Kapstream Absolute Return Income Fund

Kapstream
—JANUS HENDERSON—

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 2605mil
Distribution frequency	Quarterly
Management fee	0.40%
Buy/sell spread	Please contact us for latest spreads

Fund Statistics

Interest rate duration	0.36yrs
Credit spread duration	1.97yrs
Average credit rating	BBB+
No of issuers	86
Yield to maturity	5.56%

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

November 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)	0.26	0.10	-0.47	0.69	1.81	4.41
Fund Return (after fees, before sell spread)[1]	0.22	0.00	-0.87	0.25	1.37	4.05
Fund Return (after fees and sell spread)[2]	0.22	0.00	-0.86	0.23	1.35	4.05
RBA Cash Rate	0.23	0.63	1.01	0.50	0.84	2.68
Active return[3] (before fees and sell spread)	0.03	-0.52	-1.48	0.20	0.96	1.73
Active return[3] (after fees and sell spread)[2]	-0.01	-0.62	-1.87	-0.27	0.51	1.37
Bloomberg AusBond Bank Bills Index	0.25	0.64	1.01	0.49	0.99	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, 30 November 2022.

Performance Commentary

The portfolio generated a positive return of 0.22% (after class I unit fees) in November. Rates markets rallied as the speed and degree of central bank hiking was wound back, which boosted risk markets that continue to focus on a potential pivot. Being positively exposed to both, as well as benefiting from the positive carry that the higher yield environment offers, supported performance in the month. The yield to maturity fell 30bps in the month to 5.67%, but nonetheless still offers a strong foundation to the portfolio's expected returns looking forward.

Market Commentary and outlook

The market continues to grapple with two key questions: how far will central banks hike; and whether the rate hikes already delivered will cause a deep recession next year. The first question swings on inflation, and in the scenario where it has peaked, how quickly it comes back down. The second question around a recession will not be answered for some time after that.

Central banks generally have been performing a pivot of sorts, with a number of them switching to a slower pace of increase. It needs to be made clear that this is not a pause or a pivot in direction – the ultimate terminal rate for central banks remains unclear. It's more that with the significant amount of tightening already having been orchestrated by many central banks and a move towards neutral having been achieved, a softer approach towards further tightening may be appropriate. The RBA was one of the first to slow, moving to 25bps increases per monthly meeting. The Fed is also talking about moderating the pace of rate hikes as soon as December, from 75bps to 50bps. The ECB is only in the early stages of its cycle but is also expected to step down from 75bps to 50bps at its December meeting. The RBNZ bucked the trend and turned more hawkish, raising the expected terminal rate despite being one of the first central banks to tighten in this cycle. This highlights the uncertainty that remains around trying to anticipate the end of the tightening cycle too early.

Interest rate markets reacted to the slowing in the pace of hikes, taking out rate hike expectations at the very front of yield curves. A lower than expected CPI outcome was another significant driver, and whilst it's too early to suggest this is a trend the market was keen to lean towards a potential pivot from the Fed. A 75bps hiked at the FOMC's December meeting has been almost ruled out, but 50bps is still fully priced. The terminal Fed Funds rate range now expected to peak at 4.75%-5.00%. This is around a quarter of a percentage point below the October peaks, but still represents a further 100bps increase from current levels. This lowered yields across the structure, with US 2-year yields falling by 17bps over the month. 10-year yields fell by a larger 44bps to 3.61%, taking the 2s/10s curve down to -71bps (a level not seen since the early 1980s). The influence that US yields exert elsewhere lowered yields globally. The front end of the European yield curve was the notable exception, which rose in yield on hawkish commentary from ECB officials.

Risk markets were boosted by the more dovish lead from interest rate markets and arguably despite a softening in economic activity. Equity markets continued their rebound seen over October, with the S&P 500 up another 5%. Credit spreads continued their recent downtrend, with physical credit indices such as the US Corporate Agg spreads (OAS) in 15bps in November. The Bloomberg Australian Corporate index spread fell a similar amount, although this largely reflected a compression in swap spreads in the month. Synthetic credit spreads such also contracted, with the US Investment Grade CDX series in 14bps to close the month at 76bps. AUD Credit was mixed with a rally in big 4 bank senior but was wider for corporates and especially wider in low coupon and short dated T2 bonds.

On the 1st of November APRA released a letter entitled Expectations on capital calls which led to significant market volatility in T2. The context for the release of this letter was likely the pending calls of Challenger Nov-22 T2 and AMP Group Dec-22 T2 which had both issued at wider spreads than the deals they were replacing.

