

Strategy & Objective

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.

The fund aims 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 May 2024 (annualised)

	1M	3M	6M	1Y	2Y	3Y	5Y	Since Inception
Total Return	0.52%	1.53%	3.71%	7.12%	5.49%	3.10%	3.43%	4.48%
Cash Distribution	0.00%	1.43%	2.90%	5.80%	4.85%	4.19%	3.85%	5.32%
+/- Growth	0.52%	0.09%	0.81%	1.32%	0.64%	-1.10%	-0.42%	-0.84%
Index	0.37%	1.10%	2.20%	4.32%	3.48%	2.32%	1.59%	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 31 May 2024

Index	1m Return	3M Return	12M Return
Bloomberg Australia Bank Bill Index	0.37%	1.10%	4.32%
Bloomberg Australia Gov't 3-5 Year Index	0.31%	-0.18%	1.49%
Bloomberg Australia Composite 0-3 Year Index	0.38%	0.60%	3.37%
Bloomberg Australia Composite 3-5 Year Index	0.46%	-0.03%	2.19%
Bloomberg Australia Composite All Maturities Index	0.39%	-0.50%	0.87%

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 31 May 2024, the Net Asset Value of the Fund was \$165,169,594.91.

Portfolio characteristics 31 May 2024

Running Yield	6.73%
Yield to Maturity	9.55%
Average Margin	5.20%
Average Years to Maturity	3.15
Number of Securities Held	57
Fixed	25.19%
Floating	68.85%
Cash	5.96%
Modified Duration	0.34
Credit Duration	1.91

