Kapstream Absolute Return Income Fund

Kapstream
— JANUS HENDERSON —

Quarterly Report - Class I Units

KANGANEWS AWARDS 2017 WINNER – AUSTRALIAN CREDIT FUND MANAGER OF THE YEAR
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KANGANEWS AWARDS 2021 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 3418mil
Distribution frequency	Quarterly
Management fee	0.40%
Buy/sell spread	Please contact us for latest spreads

Fund Statistics

Interest rate duration	0.25yrs
Credit spread duration	2.74yrs
Average credit rating	A-
No of issuers	92
Yield to maturity	2.35%

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

December 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)	0.17	-0.09	0.55	2.25	2.75	4.74
Fund Return (after fees, before sell spread)[1]	0.15	-0.19	0.13	1.79	2.30	4.39
Fund Return (after fees and sell spread)[2]	0.15	-0.19	0.16	1.76	2.29	4.38
RBA Cash Rate	0.01	0.03	0.10	0.53	0.92	2.78
Active return[3] (before fees and sell spread)	0.16	-0.11	0.45	1.71	1.83	1.96
Active return[3] (after fees and sell spread)[2]	0.14	-0.21	0.06	1.23	1.37	1.60
Bloomberg AusBond Bank Bills Index	0.00	0.01	0.03	0.63	1.11	3.01

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, 31 December 2021.

Performance Commentary

The fund returned 0.15% for the month (after I class unit fees). Coupon income was the primary driver, with both rates and credit flat over the month despite price swings across all asset classes, a reminder of the volatility seen in fixed income markets throughout most of 2021 which conspired to drive sobering returns of -0.19% for the 4th quarter and 0.13% for the full calendar year period.

The fund seeks to generate consistent returns by focusing on higher-quality, shorter-dated credits that offer attractive risk-return characteristics. Underpinning our strategy is a strong belief that over the long term, an allocation to globally diversified, shorter-duration bonds offers considerable benefits relative to traditional fixed income portfolios. For every asset class, however, there is a unique set of adverse market conditions that prove difficult to fully insulate against. For shorter-dated bonds, perhaps the most challenging environment is one where inflation, and rate hike expectations, rise swiftly, which is precisely what happened over the year.

The funds defensive absolute return focus, while producing only modest positive returns in 2021, still importantly met its capital preservation objective, proving its value when compared to more traditional fixed income strategies; the Bloomberg Ausbond Composite index dropped -2.89% over the year, while the Bloomberg Global Aggregate (AUD hedged) index fell -1.53%, the latter not spending anytime in positive territory at all, the first time in history this has occurred.

Market Commentary & Outlook

In the US we saw an increase in commentary from Federal Reserve (FED) Board Members around the merits of an elevation in the pace of tapering, amid acceptance that higher inflation will last longer than first anticipated. Chair Powell noted that the spike in inflation can no longer be characterised as *"transitory"*. Mid month, when the Committee met, this was acknowledged via a doubling in the pace of tapering, agreeing to reduce purchases by USD30bn per month, from USD15bn per month just 4 weeks prior. Additionally, the December dot-plot showed a more hawkish-leaning Committee as they forecast 3 hikes by the end of calendar year 2022, with a further 3 in 2023. Importantly however, the terminal rate as forecast by the Committee remains at 2.5%, which implies that persistently higher inflation will lead to hikes occurring sooner and with a more rapid pace, as opposed to a need for more hikes. We agree with this thesis and are positioning the portfolio with a shorter duration tilt in the front end. On the data front, while headline non-farm payrolls were below expectations at +220k vs +550k expected, revisions were positive and both the unemployment rate (4.2% vs expectations of 4.5%) and participation rate (61.8% vs 61.7%) were strong. Headline inflation beat expectations for the sixth time in eight prints, with drivers once again being broad based in nature. The FEDs hawkishness continues to be corroborated by data. The 2-year US Treasury rose 16.5 basis points to 0.73% while the 10-year rose 6.6 basis points to 1.51%.

