GCI AUSTRALIAN CAPITAL STABLE FUND
MONTHLY REPORT – OCTOBER 2021

Description/strategy
The Fund's investment strategy 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. The Fund is best suited to investors who seek a low to medium risk investment over a 1 to 3-year period.

Investment objectives
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 ABN 68 140 364 576 (GCI) as the Fund's outsourced investment manager. GCI is a private, boutique asset manager that has significant experience across the many facets of financial markets.

APIR Code DDH8305AU
ARSN 622 419 578

Fund flexibility
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 October 2021 (annualised)

	3M %	6M %	1Y %	2Y %	3Y %	5Y %	Since inception
Cash Distribution	0.29	0.44	1.02	1.22	1.60	0.00	1.74
+ Franking	0.00	0.00	0.00	0.00	0.00	0.00	0.00
+/- Growth	-2.44	-2.38	-3.09	-1.56	-0.85	0.00	-0.64
Total Return	**-2.15**	**-1.94**	**-2.07**	**-0.34**	**0.75**	**0.00**	**1.10**
Index	0.00	0.01	0.03	0.27	0.73	0.00	1.00

*Fund returns are net of all fees

Australian index returns 31 October 2021

Index	1M Return	3M Return	12M Return
Bloomberg Australia Bank Bill Index	0.00%	0.00%	0.03%
Bloomberg Australia Gov't 3-5 Yr Index	-3.17%	-3.54%	-3.38%
Bloomberg Australia Composite 0-3 Yr Index	-0.96%	-0.99%	-0.66%
Bloomberg Australia Composite 3-5 Yr Index	-3.13%	-3.56%	-3.25%
Bloomberg Australia All Maturities Composite Index	-3.55%	-4.93%	-5.30%

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.

The benchmark is the Bloomberg Australian Bank Bill Index. The inception date of the fund was 25 October 2004. E&P commenced as Investment Manager on 31 December 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
Initially rated 'Favourable' by SQM Research in December 2018, the Fund was upgraded to 'Superior' in December 2020.

Superior
SQM RESEARCH

Fund Size
As at 31 October 2021, the Net Asset Value of the fund was $85,331,455.58.

Portfolio characteristics

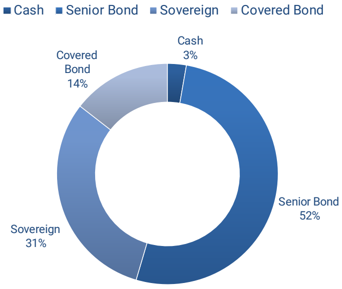
Running Yield	2.84%
Yield to Maturity	1.14%
Average Margin	1.11%
Average Years to Maturity	3.07
Number of Securities Held	27
Floating	39.21%
Fixed	58.03%
Cash	2.75%
Modified Duration	2.41
Credit Duration	0.69

Fees

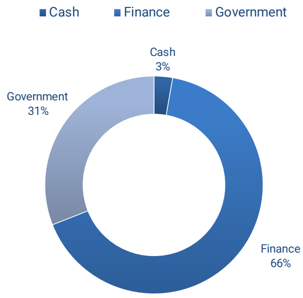
MER	0.40%
Buy/Sell Spread	+0.10%/-0.10%
Performance Fees	Nil

