Kapstream Absolute Return Income Plus Fund

Kapstream
— JANUS HENDERSON —

Monthly Report – I class units

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

Inception date	16 August 2018
Fund size	AUD 344m
Distribution frequency	Quarterly
Management fee	0.45% p.a.
Buy/sell spread	0%/0.2%

Fund statistics

Interest rate duration	0.42 yrs
Credit spread duration	1.80 yrs
Yield to Maturity	3.45%
Average credit rating	BBB+
Number of issuers	61

Fund guidelines

Target return	cash plus 3-4%
Target volatility	<3% annualised
Duration limit	-2 to +2 yrs
Credit quality	>75% investment grade

Dylan Bourke
Portfolio Manager

Steve Goldman
Portfolio Manager

October 2021

Performance (%)	1 month	3 months	6 months	1 year	calendar year to date	annualised since inception
Fund Return *(before fees and sell spread)*	**0.11**	**0.67**	**1.49**	**3.64**	**2.37**	**3.23**
Fund Return *(after fees, before sell spread)*[1]	0.07	0.56	1.26	3.15	1.98	2.73
Fund Return *(after fees and sell spread)*[2]	0.07	0.56	1.26	3.42	2.13	2.71
RBA Cash Rate	0.01	0.02	0.05	0.10	0.08	0.67
Active return[3] *(before fees and sell spread)*	**0.10**	**0.65**	**1.44**	**3.54**	**2.29**	**2.56**
Active return[3] *(after fees and sell spread)*[2]	0.06	0.53	1.21	3.32	2.05	2.04
Ausbond Bank Bill Index	0.00	0.00	0.01	0.03	0.02	0.81

Past performance is no guarantee of future results. Net of fee returns inclusive of 0.4632% annualised total expenses. 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 start and end of period sell spread level (see additional note on sell spreads at the end of this report), and management fees. 3) Active return of the Fund compared to Benchmark (RBA Cash Rate). Source: Fidante Partners Limited, 29 October 2021.

Performance commentary

The Fund returned 0.11% before fees in October which whilst low, demonstrated the resilience of the portfolio given difficult market conditions with A$ 3yr rates selling off 91bps, whilst A$ spreads widened around 10bps. The fund delivered in the middle of its cash plus 3-4% target range over the trailing twelve-month period. The largest contributor over the month was coupon income whilst credit spreads widening detracted from performance. The portfolio's interest rate exposure of 0.42yr was fairly neutral due to the exposure of a modest flattener.

Portfolio strategy

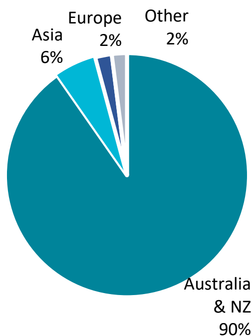
The fund rotated into attractive new issues, maintaining the yield over 3%, while spread duration reduced to 1.8yrs. We believe this spread over the cash rate should provide a strong tailwind for returns going forward. Duration was maintained around 0.4yrs, as we believe there will be continued volatility in rate markets, due to persistent concerns about inflation. We continue to run a barbell strategy, preferring short-dated, lower rated credits given their expected resilience in a sell-off and concerns over credit spreads at relatively tight levels. Repo exposure was nil.

The fund's recent purchases included market leaders in the corporate, securitised and financial sectors, where we see attractively priced securities. The average credit rating of our holdings was increased to BBB+ from BBB. Given the purchase of attractive new issues, high yield exposure was maintained at 20.7%. High yield holdings are typically BB-rated, short maturity bonds in the financial or securitised sectors where we have no concern around default risk. We minimise or completely avoid exposure to the traditionally higher beta sectors such as commodities, energy, airlines and tourism.

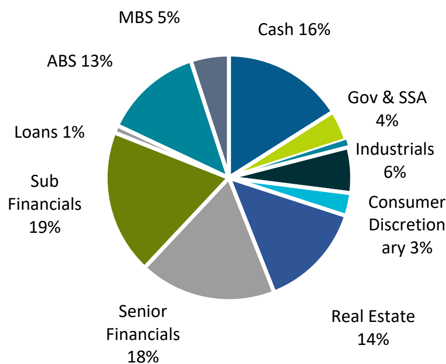
Our portfolio can be simply split across three major 'buckets'; financials (~37%), corporates (~25%), and asset and mortgage-backed (~18%) with the residual in cash and liquids. Geographically, we have an 90%/10% split between Australia/New Zealand and international issuers. Over the coming months, we expect to maintain the yield on the portfolio, as we continue to add from a very strong pipeline of investment opportunities.

