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 2849mil
Distribution frequency	Quarterly
Management fee	0.40%
Buy/sell spread	Please contact us for latest spreads

Fund Statistics

Interest rate duration	0.55yrs
Credit spread duration	2.28yrs
Average credit rating	A-
No of issuers	95
Yield to maturity	5.07%

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

June 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)	-0.18	-0.48	-0.58	1.01	2.12	4.52
Fund Return (after fees, before sell spread)[1]	-0.21	-0.59	-0.99	0.56	1.67	4.16
Fund Return (after fees and sell spread)[2]	-0.21	-0.58	-0.98	0.54	1.66	4.16
RBA Cash Rate	0.06	0.09	0.17	0.33	0.79	2.70
Active return[3] (before fees and sell spread)	-0.24	-0.58	-0.74	0.68	1.32	1.82
Active return[3] (after fees and sell spread)[2]	-0.27	-0.67	-1.14	0.21	0.87	1.46
Bloomberg AusBond Bank Bills Index	0.05	0.07	0.10	0.33	0.95	2.92

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, 30 June 2022.

Performance Commentary

The Fund posted a slight negative return in June, falling by 0.21% (after class I unit fees) in what continues to be a particularly challenging environment for all investors, and where the usual negative correlation between bonds and credit spreads was not observed. This historically uncommon combination of rising yields and widening credit spreads has dominated the 2022 year-to-date period, and while our defensive strategy has provided far greater resilience against capital erosion than most conventional solutions, we have been unable to avoid some drawdown over the period. However, in a 'gain from pain' sense the benefit that comes from a rising yield environment is evident in the astonishing rise in the yield-to-maturity profile, now at ~5% some 3-4 times higher than just 12 months ago, providing a powerful tailwind for forward looking returns.

Market Commentary & Outlook

Financial markets had another challenging and volatile month in June. After a brief respite in May, yields resumed their upward trend in June as the notion that we had seen peak inflation and peak hawkishness was challenged. Risk sentiment deteriorated further, as central banks continued to unwind the stimulus which had boosted asset prices from April 2020 to the end of 2021, and fears grew that additional rate hikes and the cost of fighting inflation would lead to a recession in the US and elsewhere.

Bond yields showed extremely large ranges both intra-day and intra-month, with the 89bps range in US two year bonds in June the second largest increase since the Global Financial Crisis (only behind March of this year which saw a 102bps intra-month range). Yields rose sharply over the first half of the month as the US CPI for May showed an increase above expectations. On the back of a jump higher in oil prices, the yearly increase moved to a new 30-year high of 8.6%. The more traditional underlying measures also exceeded expectations and, along with a jump in consumer inflation expectations measures, did not meet the Fed's requirements of clear and convincing evidence that inflationary pressures were easing. The Fed therefore backed away from its previous commitment of 50bps hikes at the June and

July meetings and raised rates by 75bps in June to a target range of 1.50%-1.75%. The Fed also indicated that rates would rise further and into contractionary territory, ending 2022 at 3.25%-3.50% (previously 1.75%-2%) and topping out in 2023 at 3.75% (previously 2.75%).

While bonds elsewhere generally take their lead from the US, central bank hawkishness in other regions supported even larger increases in yields and intra-month ranges. In Australia the Reserve Bank of Australia (RBA) hiked rates by more than expected for a second straight month, increasing the cash rate target by 50bps to 0.85%. Governor Lowe also clearly indicated that there were more hikes to follow, with the choice being between 25bps and 50bps each month in what will be one of the most aggressive tightening cycles in living memory. Australian ten year bond yields had a range of more than 100bps in the month as a result, peaking at 4.27%. The European Central Bank (ECB) announced the end of its bond buying program as of 1 July 2022 with ECB President Lagarde indicating 25bps hikes at each of the following two meetings is likely. Other ECB officials called for even larger moves to take rates out of negative territory more quickly. German ten year bond yields had an intra-month range of more than 90bp in the month, peaking at a yield of 1.92%.

However it wasn't one way traffic in bond yields in June. In the latter half of the month the chatter about recession increased noticeably and led to a paring back of rate hike expectations. The chance of a near-term recession in the US increased, with a softening in consumer spending data under the weight of higher food and energy prices supporting a potentially negative reading for US second-quarter GDP. This would fulfill the technical definition of a recession, even if the usual requirement of an increase in the unemployment rate was not present (it continues to decline and the number of job vacancies almost doubles the number of unemployed). Estimates of the probability of recession in a year's time have also increased markedly under the weight of rate hikes and are now generally above 50%. This began to impact what was stretched market pricing for the end of the tightening cycle, with the terminal rate in the US falling from above 4% mid-month (so above even the Federal Reserve's guidance of 3.75%) to finish the month below 3.50%. In Australia, Governor Lowe's questioning of market pricing saw the terminal rate similarly fall back from just under 4.50% mid-month to finish below 3.75%. Bond yields across the developed world gave up almost all their gains within the month as a result, giving a round trip that was arguably greater than the one-way trend that was seen in March.

