Kapstream
—JANUS HENDERSON—

Quarterly Report - Class I Units

Kapstream Absolute Return Income Fund

KANGANEWS AWARDS 2017 WINNER – AUSTRALIAN CREDIT FUND MANAGER OF THE YEAR
KANGANEWS AWARDS 2018 WINNER – AUSTRALIAN CREDIT FUND MANAGER OF THE YEAR
KANGANEWS AWARDS 2019 WINNER – AUSTRALIAN CREDIT FUND MANAGER OF THE YEAR

Fund Objective

The fund aims to provide a superior stream of income and capital stability over the medium term while aiming to outperform its benchmark through market cycles.

Fund Application

Investors seeking to enhance their overall fixed income returns with a higher yielding, predominantly investment grade (IG), absolute return-oriented global fixed income portfolio.

Fund Details

APIR code	HOW0165AU
Inception date	31 May 2007
Fund size	AUD 4005mil
Distribution frequency	Quarterly
Management fee	0.40%
Buy/sell spread	Please contact us for latest spreads

Fund Statistics

Interest rate duration	0.37yrs
Credit spread duration	2.81yrs
Average credit rating	A-
No of issuers	99
Yield to maturity	1.6%

Fund Guidelines

Target return	cash plus 2-3%
Target volatility	less than 1.5% annualised
Duration limits	-2 to +2 years
Credit quality	>85% investment grade

Steve Goldman
Portfolio Manager

Dan Siluk
Portfolio Manager

September 2021

Performance (%)	1 month	3 months	1 year	3 years p.a.	5 years p.a.	Annualised since inception
Fund Return (before fees and sell spread)	0.05	0.39	1.71	2.45	2.81	4.83
Fund Return (after fees, before sell spread)[1]	0.02	0.29	1.29	2.00	2.37	4.48
Fund Return (after fees and sell spread)[2]	0.02	0.29	1.34	1.96	2.35	4.48
RBA Cash Rate	0.01	0.03	0.11	0.65	0.99	2.83
Active return[3] (before fees and sell spread)	0.05	0.36	1.60	1.79	1.82	2.00
Active return[3] (after fees and sell spread)[2]	0.01	0.26	1.22	1.31	1.36	1.64
Bloomberg AusBond Banks Bill Index	0.00	0.01	0.04	0.78	1.20	3.07

Past performance is no guarantee of future results. After fee returns are inclusive of 0.41% annualised total expenses for class I units. Fund inception date 31 May 2007. No allowance is made for tax. Numbers may not add due to rounding. 1) For a continuing investor the actual return experienced based on the NAV performance of the Fund, after accounting for management fees. 2) The return experienced by a redeeming investor, based on the exit price performance of the Fund which accounts for the end of period sell spread of 0.07% and management fees. 3) Active return of the Fund compared to Benchmark (RBA Cash Rate). Source: Fidante Partners Limited, 30 September 2021.

Performance Commentary

The fund returned +0.02% in September and +0.29% for the quarter (after I class unit fees). Coupon income was the primary contributor to returns. With correlations between risk-free and risky assets moving into positive territory over the month (they typically exhibit a negative correlation), we had the rare situation whereby both interest rate duration, via higher yields in the risk-free curve, and credit spread duration, via widening of credit spreads, both led to a modest return detraction, together offsetting coupon income for the month. Our currency positions; long USD vs. CAD, GBP, JPY and EUR added marginally to returns as the USD was met with safe-haven buying.

Market Commentary & Outlook

In September, markets caught a risk-off tone, in what has been uncharacteristic of the fiscal-and-monetary-stimulus/post-pandemic return-to-normal induced bid for risk assets over the course of 2021. In the US, the S&P 500 was down -4.76%, its worst monthly return since the COVID-19 inspired rout of March 2020. Locally, the S&P/ASX 200 fared a little better, to close down -2.69%, its first drawdown since September 2020. The market shift to a risk-off tone was driven by a number of factors including: slowing global growth trajectory and implications for policymakers; the Evergrande scandal which enveloped China and drew comparisons of Lehman-style contagion; ongoing supply-chain issues, particularly in the energy sector and the threat it poses to the transitory inflation narrative; political posturing on Capitol Hill with respect to debt ceiling and government shutdowns; as well as ongoing uncertainty around COVID's delta-variant. Volatility was considerably higher across all asset classes.

September's Federal Open Market Committee (FOMC) delivered a hawkish surprise for markets, Chair Powell indicating that tapering of asset purchases will end by mid-2022, sooner than the market had expected. There was also an admission from Powell and other members that elevated inflation prints may persist for longer than anticipated due to ongoing bottlenecks in supply chains and the oddity of labour shortages despite a large number of unemployed persons. Together, this resulted in a bearish steepening of the yield curve; the 2-year Treasury closed the month 6.6 basis points higher at 0.275% while the 10-year was 17.9 basis points higher at 1.49%.

