Zenith Investment Partners Pty Ltd

Highly Recommended
Recommended
Approved
Not Approved
Redeem

DDH Preferred Income Fund

31 May 2006

The DDH Preferred Income Fund is another offering from a boutique investment manager Zenith has identified and reviewed. The Fund is an Australian hybrid fund that seeks to provide investors with an attractive level of income of approximately 2.0% above the prevailing bank bill rate (5.83% at 14/6/06) with low to moderate levels of capital volatility. Being a relatively new fund of approximately $7 million in size, the Fund does not have the capacity issues of many of its larger hybrid fund competitors. In Zenith's view this provides it with greater potential to generate attractive excess returns.

The Fund is one of a suite of products offered, distributed or administered by the DDH group. DDH are a Brisbane based funds management business with origins dating back to 1981. The manager has dedicated significant resources to the management of this fund with an experienced team of 5 fixed interest professionals (one part time) involved in the management of the Fund. The team is also relatively new and as yet unproven but have a broad range of complementary skills which Zenith believes is a strength of the investment team structure.

The investment process behind the identification and selection of hybrid securities for the Fund is thorough and disciplined. This process combines an initial filter that identifies those securities that meet the manager's investment criteria with a thorough evaluation of the company (issuer) and valuation of the security prior to investment. This research process involves evaluation of the issuer against a comprehensive set of financial ratios with particular emphasis on the debt ratios and cash flow of the company to determine its creditworthiness and ultimately, its ability to support the hybrid security interest and capital repayments. The Fund Director, Richard Meyers also utilizes his extensive financial structuring experience to analyse each securities structure from both an investor's and issuer's perspective in an effort to avoid unattractively structured securities.

The portfolio construction process then seeks to leverage off the research work to invest in those securities that offer the best risk adjusted returns. This results in a portfolio of 20 to 30 securities which we believe makes sense for a Fund of this nature and objective. The manager has also established a set of portfolio construction risk management measures that aim to control the risks in the portfolio and ensure the portfolio is well diversified by security, sector (industry), credit rating and interest rate exposure.

Overall, Zenith believes DDH have made a solid start to the effective management of this Fund. In Zenith's view, the employment of a 5 people investment team demonstrates a strong commitment to the successful establishment and ongoing management of the Fund. The investment process is thorough and while we believe it has room for further refinement and improvements, we believe this will occur as the investment team has more experience working together and the Fund matures. As a result, we rate the Fund APPROVED.

Key Features	***Description***
Asset Class	Australian Fixed Interest
Sub-Asset Class	Specialist
Investment Style	Active
Benchmark	UBS Bank Bill Index
Recommended Investment Timeframe	3 + years
Director	Ugo Di Girolamo
Fund Director	Richard Meyers
Investment Team Size	5

Cumulative and Monthly Net Performance

Performance Analysis

Performance Statistics	***1 Yr (% p.a.)***	***6 Mths (%)***	***3 Mths (%)***
Performance - Fund	8.21	4.17	1.27
Performance - Benchmark	5.74	2.81	1.41
Performance - Median Manager	6.16	2.72	1.21

The Fund has a limited performance history particularly with the current team in place but has provided investors with a consistent positive return in line with its objective. The consistent upward slope of the cumulative net performance line in the above chart illustrates that the Fund's returns have been consistent since inception and that investors who entered the Fund at different times would have enjoyed a similar return experience. As illustrated by the monthly return bars in the chart, the Fund's monthly returns have been strongly positive since inception which is a sound record in a challenging hybrid market environment. To date, the Fund has outperformed the median manager return by a significant margin which is partly attributable to the small size of the Fund and the manager's greater flexibility to add value above some of the competitors. Zenith believes this is one of the attractive features of the Fund.

