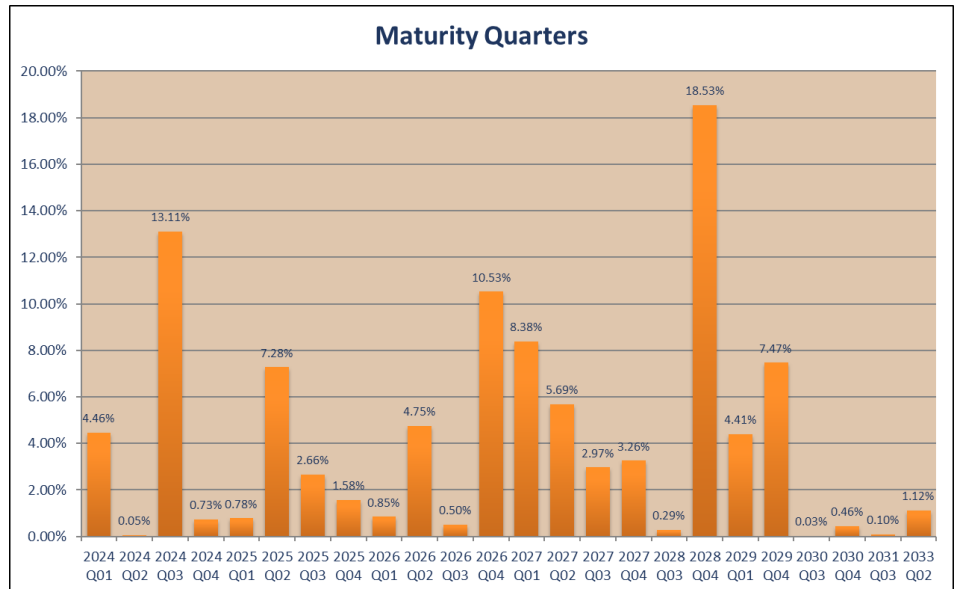
Source: Refinitiv, Arculus

Perhaps in March, but more certainly by the end of April, possibly just after the date at which CBA will announce if it is going to roll its scheduled Tier 1 redemption in April (March 26), APRA is expected to announce the results from the Tier 1 Discussion paper issued last November. (Investors interested in our response to this APRA Tier 1 Discussion paper are welcome to contact us for a copy).

### Fund positioning

The Fund remains positioned with a very low fixed duration of 0.62 and a modest credit spread duration of 1.59. Due to this low duration, performance will be driven by the portfolio’s coupon derived running yield of 6.94% in the short term and the YTM of 9.18% over the next 18 months.

At current margins, that have seen major bank and Macquarie Tier 2 subordinated debt trading at the tightest margins (5-year basis) seen since the GFC, we see little value in engaging with new issues when announced but have instead found better value in shorter dated Tier 2 major bank bonds in the secondary market. The Fund can also invest in the regional bank and mutual bank senior bonds that have been recently issued on margins between 160-185bps. This does not represent a significantly tighter margin to major bank Tier 2 offered at 195bps, and while mutual bank senior has similar liquidity to major bank Tier 2, it has a lower credit risk because it is repo eligible. The ability for a bank to sell a repo eligible bond back to the RBA at par value is not something we underestimate, even if it will only, truly, be tested in a crisis.



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