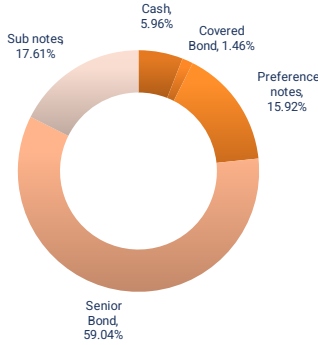
Fees

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

Asset breakdown

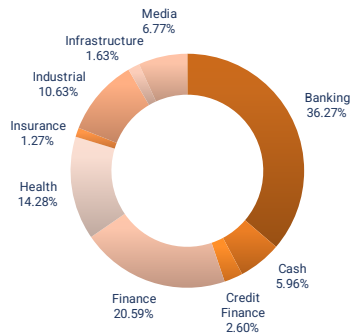
Sub Type Analysis

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



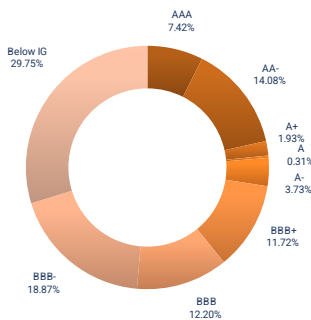
Sector Allocation

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

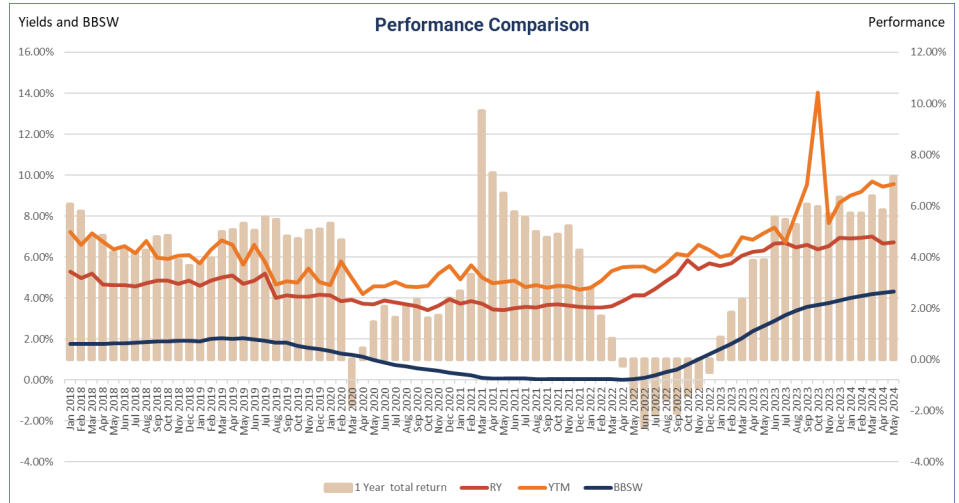


Credit Rating

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



Performance



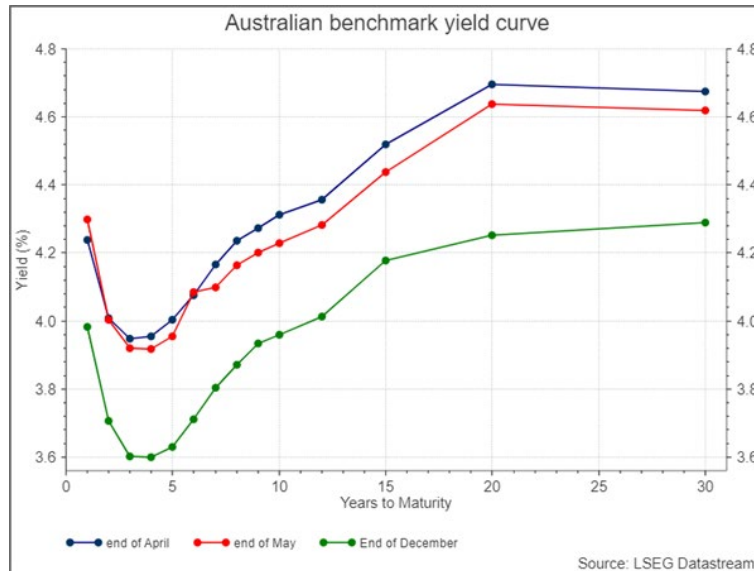
Source Arculus, DDH Graham data.

The Preferred Income Fund recorded another steady month of returns in what was, a more volatile market environment. Performance is being primarily driven by the strong running yield of 6.73% which is drawn from the floating rate coupons. As at the end of May the Fund achieved a return (after all fees) of 7.12%. Over the next 12 months, as shorter dated securities mature, the rolling 12-month return is expected to increase towards the portfolio's yield to maturity.

Market review

The Preferred Income Fund has a wide investment universe that enables funds to be shifted from fixed income to floating credit, sovereign to corporate debt and a range of subordinated debt. Although we are not consistently investing in any one of these types of securities, we continuously monitor them as part of our ongoing market review process.