Consistency Analysis

Consistency Statistics	*1 Yr*	*6 Mths*	*3 Mths*
History of Monthly Excess Return (%)	66.67	83.33	66.67
History of Monthly Excess Return (Rising Mkts %)	66.67	83.33	66.67
History of Monthly Excess Return (Falling Mkts %)	0.00	0.00	0.00

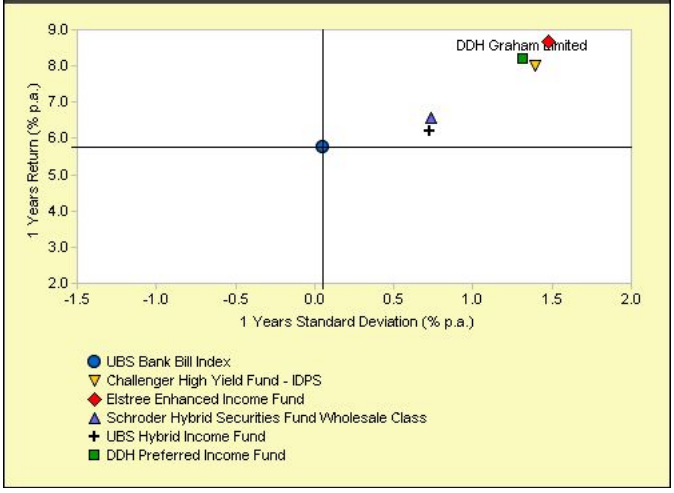
The Fund's performance benchmark (as assigned by Zenith) for comparison purposes is the UBS Bank Bill Index which Zenith believes should be an easy benchmark for the Fund to outperform over the medium to longer term. To date, the Fund has outperformed the benchmark in over 50% of months over all time frames measured. The magnitude of monthly returns has also been relatively consistent oscillating from approximately 0.5% to 1.00% in the majority of months.

Risk / Return Analysis

Risk / Return Statistics	*1 Yr*	*6 Mths*	*3 Mths*
Information Ratio - Fund	1.87	1.27	-0.24
Information Ratio - Median Manager	1.25	0.79	0.67
Sharpe Ratio - Fund	1.87	1.27	-0.22
Sharpe Ratio - Median Manager	0.48	-0.15	-0.31
Standard Deviation (% p.a.) - Fund	1.31	1.07	0.64
Standard Deviation (% p.a.) - Median Manager	1.04	0.76	0.86
Tracking Error (% p.a.) - Fund	1.32	1.07	0.58
Tracking Error (% p.a.) - Median Manager	1.30	0.88	0.96

The performance history of the Fund is still too short to draw any meaning conclusions from a risk / return perspective. Despite this the Fund has performed against its peers in the sectors as illustrated by the Risk / Return Chart vs. Peers.

Risk/Return Chart vs. Peers



Investment Personnel

Name	*Title*	*Time with Manager*
Ugo Di Girolamo	Director	6 Yr(s)
Richard Meyers	Fund Director	1 Yr(s)
Cale Bennett	Portfolio Manager	4 Mth(s)
Brett Ryder	Senior Portfolio Manager	5 Mth(s)
Moya-Anne McCaskill	Dealer / Analyst	1 Yr(s)

Manager Background

DDH Graham (DDH) is a Queensland based funds management firm founded in 1981. The group has extensive experience in trust management and administration. It is the responsible entity or manager for several property trusts, an equities fund and operates a money market fund. The group operates a money market division which administers the Bank of Queensland money market deposit account. DDH has in excess of $1.2 billion in funds under management and is an unlisted public company. There are three directors of the group including David Graham as Chairman and Managing Director, Peter Lockhart, Executive Director and Ugo Di Girolamo, Executive Director. Zenith has met with the DDH directors and believes they are well qualified to manage the business.

Investment Team

The investment team behind the management of the Fund consists of 5 people and is headed by Ugo Di Girolamo as Group Director. The other members of the investment team include Richard Meyers, Fund Director, Brett Ryder, Senior Portfolio Manager, Cale Bennett, Portfolio Manager and Moya McCaskill as the Dealer / Analyst.

As Group Director, Di Girolamo has responsibility for the management of the team and specific responsibility for the money market division of DDH. This involves overseeing the operations of the money market deposit account (as agent for the Bank of Queensland) and managing the development of the High Yield Fund. Di Girolamo has extensive money market and fixed interest management experience having worked in similar roles for Lloyds Bank, Graham & Company and

Suncorp Metway limited over the past 25 years. Di Girolamo has been with DDH since 2000.