US data was mixed. August payrolls (released early September) were weak, missing expectations by 500k (+235k print versus +733k expected), the third largest miss on record. The economic-forecasting community has shown a complete inability to forecast high-frequency data during this unusual business cycle. Despite the miss, underemployment reached a new post-pandemic low of 8.8%, down from 9.2% last month. The concerning feature for the FOMC would be the fact that the participation rate remains low, and unchanged since April, at 61.7%, pointing to supply constraints amongst the labour force. Producer Prices rose, headline +8.8% year-on-year, from +7.8% the prior month, while Consumer Prices moderated with core inflation +4.0% versus expectations of +4.2%, the first below expectation inflation print since November 2020. Unsurprisingly, the weaker inflation print was driven by re-opening sectors which had previously driven inflation to its lofty peaks; the likes of airfares, used cars and car rentals all softer. One segment we're keeping our eye on is shelter costs, a considerable slice of the consumer price basket at approximately 32%. One sub-component of shelter being Owners Equivalent Rent, was up 0.3% month-on-month, the fourth consecutive print at this level and supportive of the notion that rising house prices could impact shelter costs more broadly, leading to persistently higher inflation.

At September's meeting, the Reserve Bank of Australia (RBA) decided to move ahead with its planned taper of asset purchases, reducing purchases from $A5 billion per week to $A4 billion per week, just as the third round of Quantitative Easing begins and despite lockdowns engulfing New South Wales and Victoria. The RBA did however delay a planned review of purchases scheduled for November 2021, to February 2022. The RBA has made it clear that lockdowns "delay rather than derail" the economic recovery. Governor Lowe continued to communicate the Board's belief that conditions for a rate hike will not be met until 2024 and expressed surprise in recent market pricing to the contrary. 3-year Government bonds rose 7.5 basis points to 0.31% while the 10-year climbed 33.5 basis points to 1.49%.

Across the Tasman, the Reserve Bank of New Zealand (RBNZ) looks set to increase rates at its forthcoming October meeting. However, in September, market participants were forced to quash bets they had placed on more aggressive hikes. Overnight Index Swap (OIS) curves had at its peak priced a 48% probability for a 50 basis point hike before board member Hawkesby poured cold water on the notion and said the RBNZ would "follow a smoothed path and keep their policy rate unchanged or move in 25 basis point increments." This leaves the RBA and the RBNZ at opposite ends of the central bank hawk-dove spectrum.

Europe saw a busy month of central bank activity. Norway's Norges Bank became the first developed market central bank to hikes rates in the post-pandemic era, raising rates 25 basis points, as expected, to 0.25%. Their language was hawkish as they promised to do more in the future to fight soaring house prices and the heightened use of leverage in this low-rate world. Sweden's Riksbank maintained unchanged policy settings but commented on their expectations that inflation will remain stably "above target" throughout 2022. The European Central Bank (ECB) also left monetary policy unchanged but said they will "re-calibrate" the Pandemic Emergency Purchase Programme (PEPP) in the coming months. Lagarde stressed that such action should not be viewed as tapering. However, it was The Bank of England (BoE) who took the prize for the most market-moving central bank when, despite unchanged policy settings , the committee announced that future tightening of monetary policy, to combat inflation, should be in the form of rate hikes and that this may occur before asset purchases have been scaled back. This sent both 2-year and 10-year UK Government bonds around 9 basis points higher on the day and drove a sell-off (higher yields) across developed market rate curves into month end.

Chinese economic growth has slowed this year, at first the decline was gradual but the pace has picked up in recent times. Both Manufacturing and Services Caixin PMIs dipped below 50 at the beginning of September, signifying a contraction, not just a slowdown. Activity is set to remain weak in the months ahead judging from the sharp cutbacks in production of some energy-intensive sectors. The precarious position of Evergrande, one of China's largest property developers, has seen contagion fears over to the broader property and financial sector grow, however we note that while HY Chinese credit is significantly wider over the month, IG Chinese credit is only 10 basis points or so wider from it's lows. We maintain the view that Chinese policymakers have zero tolerance for the emergence of systemic risk.

Portfolio Strategy

The portfolio increased its yield-to-maturity over the month, from 1.33% to 1.60%, now an attractive 150 basis points above the RBA's cash rate which will provide a robust driver for returns going forward. The opportunities driving this additional return are off-index, idiosyncratic issuers. We've built an exceptional pipeline of deals and hence expect this trend of favourable yielding opportunities to continue to make their way into the portfolio over the coming months. We continue to run a barbell strategy preferring shorter dated BBB credits over longer dated A credits given their similar spread and lower losses in a sell-off. Credit spread duration and average maturity were higher over the month. Credit spread volatility picked up marginally given the broader risk-off move, however, appetite for paper, particularly primary issuance, remains resilient.

In terms of asset allocation, the portfolio can be split across three major 'buckets'; financials (~29.0%), corporates (~47.6%), and asset and mortgage-backed (~15.5%) with the residual in cash and liquids. Geographically, we have an 72%/28% split between Australian & New Zealand and international issuers.

In rates, duration was little changed over the month where we continue to run ~0.4 years total exposure. At a country level, the breakdown is ~0.3 years Australasian duration and ~0.05 years US duration. Hawkish surprises from central banks and worrying signs that the transitory inflation narrative may end up being more entrenched have driven our positioning to remain low duration to ensure capital is protected. Traditional benchmark-aware Fixed Income as an asset class had a tough September, the Bloomberg AusBond Composite down -1.5%, given the rate moves highlighted early in the piece and the fact that coupon income remains low, goes to show how modest moves in rates can impact capital. As such, we remain positioned to produce a smoother, positive absolute return profile.