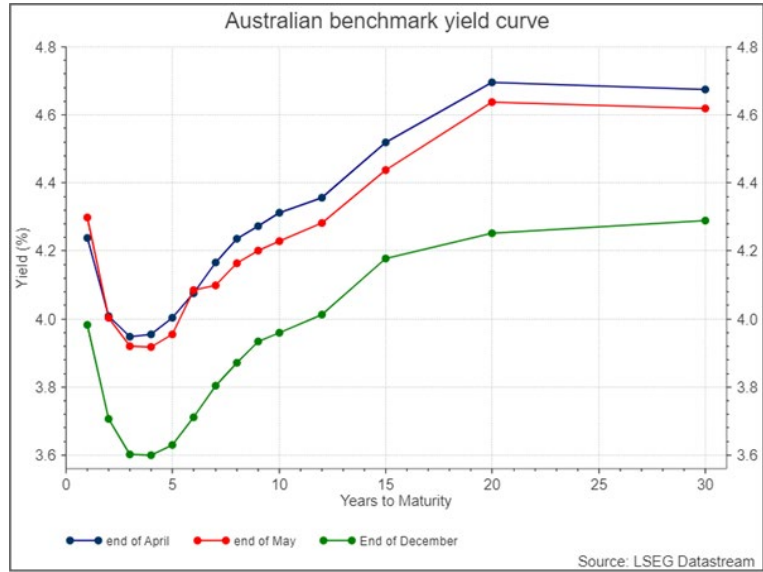
Sovereign bonds



Source: LSEG Datastream

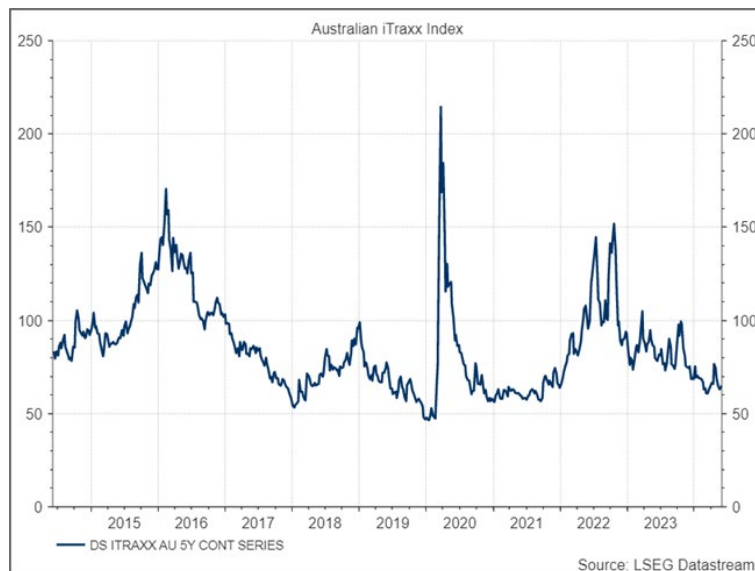
Unfortunately, not all sovereign bonds are equal. In Australia the benchmark yield curve represents the yield on Commonwealth treasury bonds which is rated AAA. Relative to the Commonwealth bonds the state government issued semi-government bonds trade at a premium that reflects the state government's underlying fiscal position. Not all semi-government bonds are equal, however, because the fiscal positions vary considerably which is reflected in the debt rating agencies' assessments (Fitch, S&P, Moodys). The market does not always reflect these risk differences in the traded yields of semi-government bonds even though there is currently a difference between the rating agency published ratings of each state. Investors have tended to treat the risks of every semi-government bond to be equal because Australia has not suffered a recession since 1992. Even without a recession, we expect that over the next 12 months, the ratings agencies will begin to downgrade Victoria's state debt into the 'A' band and that the outlook for other eastern Australian states will have a negative watch outlook. At this point we expect that the market will no longer treat the risks of different state government issued bonds as being equal.

The Australian benchmark curve yield curve finished the month of May largely unchanged from April despite a range of disparate data being released and the Federal Budget announcement.



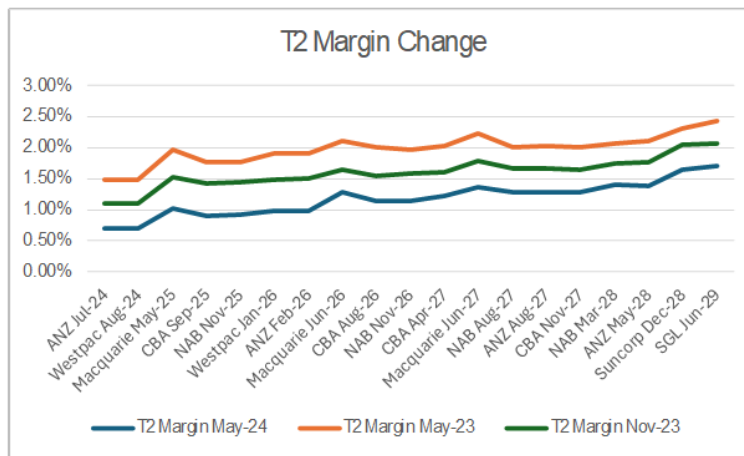
Bank senior bonds

Supply from new bank senior bond issues was relatively light in May when compared to April. The regional and mutual banks that issued in April were largely absent in May. Credit margins on all bank senior bonds remained near the tight levels seen in April due to increased demand, however, it has becoming evident that investors are now looking for value. With issuance slowing and global macro volatility increasing over the month, investors have started to show restraint and composure, especially with credit spreads at multi-year tight levels. This is a highly liquid universe of bonds because the bank senior bonds issued by authorised deposit-taking institutions (ADIs) are part of the Highly-Quality Liquid Assets that APRA requires all banks hold to have sufficient liquid assets to meet deposit withdrawals for any 30-day period. The banks trade these bonds daily as their liquidity requirements change and they can be taken to the daily RBA window where the cash funds are returned to the banks through their exchange settlement account with the RBA.



