KAPSTREAM
A JANUS CAPITAL Group Company

December 2015

Review of 2015

Business

Kapstream has enjoyed another successful year. Building on existing client relationships as well as cementing new ones, our business has grown from approximately A$8 billion to approximately A$10 billion in assets under management. Our new relationship with Janus formally began on July 1st. While a notable milestone on Kapstream's timeline, by design it has not changed the work we do for our clients in Australia. During these uncertain times in markets, our unwavering focus remains on managing risks with a strong bias to capital preservation. These core beliefs have been rewarded with universally strong inflows and we remain deeply grateful for the continued support our growing client base provides us.

Performance

Looking back it is clear that of the two elements of our dual strategy goals, capital preservation and a consistent return over cash, the market environment has been one in which a greater attention has been on not losing money rather than making money. With less than a fortnight to go before we close the books, calendar year returns of approximately 2.5% after wholesale fees are by our own admissions lacklustre, but all things considered are at least the right side of the ledger! The climate is one in which we have had to work hard to balance the absolute return aspirations of the portfolio with our promise to clients to preserve capital.

Environment

We have long held a positive view on investment grade credit in Australia, largely due to the attractive real yields and robustness of issuers compared to other developed markets. Our portfolios continue to have material exposure to the sector. Through the year and particularly in the second half, we have seen spreads drift gradually wider (which we think will continue throughout Q1 2016) having a negative mark-to-market impact on prices. This widening reflects both domestic and international factors:

- Australian corporate bond technicals have been weak (recent issuers had to price wider to attract investors more defensively oriented)
- More bank issuance under TLAC banking regulation is expected in 2016 (and beyond), adding to the weak technical sentiment
- Weak commodity names (BHP, Rio, etc.) have pushed the broader index wider (iron ore hitting new lows with little chance of fundamentals improving in the foreseeable future)
- Oil prices down to sub $35 levels (trading close to GFC lows)
- Confidence hit by some US high yield funds experiencing a flood of redemptions and fears this trend could spread (already having triggered a rally in treasuries)
- Most risk assets down for the year in Australia and Asia (ASX200 -8.7% YTD (year-to-date), Hang Seng -9.3% YTD, Shanghai Comp -13% last 6 months at the time of writing)

Avoiding the banana skins

While we would like to claim ability to see into the future, our avoidance of all the 'blow ups' of 2015 has simply been the result of our risk-centric philosophy and defensive bias. In the Australian Dollar space, we avoided the worst 10 performing corporate bonds (worst 5 listed below with their performance of the past 6 months highlighted):

- Anglo America '18s (BBB-/Baa3) out +748bpts
- Glencore '19s (BBB/BBB) out +526bpts
- Volkswagen '19s (A3/BBB+) out +180bpts
- Volkswagen '18s (A3/BBB+) out +177bpts
- BHP '20s (A+/A1) out +85bpts

Equally our orientation leading us to remain underweight unfavourable sectors has also been beneficial:

- Energy: Our exposure remains very small at 2.7% (reduced from 3.2% ahead of the slide in oil pricing). Holdings are high quality (AA-), short dated (2.2 years average maturity) securities that are majority owned by governments
- Autos: Prior to the VW scandal, we held just 1.5% in the autos sector (in VW 3 month commercial paper, not the bonds). The auto sector is one that we have historically always been given our view that relative value is poor (we never felt the sectors' bonds priced in the risk of the banking arm, or car recalls).

And how can we forget the impact of the Fed…

Our message for the past couple of years has been that we expected rate hikes to be further out than markets anticipated. As such we have retained a tempered duration position of just under 1 year. This has largely been rewarded and our view that any more significant a wager on the direction of rates remains a low information ratio trade. With the Fed finally initiating 'lift off', all eyes remain on the pace and magnitude of subsequent rises. Our view that 'slow and steady' continues to be prudent in an environment in which recovery strength remains tenuous.