Richard Meyers is the Fund Director and as such is responsible for the High Yield Fund. His role specifically involves assisting with new issue analysis, relative value calculations and the sourcing of private placements. Meyers is a relatively recent addition to the DDH investment team having joined in March 2005. He has extensive experience in capital markets having held roles as Head of Capital Markets at Suncorp Metway (1997 - 2003), Head of Capital Markets at QIDC (1995 - 1997) and a number of other roles involving debt, hybrid and equity raisings since 1986.

Cale Bennett is the Portfolio Manager of the Fund and is responsible for its trading activities which includes actively managing the portfolio of convertible bonds, hybrid securities, collateralised debt obligations (CDO's), structured credit securities and corporate bonds to produce absolute returns irrespective of benchmark performance. This involves designing and implementing the fund's trading strategies, quantitative trading and valuation models, product development and refinement of systems and processes. Bennett is another recent addition to the group having joined in February 2006 from Macquarie Bank where he held the role of Treasury Risk Manager for a short period (September 2005 - February 2006) and before that as Portfolio Manager of a "Cash Plus" fund for an external third party of the Bank of Queensland (2003 - 2005). Prior to that Bennett held a number of treasury dealer and money market roles from 1998. As a result, he has over 8 years relevant industry experience and is well suited to his current role at DDH.

Brett Ryder is the Senior Portfolio Manager of the Fund and is employed by DDH on a part time basis as he is currently completing his PhD in Economics. Ryder is responsible for building and testing a number of performance management, attribution analysis and risk management frameworks to enable improved internal and external reporting for the Fund. Ryder is a recent appointment to the group having joined DDH in January 2006 from Suncorp Investment Management (Suncorp) where he was Head of Fixed Interest Funds Management from 1998 to 2005. In his role at Suncorp one of his main areas of responsibility was the performance measurement and attribution analysis for the various portfolios run by the group. He also worked as a senior economist with Suncorp and also held similar roles at the Australian Bureau of Agricultural and Resource Economics (ABARE) and Commonwealth Treasury. As such he has 18 years economic and investment market experience and provides a strong macro economic input into the investment process.

Moya-Anne McCaskill is the Dealer / Analyst and the final member of the DDH fixed interest and cash investment team. McCaskill's responsibilities include the generation of the daily portfolio valuation and hybrid pricing sheets, quantitative and qualitative research for potential investments, market risk analysis and administration duties. McCaskill has been with the group since November 2004.

Investment Committee

The manager's investment committee consists of the three directors of the business, David Graham, Peter Lockhart and Ugo Di Girolamo plus the entire High Yield Fund investment team. This committee meets monthly for the purpose of reviewing the performance of the Fund, to consider changes to the Approved Investments List and to consider any new investment initiatives from the investment management team. The committee also considers macro economic and industry sector developments that may result in a variation to existing investment parameters or asset allocation.

In Zenith's opinion, much of this is duplicating what the investment team already does and therefore is unnecessary and adds a further level of decision making for little if marginal benefit. We believe a better structure would be to limit the investment committee's involvement to a meeting with the Fund Director on a monthly basis to review performance rather than playing an overseeing role in the management of the Fund.

Apart from Ugo Di Girolamo and Moya-Anne McCaskill, the remaining members of the DDH High Yield Fund team are relatively new to the group. The Fund itself is also relatively immature having been launched in September 2004. The newness of the team makes it difficult to assess their performance as a group however we have met with and reviewed all members of the investment team (with the exception of McCaskill) and believe the team is very well resourced for a fund of this nature and size (FUM currently approximately $7 million). We believe the recruitment and full resourcing of the team by DDH demonstrates a strong commitment by the manager to the successful establishment of the Fund. In addition, the members of the team bring a wide range of different and complementary knowledge and experience which is a strong feature of the team structure. In Zenith's opinion there is some lack of clarity in terms of the responsibility for management of the actual portfolio which we believe needs to be more clearly defined. Despite this, the team is one of the better resourced we have seen for the dedicated management of a domestic hybrid / high yield fund.

