ARCULUS PREFERRED INCOME FUND
MONTHLY REPORT – APRIL 2024

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 30 April 2024 (annualised)

	1M	3M	6M	1Y	2Y	3Y	5Y	Since Inception
Total Return	**0.38%**	**1.44%**	**3.78%**	**5.82%**	**4.83%**	**3.11%**	**3.38%**	**4.47%**
Cash Distribution	0.00%	1.43%	2.91%	5.73%	4.82%	4.19%	3.85%	5.34%
+/- Growth	0.38%	0.01%	0.88%	0.10%	0.01%	-1.09%	-0.47%	-0.87%
Index	0.35%	1.07%	2.17%	4.24%	3.30%	2.19%	1.55%	3.38%

*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 30 April 2024

Index	1m Return	3M Return	12M Return
Bloomberg Australia Bank Bill Index	0.35%	1.07%	4.24%
Bloomberg Australia Gov't 3-5 Year Index	-1.26%	-0.73%	0.21%
Bloomberg Australia Composite 0-3 Year Index	-0.23%	0.37%	2.60%
Bloomberg Australia Composite 3-5 Year Index	-1.31%	-0.69%	0.88%
Bloomberg Australia Composite All Maturities Index	-1.98%	-1.18%	-0.73%

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.

Superior
SQM RESEARCH

Fund size

As at 30 April 2024, the Net Asset Value of the Fund was $165,559,186.26.

Portfolio characteristics 30 April 2024

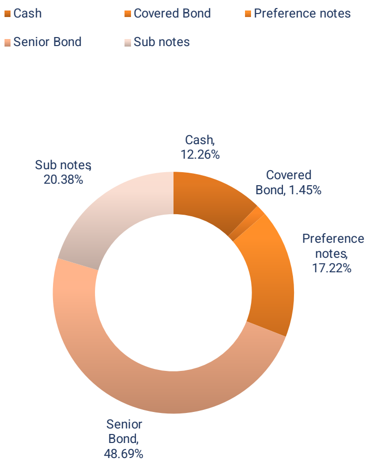
Running Yield	6.67%
Yield to Maturity	9.45%
Average Margin	5.05%
Average Years to Maturity	3.03
Number of Securities Held	55
Fixed	24.38%
Floating	63.36%
Cash	12.26%
Modified Duration	0.32
Credit Duration	0.66

Fees

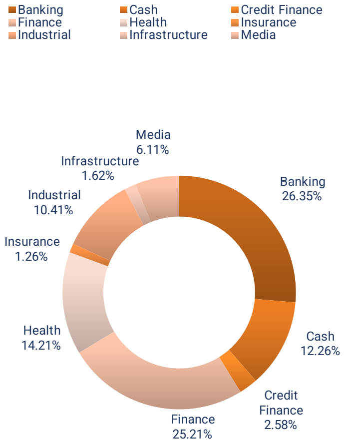
MER	0.75% +GST
Buy/Sell Spread	+0.15% / -0.15%
Performance Fees	Nil