Asset breakdown

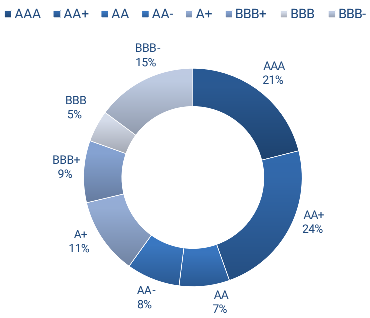
Sub Type Analysis



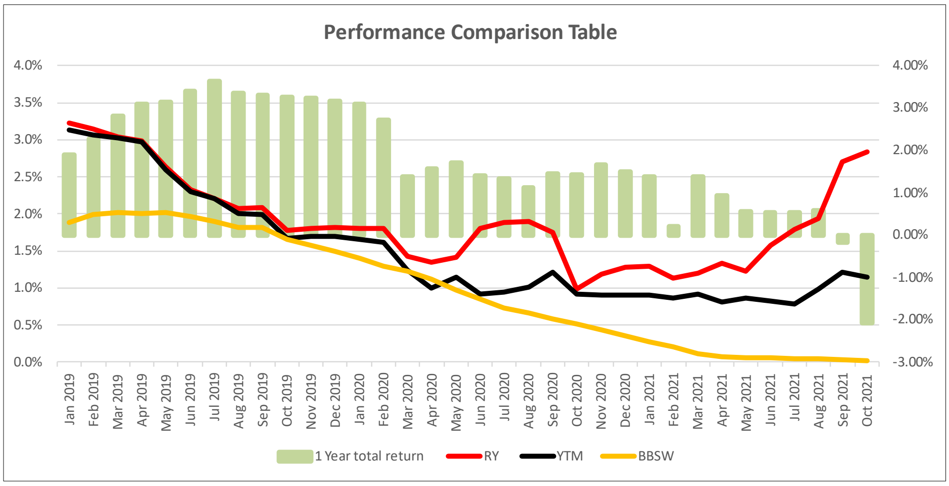
Sector Allocation



Credit Rating



Monthly performance

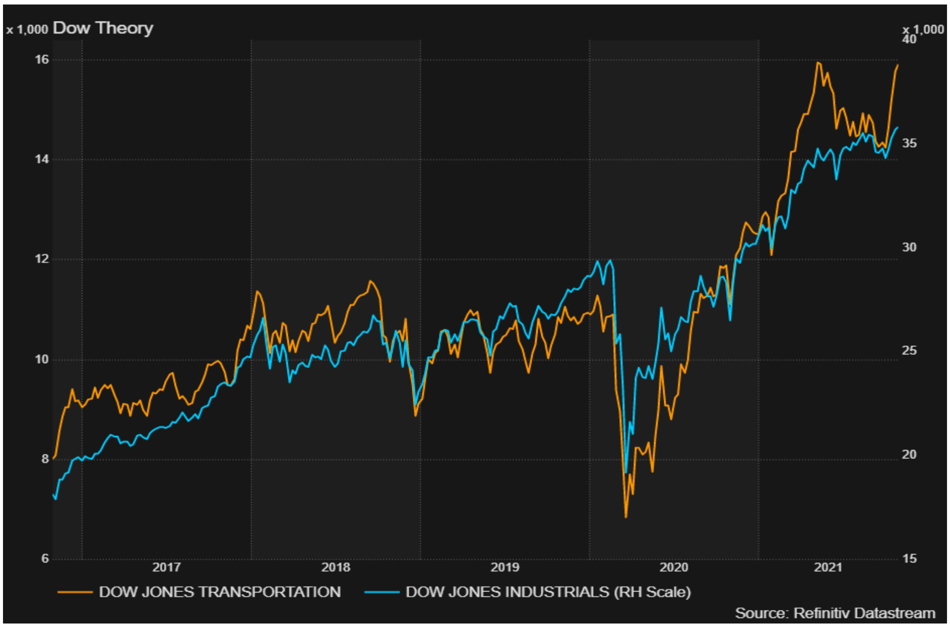


Source GCI Australia, DDH Graham data

The past month has been challenging for fixed income managers. The Bloomberg Australian Composite 3–5-year index fell 3.13% in October while the Bloomberg Australian All Maturities Composite index lost 3.55% and 5.04% over September and October combined. The future performance of the Fund, over the next 12 months, is supported by the strong running yield of 2.84% and the current yield to maturity of 1.14%.