Investment Process

Investment Philosophy

The Fund aims to provide investors with enhanced risk / return characteristics when compared to traditional equity or fixed income portfolios. The objective of the Fund is to generate a return of 2.0% p.a. above the bank bill rate with 2.0 - 5.0% p.a. volatility over rolling 3 to 5 year terms.

DDH believes that credit spreads and stock price movements are closely related, that is credit spreads widen as stock prices decline and volatility increases. The manager also believes that investment opportunities result from market inefficiencies created as a result of the hybrid securities market having a large participation by private investors who do not fully understand the securities and / or market. In addition the manager is conscious of the current size of the hybrid market and maintaining the ability to generate solid excess returns to investors. The manager utilises a top down economic and sector based approach combined with a bottom up approach to individual security selection in the management of the Fund.

Information Resources

The investment team utilise a broad range of information sources to assist in the management of the Fund. This includes information on economic conditions, identification and valuation of securities and views on market conditions and securities ratings from brokers and other financial participants. From a systems perspective, the team has access to Bloomberg, Reuters and Iress. They also have access to credit rating agencies research and ratings, broker research reports on securities and information on securities and / or new issues from investment banks. These resources are extensive and form a sound source of information and views on the universe of securities being researched for the Fund.

Security Selection

Universe of Securities

The manager narrows down the hybrid universe of securities they focus on to only include securities:

- Issued in Australia;
- Issued in $A;
- With a delta < 0.5;
- With a credit margin (yield margin above the comparable government bond) > 1.0%; and
- That are supported by the lead manager - that is, the issuing broker of the security supports it and provides a market for the trading of the security.

In addition, while not strict requirements the manager also prefers securities that are:

- ASX listed;
- Have more than one market maker - that is, have more than one broker providing a market for trading in the securities; and
- Have direct credit exposure - that is, are not overly structured.

This universe then forms the universe of securities the manager seeks to research in detail. The investment team has already achieved this by having research on all securities meeting these criteria.

Security Research Process

Top Down Analysis

The process begins with an analysis of the domestic and international economic environment. This leads to a formulation of the investment strategy in terms of the identification of trends in interest rates and credit spreads (hybrid securities yields over bank bill swap rates). The team also conducts industry analysis with the aim of identifying those industries and sectors that should benefit from the expected future economic environment.

These top down views are formalised by a four page economics and strategy note which consists of a quarterly economic, equity and credit market outlook and sector recommendations. Zenith believes that the formalisation of these views is an excellent discipline as it clarifies the views, keeps them on record so that they can be assessed to determine if they are adding value and a historical record as to where the process can be improved.

Security Identification

Potential hybrid securities are screened and ranked based on the following criteria which essentially involves "understanding the prospectus":

- Whether the security has a coupon step-up feature if it is not called (redeemed) by the issuer;
- Whether there is any mandatory non-payment language;
- Can the issuer voluntarily cease paying the coupon;
- What senior debt covenants are in place;
- Ranking in capital structure;
- Level of subordination (at which level of capital structure) and existence of a dividend stopper;
- Relative value analysis against existing issues based on where the security lies in the capital structure;
- Maturity date; and
- Assessment of prospectus risk and severity of any replacement language.

Bottom Up Company (Issuer) Analysis

DDH believe that high yield securities such as hybrids have a strong correlation to equity markets and that credit spreads and stock price movements are closely related. As a result, the group takes the approach that if there is no compelling reason to own the company's shares, they are reluctant to invest in its hybrid or subordinated debt securities. In Zenith's experience this approach is relatively unique to DDH as other hybrid managers Zenith has reviewed believe equity and debt analysts have a different emphasis and and such, hybrid managers will often invest in securities that do not interest equity analysts and vice versa. As a consequence of this approach, the investment team utilise traditional equity analysis as part of their research on issuers. External broker research is referenced and used mainly for large issuers while small companies are usually assessed through in-house research.

Qualitative security assessment is conducted on an ongoing basis and the investment team use information from the credit rating agencies and a comparative analysis of broker research to assist in deriving their own security rating. This involves the team undertaking further ratio analysis with a view to deriving a relative value for the security. This analysis focuses on the issuer's future earnings and cash flow, capital structure leverage, off balance sheet liabilities, management quality and industry competitiveness. Consideration is also given to the liquidity of the security. Specifically, the manager seeks to identify trends in credit metrics (debt ratios) of the security relative to the sector and derive a "shadow" rating and fair value based on comparative analysis and relative value to peers and similarly structured issues.

