Kapstream
— JANUS HENDERSON —

Kapstream Absolute Return Income Fund

KANGANEWS AWARDS 2017 WINNER – AUSTRALIAN CREDIT FUND MANAGER OF THE YEAR
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

APIR code	HOW0165AU
Inception date	31 May 2007
Fund size	AUD 3022mil
Distribution frequency	Quarterly
Management fee	0.40%
Buy/sell spread	Please contact us for latest spreads

Fund Statistics

Interest rate duration	0.73yrs
Credit spread duration	2.55yrs
Average credit rating	A-
No of issuers	99
Yield to maturity	4.50%

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

May 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)	-0.16	-0.69	-0.36	1.20	2.19	4.56
Fund Return (after fees, before sell spread)[1]	-0.20	-0.79	-0.78	0.75	1.75	4.20
Fund Return (after fees and sell spread)[2]	-0.20	-0.79	-0.77	0.72	1.74	4.20
RBA Cash Rate	0.03	0.04	0.12	0.35	0.81	2.71
Active return[3] (before fees and sell spread)	-0.19	-0.73	-0.48	0.85	1.39	1.85
Active return[3] (after fees and sell spread)[2]	-0.23	-0.83	-0.88	0.38	0.93	1.49
Bloomberg AusBond Bank Bills Index	0.03	0.02	0.05	0.36	0.97	2.93

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 May 2022.

Performance Commentary

The Fund posted a modest negative return in May, falling by -0.20% (after class I unit fees). This occurred against a backdrop of weaker Australian credit spreads, in a continuation of what has been a challenging year for risk sentiment. The extent of the drawdown was mitigated by a long duration position at the front end of the US yield curve, with two year yields posting their first monthly decline this year. Calendar year-to-date performance now stands at -0.87%, in no small part reflecting the highly unusual market environment this year where both credit and rates returns have been negative simultaneously.

By way of comparison, the Bloomberg Australian composite bond index fell another -0.89% in May alone (to be a staggering -8.1% lower since the start of the calendar year). We have taken the opportunity to examine the extent, causes and impacts of the unusual market conditions this year in a fixed income context, which can be read in ‘When The Rising Tide That Lifts All Boats Subsides’.

Market Commentary & Outlook

Risk sentiment remained weak in early May, but some light at the end of the tunnel appeared in the latter part of the month. In contrast, US bond markets had a more constructive tone, with yields falling across the curve. However the yield move was not replicated globally and we still see only tentative evidence that the usual negative correlation between risk markets and bond returns has re-asserted itself.

May began as a continuation of the theme so far this year, of deteriorating risk sentiment. Recession fears increased under the weight of expected central bank tightening, alongside concerns around the increased cost of living globally. Economic data releases are already weakening in response, with the Citibank Economic Surprise Index turning around sharply from a relatively high level of 70 points in mid-April (close to usual cyclical highs) to be around -40 points in the last week of May. Some of the key data included the Manufacturing

ISM (Institute of Supply Management) survey, one of the better leading indicators of US economic activity, which fell to a below-expectation (but still high) 55.4 reading. The interest rate sensitive housing sector also showed some softening, with US new home sales down an alarming 16.6% in April to levels last seen during early 2020.

Combined with lock downs across China due to their zero COVID policy, weakening sentiment saw the decline in the S&P 500 reach as much as 20% from its peaks around the turn of the year. However, as these lock downs began to be lifted, a rebound saw equities recover with S&P 500 futures finishing the month higher. Credit spreads broadly followed suit and finished lower in May. However, Australian physical credit spreads lagged the move significantly, with the Barclays Corporate Average spread to bond closing 11bps wider and the Bloomberg 0+ Credit Index spread to bond out a similar 10bps. High levels of dealer inventory and the ability of new issues to reset the market wider were key factors behind this under-performance.

US inflation data was mixed with the core CPI (Consumer Price Index) in the month of April coming in well above expectations at 0.6%. Year-on-year rates still fell to 6.2% as an even larger increase from a year ago fell out of the calculation. The Fed's (Federal Reserve) preferred measure in the core PCE (Personal Consumption Expenditures) deflator rose a more subdued 0.3%, seeing the yearly rate drop below 5% and on track to achieve the Fed's 4.1% forecast at year end. The decline in yearly rates is strong evidence that peak inflation may be behind us, with base effects likely to see further declines in the months ahead.

