

Strategy & Objective

The investment strategy of the Arculus Fixed Income Fund 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 of the 90-day BBSW rate plus 150bps. The Fund is best suited to investors who seek a low to medium risk investment over a 1 to 3-year period.

The Fund aims 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 31 August 2024 (annualised)

	1M	3M	6M	1Y	2Y	3Y	5Y	Since inception
Total Return	0.41%	1.43%	3.00%	6.22%	5.04%	1.71%	1.37%	1.73%
Cash Distribution	0.00%	1.16%	2.30%	4.73%	3.79%	2.85%	2.25%	2.24%
+/- Growth	0.41%	0.27%	0.70%	1.48%	1.26%	-1.14%	-0.87%	-0.51%
Index	0.38%	1.11%	2.22%	4.39%	3.88%	2.69%	1.75%	1.78%

* 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 16 November 2017.

Australian index returns 31 August 2024

Index	1M Return	3M Return	12M Return
Bloomberg Australia Bank Bill Index	0.38%	1.11%	4.39%
Bloomberg Australia Gov't 3-5 Year Index	1.02%	2.92%	4.98%
Bloomberg Australia Composite 0-3 Year Index	0.61%	1.72%	4.54%
Bloomberg Australia Composite 3-5 Year Index	1.05%	3.10%	5.54%
Bloomberg Australia Composite All Maturities Index	1.21%	3.50%	5.15%

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 2018, the Fund was upgraded to 'Superior' in December 2020 and retained annually. Last updated February 2024.



Fund size

As at 31 August 2024, the Net Asset Value of the Fund was \$64,617,630.07.

Portfolio characteristics 31 August 2024

Running Yield	5.76%
Yield to Maturity	5.40%
Average Margin	0.90%
Average Years to Maturity	2.76
Number of Securities Held	24
Floating	87.75%
Fixed	10.33%
Cash	1.93%
Modified Duration	0.17
Credit Duration	1.40

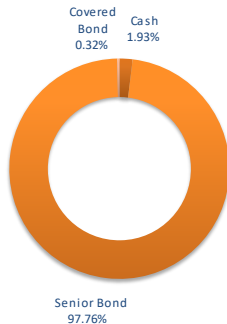
Fees

MER	0.368% + GST
Buy/Sell Spread	+0.10%/-0.10%
Performance Fees	Nil

Asset breakdown

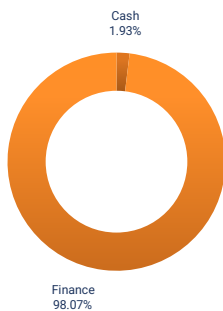
Sub Type Analysis

■ Cash ■ Senior Bond ■ Covered Bond



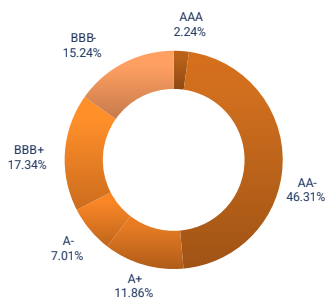
Sector Allocation

■ Cash ■ Finance

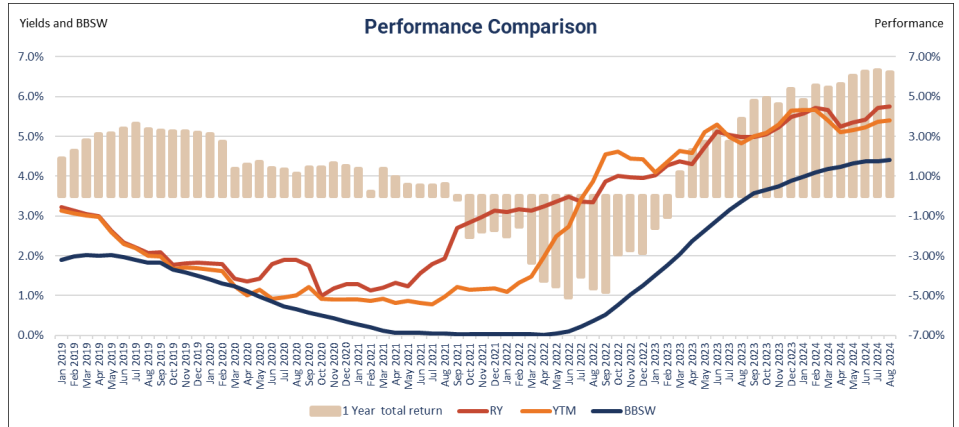


Credit Rating

■ AAA ■ AA- ■ A+ ■ A- ■ BBB+ ■ BBB-



Performance



Source Arculus, DDH Graham Limited data.