APRA-regulated Tier 2 securities

Tier 2 securities are traded in the Over the Counter (OTC) market. They have distributions that are not deferrable (like Equity or Tier 1 securities) and have a defined maturity date. They form part of the Total Loss Absorbing Capital mandated for all financial institutions. Tier 2 securities have a much lower degree of liquidity than senior bank bonds because banks are not required to hold Tier 2 securities on their balance sheet as part of managing their capital liquidity needs. The following chart illustrates the change in the floating rate traded margin for a number of Tier 2 securities issued by Australian institutions. Margins on shorter dated Tier 2 have contracted by more than for the longer dated bonds. This can be explained by the demand and supply functions of the Tier 2 universe. We know that Regulatory Tier 2 supply is increasing because APRA increased the minimum Tier 2 capital requirement from 3% to 4.5% (increase is systemic risk buffer) in December 2021 with the banks given four years to comply. The margin contraction has then been driven by an increase in demand, principally from fund management and ETF mandates that include Tier 2.



Source Arculus Funds Management

Over the month of May Tier 2 margin contraction slowed to @3 basis points with new demand met by NAB issuing \$1.25bn of 15-year non-call 10-year fixed rate Tier 2 securities.

APRA-regulated Tier 1 securities

By definition, a Tier 1 security under the Basel and APRA rules is the first tier of capital that absorbs losses from either specific or systemic events. The Arculus Preferred Income Fund mandate includes Tier 1 securities but does not extend to ordinary (common) equity.

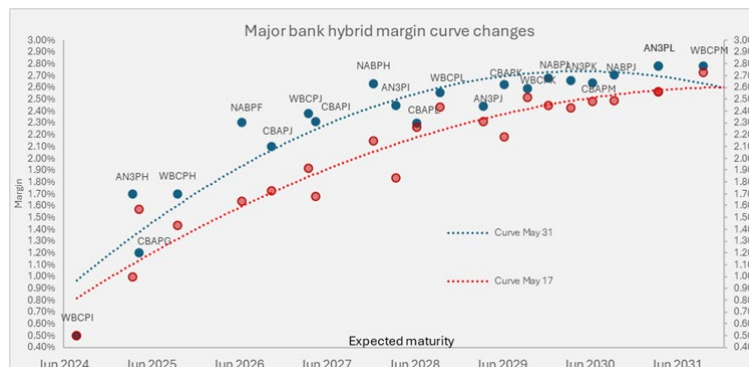
Tier 1 Regulatory Capital comprises:

- Common Equity Capital
- Additional Tier 1 capital (AT1)

Tier 1 Regulatory Capital must have the following characteristics:

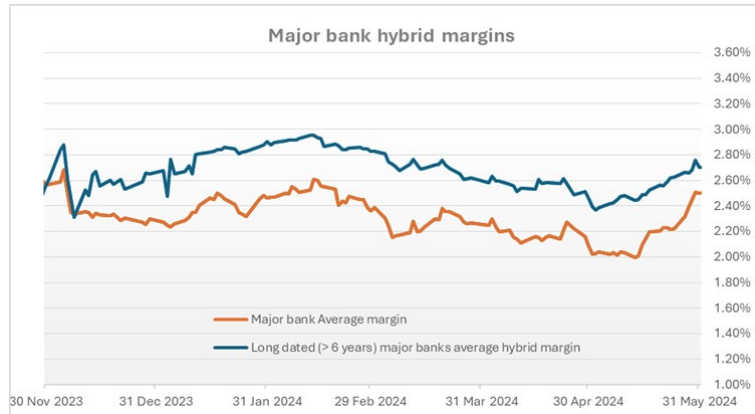
- Provide a permanent and unrestricted commitment of funds
- Distributions must be discretionary
- Rank behind the claims of Tier 2, depositors and senior debt providers in the event of a winding up of the entity.

Most of the Regulatory Tier 1 capital issued by Australian banks is listed on the ASX (Common Equity & Tier 1). For a range of reasons ASX listed Tier 1 securities have a poor degree of liquidity with average daily total ASX volumes near \$30 million. This can mean that the ASX listed Tier 1 sector traded margins are more volatile than Tier 2 securities and senior bonds. In May we saw a good example of this when, despite credit and equity markets remaining strong, hybrid margins moved wider as investors sold stock to fund the new \$1bn NAB hybrid issue. The following chart illustrates the margin changes from the trading day before the NAB issue was launched (red dots) to the end of May (blue dots and labels). Most of the curve has been affected, especially in the middle, which is unusual, as typically funding selling is seen in short dated and longer dated issues.