Asset breakdown

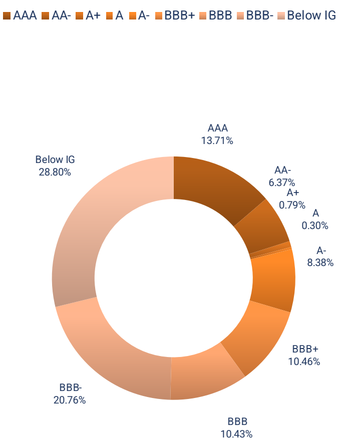
Sub Type Analysis



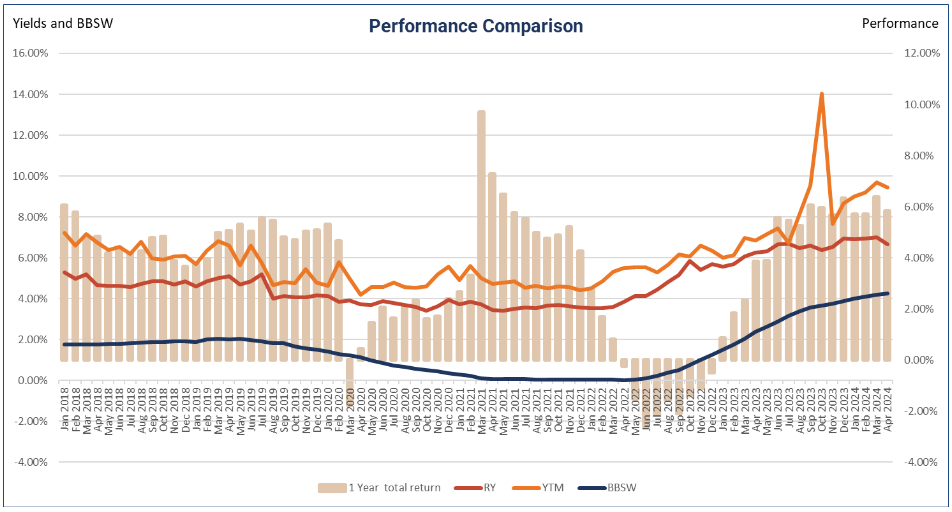
Sector Allocation



Credit Rating



Performance

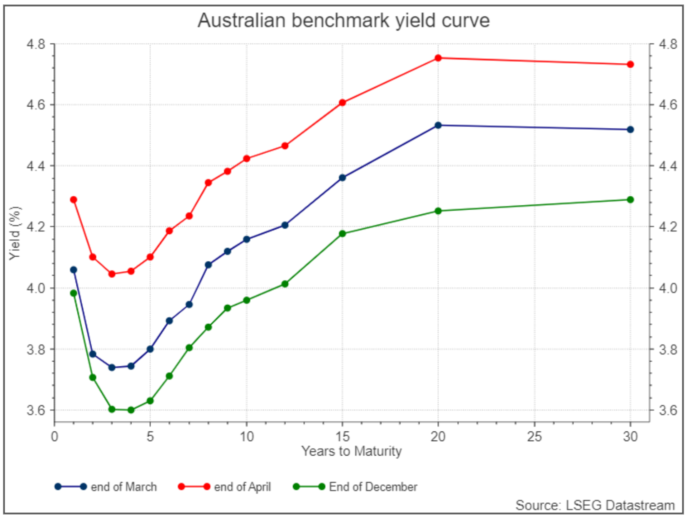


Source Arculus, DDH Graham data.

The portfolio's performance is currently driven by the coupon derived running yield as the holdings are almost entirely floating rate bonds. These coupon payments are not spread evenly across the entire quarter but occur mostly in the quarter's second half. This meant that the portfolio begins each quarter with a subdued performance and then has stronger returns in the subsequent months. The expectation remains that the portfolio will produce a performance approaching its yield to maturity of near 9%pa over the following 18-24 months.

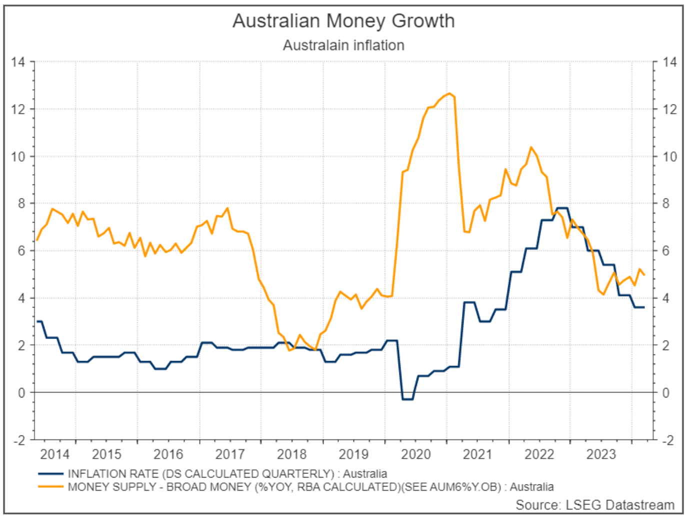
Market review

In April the market abandoned its earlier confidence in the RBA cutting rates by 3 times in 2024 to, at most, one cut later in the year. In fact, the shift in the benchmark yield curve is now suggesting that a rate rise may occur as early as May.