Market review & outlook

October has proved to be a good month for global equities with record levels on both the Dow Jones Index and the Dow Transports Index, signalling a broader and stronger period of economic growth in the US than we have really seen since 2008. There is, however, a risk that fixed income instruments will underperform connected to this strong economic recovery.



Many investors are likely to see their strong equity returns offset to some degree by negative returns from their fixed income fund this year and probably next year too.

There are broadly two types of fixed income funds. These are:

- Fixed duration funds that track a benchmark like the Bloomberg Australian composite index with a duration of 5 years, and
- Credit funds that seek an absolute return by investing in floating credit securities

Unfortunately, both types of funds are likely to perform poorly over the next 12 months. The fixed duration funds will suffer capital losses with the benchmark yield curve steepening to reflect stronger economic growth and rising inflation risks. A fixed income fund with a fixed duration (calculated as modified or Macaulay duration) of 5, will generally suffer a capital loss of 4.5% for every 100 basis point (bp) rise in the 10-year bond yield.

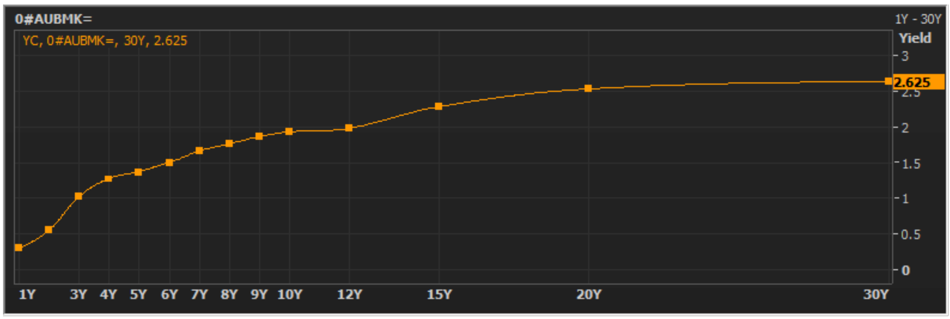
Credit fund managers are also likely to suffer capital losses because the emergency pandemic monetary measures taken by the Reserve Bank of Australia (RBA) pushed the margin on bank and other corporate debt to the lowest level in Australian history.

When the margin on major bank senior bonds contracted to just 24bps in May of this year there really wasn't anywhere else to go but wider. Already we have seen the margin on major bank senior bonds expand to approximately 50bps, and there are reasons to expect that they will widen further. These reasons include:

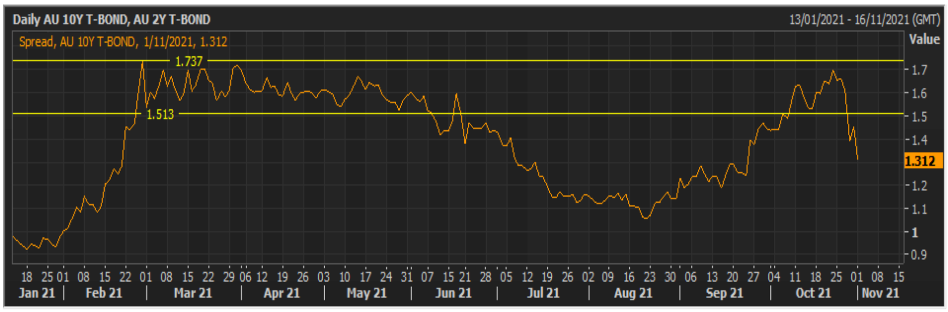
- The expiry of the Term Finance Facility in July of this year that saw the banks not issuing new bonds, but instead borrowing from the RBA at 10bps for three years. When the banks return to issuing new bonds, margins will widen with the increased supply.
- The tapering of the RBA quantitative easing will reduce system liquidity.
- The cancellation of the Committed Liquidity Facility (CLF) in November that was enabling the banks to purchase any Australian bank debt or any mortgage-backed security rated AAA and hold it in the CLF as part of their respective Liquidity Coverage Ratio (LCR). The banks will instead hold cash or sovereign bonds to meet their LCR requirement.
- A tightening of global liquidity conditions with many developed countries increasing interest rates.