Market recap 2015

After keeping rates near zero for the past 7 years, the US Federal Reserve raised interest rates for the first time in 9 years in December, following their well-telegraphed plan to gradually increase interest rates. With the unemployment rate falling to 5%, a level believed to be near full employment and leading to wage gains and inflation, the Fed faced a difficult decision, balancing continuing low inflation versus a fear of loss of credibility. The Fed's preferred inflation measure, the PCE, remained at 0.2%, well below its 2% target. By the Fed's own estimates, probabilities for inflation reaching the 2% target in 2016 remained near zero.

Reflecting the likelihood of inflation remaining low in 2016 and beyond, markets forecast only an approximate 1% per year increase in rates over the coming years, in line with current Fed messaging. Bond yields remained stable and still near record lows, reflecting a low growth, low inflation environment over the intermediate to long term. The Fed's zero rate policy and $3.8 trillion in asset purchases since the GFC had led to a mere 2% annualized growth over the past 5 years.

Markets remain concerned over faster than expected Fed hiking, which could exacerbate US dollar strength and capital flows out of Emerging markets. The rest of the world remains in easing mode, with much of the Emerging world abandoning domestic-led growth policies in favour of export-led growth and corresponding weakening currency plans.

In China, policymaker's focus on social stability and bringing more of the population out poverty and into the middle class suffered a setback following the volatile ride for Chinese equity markets through the first half of the year. Although the Shanghai index rose 10.6% over the year, it fell by 44% over the 3 month period from June to August 2015, despite official attempts to stabilize the markets. A Yuan devaluation and forced buying by large government sponsored investors yielded little result as investors increased their worry over slowing growth. However, GDP remained near 7%, as the 2010 plan to double per capita GDP by 2020 remained on track.

The Russian economy suffered severe setbacks in 2015. It was expected to contract by almost 4% in 2015, hamstrung by falling oil prices, which hit $38/barrel by year-end and Western economic sanctions enacted in response to Russian military action in Ukraine.

South American markets suffered the contagion effects of Brazil, where inflation reached a 12 year high at 10.5%, a corruption scandal hit the state run oil company, Petrobras, and ratings agencies warned of continuing downgrades amidst further political corruption.

The far left Syriza party rose to power in Greece, who promptly rejected IMF/EU austerity measures before being forced to accept an even tougher deal in exchange for another bail-out. Counter-intuitively, voters subsequently re-elected Syriza with a mandate to continue on the austerity path - or at least kick the can down the road for as long as possible.

The ECB continued with its efforts to paper over Europe's growth and fiscal woes, announcing a €60 billion/month bond buying program in January which was subsequently extended to last at least until March 2017. By year-end 40% of European sovereign bonds had negative yields.

Spain appeared to remain the European economic success story as growth reached 3% in 2015, the best in Europe. After peaking at 26% in 2013, unemployment fell to 21% by year end as the prior banking crisis and budget deficits were resolved, austerity measures continued and reform in labour and product markets progressed. While upcoming elections increase probabilities for uncertainty, a likely ruling coalition government gave markets confidence that prior reform measures will continue.

Continuing low rates and policy makers' push to force investors into more risk seeking investments allowed M&A activity to reach a new record level in 2015 at $4.3 trillion, surpassing the 2007, pre-GFC record. Mega deals priced from $50 to $160 billion included Pfizer/Allergen, Dow/DuPont, Anheuser-Busch /SAB Miller, Shell/BG, Dell/EMC, Charter/Time Warner and Heinz/Kraft.

The pace of regulatory reform remained high in 2015 as centralized clearing and reporting of OTC derivatives became required in most developed markets, managing to overshadow the exponential growth in regulatory and compliance staff. Nonetheless, fraud and corruption remained at center stage. Volkswagen's emission scandal, FIFA's bribery scandal and the global foreign exchange and LIBOR fixing scandals made 2015 headlines, rounded out by the alleged securities fraud by Martin Shkreli.

Thank you for your support through the year and we look forward greatly to continuing the relationship into 2016 and beyond!

With best wishes for a safe and relaxing break.

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