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 3371mil
Distribution frequency	Quarterly
Management fee	0.40%
Buy/sell spread	Please contact us for latest spreads

Fund Statistics

Interest rate duration	0.39yrs
Credit spread duration	2.79yrs
Average credit rating	A-
No of issuers	93
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

January 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)	0.07	0.10	0.47	2.15	2.68	4.72
Fund Return (after fees, before sell spread)[1]	0.03	0.00	0.05	1.69	2.23	4.37
Fund Return (after fees and sell spread)[2]	0.03	0.00	0.08	1.66	2.22	4.36
RBA Cash Rate	0.01	0.03	0.10	0.49	0.89	2.77
Active return[3] (before fees and sell spread)	0.06	0.07	0.37	1.65	1.78	1.95
Active return[3] (after fees and sell spread)[2]	0.02	-0.03	-0.02	1.17	1.32	1.59
Bloomberg AusBond Bank Bills Index	0.01	0.01	0.03	0.57	1.08	3.00

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 January 2022.

Performance Commentary

The fund returned 0.07% for the month (after I class unit fees). Coupon income was the primary driver of returns, with both rates and credit detracting, while contribution from FX was flat. While modest in an absolute sense, we are pleased with the return given market volatility, which saw rates climb on the back of central bank hawkishness, as well as credit spreads widening on a combination of tighter monetary policy expectations and escalating geopolitical tensions. Traditional fixed income indices have begun 2022 in negative territory for a second consecutive year and while coupon income is higher today than a year ago, the prospects of traditional bond portfolios delivering negative absolute returns again this year remains high, and the value of strategies such as ours compared to more conventional approaches evident. We will seek to protect investors from such adverse conditions with our primary objective of capital preservation.

Market Commentary & Outlook

The year began with a 'sea of red' driven by two main themes. The first was a more hawkish than anticipated Federal Reserve (FED) who continue to react to persistently high levels of inflation, which in turn drove markets to price in a more aggressive hiking cycle. The second was an escalation in geopolitical tensions between Russia and the West over Ukraine. Together these led to a sharp correction in risk assets. In fact, the intraday volatility witnessed in January has been the most pronounced since the days of the Global Financial Crisis (GFC) in 2008. The VIX Index, at its peak, traded just shy of 39, having begun the year at 17.2. The S&P 500 declined -5.3%, but the peak-to-trough move at one point reached down -12.4%. The tech-laden Nasdaq Composite Index was down -9% on the month, it's peak-to-trough move a staggering -17.4%. In credit markets, the US Investment Grade Index, CDX IG, widened +10.8 basis points to 60.3 while the High Yield Index, CDX HY, widened +46.2 basis points to 339. Russia/Ukraine tensions saw oil prices climb to 88.15, up +19.35% on the month

The Minutes from the December Federal Open Market Committee (FOMC) meeting were

released in the first week of January and they were far more hawkish than market participants had anticipated. Additionally, for the first time since the last tightening cycle of 2015-2018, Quantitative Tightening (QT) - the reduction in the size of the FEDs balance sheet - was placed on the agenda. This paved the way for higher rates across the curve during the course of the month. Data releases further justified the FEDs hawkish stance with unemployment dipping to 3.9% from 4.2% the previous month. Headline CPI rose 7% over the full calendar year. To add some context around the loftiness of this result the last time CPI was at such levels the FED Funds Rate was at 13% (1982). Inflation continues to outpace market projections, with 8 of the last 10 monthly prints being above consensus. By the time the FOMC met again late in January, market pricing for hikes had climbed from 3 to almost 5, with some market commentators calling for as many as 7 hikes and there were even suggestions of a “shock and awe” 50 basis point hike. Chair Powell indicated QE will cease in March, but of more interest was his lack of use of terms such as “gradual” and “methodical”, replacing them with moving “steadily” and being “nimble” to describe the removal of monetary accommodation, which we interpret as leading to a steeper path of rate hikes over the calendar year. We also believe that every meeting throughout the year should be considered “live”, where policy adjustments may be made, as opposed to only quarterly changes observed during the last tightening cycle. However, ultimately hikes will be dependent on the path of data as the year progresses, with the FED recognising that too aggressive a hiking cycle can slow economic growth or even lead to recession. The yield on the 2-year US Treasury rose +45 basis points to 1.18%, while the 10-year Treasury was up 27 basis points to 1.78%. We remain short duration and continue to favour flatteners in the US, adding to our position during the month.

