Kapstream
— JANUS HENDERSON —

Kapstream Absolute Return Income Fund

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 3324mil
Distribution frequency	Quarterly
Management fee	0.40%
Buy/sell spread	Please contact us for latest spreads

Fund Statistics

Interest rate duration	0.12yrs
Credit spread duration	2.64yrs
Average credit rating	A-
No of issuers	94
Yield to maturity	2.49%

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

February 2022

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)	-0.08	0.16	0.54	1.97	2.55	4.69
Fund Return (after fees, before sell spread)[1]	-0.11	0.07	0.12	1.51	2.11	4.33
Fund Return (after fees and sell spread)[2]	-0.11	0.07	0.12	1.49	2.09	4.33
RBA Cash Rate	0.01	0.02	0.10	0.46	0.87	2.75
Active return[3] (before fees and sell spread)	-0.09	0.14	0.44	1.51	1.68	1.94
Active return[3] (after fees and sell spread)[2]	-0.12	0.04	0.02	1.03	1.22	1.57
Bloomberg AusBond Bank Bills Index	0.01	0.01	0.03	0.51	1.05	2.98

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, 28 February 2022.

Performance Commentary

The portfolio returned -0.11% for the month, close to flat for the calendar-year-to-date period at -0.08% (after I-class unit fees). Considered against the significant levels of uncertainty on the global stage this is a relatively strong defensive result and testament to heightened risk mitigation. With rising interest rates and widening credit spreads, both rates and credit positioning detracted from portfolio performance, while coupon income remained consistently positive.

2022 is shaping up to be a challenging repeat of 2021 for traditional fixed income investors, where higher yields are leading to capital losses and an increase in the volatility of returns. The Bloomberg AusBond Composite Index was down -1.2% for the month and now sits at -2.2% for the calendar-year-to-date period, and with a current yield of 1.9%, even if rates remain unchanged for the remainder of the calendar year, coupon income is insufficient to bring that index (and likewise any traditional strategies managed against it) back to a positive absolute return throughout the whole of 2022. Having avoided material drawdown through this recent period of excruciating rate volatility, with a portfolio yield now in or above the 2.5% level, we're confident of meeting our primary objective of capital preservation while concurrently generating a reasonably attractive return for investors.

Market Commentary & Outlook

Risk sentiment soured materially in February as Russia's President Vladimir Putin began a full scale invasion of Ukraine. This marks an escalation of the war which began in 2014 with the annexation of Crimea and occupation of the Donbas region in the south east, both internationally recognized as Ukrainian lands. Putin's goal, it seems, is to instil a pro-Russian government (similar to Belarus) and prevent Ukraine from being militarised and joining NATO. Ukraine on the other hand seeks to align itself closer to western Europe, join NATO, and be able to defend itself from its eastern neighbour. The upheaval is felt most harshly in Europe with Germany looking to increase military spending and previously neutral nations such as Switzerland, Sweden and Norway feeling the need to finally 'choose a side' in this debate. While sanctions designed to cripple the Russian economy are having their desired

impact, the knock-on effects in terms of energy and food inflation will have significant consequences for inflation globally. The S&P 500 declined -3.1%, the VIX Index, a measure of implied volatility, rose 21.4% to 30.15. Oil (Brent) and gold rallied, up 11.5% and 6.2% respectively.

While the second half of the month was influenced by Russia/Ukraine developments, the first half of the month was dominated by a growing chorus of commentary around central bank tightening, which may need to be more aggressive than earlier anticipated to combat inflation which is at multi-decade highs. In the US, members of the Federal Open Market Committee (FOMC) agreed that the first hike will occur soon (at the March meeting) and that the hiking cycle will be at a faster pace than previous tightening cycles. There was some talk from more hawkish-leaning members of the committee, in particular St Loius FED President Jim Bullard, who said that a 50 basis point hike and a more rapid withdrawal of accommodative monetary policy was warranted. While this was briefly reflected in market pricing, the volatility induced by an uncertain geopolitical climate quickly saw this revert to a 25 basis point hike being priced for March. On the data front, both non-farm payrolls and CPI printed above expectations, with the latter touching 7.5%, the highest level since 1982. The front end of the Treasury curve sold off sharply with the 2-year Treasury up +25 basis points to 1.43%, while the 10-year rose +5 basis points to 1.83%. We maintained our bias for a curve flattener through the month, but given the speed of the move have begun clipping profits on the position.

In Australia, the RBA met early in the month and while there was no change to the level of cash rates at 0.10%, the RBA did formally announce the discontinuation of their bond buying program. An announcement on their bond reinvestment strategy will be made in May. Governor Lowe did go to lengths in his communique to remind the market that the end of Quantitative Easing (QE) did not imply that they were about to embark on a hiking cycle, as wage growth remains modest and there is some uncertainty from Board members as to how sustainable inflation will be given supply-side issues are yet to be resolved. After years of failing to reach their inflation target range Lowe also pointed out that an inflation miss to the upside was an acceptable risk, as it implied a strong labour market and therefore strong economy. Australian employment data remains robust, despite the Omicron overhang, with unemployment stable at 4.2%. The yield on the 3-year Australian Government Bond rose +23 basis points to 1.54%, while the 10-year rose +24 basis points to 2.14%.