The portfolio delivered a solid 41 basis points in July driven by coupon payments. This return should be judged in terms of its highly liquid and low-risk nature of the mandated bond universe that holds only APRA-regulated senior bonds and sovereign debt. The current running yield of the portfolio is expected to increase over the next few months with several maturities affording the reinvestment to new senior bank bonds at better yields.

Market review & outlook

All bank economists and politicians are biased to seeing interest rate cuts. The banks' business model is to borrow short and lend long and well, politicians just want to hold onto power. Then there are the fund managers that fall broadly into two competing camps:

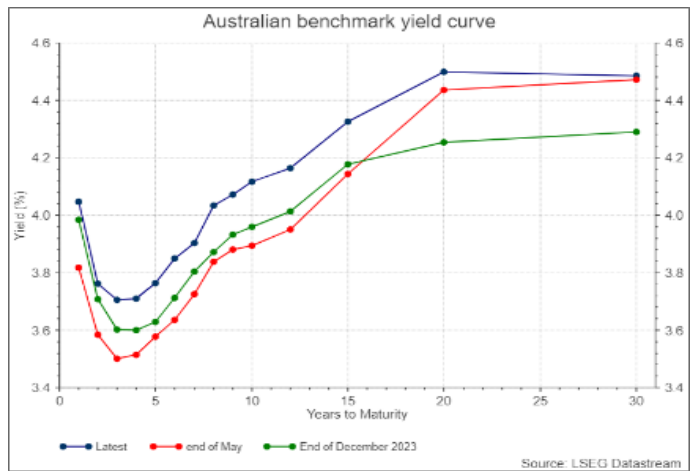
- Long duration fixed rate bond managers.
- Credit funds holding floating rate bonds and other debt-like securities.

One side is screaming a recession is imminent and inflation is under control and the other is yelling that you need to stay in floating rate credit because the economy is still robust, and inflation remains a risk. There is, however, a problem with both right now because credit margins have contracted into a very tight level even with a belief that economic growth is about to accelerate, and inflation will keep falling.



There are then two problems with taking a long duration approach to the fixed income asset class at the moment:

1. Inflation in Australia is at risk of rising in the year ahead.
2. The fall in the bond yield curve is mostly due to the fall in the US bond yield curve, therefore, most of the possible gains have already been priced into bond values. This can be seen in the following chart that shows the yield curve in May and the yield curve now. The market is back to a yield curve very near to where it began 2024 when it was predicting seven rate cuts during the year in the US and at least four in Australia (currently there are three rate cuts priced into the short end of the Australian curve before year end).



Investors in long credit funds are at risk of a margin expansion and investors in long duration are at risk of inflation rising and the Australian yield curve shifting back to where it was only at the end of May.

Inflation Outlook

Despite the narrative that inflation at a headline CPI level will fall to the RBA 2.5% target and force an official interest rate cut this year, we still see a higher probability of another interest rate increase in this cycle and more importantly the RBA holding rates at a higher level than expected for a considerable period of time.