The manager uses a proprietary credit ratio database which consists of key debt ratios for all ASX listed companies and GICS (Global Industry Classification Standard) to track trends in key debt metrics and compare these with individual securities. This assists in assessing the credit worthiness of potential issuers. The manager also uses the Altman Z-score which is a linear model that uses five financial ratios to predict bankruptcy / default risk up to two years in advance. This tool also assists in the identification of potential credit rating downgrades.

As with the top down strategy, the research process for securities is also formalised by the production of a research note. The research note is an in-depth research report on a particular issuer culminating in an investment recommendation - Add, Sell or Watch. Each recommendation is peer reviewed by investment team and presented to the investment committee for addition to the Approved Investment List. While Zenith believes the peer review process with the investment team is a sound practice, the presentation to the Investment Committee is, in our view, unnecessary and adds an element of bureaucracy to the process. We would prefer this process to be the responsibility of the investment team. Zenith has been provided with samples of the research note and believes it is of a high quality in terms of its level of depth and coverage of the key financial metrics.

Security Valuation

Utilising the results of the security research process, the manager then derives a fair value or fair yield spread for the potential investments using proprietary valuation models. These models are updated on a daily basis which facilitates the identification of relative value opportunities which have also passed the qualitative security research process. A daily valuation report is produced to support the recommendations and trading decisions. This report consists of relevant quantitative and fundamental data within the subset of the investment universe that have been screened by the first three steps of the investment process. Any optionality (ability to convert to underlying shares) in a security is also valued using the binomial option pricing model.

In Zenith's opinion the security research and valuation approach is logical and thorough with each component building on the next to determine the most attractive securities. The production of the written reports adds discipline to the process and ensures that all relevant areas have been covered and provides a record for reference and review.

Portfolio Construction

The manager seeks to construct a portfolio of 20 to 30 securities. The portfolio construction process consists of quantitatively driven risk / return analysis followed by a subjective overlay resulting in security rebalancing and security selection decisions. The manager uses a portfolio optimisation approach that ranks all securities that pass the screening process on a risk adjusted basis by their highest expected return. It is this combined with the relative valuation at the asset, industry sector and security level that drives the final security weighting subject to the portfolio's risk management constraints.

Implementation / Trading

Whilst the manager's investment decisions are primarily driven by the screening and valuation processes, they believe that market timing is also integral to the implementation process as it enables the exploitation of market inefficiencies to maximise return. The manager utilises some technical analysis to assist in the timing and implementation of trades.

Trading is the responsibility of the Portfolio Manager (Cale Bennett) as this ensures that market intelligence is fed directly into the portfolio construction process. Trading notes are produced to provide support for trading decisions and whether the trade is a relative value trade or a trade with the objective of exploiting market inefficiencies.

Sell Discipline

Portfolio turnover is deliberately low and the majority of turnover is predominantly driven by a security becoming expensive. That is, if the security's price rises above its assessed fair value, the investment is reviewed. If a fundamental reason no longer exists for investment in the security, the position is reduced or completely exited. On the other hand, if the price of a security in the portfolio falls the investment is reviewed against the original reasons for investing in it and if the original valuation parameters have changed the security is sold.

The output of this portfolio construction process is designed to produce a portfolio that has the following characteristics:

- Low duration (of approximately 6 months);
- No foreign exchange exposure; all securities in A$;
- Low portfolio delta (approximately 0.1);
- Strong industry diversification; and
- Low exposure to structured credit securities.

The portfolio construction process is thorough however Zenith believes the determination of the weighting for each security could be more transparent. Ideally the manager likes to hold up to a maximum of 5.0% with the usual range up to 4.0%. At this point while the Fund is still in its infancy with some investors representing up to 10% of the Fund, the manager retains a minimum cash weighting of 10%. This cash position will be reviewed as the Fund grows and the investor base becomes more diversified. Zenith believes this approach is a sensible position to take while the Fund remains small.

