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 334m
Distribution frequency	Quarterly
Management fee	0.45% p.a.
Buy/sell spread	0%/0.2%

Fund statistics

Interest rate duration	0.37 yrs
Credit spread duration	1.98 yrs
Yield to Maturity	4.70%
Average credit rating	BBB
Number of issuers	68

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

March 2022

Performance (%)	1 month	3 months	6 months	calendar year to date	1 year	3 years annualised	since inception annualised
Fund Return *(before fees and sell spread)*	**-0.13**	**0.27**	**0.72**	**0.27**	**2.51**	**2.67**	**3.02**
Fund Return *(after fees, before sell spread)*[1]	-0.17	0.16	0.49	0.16	2.03	2.19	2.59
Fund Return *(after fees and sell spread)*[2]	-0.17	0.16	0.49	0.16	2.04	2.16	2.51
RBA Cash Rate	0.01	0.02	0.05	0.02	0.10	0.42	0.60
Active return[3] *(before fees and sell spread)*	**-0.14**	**0.25**	**0.67**	**0.25**	**2.41**	**2.25**	**2.42**
Active return[3] *(after fees and sell spread)*[2]	-0.18	0.13	0.44	0.13	1.94	1.74	1.91
Ausbond Bank Bill Index	0.00	0.01	0.02	0.01	0.04	0.46	0.72

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, and management fees. 3) Active return of the Fund compared to Benchmark (RBA Cash Rate). Source: Fidante Partners Limited, 31 March 2022.

Performance commentary

The Fund returned -0.13% before fees in March. Despite being negative the return is one of the strongest amongst peers demonstrating robust capital preservation and resilience, notably when compared to conventional indices such as the Ausbond Credit 0+ and Ausbond Composite 0+ indices which fell -3.05% and -3.75% respectively. The largest contributor was coupon income. Rate duration of 0.37yr detracted as rates sold-off, and rapidly widening spreads driven by broader risk-off moves also detracted.

Portfolio strategy

The Fund used the correction to selectively buy primary issuances offering up to 10-20bp new issue concessions, which were attractive especially as these were on top of widening in USD and in AUD credit spreads of up to c50bps and c30bps. So far, the year to date sell-off in US IG credit is comparable in magnitude to the Q4 2018 sell-off. Although this was our base case for the year, it happened earlier than expected, triggered by the Ukraine invasion. Fortunately, we repositioned defensively in December/early January for Fed lift-off. Level 1 liquidity reduced to a still conservative level of ~12.6% (cash, semis, commercial paper, SSGA) and Level 2 liquidity ~14.3% (<1yr investment grade) reflecting deployment of cash.

The Fund currently yields over 4%, providing a strong tailwind for future returns. Spread duration ex SSGA increased to ~1.8yrs from 1.6yrs reflecting additions of new issues. This was possible due to the barbell strategy's success in limiting losses and providing liquidity at an opportune timeThis strategy overweights short-dated, lower-rated credits in tight spread environments (assets with equal carry but less spread compression potential providing greater resilience to sell-offs) and invests in a small bucket of less-liquid, high-spread assets to subsidise an overweight position in liquid assets. The Fund took profits on virtually all credit hedges. Duration increased from 0.14yrs to 0.37yrs, which is still low, as we believe there will be continued volatility in rate markets, due to persistent concerns about inflation. Repo exposure was stable at 3%.

Purchases included leaders in the financial sector. The average credit rating of holdings was stable at BBB. High yield increased to c23%, where holdings are typically BB, short maturity bonds in the financial or securitised sectors where we have no concern around default risk. We continue to minimise or avoid exposure to the traditionally higher beta sectors such as commodities, energy, airlines and tourism. Our portfolio is split across financials (~56%), corporates (~17%), and asset and mortgage-backed (~18%) with the residual in cash and SSGAs. We have an 87%/13% split between Australia/New Zealand and international issuers.

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, especially as short dated rates have increased significantly.