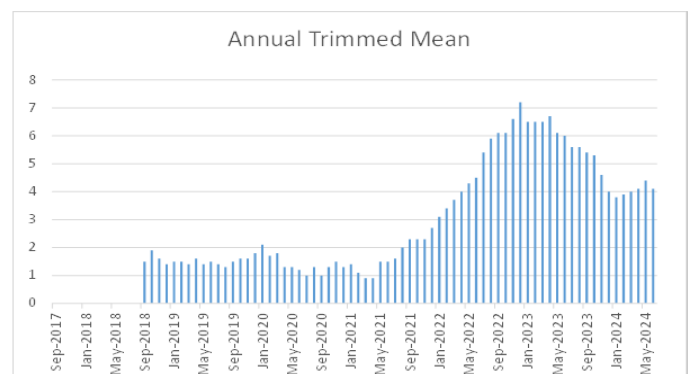
The following tables were assembled with data provided by the ABS. [Monthly Consumer Price Index Indicator, July 2024 | Australian Bureau of Statistics \(abs.gov.au\)](https://www.abs.gov.au/australian-bureau-of-statistics)

Weighted average of eight capital cities, annual movement	May 23 to May 24 % change	Jun 23 to Jun 24 % change	Jul 23 to Jul 24 24 % change
All groups monthly CPI	4.0	3.8	3.5
Food and non-alcoholic beverages	3.3	3.3	3.8
Alcohol and tobacco	6.7	6.9	7.2
Clothing and footwear	2.8	3.6	1.9
Housing	5.2	5.5	4.0
Furnishings, household equipment and services	-1.1	-1.1	-0.9
Health	6.1	5.3	5.3
Education	5.2	5.6	5.6
Insurance and financial services	7.8	6.4	6.4

The headline CPI shows a declining pattern from 4% in May to the current July reading of 3.5%. A great deal of caution needs to be used when relying on the monthly data because the ABS does not yet consistently survey all the CPI basket every month but does so only over an entire quarter.

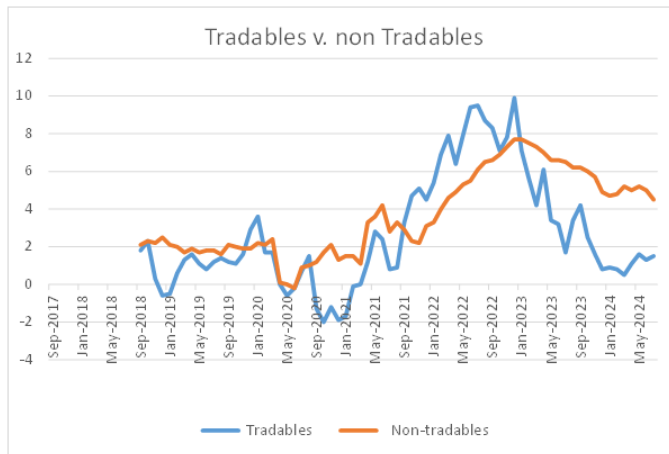
Weighted average of eight capital cities, annual movement	May 23 to May 24 % change	Jun 23 to Jun 24 % change	Jul 23 to Jul 24 24 % change
Seasonally adjusted CPI excluding volatile items** and holiday travel	4.1	3.8	3.6
Annual Trimmed mean	4.4	4.1	3.8

There has also been a pattern of falling inflation in the seasonally adjusted CPI excluding volatile items and the all-important Trimmed Mean which is the data the RBA uses to measure inflation.

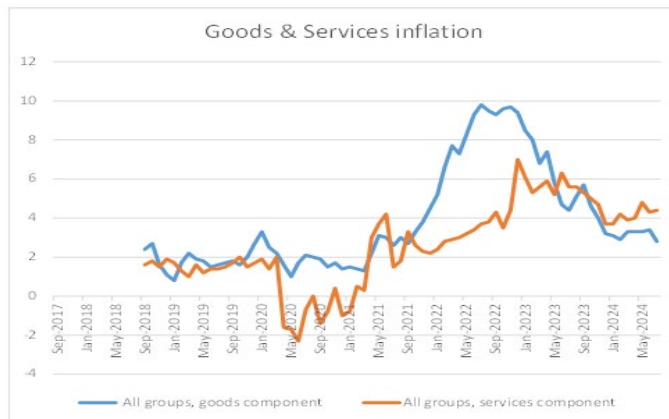


There are then several ways to interpret this CPI data provided by the ABS.