In rates, we have ~0.2yrs Australasian duration and ~0.2yrs US duration for a total portfolio duration of ~0.4yrs. We believe there is merit in maintaining some level of neutral duration as a hedge for the credit book.

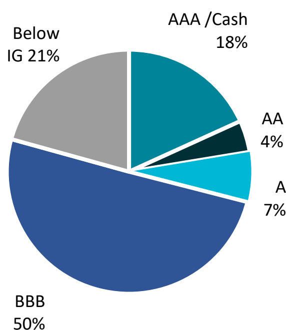
Geographic Allocation



Sector Allocation



Credit Rating



Outlook

In global markets, the S&P 500 rebounded strongly from a weak September, volatility reduced with the VIX down 6.9 points to 16.3. Credit spreads widened in Australia and the US, whilst CDS was stable, being well anchored by equity markets. Globally rates suffered a sharp sell off in the front end. This was caused by markets re-pricing rate hike expectations, bringing them forward as a result of higher inflation, which is also proving to be more persistent than anticipated. As we enter November, investors continue to grapple with the implications of shifting monetary policy stance across the globe and how countries are choosing to combat and balance rising inflation with softer growth.

In the US, non-farm payrolls disappointed again with 194,000 jobs compared to 500,000 expected and unemployment went to 4.8% from 5.2%. Counteracting that softness, previous months' payroll figures were revised higher. Participation remained weak at 61.6%, as ongoing supply constraints continue to weigh on the labour force. The minutes from September's Federal Open Market Committee meeting suggested a taper of asset purchases is likely to begin in November depending on how the data evolves. Inflation is key and with headline running at 5.4% annualised and core (which excludes volatile food and energy components) at 4%. The details were inflationary, as structural factors, and not 'transitory' sectors, drove the strong numbers. In particular, the shelter component was a key driver, with owners-equivalent-rent up 0.43% on the month, the strongest monthly gain since 2006. 2-year US Treasury yields were 22bps higher at 0.497%, while 10-year yields rose 6.5bps to 1.55%.

Australia suffered the fiercest rate sell-off. The Reserve Bank of Australia's (RBA) policy of Yield Curve Control (YCC) , where it had targeted 0.10% yields in the 3-year and below part of the curve, was challenged by market participants. On 21 October, the yield on the Apr-24 bond traded as high as 0.18%. The following day the RBA purchased $A 1bn of bonds, bringing the yield closer to target at 0.115%. However, on 27 October, Australia's Core CPI printed at 2.1% annualised, within the RBA's target range for the first time since 2015, and yields on the Apr-24 bond climbed to 0.2%. The following day there was anticipation the RBA would, once again, be back in the market, purchasing bonds, to draw the yield closer to target once again. However, the RBA was absent from the market and there was no communication. Over the next few trading sessions, yields on the Apr-24 bond climbed as high as 0.8%, suggesting YCC would be abandoned at the upcoming RBA meeting early November (which is exactly what transpired). Over the course of the month, the 3-year bond soared 91bps to 1.22%, while the 10-year rose 60bps to 2.09%.

In Europe, the European Central Bank (ECB) maintained unchanged policy settings. The ECB remains one of the more dovish developed market central banks and also continues to fervently believe inflation is transitory. The ECB's Chief Economist, Philip Lane, suggested inflation is far from the "red zone", while Board Member Isabel Schnabel fears premature rate hikes are "harmful and risk jeopardising the ongoing economic recovery". We expect European markets to continue to lag the rest of the world as it pertains to the pricing in of rate hikes. However, across the English Channel, the story is much different. The Bank of England (BoE) Governor, Andrew Bailey, has acknowledged that inflationary pressures are building, which has made rate hikes more likely. BoE inflation forecasts have regularly been revised higher and when interviewed by the Financial Times, BoE Chief Economist Huw Pill said that their upcoming November meeting was "live" and "finely balanced". Markets responded by sending front end rates higher, the 2-year UK Gilt rose 30bps to 0.71%, meanwhile the 10-year was little changed, up 1bp to 1.03%

Chinese economic growth has slowed this year. At first, the deceleration was gradual but recently it has become more apparent. Activity is likely to remain weak in the months ahead given 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 flow over to the broader property and financial sector. We maintain the view that Chinese policymakers have zero tolerance for the emergence of systemic risk but the timing of any support is unclear.

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