Kapstream Absolute Return Income Plus Fund

Kapstream
— JANUS HENDERSON —

Monthly Report – I class units

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

Inception date	16 August 2018
Fund size	AUD 380m
Distribution frequency	Quarterly
Management fee	0.45% p.a.
Buy/sell spread	0%/0.2%

Fund statistics

Interest rate duration	0.34 yrs
Credit spread duration	1.91 yrs
Yield to Maturity	3.36%
Average credit rating	BBB
Number of issuers	67

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

December 2021

Performance (%)	1 month	3 months	6 months	1 year	calendar year to date	annualised since inception
Fund Return *(before fees and sell spread)*	**0.27**	**0.45**	**1.39**	**2.72**	**2.72**	**3.16**
Fund Return *(after fees, before sell spread)*[1]	0.23	0.33	1.15	2.24	2.24	2.67
Fund Return *(after fees and sell spread)*[2]	0.23	0.33	1.15	2.40	2.40	2.65
RBA Cash Rate	0.01	0.03	0.05	0.10	0.10	0.64
Active return[3] *(before fees and sell spread)*	**0.26**	**0.42**	**1.34**	**2.62**	**2.62**	**2.52**
Active return[3] *(after fees and sell spread)*[2]	0.22	0.30	1.10	2.30	2.30	2.01
Ausbond Bank Bill Index	0.00	0.01	0.01	0.03	0.03	0.77

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, 31 December 2021.

Performance commentary

The Fund returned 0.27% before fees in December. During calendar year 2021, despite A$ credit spread widening, the fund delivered only marginally below its cash plus 3-4% target range over the trailing twelve-month period, driven by a strong coupon income and strong credit gains. The main detractor was a volatile rate environment costing ~185bps over the year, reversing the large positive rate contribution in 2020. For the month, the largest contributor was coupon income, with a small contribution from credit spreads tightening. The 0.34yr duration slightly detracted from performance as rates sold-off.

Portfolio strategy

The fund allowed inflows to build up liquidity, with level 1 liquidity reaching 15.6% (cash, semi-government, commercial paper, SSGA) and level 2 liquidity reaching 20.7% (<1yr IG) as we prepare for Fed tapering, rate hikes and potential balance sheet run-off. This positioning reflects our belief that in 2022 there will be attractive buying opportunities after temporary stumbles for risk assets, similar to 2018.

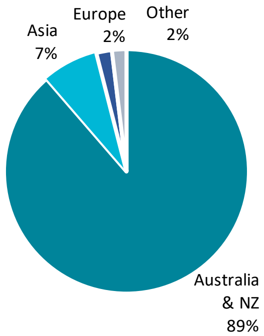
Even if stumbles don't eventuate, the fund yields over 3%, providing a strong tailwind for future returns. Spread duration was stable at 1.91yrs reflecting the barbell strategy of overweighting short-dated, lower rated credits given their expected resilience in a sell-off and concerns over credit spreads at relatively tight levels. Duration was reduced marginally to 0.3yrs, as we believe there will be continued volatility in rate markets, due to persistent concerns about inflation. Repo exposure was 0.9%.

Recent purchases included leaders in the financial and securitised sectors. The average credit rating of holdings was stable at BBB. High yield was stable at 19.9%. 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 continue to minimise or completely avoid exposure to the traditionally higher beta sectors such as commodities, energy, airlines and tourism.

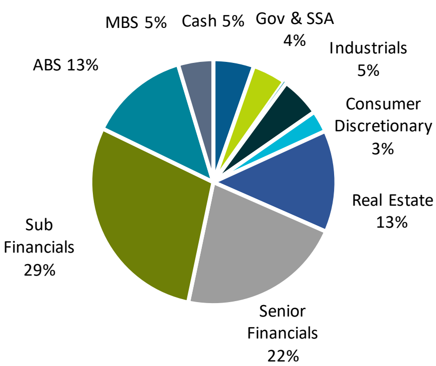
Our portfolio is split across financials (~47%), corporates (~23%), and asset and mortgage-backed (~18%) with the residual in cash and liquids. Geographically, we have an 88%/12% split between Australia/New Zealand and international issuers.

In rates, we have ~0.2yrs Australasian duration and ~0.1yrs US duration for a total portfolio duration of ~0.3yrs. We believe there is merit in maintaining some level of neutral duration as a hedge for the credit book.

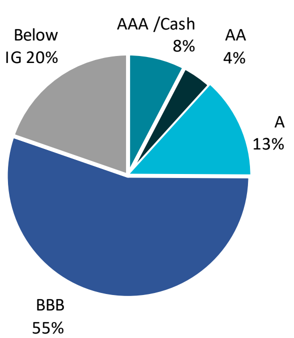
Geographic Allocation



Sector Allocation



Credit Rating



Outlook

In global markets, risk assets reversed the sell-off in November, with global equities up, CDX tightening 5bps and the VIX reducing 10ppt to 17%. US credit spreads tightened 9bps, with AUD spreads being fairly stable except for T2 which tightened 9bps. Global rates sold off, particularly in the short end. Swap spreads rallied a few bps unwinding some of the significant sell-off last month. We expect there will be increased volatility in 2022 given likely Fed tapering, hiking and potential balance sheet unwinding, as well as US mid term elections providing plenty of opportunities for sharp sell-offs. We expect these volatile periods to be self-correcting given the strong GDP and weight of money remaining in the system, so we are prepared and adopting a 'buy the dip' philosophy.

In the US, we saw increased commentary from Fed members around faster tapering, amid acceptance that higher inflation will last longer than anticipated. Powell noted the spike in inflation can no longer be characterised as "transitory". This was acknowledged via a doubling in the pace of tapering, agreeing to reduce purchases by USD30bn per month, up 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 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 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 Fed's hawkishness continues to be corroborated by data. The 2-year US Treasury rose 16.5bps to 0.73% while the 10-year rose 6.6bps to 1.51%.

In Australia, the COVID-19 impacted Q3 GDP print was surprisingly strong at -1.9%, beating expectations of -2.7%. Household consumption fell as anticipated; business investment, public spending and net exports all contributed positively. A spike in the household savings ratio to 19.8% indicates to us that 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 impressive given a participation rate which climbed significantly from 64.6% to 66.1%. The 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, it noted the possibility of an end to Quantitative Easing (QE) in February if data remains strong. We expect the RBA will speed up its conclusion to the QE program, 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 5bps to close the month at 0.91%, while the 10-year fell 2bps to 1.67%.

Europe's rise in COVID-19 cases coupled with persistently higher energy costs has continued to weigh on sentiment. The 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 11.6bps to -0.62%. The Bank of England (BOE) meanwhile hiked rates by 15bps to 0.25%. As such, the 2-year UK Gilt yield rose 20bps to 0.687% while the 10-year rose 16bps to 0.97%.

In China, we saw a weak Caixin PMI print of 49.9 compared to consensus of 50.6, but by the end of the month the NBS PMI was 50.3 vs consensus of 50 providing a mixed signal. CPI was soft at 2.3% below consensus of 2.5%. China's property developers' debt issues remain unresolved and represent a continued headwind for China's recovery from the pandemic.