DDH PREFERRED INCOME FUND – MONTHLY REPORT DECEMBER 2018 ISSUED BY DDH GRAHAM LIMITED

ABN 28 010 639 219 AFSL 226319

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 ABN 68 140 364 576 (GCI) as the Fund's outsourced investment manager. GCI is an independent boutique asset manager and corporate advisory firm that has significant experience across the many facets of financial markets.

APIR Code DDH0001AU
ARSN 108 161 575

Fund Flexibility

This Fund can be accessed by investing directly, or indirectly, using the HUB24, Netwealth, OneVue, Praemium Investment, Ausmaq and BT platforms.

Suggested Investment Timeframe

The Fund is best suited to investors who seek a medium risk investment over a 3 to 5-year period.

Information on the Fund

At 31 December 2018, the Net Asset Value of the Fund is $107,451,933.81 (+0.57% on the previous month).

Benchmark

Bloomberg Australia Bank Bill Index

Description/Strategy

The Fund's investment strategy is to identify appropriate investments that are expected to generate a sufficiently high yield, commensurate with the assumed risk, with minimum volatility of returns. The fund consists of a core portfolio constructed with reference to macroeconomic factors and industry exposure. The balance of the fund is a tactical component that seeks to enhance returns via investing in short-term yield opportunities in the same fixed interest asset classes but especially those traded on the ASX.

Investment Objectives

The DDH Preferred Income Fund aims to provide to unit-holders returns in excess of cash and traditional debt securities over the medium to long term by investing in Senior Bank Bonds, Senior Corporate Bonds, Bank Subordinate debt and ASX listed Hybrid securities. The return is a combination of income distribution and capital growth.

Performance to 31 December 2018 (Annualised)

	3 mth %	6 mth %	1 year %	2 year %	3 year %	5 year %	Since Incept.
Cash Distribution	1.11	2.41	4.61	4.37	4.58	4.81	5.91
+ Franking	0.00	(0.00)	0.00	0.04	0.11	0.22	0.47
+/- Growth	(0.48)	(0.14)	(0.94)	0.49	1.37	(0.11)	(1.11)
Total return	**0.63**	**2.27**	**3.66**	**4.90**	**6.06**	**4.92**	**5.27**
Index	**0.48**	**0.99**	**1.92**	**1.84**	**1.91**	**2.15**	**4.06**

Returns are calculated using exit prices and are calculated after all fees have been deducted with distributions included 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.** Benchmark is the Bloomberg Australian BankBill Index.

The inception date of the Fund was 25 Oct 2004. E&P commenced as Investment Manager on 31 Dec 2010. GCI commenced as Investment Manager on 01 July 2015. Total includes cash distribution, franking credits and growth. Past performance is not an indicator of future performance.

Fund Rating

Rated Favourable by SQM Research Dec 2016 & retained January 2018.

Current Return Profile

Running Yield:	*4.85% (incl. franking)*
YTM:	*6.09% (incl. franking)*
Margin over bills:	*2.93% (incl. franking)*

Portfolio Characteristics

Running Yield	*4.85%*
Yield to Maturity	*6.09%*
Average Margin	*2.93%*
Average Years to Maturity	*3.18*
Number of Securities Held	*36*
Fixed	*2.32%*
FRN	*91.78%*
Cash	*5.89%*
Duration	*0.13*
Credit Duration	*2.82*

Top 5 Holdings as at 31 December 2018

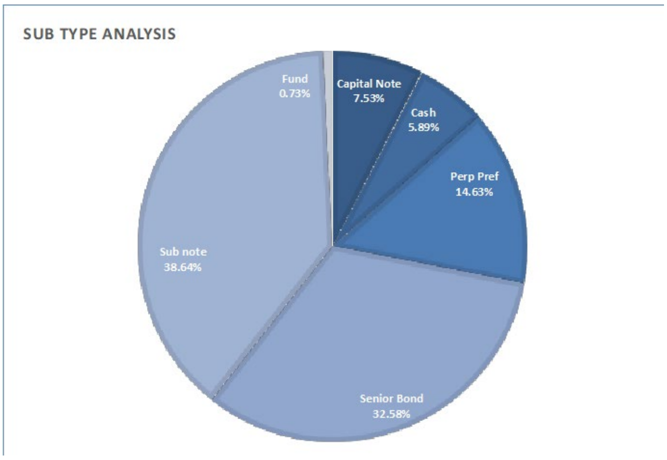
Code	Name	% Holding
+AU3FN0046066	Bendigo and Adelaide Bank Ltd 3mBBSW+245bps 30/11/2028	8.877%
+AU3FN0046231	Australia and New Zealand Banking Group Ltd 3mBBSW+103bps 06/12/2023	8.378%
NABHA	NATIONAL AUSTRALIA BANK LIMITED HYBRID 3-BBSW+1.25% PERP SUB EXCH NON-CUM STAP	7.577%
IMFHA	IMF BENTHAM LIMITED BOND 3-BBSW+4.20% 22-12-22 SEC STEP T-01-22	7.487%
NFNG	NUFARM FINANCE (NZ) LIMITED CONVERT BOND 6-BBSW+1.90% PERP SUB NON-CUM EXH STP	7.038%
TOTAL		**39.36%**