In Australia, the month kicked off with a surprisingly strong (COVID-19 impacted) Q3 GDP print of -1.9%, beating expectations of -2.7%. While household consumption fell as anticipated; business investment, public spending and net exports all contributed positively. With a spike in the household savings ratio to 19.8% we believe the consumer will lead the recovery into 2022. Employment also surprised to the upside with 366k jobs returning, relative to expectations of 200k, reversing most of the Q3 deterioration. The unemployment rate fell to 4.6% from 5.2% the prior month, while the underemployment rate fell to 7.5% from 9.5%. This was made all the more impressive given a participation rate which climbed significantly from 64.6% to 66.1%, only marginally below the pre-delta variant high of 66.3%. The Reserve Bank of Australia (RBA) maintained the overnight cash rate at 0.1%. While the RBA reiterated their central scenario for no rate hikes in 2022 given inflation is not yet sustainably within the target range, they noted the possibility of an end to Quantitative Easing (QE) in February if data remains strong. In our view, the RBA will speed up its conclusion to the QE program, more so in response to FED hawkishness, rather than domestic conditions. Despite a fairly wide trading range of 25bps during the month, the yield on the 3-year Australian Government Bond rose a modest 5 basis points to close the month at 0.91%, while the 10-year fell 2 basis points to 1.67%.

Europe's rise in COVID-19 cases coupled with persistently higher energy costs has continued to weigh on sentiment. The European Central Bank (ECB), unlike some of its global counterparts, continues to believe inflation is linked to the pandemic and therefore transitory, so has maintained a dovish tone. Board member Schnabel highlighted that "*raising policy rates prematurely would risk choking the recovery and, given the long lags in transmission, exert downward pressure on inflation at a time when the shocks are likely to have already faded".* German 2-year rates rose 11.6 basis points to -0.62%

The Bank of England (BOE) meanwhile hiked rates by 15 basis points to 0.25%, in somewhat of a surprise move given the surge in COVID-19 cases and Monetary Policy Committee (MPC) member Saunders comments in the early stages of the month that the MPC may benefit from waiting to observe Omicron-variant impact on the economy before hiking. While growth expectations for both Q4 2021 and Q1 2022 were revised down, the focus was on the trajectory of inflation given rising energy costs and ongoing labour supply constraints, hence the hike was instituted to combat this. The 2-year UK Treasury yield rose 20 basis points to 0.687% while the 10-year rose 16.2 basis points to 0.97%

Portfolio Strategy

The portfolio yield rose again slightly to ~2.3% as rates increased and investments in non-bank lender warehouses funded. Overall portfolio liquidity was elevated at 18% for Level 1 investments (cash, commerical paper, term deposits, government, semi-government, and supranationals) and 14% for Level 2 investments (<1yr investment grade bonds), prefunding deals closing over the seasonally quieter period. We expect this to trend back towards 15% for Level 1 (normally 5-10%) as we prepare for a more volatile year driven by expected Fed rate hikes, tapering and potentially balance sheet run-off. We expect these volatile periods to be self-correcting given the weight of money remaining in the system, so are prepared and waiting to 'buy the dip'.

We continue to run a more acute barbell-shaped strategy (that has worked well from a credit perspective in most of 2021), for example preferring shorter dated BBB-rated credits over longer dated A-rated credits given their similar spread and lower losses in a sell-off. Credit spread duration remained little changed over the month. From a spread per unit of risk perspective, the excess yield the portfolio is able to earn above the risk free rate remains near historical highs, highlighting the robustness of the portfolio and underscoring confidence in being able to deliver to our return objective on a forward looking basis. We believe from a credit perspective we are well placed to provide a stable and appealing income stream well insulated from the various headwinds faced, maintaining a yield comfortably in excess of 2%, higher in a spread sense than for several years.

In terms of asset allocation, the portfolio can be split across three major 'buckets'; financials (28%), corporates (~39%), and asset and mortgage-backed (<15%) with the residual in cash and liquids. Geographically, we currently have a roughly 90%/10% split between Australian & New Zealand and international issuers.

From a rates perspective, we saw volatility climb and remain elevated throughout 2021, even during periods where volatility across other asset classes was more sanguine. Persistent inflation has led central banks to recently pivot and begin the process of enacting tighter monetary conditions. Unlike in times of crisis where the central bank 'playbook' is to cut rates to their effective lower bound and dial up quantitative easing, this period of higher inflation has no playbook. Uncertainty in the reaction function of central banks is high.

Active management and a tactical mindset to rate positioning and risk management are going to be key in 2022, and as such we expect our neutral level of duration to remain well below 0.5 year through the year ahead, in order to mitigate some of this uncertainty. As a result, we reduced interest rate duration further in December, from 0.4 years, to close the year at a little under 0.3 years, reflecting our belief that central banks are speeding up their exit from QE and bringing forward rate hiking cycles. The geographic split is 0.1 years in each Australia and US, with the residual coming from Europe and New Zealand. On curve positioning, we retain our bias for flatter curves in both Australia and US.