Kapstream Absolute Return Income Plus Fund

Kapstream — JANUS HENDERSON —

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

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 324m
Distribution frequency	Quarterly
Management fee	0.45% p.a.
Buy/sell spread	0%/0.2%

Fund statistics

Interest rate duration	0.54 yrs
Credit spread duration	1.68 yrs
Yield to Maturity	6.23%
Average credit rating	BBB
Number of issuers	62

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

June 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)*	**-0.15**	**-0.07**	**0.20**	**0.20**	**1.59**	**2.14**	**2.81**
Fund Return *(after fees, before sell spread)*[1]	-0.19	-0.19	-0.03	-0.03	1.11	1.65	2.32
Fund Return *(after fees and sell spread)*[2]	-0.19	-0.19	-0.03	-0.03	1.12	1.63	2.30
RBA Cash Rate	0.06	0.09	0.12	0.12	0.17	0.33	0.59
Active return[3] *(before fees and sell spread)*	**-0.21**	**-0.17**	**0.08**	**0.08**	**1.42**	**1.81**	**2.22**
Active return[3] *(after fees and sell spread)*[2]	-0.25	-0.28	-0.15	-0.15	0.95	1.29	1.71
Ausbond Bank Bill Index	0.05	0.07	0.08	0.08	0.10	0.33	0.69

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, 30 June 2022.

Performance commentary

The Fund returned -0.15% before fees in June, though remains one of very few liquid fixed income strategies to still show a positive return over both the financial year and calendar year-to-date period, preserving investor capital in an extreme fixed income bear market across rates and credit as yields have reset significantly higher. Conventional indices such as the Ausbond Credit 0+ and Ausbond Composite 0+ indices fell in June -1.34% and -1.48% respectively and -8.86% and -10.52% for the financial year. The largest contributor was coupon income. Credit spreads and rates sold-off causing detraction this month and over the financial year but we expect this sell-off to support higher forward looking returns given the fund yields over 6%, more than *double* compared to a year ago!

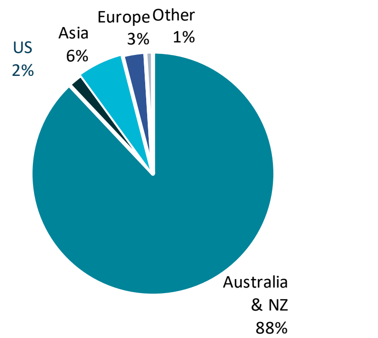
Portfolio strategy

The Fund invested in a limited number of new issues and opportunistic secondary trades that were attractive enough to meet the hurdles to deploy into the tepid environment. We remain concerned about the potential for a 2023 recession (or at least talk of it), and particularly for risk assets to price this earlier. This is driven by decelerating GDP, high inflation impacting consumers, aggressive rate hiking and a likely China slowdown, and as a result, we continue to hold CDX of ~9%. Liquidity was maintained at the higher end of the range with Level 1 liquidity at ~14% (cash, semis, commercial paper, SSGA) and Level 2 liquidity ~19% (<1yr investment grade).

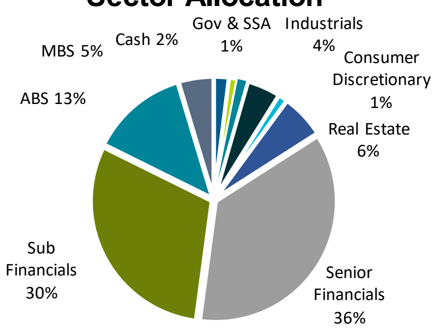
The Fund currently yields over 6%, providing a strong tailwind for future returns. Physical spread duration ex SSGA was stable at ~1.7yrs and ~1.2yrs net of CDX. There is still capacity to add attractive credits, which is possible due to the barbell strategy's success in limiting losses and providing liquidity at an opportune time. This 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. Duration reduced from 0.8yrs to 0.54yrs, 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%.

The average credit rating of holdings was stable at BBB. High yield was stable at ~21%, where holdings are typically BB-rated, 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 (~66%), corporates (~13%), and asset and mortgage-backed (~18%) with the residual in cash and SSGAs. We have an 88%/12% split between Australia/New Zealand and international issuers.

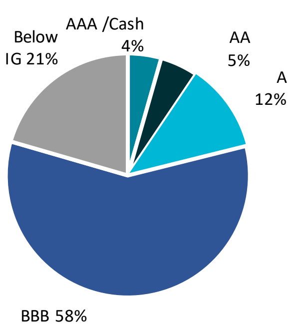
Geographic Allocation



Sector Allocation*



Credit Rating*



*Scaled to 100% for repo

In rates, we have ~0.1yrs Australasian duration and ~0.4yrs US duration for a total portfolio duration of ~0.5yrs. 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.

Outlook

Global equities fell with the S&P 500 down 8.4%, cumulatively down more than 20% from the highs, putting it into bear market territory and being the worst first half of any year for decades. The VIX was up 2.5ppts to 28.7% and CDX widened 21bps to 101bps. Unsurprisingly, Aussie and US physical credit as well as swap spreads sold off. US and Aussie rates widened rapidly spurred on by an increasingly aggressive Fed & RBA. While broader risks have not changed - war in Ukraine and increased economic uncertainty in Europe; China's COVID-19 lockdowns and subsequent slowing data; central banks grappling to deal with an environment of persistent inflation and slowing growth - investors have begun to price in greater chance of monetary policy mistakes leading to an increased probability of a hard landing and/or recession.

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%). US 10yr Treasury yields peaked at 3.47%.

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. Governor Lowe's questioning of market pricing saw the terminal rate fall back from just under 4.50% mid-month to finish below 3.75%. Australian ten year bond yields had a range of more than 100bps in the month as a result, peaking at 4.27%.

In Europe, 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. 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. European credit spreads widened on the reduced direct purchases from the ECB and relatively worse activity outlook. German ten year bond yields had an intra-month range of more than 90bp in the month, peaking at a yield of 1.92%.

In Asia, China showed mixed economic prints. May Caixin Manufacturing PMI was below 50, signalling declining activity, whilst June NBS Manufacturing PMI was 50.2 up marginally but still below consensus of 50.5. Meanwhile, industrial production increased to 0.7% above the expectations of 0.7%. 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. However, until the 0 Covid policy is clearly abandoned or more vaccination occurs, it is difficult to envision strong sustained growth returning.