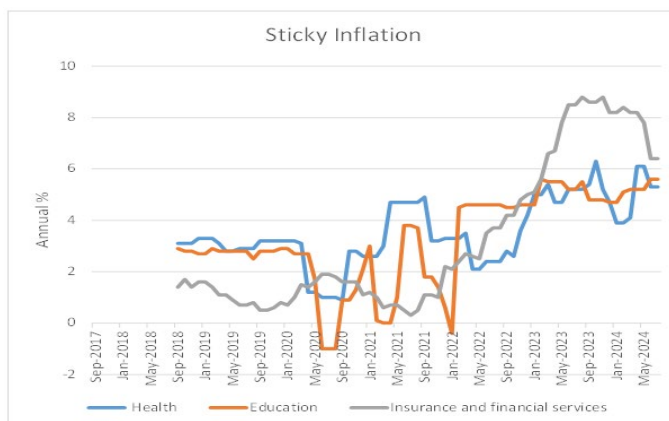
1. Tradables inflation includes household furnishings, clothing and footwear that have been consistently declining since the pandemic restrictions were lifted and the global supply chains were restored. Non-tradables inflation remains at a high level.



2. Goods and services inflation shows a divergence with goods price increases back to long-term levels and services prices still at a high level and importantly beginning to rise again.



3. Inflation remains elevated due to 'sticky' prices such as insurance, health and education still increasing. It would be reasonable to expect that insurance costs will begin to rise again in the months ahead because health insurance premiums need to increase to fund the increased costs of private hospitals following the large wages increase in the industry sector. Pleasingly, the fall depicted in the chart below appears to be due to increased competition. After strong price increases over several years directors' and officers' liability insurance has seen a 20% decline in the first half of 2024.



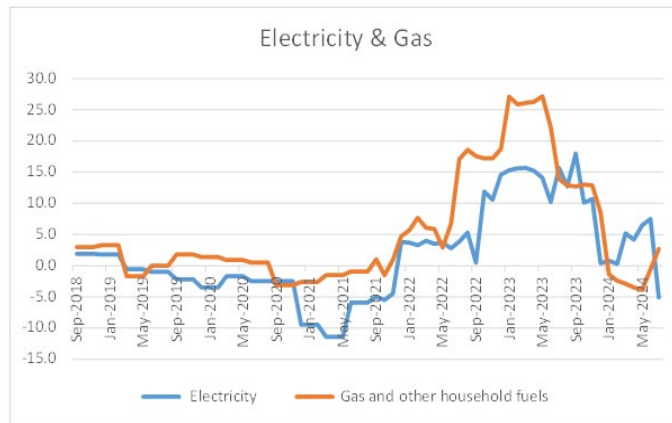
- The housing category has a large weighting in the CPI basket and has been targeted by both State and Federal government with a number of subsidies.

Weighted average of eight capital cities, annual movement	May 23 to May 24	Jun 23 to Jun 24	Jul 23 to Jul 24
	% change	% change	% change
Housing	5.2	5.5	4.0
Rents	7.4	7.1	6.9
New dwelling purchases by owner-occupiers	4.9	5.4	5.0
Electricity	6.5	7.5	-5.1
Gas and other household fuels	-3.9	-0.6	2.7

The housing category can be further broken down into two groups:

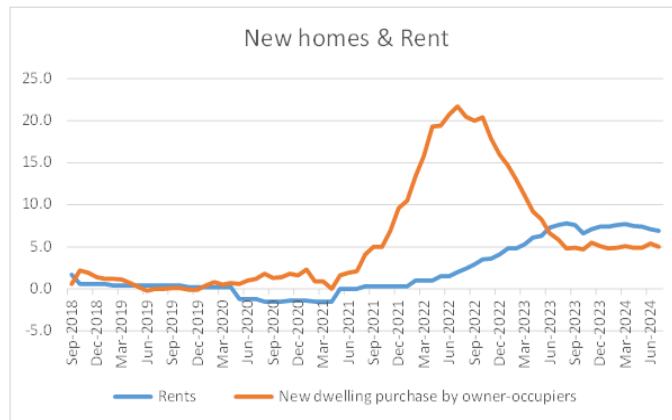
1. Electricity and gas

The spike in electricity and gas prices in the 2021-2023 period ended abruptly in December 2023. While gas prices continued into 2024, electricity prices began to increase again before the Federal and State subsidies brought a sharp drop in June and July. To some extent the rise in gas prices will now be offsetting the electricity subsidy benefit.