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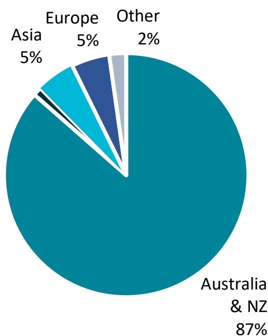
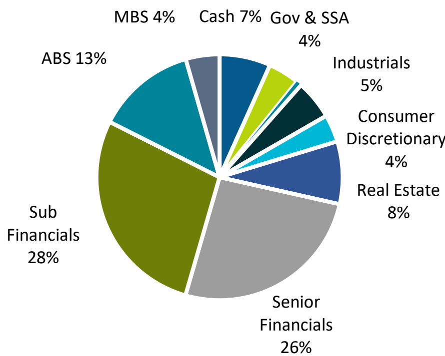
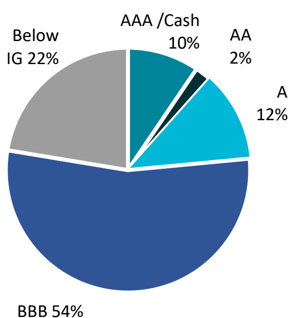
Geographic Allocation



Sector Allocation*



Credit Rating*



*Scaled to 100% for repo

Outlook

Lenin the leader of Soviet Russia between 1917-1924 said “there are decades where nothing happens, and there are weeks where decades happen". Putin continues to oversee a military regime change in the region, which has seen him exert his influence in Georgia (2008), annexing Crimea (2014) and the more recent military campaign in Ukraine. This has been met with an economic regime change by the West. In an attempt to undermine Russia’s economy and creditworthiness, the West has imposed punitive economic sanctions and plan to wean itself off Russian energy. Global markets, were volatile as a result with the S&P 500 +3.6%, but the peak-to-trough move reached down -13.1% for the year at one point. Additionally, rates sold off significantly with US10yr rising 51bps and Aus10yr rising 70bps. VIX reduced 9.6ppt to 20.6%. In credit markets, the US CDX Investment Grade, ranged between 64 and 78 ending fairly unchanged at 68.

Economic concerns have shifted from pandemic-induced inflation, which impacted supply chains, to conflict-induced inflation, which is increasing energy and food prices which are more important components of consumer’s basket. We expect this to lead to a drop in discretionary spending, confidence and ultimately a slowdown in growth. However, central banks believe they face a greater risk of policy mistake in not combating inflation, than they do from slower growth, and will therefore continue with their aggressive rate policy normalisation. Financial market volatility is higher today than for most of the post-global financial crisis cycle and we expect this theme to continue. We believe volatility will be structurally higher going forward, which implies yields and credit spreads should settle at structurally higher levels. Currently, this means maintaining a low-duration position within portfolios, but eventually front-end carry and roll down will be too attractive to pass on.

In the US, labour market tightness continues with non-farm payrolls beating expectations and both unemployment (3.8%) and underemployment (7.2%) trended lower and approached historic lows. The Fed hiked rates for the first time this cycle with a 25bp increase to 0.5%, with Powell highlighting price stability is the number one priority. Given headline CPI and PCE printed 7.9% and 6.4%, and continue to climb, the Fed has a long way to go before it can claim any credibility on the inflation fighting front. The dot plot released at the March FOMC meeting implied a 1.75% increase in cash rates over the course of the calendar year, up from 0.75% at the December meeting. James Bullard, the most hawkish of FOMC members, was the only voter to favour a move higher by 50 bps and continues to call for an even more rapid removal in accommodation, with suggestions of 3% cash rates by year end. The front end of the Treasury curve sold off, with 2yr up +90 bps to 2.33% and 10yr rose +51 bps to 2.34%.

Europe has a larger current account surplus and a healthier corporate balance sheet, as such, the response to Russia/Ukraine has been more cohesive than we would have expected a decade ago. Decisions to sanction the Russian economy, plans to reduce reliance on Russian energy and the re-settling of millions of Ukrainian refugees will pose problems for Europe in the near term, not least a deceleration in an already sanguine growth environment of recent years, ushering in a prolonged period of higher inflation and fiscal injections required to meet social welfare needs. Nonetheless, while stressing data dependence and optionality, ECB President Lagarde did announce that the taper of asset purchases has been brought forward to the third quarter this year, paving the way for rate hikes toward the end of the year. German 2yr yields rose 46 bps to -0.07%, while the 10yr rose 41 bps to 0.55%.

In Australia, the RBA met early in the month, keeping policy rates on hold. Governor Lowe maintains that while inflation risks are to the upside, the Board believes inflation and wage price dynamics differ in Australia to other jurisdictions globally and therefore “patience” is warranted. Unemployment dipped to 4%, the lowest level since 2008. GDP growth ended the 2021 calendar year at 4.2%, slightly above expectations, boosted by household spending as the economy emerged from lockdowns. While the RBA can point to domestic conditions as driving monetary policy, the reality is Australian yield curves continue to exhibit a high correlation to US yields, in particular the front-end. Australian 3yr yields rose +80 bps to 2.34% while the 10yr rose +70 bps to 2.84%.

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