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
KANGANEWS AWARDS 2022 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	$2,599.11m
Distribution frequency	Quarterly
Management fee	0.40%
Buy/sell spread	Please contact us for latest spreads

Fund Statistics

Interest rate duration	0.24yrs
Credit spread duration	1.91yrs
Average credit rating	BBB+
No of issuers	86
Yield to maturity	5.72%

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

December 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)	0.64	0.89	0.00	0.87	1.89	4.43
Fund Return (after fees, before sell spread)[1]	0.61	0.78	-0.42	0.43	1.45	4.07
Fund Return (after fees and sell spread)[2]	0.61	0.78	-0.41	0.40	1.44	4.07
RBA Cash Rate	0.25	0.69	1.25	0.56	0.87	2.68
Active return[3] (before fees and sell spread)	0.40	0.20	-1.25	0.31	1.02	1.75
Active return[3] (after fees and sell spread)[2]	0.36	0.09	-1.66	-0.15	0.57	1.38
Bloomberg AusBond Bank Bills Index	0.25	0.74	1.25	0.55	1.01	2.90

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 December 2022.

Performance Commentary

The fund finished the year strongly with a monthly gain of 0.61% in December (after class I unit fees). Australian physical credit spreads compressed in the month, benefitting the portfolio despite risk markets elsewhere unwinding some of the optimism that had been building. Global bond yields generally rose, quite sharply in many cases, but less so where our exposures were concentrated. The rise in yields therefore had little bearing on what is now a significant amount of carry in the portfolio, which is now showing a yield to maturity of 5.72%, the highest in over a decade indicating a far richer return expectation for the portfolio heading into 2023.

The pleasing monthly result supported a positive absolute return in the three months to December, helping unwind losses earlier in the year from the sharp rise in yields and widening in credit spreads. However this was insufficient to avoid a modest negative absolute return for the full 2022 calendar year. Whilst we acknowledge that this does not compare favourably to the portfolios 'cash plus 2%' target, it is significantly ahead of conventionally-managed bond portfolios, such as those based on the Bloomberg Ausbond Composite 0+ Index that registered a 9.9% decline over the same period, or indeed many other asset classes such as the equity S&P500 total return index that was down 18.1%. This showcases how the capital preservation objective is squarely incorporated into the portfolio's product design, as sharply rising yield environments and worsening risk sentiment can both exert a negative influence on fixed income funds. The large jump in the yield to maturity will therefore be a strong contributor to the strategy's return objective looking forward.

Market Commentary

Central bank tightening continued in December, but the pace was wound back from that seen at recent meetings. The US Federal Reserve increased the Fed Funds rate by 50bps in December to 4.25%-4.50%, with a more hawkish statement and Fed Funds rate projections than the market was expecting. The ECB similarly raised rates by 50bps last month to 2.50% and was also understandably hawkish given the tightening cycle started later and is less advanced. Both of these central banks had been hiking by 75bps per meeting recently. The RBA had already stepped down to 25bps per meeting and maintained that in December, also warning that more hikes should be expected. The other main central bank event of the month was the Bank of Japan decision to widen its 10 year bond yield target by lifting the upper bound from 0.25% to 0.50%.

With higher official interest rates and still hawkish overtones, bond yields pushed higher in the month. In some cases, it was quite a sharp move. US 10 year yields rose 27bps to 3.87%, with an even larger increase of 64bps seen in Germany and 52bps in Australia at the same part of the curve. Front end moves were more subdued, with US 2 year yields rising 12bps to 4.43%, although German 2 year yields were still up 63bps to 2.76% and Australian 3 year yields rose 34bps to 3.50%. This larger move at the back end saw yield curves generally steepen, bucking the flattening trend seen over the past year as a whole.