2. New home prices and rent costs

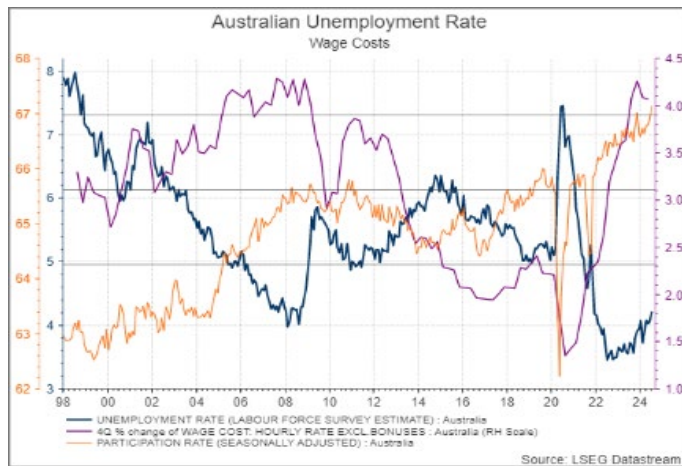
The price growth in the cost of building a new home and the reflected rent cost appears to have stabilised at a higher than historical level.



The rise in labour costs and its impact on inflation is central to Phillips Curve Theory, however, labour costs must be considered alongside labour productivity. In the US, the strong level of labour productivity has historically made Phillip Curve Theory irrelevant (see our Monetary Policy paper). In Australia where labour productivity is actually declining, we have a real problem. When the RBA said that wages growth of no more than 3% was consistent with its inflation target, it did so with an assumption that labour productivity would be near 1% and at least positive. Today labour productivity is negative and so we need a much lower level of wages growth to see inflation falling (something like 1.5% with labour productivity at negative 1.2%).



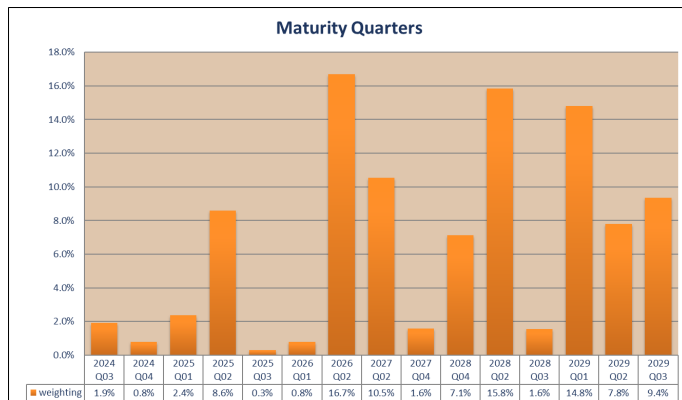
Historically, and according to economic theory, we will now need to see a large rise in unemployment in order to get an actual material fall in inflation from the current levels. We currently have wages growth above 4% with the highest level of labour participation ever recorded in Australia. The slight rise in unemployment last month is only a reflection of the rise in the labour participation rate. Looking forward we have seen numerous examples of Enterprise Bargaining Agreements locking in annual wage gains of 4-5% over three to four years. These wage gains are in response to the historical and current level of inflation (and fair enough) but what they do is entrench inflation at a level at or above 4%pa.



Fund positioning

The portfolio has retained the tactical shift into 3-year floating rate bonds made last December ahead of the expected margin contraction that subsequently occurred. This maturity is likely to be maintained over the next few quarters, at least, unless the economic outlook deteriorates unexpectedly.

If the RBA increases the official rate of interest prior to year end we would expect the benchmark yield curve to steepen and floating rate margins to widen out. This may provide an opportunity to increase the yield on the portfolio from current levels.



Over the past 12 months, funds have been conservatively shifted into major bank senior bonds and away from higher yielding lower rated bonds.

Once the economic outlook becomes more certain there is scope to increase the portfolio yield by reducing major bank senior bond holdings that are rated AA- and increasing regional bank holdings now rated by S&P at A+.



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