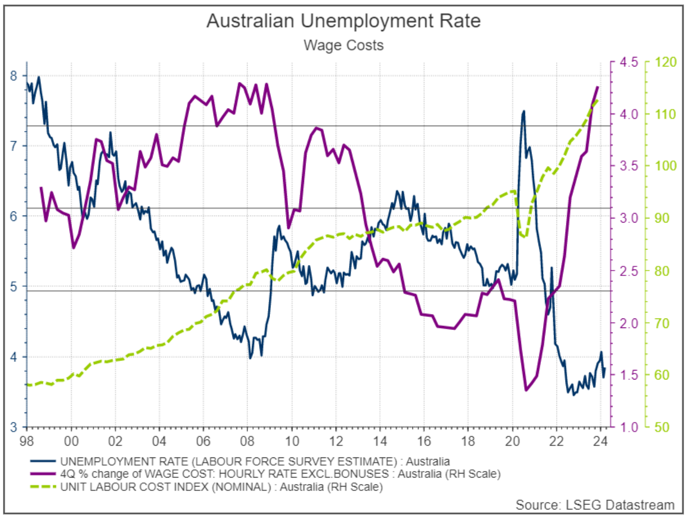
This dramatic change in the outlook for interest rates was fundamentally driven by the unexpected rise of inflation in March. Our view has consistently been that inflation will be higher for longer than the market expects, and this is driven fundamentally by both Monetary and Phillip Curve Theory.

According to Monetary Theory, the RBA has not yet done enough to reduce the rate of money growth if its intention is to reduce the rate of inflation. Broad money growth in Australia remains at an elevated level not consistent with reducing inflation. In the chart that follows we can see that broad money growth is near 5% in Australia. In the US and the EU money growth has been negative for some time.

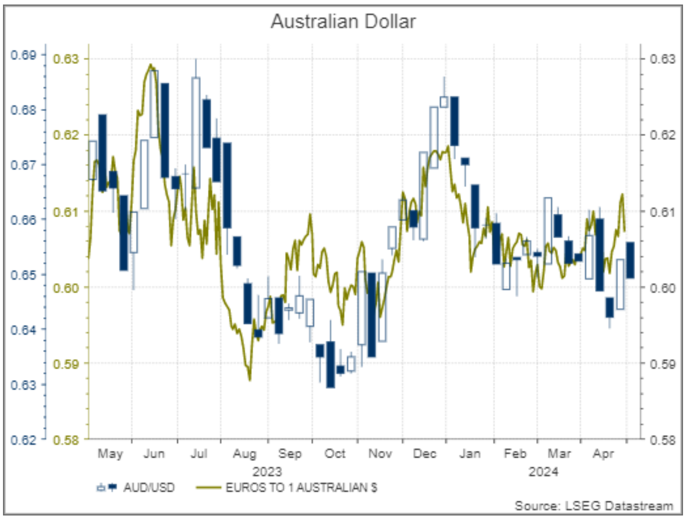


The following chart shows the inverse correlation between unemployment and wages growth as well as the Unit Labour cost index which accounts for labour productivity. Some economists realise that this rise in unit labour costs is going to be a big problem at many levels:

- In Australia there is a strong correlation between rising wages growth and inflation. Wages growth appears to be accelerating;
- Australian-based manufacturing will not be competitive with offshore produced goods;
- Company profitability will decline, which will reduce business investment that is needed to boost labour productivity.



If rates don't rise in Australia and inflation continues to rise, then the value of the currency will adjust to a lower level over time.