The rise in yields contributed to a reversal of the improvement seen in risk sentiment in the preceding two months. This was despite some increased optimism around China re-opening with a possible relaxation of certain COVID-related restrictions. The S&P500 fell 5.9% to 3,839.50, reversing around half the gains seen over October and November. Some credit spreads widened marginally in sympathy, with the more responsive US investment grade synthetic credit spreads (CDX IG) 6bps wider to 82bps. Physical credit in the US closed the month 3bps tighter to 130bps supported by limited issuance for the month. Australian credit spreads performed similarly, with synthetic investments grade spreads (Australian iTraxx) out 1bp to 91bps, whilst Australian physical credit spreads, such as the Bloomberg Australian Corporate OAS series, contracted 10bps to 191bps (a narrowing in Australian swap spreads was a significant contributor in this rally).

Portfolio Strategy

The defensive posture that we have held throughout 2022 was maintained in December. With central banks continuing to tighten, we looked to lighten up further on duration from what was already a low level. On the exposure to credit we continued to position defensively with physical credit spread duration under 1.9yrs (ex. SSGA), reducing with the passage of time. We maintained CDX credit protection at ~7%, reducing spread duration by ~-0.3yrs.

We continue to buy credit selectively where we believe it is mispriced such as short dated financial bonds in primary given attractive new issue concessions and wide spreads. We are also seeing value in securitised and have been selectively buying primary deals with short WALs and high spreads. We continue to remain liquid and await increasingly attractive credit opportunities which we expect next year. The higher starting carry is providing a robustness to the portfolio which hasn't been seen for around a decade.

In terms of asset allocation, the portfolio can be split across three major 'buckets'; financials (~40%), corporates and REITs (~30%), and asset and mortgage-backed securities (<15%) with the residual in cash and liquids. Approximately 85% of the portfolio is held in Australian & New Zealand names, and by currency around 90%+ of the portfolio is held in AUD-denominated securities.
This defensive duration positioning is another factor that has allowed the portfolio to significantly outperform fixed income benchmarks that are forced to have a higher duration exposure, and other asset classes, given the risk off nature seen over the year as a whole. We have also maintained a higher than usual amount of liquidity to the portfolio as we move through the quieter period around the turn of the year.

As noted before, yields rose sharply almost everywhere except the US front end. This is where the limited exposures that we have to duration are largely concentrated. We took the opportunity in December to lighten up on our exposures to around a quarter of a year. This reflects that we are not yet at the end of the tightening cycle globally, and historically it closer to this point that bond yields tend to peak.

The portfolio retained liquidity above target with 'Level 1' liquidity at ~15-20% (cash, commercial paper, SSGA) and 'Level 2' liquidity at 10%+ (<1yr investment grade). We believe that having significant liquidity in 2023 will provide the flexibility to buy discounted credit at initially attractive levels in early 2023 and at very attractive levels as recession fears may start to intensify.

Outlook

Looking ahead, central banks are likely to continue hiking in early 2023, albeit at a lower pace and with an eye to the end to the tightening cycle. History shows that yields tend to peak at around this time, so it is when we have higher conviction that we have seen the end of the hiking cycle that we would look to significantly increase our duration exposure. This would add additional carry into the portfolio, as well as re-introducing the defensive qualities from duration that see it act as a hedge for the credit exposures in the portfolio.

As we move further into 2023, the lagged impact from the tightening cycle in its entirety is likely to see the US and elsewhere go into a recession. Our analysis is that during recessions it is fairly common for equities to fall ~30-35% and with equities only down 18-25% at this point there is potentially more to go. Since we believe that US equities form the 'centre of gravity' for most global risk-on investments we believe that in such a scenario, credit spreads would tend to widen in sympathy. Therefore, it is not until the drops in earnings that we normally see during a recession are more accurately factored in that we are likely to unwind our more defensive stance in terms of credit spread duration. One common counter-argument we hear is that a Fed pivot from hawkish to more neutral is likely to result in risk assets rallying. However, we think that this confuses a Fed that is no longer hiking, with a Fed that is aggressively easing. It is the latter which normally forms the basis of a sustainable rally in risk markets, as the economy and earnings would eventually be seen as recovering their way out of recession. Given the recession hasn't even happened, we don't see markets as being at this point yet.