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 2744mil
Distribution frequency	Quarterly
Management fee	0.40%
Buy/sell spread	Please contact us for latest spreads

Fund Statistics

Interest rate duration	0.46yrs
Credit spread duration	2.26yrs
Average credit rating	BBB+
No of issuers	92
Yield to maturity	4.98%

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

Dan Siluk
Portfolio Manager

Dylan Bourke
Portfolio Manager

July 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	-0.51	-1.02	0.80	2.01	4.49
Fund Return (after fees, before sell spread)[1]	-0.19	-0.60	-1.42	0.35	1.56	4.13
Fund Return (after fees and sell spread)[2]	-0.19	-0.60	-1.41	0.33	1.55	4.13
RBA Cash Rate	0.10	0.18	0.26	0.33	0.79	2.69
Active return[3] (before fees and sell spread)	-0.26	-0.69	-1.27	0.47	1.22	1.80
Active return[3] (after fees and sell spread)[2]	-0.29	-0.78	-1.67	0.00	0.76	1.43
Bloomberg AusBond Bank Bills Index	0.12	0.21	0.22	0.33	0.94	2.91

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 July 2022.

Performance Commentary

The fund posted a slight negative return in July, declining by 0.19% (after Class I unit fees). This was despite sentiment improving in the month (after a very negative first half the year), as market expectations about future central bank tightening were pared back. However, this improvement occurred unevenly across the fixed income universe. In particular, the synthetic credit hedges that contribute to resilience and benefited the portfolio significantly in the first half of 2022 reversed markedly in line with global risk sentiment, detracting from performance. In contrast, the Australian physical credit this was hedging did not participate in the improvement with spreads widening. This divergence is an uncommon occurrence and not one expected to persist. As a result, the increase in the portfolios yield-to-maturity over the past year (to ~4.5%-5.0%) remains a solid basis for improved absolute returns looking forward.

Market Commentary & Outlook

Financial markets had a more positive month in July, but conditions remained volatile and a high degree of uncertainty remains. Risk sentiment rebounded despite a range of economic data pointing to a slowdown in activity. Somewhat ironically the focus was more on the expectation that central banks around the world won’t raise rates as far in the fight against inflation. This factor also lowered yields in July, more so at the back end of yield curves as recession risks saw further flattening of yield curves across the globe.

The economic data in July generally confirmed that inflation remained elevated, activity levels softened and labour markets were strong. Yearly inflation reached multi-decade highs in several regions, hitting 9.1% in the US, 8.6% in the Eurozone and 6.1% in Australia. The global rise in energy and food prices were big contributors to these outcomes, but even aside from this the underlying measures of inflation in each region were well above central banks' targets. Activity measures were also suffering from the impact of higher prices for essential items, being a drag on the ability to spend elsewhere, with the most notable being the second consecutive negative reading for US GDP. US officials were quick to state that this technical recession was not a genuine recession, partly due to the labour market remaining firm with the unemployment rate low and stable at 3.6%. Record lows in the monthly unemployment figures in the Eurozone (6.6%) and in Australia (3.5%) also indicated that labour markets remain tight in those regions.

Central banks raised rates aggressively in response to the increase in headline inflation and tight labour markets. In the US, the Federal Reserve raised rates by the unusually large amount of 75bps again at the June meeting to 2.25%-2.50%, but was less clear about what should be expected at the next meeting than in the past now that rates have returned to be closer to the long-run neutral setting. The ECB began its tightening cycle with a larger than expected 50bps increase, taking their benchmark rate out of negative territory in one go, but suggested this was to get back to where it wanted more quickly rather than suggesting that the end point was higher than previously thought. The ECB also stepped away from providing forward guidance. The Bank of Canada raised rates by an exceptionally large 100bps, outdoing other developed market central banks. The RBA hiked rates by 50bps in early June but at 1.35% this remained below it's estimates of neutral of at least 2.50%.

Despite the sizeable increases in official interest rates in the month, the less explicit forward guidance and softening in activity saw a pull back in rate hike expectations and bond yields. In the US, the markets pricing for the terminal rate finished July at 3.30%, well down from the 4% levels seen in mid-June. US 2yr yields declined by 7bps to 2.88% in July as a result, but did reach as high as 3.27% intra-month in a sign of how high volatility has been in rates markets as they wrestle with the terminal rate question. Recession fears saw US 10yr yields fall by a much larger 36bps to 2.65%, in what was a near 50bps range within the month and seeing the curve invert considerably further into negative territory. Larger declines in RBA terminal rate expectations saw Australian 3yr bond yields finish the month 46bps lower, whilst German 2 year bond yields finished down 37bps on the more dovish than expected tone from the ECB.

Risk markets chose to focus on the less restrictive outlook for central banks rather than the softening in activity. Equity markets had a particularly solid rebound, with the S&P 500 up 9.1%. The more liquid aspects of the credit universe followed suit, but arguably by less than what the rise in equities might have suggested. Spreads on US investment grade physical credit narrowed, with the Bloomberg US Corporate Agg spread to bond down 11bps to 144bps, but the more responsive synthetic equivalent in CDX IG fell by 21bps to 80bps. Low dealer inventory levels in the credit space were cited as a factor here, along with the observation that the market had become quite pessimistic in June. European credit spreads unwound some of their recent under performance and recovered even more strongly than in the US. In contrast, the less liquid Australian physical credit market saw spread widening in July, with the Bloomberg Ausbond credit index spread to swap 5bps wider to 102bps. Dealer inventory levels not being as low as in the US may help explain this apparent difference relative to offshore.

Whether the markets are correct in their optimism around peak hawkishness being behind us will largely depend on upcoming inflation readings. It will also depend on whether the central banks react to the softening in activity in the event of continued elevated inflation, with markets factoring in rate cuts as soon as next year in some jurisdictions on recession fears and an expected softening in labour markets. Ultimately then the key issue for markets remain unchanged from the first half of the year, namely whether the peaks in inflation and interest rates are in, or if there is yet further pain to go.

Portfolio Strategy

Whilst markets had an improved tone in July, we remain defensively positioned until a pivot from central banks away from inflation towards recession fears is clearer. We therefore remain relatively light on in terms of rates positioning and see further tightening and recession-related risks as headwinds for risk markets looking forward.

In terms of duration, we did not significantly shift positioning in July and remain shorter than the historical average of the portfolio. As indicated above, central banks continue to hike rates at a brisk pace and the end point is no clearer. Headline inflation is likely to come off in July with the pullback in energy prices, but underlying inflation measures are still rising for the most part. Without a clear and consistent sign that inflation has peaked, central banks will continue in the fight against inflation, even if activity does soften as the central banks currently desire. Furthermore there is still little evidence that the negative correlation typical between bonds and risk markets has returned, which underpins the inclusion of bond exposures in the portfolio. We therefore maintain a modestly positive rates duration exposure and await greater clarity that peak hawkishness has been seen before extending.

We continued to position defensively, holding credit spread duration below historic strategy averages at just over 2yrs ex. SSGA as well as holding significant CDX credit protection position of ~13%. We are 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 vs the likelihood of a short term bear market risk rally.

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 times. This approach (1) underweights longer dated A-rated credits and overweights shorter dated lower rated credits (mainly BBB assets), assets with similar 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 (~48%), corporates and REITs (~36%), 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 over 90% of the portfolio is held in AUD-denominated securities.