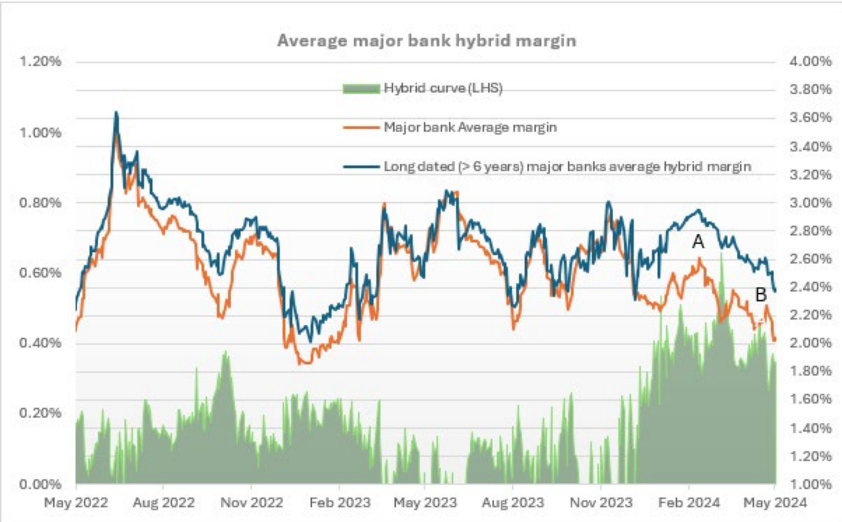
Hybrids

April began with the market in the final stages of digesting the three recent issues:

- ANZ's $1.7bn AN3PL issue (2.90% margin) trading from March 21
- Bendigo bank's $300m BENPI issue (3.20% margin) commenced trading March 26
- IAG's IAGPF $350m issue (3.20% margin) commenced on March 27 (see margin histories below).

The issue margins for the Bendigo and IAG issues were at historical lows. Suncorp was the fourth issuer in 2024, when in mid-April it announced a rollover for the June maturing SUNPG issue. $360m was raised to replace the $375m SUNPGs, hence a slight size contraction, reflecting the loss of the Suncorp bank AT1 requirements post the Metway Bank sale to ANZ. Again, the issue was at a record tight spread for the issuer Suncorp of 2.80%. Suncorp hybrids do show a pattern of margins, after 3-4 years, trading close to the comparative, by maturity, major bank hybrids (see below).

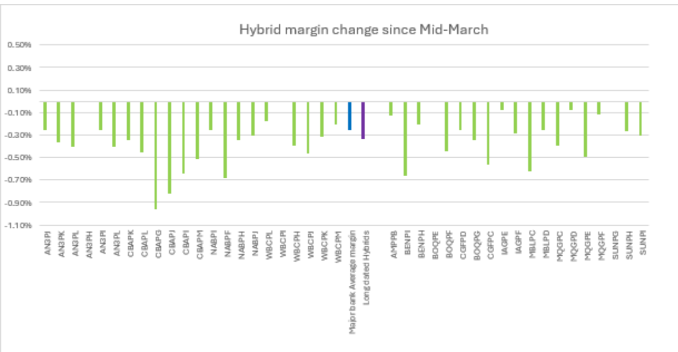
The market was surprised to be informed by CBA in mid-March that the bank was not considering a reinvestment offer for the $1.59bn CBAPH issue and instead opted for cash repayment on April 26. This decision may have been impacted by the timing of the expected APRA Tier 1 Discussion Paper update that was expected in April. It will result in hundreds of millions of hybrid-invested dollars being reinvested back into secondary market hybrid issues.



Source: Arculus Funds Management

The chart above shows the average major bank hybrid margin for all issues with more than 12 months to maturity and the average margin for issues with more than six years to maturity (to isolate long-dated hybrid margins). Also shown is the gap between these two margin time series which, in effect, is the steepness of the hybrid margin curve. The area noted "A" demonstrates how margins overall rose in anticipation and during pricing of the three issues announced in Feb-March as described above. Average long dated hybrid margins (blue line) moved wider to about 2.95% and the whole market margin (orange line) to about 2.60%. Subsequently margins fell. The continued margin contraction to (notation "B") shows the effect of the anticipation and then direct impact of the CBAPH funds hitting the market. The result after the cash was received and reinvested shows margins taking another leg down as buying demand soared.