While there was no central bank meeting in Australia during January, data releases continue to beat expectations. Unemployment came out at 4.2%, down from 4.6%, and underemployment at 6.6%, down from 7.5%. These are at the lowest level since the GFC and point to further increases in wage prices in the coming quarters. Inflation data was also strong with core CPI at 1.0% on the quarter relative to expectations of 0.7%, the strongest quarterly print since 2008, and on an annualised basis up 2.6% versus expectations of 2.3%, comfortably within the Reserve Bank of Australia's (RBA) target band. We think the strength in the data and the inflation experience seen abroad will mean that the RBA won’t necessarily wait for wage inflation to hit 3% before beginning its hiking cycle, and therefore hikes in 2022 remain a possibility and we fully expect the RBA to drop its dovish rhetoric in the coming quarters. Australian rates exhibited a high correlation to that of the US, with the yield on the 3-year Australian Government Bond up +40 basis points to 1.31%, while the 10-year rose +22.5 basis points to 1.895%.

New Zealand too saw inflation data beat expectations, up 5.9% on an annualised basis relative to consensus of 5.7%. This is the strongest annual rate since the 1990’s and while markets had already priced in a hike by the Reserve Bank of New Zealand (RBNZ) at their next meeting, this certainly keeps them on track. Housing and utilities were once again the largest contributors to inflation and being more persistent or structural components of the inflation basket, together with tight labour markets by virtue of the New Zealand governments' strict COVID-19 policies, we expect the RBNZ tightening to outpace most dollar-block central banks this year.

In Europe, geopolitical headlines around Russia/Ukraine dominated. Russia is the second largest producer of crude oil and petroleum products and it supplies roughly one-third of Europe’s energy needs, so the tensions with Ukraine, which saw oil prices soar, will put more upward pressure on inflation. While many members of the European Central Bank (ECB) continue to believe energy costs and supply pressures are near their peak and should ease over the course of the year, we remain circumspect. The German 2-year bond rose +9.2 basis points to -0.53%, while the 10-year was up +18.8 basis points to 0.01%, closing the month in positive territory for the first time since mid-2019.

In the United Kingdom (UK), central bankers appear more vigilant than their European cousins in fighting inflation, having already hiked rates in December and are expected to follow these up with additional hikes in the coming months. Inflation data, like in other regions, continues to be elevated, printing at an annualised pace of 5.4%, up from 5.1% the prior month. Economists do not believe the peak has been put in place with utility costs set to rise in April as the country’s energy regulator is set to raise caps on prices. The yield on the 2-year UK Treasury rose +35.8 basis points to 1.045% and the 10-year was up +33 basis points to 1.30%.

In Asia, the People's Bank of China (PBoC) eased monetary policy by cutting rates on medium term loans for the first time since April 2020, going against the grain of tightening seen in the developed world. China faces a slowing pace of economic growth and a property sector in need of triage. In addition to looser monetary policy we also see the need for fiscal injections, either in the form of funding to drive infrastructure projects or tax cuts for businesses and households to drive investment and spending, over the course of 2022. The Bank of Japan (BOJ), one of the perennial doves on the global central bank scene, guided a slight but meaningful shift in it’s inflation narrative, moving from “skewed to the downside” to “evenly balanced” in its description of inflation forecasts, the first such change in their language since 2014. While immaterial if it were to resound from any other central bank, we believe this is as hawkish a shift as we’ve seen from Japan for some time, a recognition that they are not immune from rising inflation globally.

Portfolio Strategy

Portfolio yields rose again to remain comfortably above 2% as rates increased and investments in non-bank lender warehouses funded. Overall portfolio liquidity remains high at 14% for ‘Level 1’ investments (cash, commercial paper, term deposits, government,

semi-government, and supranationals) and 14.7% for 'Level 2' investments (<1yr investment grade bonds). We expect this to average around 15% for Level 1 (normally 5-10%) as we prepare for a more volatile year driven by expected FED rate hikes, tapering and possible balance sheet run-off. We expect these volatile periods to be self-correcting given the weight of money remaining in the system, so are actively 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. Given increased volatility, in the first few weeks of the year we added some tail risk hedges including 3% notional of CDX and 4bps of premium on put options on HYG, a high yield ETF. We have a disciplined unwinding schedule to take profits on these hedges should volatility persist. We expect these hedges to insulate the portfolio somewhat to credit widening and provide cash to buy into any dip. Macro volatility provides good opportunities to add credit with idiosyncratic mispricing and we have been switching into credit where there is a significant new issue concession, or where we believe the secondary market is mispriced. 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 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 (29%), corporates (~45%), 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, the shift in narrative at the FED from "gradual" to "nimble" implies high uncertainty around this tightening cycle in an already frayed market. While overall interest rate duration did rise over the month from 0.24 years to 0.38 years, it is important to highlight that average interest rate duration was 0.26 years and touched a low of 0.17 years, underlining the fact that we too need to remain "nimble" in managing interest rate exposure and will tactically adjust the portfolio accordingly. The split in duration from a geographic perspective was 0.14 years in Australia, 0.20 years in the US, with the residual in New Zealand and Europe. The bias is to retain a low interest rate exposure, between zero and 0.5 years, as well as positioning for flatter curves in Australia and the US as markets price in hikes and central banks ultimately embark on their tightening cycles.

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