Many credit funds already have running yields higher than their yield to maturity because over the past 18 months they have continued to purchase long-dated floating rate bonds as margins tightened. These funds with credit duration mainly over 2.5 years are now trapped holding bonds whose capital value will continue to fall as margins expand. If major bank margins expand to where they were prior to the pandemic they will reach 85bps (regional BBB+ will reach 110bps).

Towards the end of October, the Australian bond market began to exhibit disorderly behaviour with some similarities to the pandemic sell-off in March 2020. We expect this to be a short-term event because it is a market-driven taper tantrum (bond sell-off), rather than one based on economic facts that are in short supply due to the pandemic distortions. Speculators watched the US short end of the curve rising in response to much higher inflation readings than we have seen here (the US has an inflation problem be it transitory or not). They then employed a short selling strategy targeting the April 2023 and April 2024 sovereign bonds with an expectation that the Australian curve would mimic the US curve. At a strategic level, the benefit of shorting these bonds near 10bps was that there was no downside with the RBA being the only central bank with a yield curve target. This caused the benchmark curve to steepen a great deal (70bps) in the 1–3-year part of the curve only.

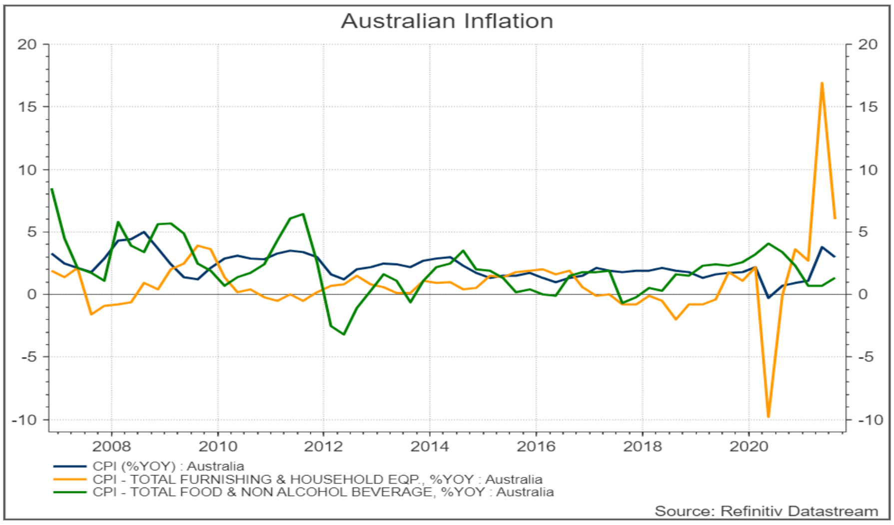


The sharp rise in 2-year yields brought about a flatter curve as depicted by the 2–10-year spread.



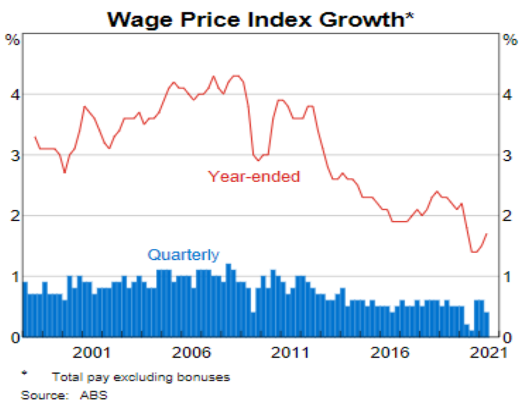
There are several reasons we expect that this sell-off at the short end of the curve will be a short-term event and why we have accepted an increase in duration risk for a significant increase in the running yield of the fund. These include:

- The sharp steepening in the front end of the curve is mimicking a sell-off in this part of the curve in the US on more genuine inflation fears. The September quarter trimmed mean CPI (the RBA's preferred measure of inflation) reading of 0.7% for an annual rate of 2.1% was driven by distortions to economic activity due to pandemic lockdowns in Sydney and Melbourne. When pandemic restrictions are removed, we expect that transport and home building costs will ease.