The following chart shows the change in margins since the CBA announcement that CBAPH would not be rolled over. The whole sector has benefitted, including non-major bank issuers. However, the major beneficiaries have been the CBA issues, where margin contractions have been mostly over 0.50%.



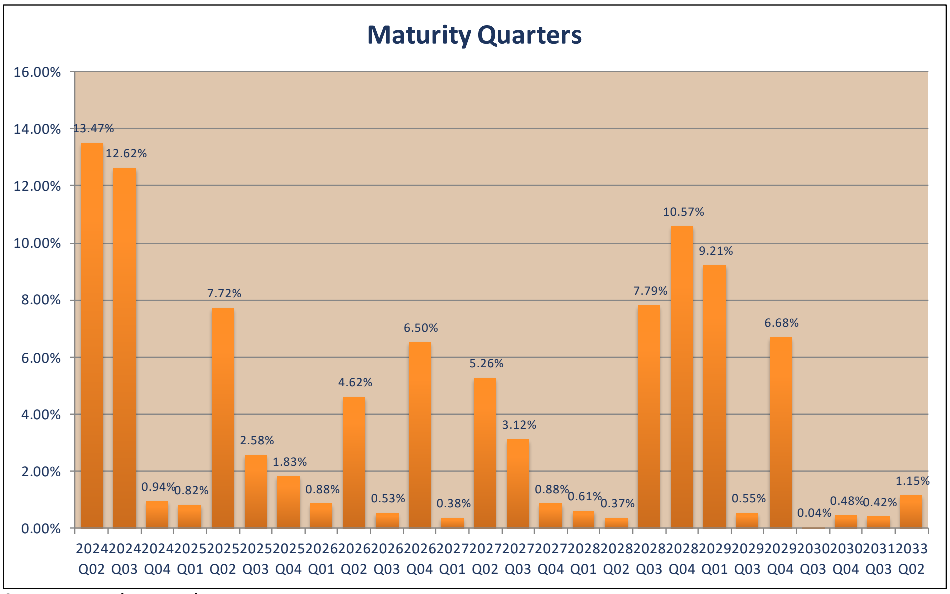
Source: Arculus Funds Management

The overall hybrid market yield is close to lows, whereas for longer-dated hybrids the yield is above lows of May and September 2023. This suggests that right now better value is found in longer dated hybrids, however, we are cautious and not buying as the whole market is being influenced by the CBAPH redemption funds, on top of the sector being already tightly priced. We expect that once the CBAPH funds are re-invested, hybrids will go back to being priced on the fundamentals of equity and credit markets. Additionally, as we have previously mentioned, new issuance also strongly affects pricing - we expect new issuance to resume in late May/June. The average major bank hybrid margin hit 2% in the first week of May. This is close to all-time lows since 2014 of 1.85%, a low level held only twice before and then only briefly.

Fund positioning

Very few changes were made to the portfolio in April. The strong margin contraction of Tier 1 and Tier 2 bank securities enabled profits to be taken and the cash weighting increased. The credit margin contractions have now reached a level that precludes investment in these types of securities. It is very difficult to forecast a positive 12 month return from either Tier 1 or Tier 2 securities despite the higher coupons than bank senior bonds. Our preference will increasingly favour holding senior bank bonds while maintaining an estimated yield to maturity above 9%pa over the next 18 months. We expect that being in liquid markets that have transparent pricing will be very important over the next 12 months.

The maturity profile shows that the Fund is positioned to be able to invest when either floating rate credit margins expand (due to increased economic risk) or fixed rates rise (due to increased inflation risk).



Source: Arculus Funds Management