The only new requirement was some vague guidance around the data APRA required from issuers to justify a call being economic. These included comparative spread levels, issuance volume and any loss of Tier 2 capital benefit due to amortisation, offset by the benefit that instrument provides as debt funding. Additionally, APRA also required the issuer to disclose a level at which calling would be uneconomic. Interestingly, the letter does not discuss the issuers' ability to allow the additional costs of investors pricing in an assumption of not-calling on the entire outstanding portfolio of T2 & T1 for the life of an issuer.

The initial market response was for liquidity to dry up as investors assessed the impact on Challenger & AMP bonds. Once Challenger and AMP were successfully called, liquidity improved as the market regained some confidence. There are still lingering uncertainties that APRA's intention may be trying to narrow the ability for issuers to call bonds, particularly where a replacement bond has a higher coupon than the existing bond. The impact has been for bear credit spread flattening with the short end selling off. The T2 bonds most affected had the following characteristics: low coupon, USD denominated (one chance to call rather than every quarter), regional bank (small outstanding debt) and insurance bonds which do not convert to equity (long tails). Whilst on the run high coupon T2 bonds actually rallied as they became relatively rare. Westpac's upcoming T2 scheduled to call in February (spread of +140bps vs new issue in the+260-280bp area) will shed additional light on APRA's interpretation. Whilst we expect Westpac to call, we have sold some T2 bonds, to reduce the tail risk of a noncall, by selectively selling when decent bids were available.

Portfolio Strategy

We continued to be defensively positioned in November, with our exposure to interest rates and credit remaining well below average levels expected through the cycle. That said, we remain positively exposed to both, which supported performance in November as rates and credit rallied. The defensive nature of our positioning, which has been such a strong reason why underperformance has been less significant in 2022, would have acted to moderate the extent of the gains in November.

In the rates space, the decrease in yields was an opportunity to lighten up on duration given the full extent of the tightening cycles are yet to be known. Most central banks are seen to be still hiking rates over successive meetings, and as noted in previous monthly commentaries yields historically have not tended to peak until closer to the time of the last rate hike. This is not expected until sometime in early 2023. We continue to keep an eye on opportunities to move the portfolio longer duration to take advantage of higher yields, but for now the terminal rate for most central banks remains unclear and the strong uptrend in yields seen this year has not been broken by the fall seen in November.

On the credit front we continue to position defensively, holding physical credit spread duration under 2yrs (ex. SSGA), gently reducing over the passage of time. We maintained CDX credit protection at ~7%, reducing spread duration by ~-0.3yrs. We are balancing concerns about the Fed's ability to guide the global economy through an inflation and rate hiking induced slowdown vs the difficulty of ascertaining the bottom in any bear market. Physical spread duration suffered some minor spread widening and CDX tightened in sympathy with a rally in the SP500, which also detracted. Overall, after carry, credit was still a small net detractor.

We continue to remain cautious holding very short dated spread duration because we expect in 2023 the US is likely to go into a recession as a result of inflation, interest rate and USD dollar shock. Our analysis is that during recessions it is fairly common for equities to fall c30-35% and with equities only down 18-25% there is potentially more to go. Since we believe that US equities are the centre of gravity for most global risk-on investments we believe that in such a scenario, credit spreads tend to widen in sympathy. One common argument is that a rate pivot from hawkish to more neutral is likely to result in risky assets rallying. Based on past hiking cycle rates are often on hold for an extended period of time, being months to over a year before rate cuts eventuate, which would represent continued pressure on financial assets. Given inflation is a lagging indicator and Powell's requirement for "clear and convincing" evidence of inflation reducing to stop hiking, it seems likely that the requirement for a sustainable rally is rate cuts which could be more than a year in the future.

We continue to buy selectively but mainly on a switch basis. We are buying short dated fixed rate financial bonds in primary given attractive new issue concessions and wide spreads. Fixed rate financial bonds have continued to perform well driven by strong buying technicals from middle markets and high net worth buyers in Australia and Asia. We are also seeing value in securitised and have been selectively buying primary deals with short WALs and high spreads. We continue to remain highly liquid and await increasingly attractive credit opportunities. 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 (~32%), and asset and mortgage-backed securities (<15%) with the residual in cash and liquids. Approximately 84% of the portfolio is held in Australian & New Zealand names, and by currency around ~92% of the portfolio is held in AUD-denominated securities.

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