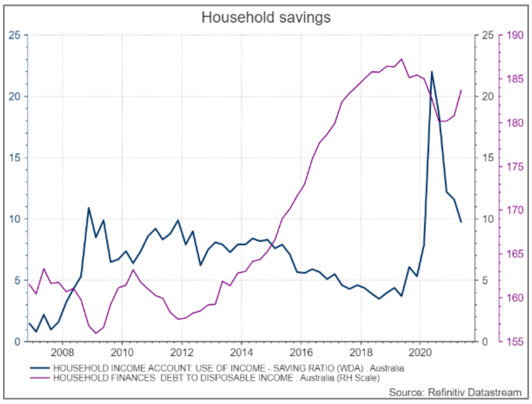


- Labour supply in Australia, and in most of the developed world, has been disrupted by the pandemic restrictions. This impact has occurred at a few levels that include:
    - Foreign students that provide part-time labour to the hospitality industry.
    - Labour moving between states and even regions as they were able to pre-pandemic.
    - A reluctance to leave home because of the pandemic fear and the need to home school children.

In Australia, despite strong employment growth and workforce participation, wages growth has remained modest. The RBA has stated on many occasions that it does not believe sustainable inflation is possible without wages growth of at least 3% pa. The latest RBA chart pack still shows wages growth well below this level, but it is still hopeful that it will reach 3% by 2023.



The Australian economy may not emerge from the Delta pandemic restrictions with the same gusto that it did in the December quarter of 2020, because the household balance sheets are not as strong as they were then. Last year households reacted to the first pandemic lockdowns with a sharp increase in savings and this was seen in both the savings ratio and household debt to income ratios. This gave the households a strong position from which to respond to the easing of restrictions with an increase in spending. This is not the case this year, so a post-pandemic spending surge may not materialise.



Fund positioning

- The Fund is positioned with a running yield of 2.84% and a yield to maturity (YTM) of 1.14%. The higher running yield than YTM reflects the current market conditions; however, the fund will pay distributions based on the 1.11% running yield and accrue the gains from the net running yield (approximately 2.42%) until the YTM is once again above the running yield.
- The Macaulay or fixed duration is 2.41. The Fund holds a range of fixed rate bonds that are in the 1-3 maturity area. This strategic positioning in sovereign and covered fixed rate bonds increased the running yield of the portfolio.
- A credit duration of 0.69. The very low credit duration reflects the switch into fixed rate short-dated sovereign and covered bonds and the holdings of floating rate senior bank bonds that will mature over the next 6 months. As these bonds mature, they will be rolled into new 5-year bonds at higher margins, which will boost the overall running yield and YTM of the portfolio to a level sustainable over a 3–5-year time frame. The aim will be to lift the average margin from the current 111bps to over 150bps.
- The switch from senior bank floating rate debt into sovereign and covered (AAA) senior debt has lifted the average credit rating of the Fund from A+ to AA. Strategically, the regional bank BBB+ senior bonds have been mostly divested with a view that they no longer offered a sufficient return for the risks associated with Australia's extended housing price bubble. All the banks in Australia are well regulated by APRA and hold excess total loss absorbing capital, however, should an external shock impact employment levels then there is a risk of a housing price decline that may impact regionally exposed lenders. This is a risk that we have written about on many previous occasions, however, it is only in the past 6 months with central banks beginning to tighten liquidity, China's growth slowing and a tremendous surge in house prices that we have now moved to reduce exposure to BBB rated banks.