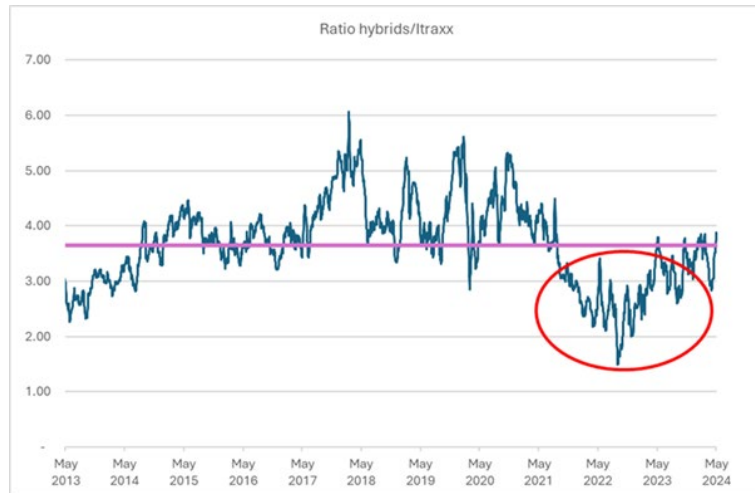
Source Arculus Funds Management

The following chart shows the average change in Tier 1 margins for the major banks. A distinction is drawn here between the average margin of all major bank Tier 1 securities and those with first call dates longer than six years.



Source Arculus Funds Management

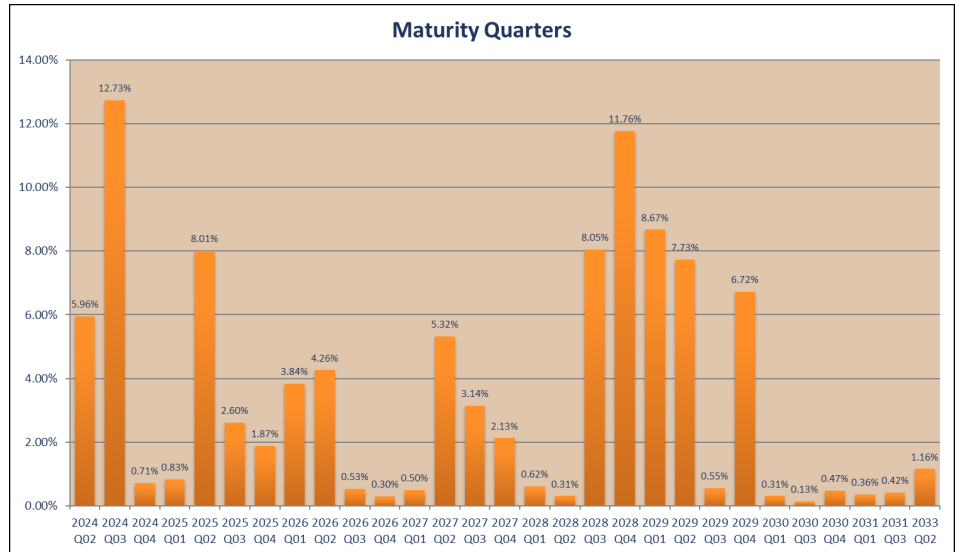
Hybrids are priced off the general levels of both credit and equity markets as well as liquidity factors. The chart below shows the average major bank margin vs the Australian credit market, represented by the iTraxx index (a measure of the average margin of the top 25 Australian investment grade company bonds). A simple ratio of hybrid margins/iTraxx gives a good relative measure over time. The long-term average back to 2013 just after Basel III/IV hybrids were introduced is 3.65x (purple line), below the latest reading is at 3.88. The large rise in hybrid margins discussed above has pushed this ratio above the long-term average. Prior to 2023, it looked like this ratio was in a new trading range (as circled) well below that of the previous decade, reflecting that hybrids had possibly been “re-rated” in the time of rising rates, the ratio then having a range of about 2.00-4.00 rather than the long-term range of 2.00-5.50. Note that this ratio is quite volatile. Essentially this is because hybrid margins tend to move rather than the denominator, the iTraxx index, which has been quite steady in 2024.



Source Arculus Funds Management

Fund positioning

Overall, the Fund retains a low fixed duration and low credit spread risk position. 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

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