Risk Management

Portfolio Constraints	*Description*
Security Numbers	20 to 30
Cash (%)	min: 10% This cash level will be reviewed as Fund grows in size.
Listed Securities (%)	min: 90% Listed securities must make up at least 90% of portfolio.
Unlisted securities (%)	max: 10%
Sector Constraint	max: 10 Exposure to any one industry restricted to 10%
Duration (Yrs)	0 Yrs to 1.5 Yrs
Weighted Average Credit Rating (%)	Must be BBB- or above.

In an effort to diversify the portfolio and control risks the manager operates within a number of portfolio construction / risk management constraints. These constraints are summarized in the table above. The duration of the portfolio is restricted to a maximum of 1.5 years which is designed to limit the impact on the valuation of the portfolio by moves in bond yields and interest rates. This is consistent with the manager's objective of generating attractive levels of income with low levels of capital volatility. To ensure that the Fund remains an income fund and not tied to the security's underlying equity exposure, the manager restricts the portfolio delta to below 0.5. In addition, as sector / industry diversification is an important component of the portfolio construction process, the manager restricts the exposure to any one sector to 10%. To assist with the liquidity of the portfolio there is a further constraint that at least 90% of the portfolio must be invested in listed securities. Finally, as a further control over the credit quality of the portfolio, the minimum weighted average credit rating (including the manager's own shadow ratings for unrated securities) must be BBB-.

Derivatives

Derivative positions are monitored on a daily basis by the investment team. Market risk analysis and reporting is conducted on a weekly basis through the use of quantitative models which calculate the portfolio's sensitivity to various market risks including credit, interest rate and equity risks. This is an area that Brett Ryder is continuing to refine and in Zenith's view is well advanced particularly for a boutique manager of this age and size.

Zenith believes the risk management constraints are appropriate for a Fund of this nature and are consistent with the manager's investment approach and objectives of the Fund.

Risks of the Fund

As the Fund is focused on one market, the Australian hybrid market, Zenith believes the main risk pertinent to investors in the Fund is market risk. That is, the risk that prices on all Australian listed fixed interest securities fall. In this case it is likely the returns of the Fund would be adversely impacted. In extreme circumstances, the manager has the ability to liquidate all holdings and hold 100% cash, however this would only occur in extreme market conditions.

As the Fund is relatively new, its current small size is also a risk for early investors. The reason for this is that if any dominant investor redeems their investment, this could leave the fund at a size where it is too small to provide a properly diversified portfolio. This could also be problematic from a tax perspective where any sale of assets required to meet a large redemption result in realised gains being distributed to all unitholders as realized income thereby affecting their tax position. The manager is aware of this and will retain a minimum of 10% invested in cash to meet any redemption requests while the Fund is small.

Sector risk, credit risk and interest rate risk are further risks that could adversely impact on the Fund, however we consider these risks to be less given that the manager seeks to maintain a well diversified portfolio of attractively valued securities and limit these risks specifically within their portfolio risk management constraints. In addition, given that the interest rate duration of the portfolio tends to be short, increases in interest rates are likely to have limited impact on the capital value of the portfolio over a short term period.

As with most boutique funds management firms, there is key person risk as a result of the small size of the team however we believe with a team consisting of four highly experienced fixed interest professionals this risk is somewhat mitigated.

Applications of the Fund

This Fund is ideal for those investors who are comfortable with a medium risk investment and are seeking attractive income returns with moderate potential for capital growth. From a return perspective, the Fund's exposure to higher yielding securities should result in investors receiving an attractive income return with small levels of franking over the medium term. As a moderate level of capital volatility is expected over time investors should not use the Fund as a substitute for cash and should adopt a medium term (3+ years) timeframe when investing in order to "ride out" any short term capital movements.

The specialist nature of the Fund in terms of the hybrid securities into which it invests means that it will combine well with an international or diversified fixed interest fund within a portfolio.

The portfolio allocation to the fund will be driven by the risk tolerance of the investor however research we have completed suggests a 25% allocation to hybrids within a fixed interest portfolio is appropriate. This equates to around a 6.0% weighting for a balanced portfolio with a 25% weighting in fixed interest.

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