The direction of travel in risk sentiment was more one-way. Here the two main narratives over the month of June, namely the removal of post-pandemic stimulus and the increased chance of a recession, both worked to see equities fall and credit spreads widen. The fall in equities has now reached more than 20% from the highs, putting it into correction territory and being the worst first half of any year for decades. Australian and US synthetic investment grade credit spreads are now around half way back to the early-2020 pandemic wides, with the former out 35bps in June alone to be at 130bps and the latter widening 22bps to 101bps. Physical credit spreads also deteriorated significantly, with concessions demanded by investors for new deals increasing. US and Australian physical credit spreads to bond widened by around 25bps in the month, with European credit spreads widening more on the reduced direct purchases from the ECB and relatively worse activity outlook. Looking ahead, we continue to see spreads as being inside the peak levels historically observed when the US and global economies have headed into recession.

However, June was not without a number of reasons to be positive. Energy, metals and food prices pulled back significantly on recession fears in the second half of the month, which have been the chief architects behind the rise in headline inflation globally. This may result in central banks not having to raise rates as far in the attempt to quell inflation and consumer inflation expectations. Market pricing of inflation has continued to pull back significantly on expectations that central banks will be successful in their inflation aspirations, with US 10 year break even inflation ending up at 2.34% at the end of June (from above 3% during April). The ECB also announced its intention to introduce measures to limit the possible increases in Southern European government bond yields, reducing contagion risks into other markets. The lifting of mobility restrictions in Shanghai and other parts of China under the zero COVID-19 policy should also help reduce supply side constraints, and contribute to a rebound in manufacturing activity globally in coming months.

Portfolio Strategy

We continued to position more defensively over June, holding credit spread duration below historic strategy averages. This involved holding a significant CDX credit protection position of ~10%, balancing concerns about the Fed's ability to guide the global economy through an inflation and rate hiking induced slowdown, whilst avoiding tipping the economy into recession in the next 12-24 months, vs the likelihood of a short term bear market risk rally.

Physical spread duration ex. SSGA was reduced to just over 2 years taking advantage of pockets of buying as our concern over increasing odds of global recession appear to increase. We continue to buy selectively but mainly on a switch basis. Our ability to buy on a switch basis is possible as a result of the more acute barbell-shaped strategy we've pursued in the portfolio for some time to limit losses and provide liquidity at opportune points. This approach (1) underweights longer dated A-rated credits and overweights shorter dated lower rated credits (mainly BBB assets), assets with equal carry but less spread compression providing greater resilience in sell-

offs, and (2) invests in a small bucket of higher spread assets to subsidise an overweight position in highly liquid assets which provide the ammunition to add cheap new credits.

In terms of asset allocation, the portfolio can be split across three major 'buckets'; financials (~40%), corporates (~40%), and asset and mortgage-backed securities (<15%) with the residual in cash and liquids. Approximately 75% of the portfolio is held in Australian names, and by currency ~90% of the portfolio is held in AUD-denominated securities.

On the duration front, whilst we had been gradually increasing the position from around flat at the turn of the year to something more positive, a number of developments led to us winding this back somewhat in June. The key catalyst was that evidence increased that we were not yet at peak hawkishness from a number of central banks in addition to the Federal Reserve. The RBA surprised on the high side for a second straight month and the ECB's commitment to larger than previously expected 25bp increases in coming meetings saw yields rise strongly in both markets. The stability in US yields seen in May was therefore thought to be a misleading guide, and we acted to reduce exposure ahead of US CPI news from a little below three-quarters of a year to closer to half a year. We expect to resume adding to this duration position as confidence increases that we have seen peak inflation and peak hawkishness, but event risk around oil prices and upcoming CPI readings means it is difficult to form a high conviction view at this time.

The other factor helping to explain our positioning across both rates and credit (as well as the return experience of the past six months) remains the unusual positive correlation between the returns from bonds and credit spreads. After a brief return to the more usual negative correlation in May, the experience that has been the norm so far in 2022 resumed in June. The other uncommon aspect has been how aggressive the increase in bond yields has been, with some markets showing increases over the past six months that has not been seen since the mid-1980s. Only once the market pricing of terminal rates reaches its zenith do we expect these destructive influences to ease. When inflation fears are replaced with recession fears, monetary policy expectations and bond yields will begin their descent and the positive returns from bonds will help offset any continued negatives from risk sentiment at that time. We continue to look to position the portfolio at the appropriate time to take advantage of the more usual negative correlation between these asset classes.

The other beneficial impact from developments of the past six months has been the dramatic rise of the running yield of the portfolio. From being just over 1% at the end of 2020, the yield to maturity now sits at ~5% as at the end of June. The bulk of this increase has come from the sharp rise in underlying yields from the global tightening cycle, but the widening in credit spreads is also contributing. This provides a far stronger forward looking absolute return profile, as well as providing a much greater buffer against adverse market movements in the period ahead.

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