Australian Index returns to 31 December 2018

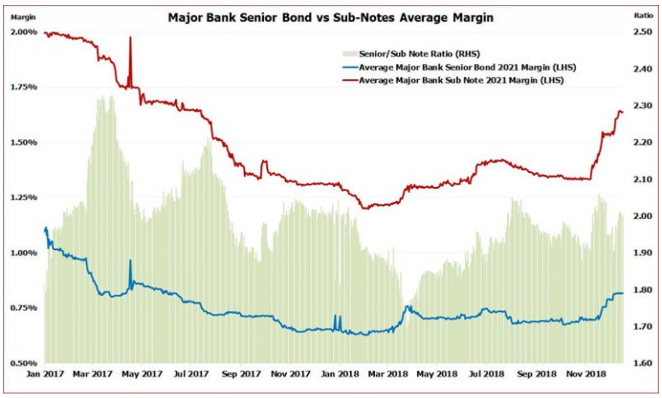
Index	1 month return	3 month return	12 month return
Bloomberg Australia Bank Bill Index	0.15%	0.48%	1.92%
Bloomberg Australia Gov't 3-5 year Index	1.11%	1.61%	3.95%
Bloomberg Australia Composite Index	0.32%	0.70%	2.41%

Commentary

The DDH Preferred Income Fund (PIF) yield to maturity was tactically reduced in December through a switch out of Basel III Tier 1 securities and senior bonds into Tier 2 debt.



Since the beginning of October, margins on senior and subordinated debt have expanded to a point where these types of securities offer value. The portfolio retains a significant exposure to senior bonds but has begun to increase the credit duration to take advantage of margins moving above 100 basis points. This was a move that was anticipated 12 months ago by shifting into short duration bonds before the two jumps in credit margins seen over the past year.



Remarkably Tier 1 securities that have more equity than debt characteristics remained buoyant despite:

- A sharp sell-off in the equity market particularly focused on the banks. Tier 1 securities normally correlate with changes in bank equity prices because like equity, the distributions on a Tier 1 security can be suspended;
- The relative value of senior and subordinated debt after margins rose in November;
- Tier 1 security yields including franking credits. A future ALP federal government has already announced that they will legislate to stop cash being returned on unused franking credits. This will mean that investors that cannot use all the franking credits will no longer receive the same yield on a Tier 1 grossed up for franking credits; and
- The implications from the Banking Executive Account Responsibility (BEAR) legislation, the new Australian Financial Complaints Authority and a more active approach from ASIC and APRA are lower future bank profitability. This has the potential to mean lower earnings growth.

The current outlook for lower bank profitability and lower dividends partly explains why Tier 1 securities outperformed senior and subordinated over the past few months. Bank equity investors appear to have been switching from ordinary equity, where returns are more dependent on earnings growth, into Tier 1 hybrids, where the distribution is more certain and there is greater capital stability. This switch however is not without risks that include:

- Changes to government regulations under a new federal government within the next 12 months;
- Changes to global banking capital adequacy requirements as determined by the Bank of International Settlements (BIS);
- A change in the availably of franking credits attached to these securities under the announced ALP policy; and
- A change in the capital adequacy requirements by APRA.

In late November, APRA released a discussion paper proposing that the major banks raise their Total Loss Absorbing Capital (TLAC) by 4% within the next 5 years in order to bring Australian banks into line with TLAC levels introduced by the BIS in 2016. APRA has been considering Australia's approach to TLAC for some time and have stated in the discussion paper that the increase is likely to come from new Tier 2 issuance. However, the market for Tier 2 debt is currently much smaller than for other forms of bank capital, so there is a possibility that the banks may respond to a sustained fall in residential property by just quickly issuing ordinary equity. As in 2015, this may result in investors purchasing this new equity funded by selling Tier 1 securities.