In Europe, the European Central Bank (ECB) kept policy settings unchanged at its February meeting, however, there was a notable change in tone from President Lagarde who highlighted that there was unanimous concern from the committee about inflation and that risks were tilted to the upside. Oftentimes it is what central bankers don't say that capture market's attention and this month was a good example. In prior months' commentary Lagarde had ruled out a 2022 hike and the omission of this statement led to rates selling off and a rally in the Euro currency on the expectation that rate hikes from the perennially dovish central bank were possible this year. However, these moves were reversed later in the month by the onset of the Russia/Ukraine war. The continents' dependence on Russian energy and how prolonged this war becomes will lead to economic disruptions and our view is that the subsequent policy response cannot be as hawkish as central banks outside the region. German 2-yr government bonds were flat at -0.53%, while the 10-yr rose +12 basis points to 0.135%.

In the UK we saw the Bank of England (BOE) hike rates 25 basis points to 0.5%. While the vote was 5-4 in favour of a 25 basis point hike, the 4 dissenters had called for a 50 basis point hike, hence this was a hawkish outcome for UK rates markets. Voters unanimously agreed upon the winding down of bond purchases and cessation of maturity reinvestments. The BOE minutes also highlighted concerns that rising energy costs would reduce discretionary consumption going forward, slowing growth. The BOE Chief Economist Huw Pill outlined that this moderation in growth would ease pressure on inflation, stressing that the BOE is not behind the curve and their approach to the monetary policy adjustment was to ensure the real economy does not suffer. The UK 2-year Treasury was unchanged at 1.04% and the 10-year moved higher +11 basis points to 1.41%.

Portfolio Strategy

Portfolio yields rose and are now at or above 2.5% as front end rates increased and we used the risk-off environment to opportunistically switch from expensive to discounted credits. Overall portfolio liquidity remains high at ~20% for 'Level 1' investments (cash, commercial paper, term deposits, government, semi-government, and supranationals) and ~8% in 'Level 2' investments (<1yr investment grade bonds). We expect this to reduce to 10% for Level 1 (normally 5-10%) as we use a backdrop of volatility from FED rate hikes, tapering, possible balance sheet run-off and geopolitical risks to gradually add discounted credits. We are starting to see attractive opportunities, and we expect to benefit from the ability to add more credit to move from an underweight credit position to at least neutral, having run a light book in December and January accordingly given peak uncertainty on the rates front, a strategy which has paid off.

We continue to run a more acute barbell-shaped strategy (that 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, but 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. The credit protection strategies we employed during January have paid dividends, dampening volatility of our physical assets and hence driving some positive return

contribution. As such, we have begun unwinding some of these protection positions in a disciplined and systematic manner, reducing the size of the hedge by around a third. Macro volatility provides good opportunity to add credit with idiosyncratic mispricing, and we have been switching into credits where a significant new issue concession exists, or where we believe the secondary market is mispriced. We are aiming to incrementally increase our spread duration as credits cheapen, shifting from an underweight to a more neutral credit positioning. This places us in a strong position to provide a stable and appealing income stream, well insulated from the various headwinds faced, and maintaining a yield in the mid 2% range, higher in a spread sense than for several years.

In terms of asset allocation, the portfolio can be split across three major 'buckets'; financials (~30%), corporates (~40%), and asset and mortgage-backed (<15%) with the residual in cash and liquids. By currency, we currently have a roughly 95%/5% split between Australian & New Zealand and international issuers which is a conservative position given AUD & NZD credits trade with lower volatility compared to USD & EUR.

From a rates perspective, volatility remains elevated. The MOVE index, a measure of implied volatility across a number of points on the US Treasury yield curve, breached 100 during February, levels not seen since the Global Financial Crisis (2008-09) and subsequent Eurozone Crisis (2010-11). A clear example of this volatility is seen in the intra-month trading ranges of the US 2-year Treasury, trading as high as 1.63% and as low as 1.13% over the month. On the day of the CPI print (February 10th) the 2-year Treasury traded in a 30 basis point range, the largest one-day move since 2009. Given the volatility in rates we reduced duration over the month from ~0.4 year to ~0.1 year. While central banks embarking on their tightening cycles has led us to run very low duration exposure over these last few months, looking forward, there are two scenarios where we would seek to add duration; 1) ongoing geopolitical tensions lead to a flight-to-safety reallocation into fixed income which drives yields lower, and 2) where we feel market pricing of rates hikes is too aggressive, such that if a central bank were to meet those market expectations they would risk a sharper slowdown or potentially even a recession. We are monitoring market conditions closely and will make portfolio changes in a timely manner, as the situation develops.

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