Bond markets reacted to these developments by paring back the amount of tightening priced into the yield curve. Despite the Fed hiking by 50bps to 0.75%-1.00% in May and committing to two similar sized moves in June and July, the market's estimate of the terminal rate fell from around 3.50% in early May to 3% by month's end. As a result, US 2-year Treasury yields declined by 16bps to 2.56% and 10-year Treasury yields fell 9bps to 2.85%, seeing the 2s/10s yield curve steepen and remain firmly in positive territory.

It doesn't happen regularly but bonds from several regions failed to follow the normal lead from their US counterparts. This was most evident in Europe, where yields rose on talk from ECB (European Central Bank) President Lagarde signalling two 25bps increases at the July and September meetings. Unlike the US, yearly growth in German inflation hit a new high of 7.9%, making it more difficult to say that peak inflation has been seen. The European Union's move to a phased embargo on Russian oil is unlikely to ease any such concerns, given the geographical and economic proximity to developments surrounding the Russian invasion of Ukraine.

Australian bond yields similarly bucked the trend from the US, with the RBA (Reserve Bank of Australia) turning hawkish and beginning the tightening cycle in May. The larger-than-expected 25bps increase was the first rise since 2010, and completes the RBA's turnaround from as recently as October 2021 where it stated that conditions for a rate hike would not be met until 2024. To be fair, the recovery from the pandemic-related lock downs has been extremely rapid relative to previous recessions. The unemployment rate has fallen from the 2020 highs of 7.5%, through the pre-pandemic lows of 5.0%, to record lows of 3.9% in April of 2022. The removal of stimulus has therefore taken on increased urgency, and attention now shifts to the pace and extent of tightening. Markets largely shrugged off the change in Government in May's election, with the Labor Party looking to take a thin majority in the House of Representatives with a 6.5% swing on a two-party preferred basis.

Somewhat ironically, New Zealand bond yields followed the US lead with 10-year yields finishing 3bps lower at 3.61%. This was despite a 50bps rate hike in the month and a particularly hawkish set of interest rate forecasts from the RBNZ (Reserve Bank of New Zealand).

Portfolio Strategy

Generally speaking, we continued with heightened defensive positioning in May. This involved actively managing a significant CDX credit protection position (from ~9.4% to ~11.1%), balancing concerns about the Fed's ability to guide the global economy through an inflation and rates 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. Holding credit spread duration below historic strategy averages, we also continued to gradually increase the rates duration exposure, as evidence continues to accumulate that we have seen peak inflation and to a lesser extent peak hawkishness from central bank speakers and the market.

Physical spread duration ex. SSGA was roughly unchanged at <2.5 years. Macro volatility provides good opportunity to add credit with idiosyncratic mispricing, and we have been adding credits where there has been significant widening as well as a material new issue concession, or where we believe the secondary market is materially mispriced, more recently on a switch basis. This 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 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 (~43%), corporates (~40%), and asset and mortgage-backed securities (~13%) 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.

With peak inflation arguably behind us, we may be approaching the point at which the market has sufficiently priced in the coming tightening cycle from the Fed. We therefore continued to increase the exposure to the front end of the US yield curve in the Fund, partly to be able to pick up the significant and rising carry and roll benefits at this part of the curve. We are preferring these exposures to those further out the US yield curve where the benefits are less apparent, as well as avoiding other regions where monetary policy hawkishness and yields are still rising.

That said, the pace of increase in our rates exposure has been gradual. After holding the duration position at close to flat earlier in the year, at ~0.7yr we are still yet to reach the historical average duration exposure for the strategy of around one year’s duration. There remains a risk that yields could resume their upward trend of the past year, so we remain cautious in how strongly we are looking to add risk. We are also looking to see greater evidence of a negative correlation with the credit spread-related elements of the portfolio, notably absent so far in 2022. We suspect that when FOMC (Federal Open Market Committee) officials and the market more broadly reach peak hawkishness, that the usual negative correlation and defensive benefits of being long duration are more likely to return.

One silver lining of the rise in yields seen this year is that the running yield of the portfolio has increased dramatically. After being little over 1% at the end of calendar year 2020 the yield-to-maturity has since risen to 4.5% at the end of May. The rise mostly reflects the unwind of the emergency stimulus that was needed in the early days of the pandemic, with rising official interest rates raising bond yields and running yield on the portfolio as a result. However, the potential recession that the tightening cycle may induce has seen risk sentiment deteriorate, leading to credit spreads widening (further adding to the portfolio yield). The negative returns to date this year, the result of having such a sharp increase in bond yields at the same time as there has been a widening in credit spreads, has been the unfortunate cost of securing this more beneficial starting point going forward. The additional yield serves to provide an increased buffer against any further adverse market developments, but more importantly is expected to provide the basis for significantly higher absolute returns for the strategy looking ahead.