Kapstream Absolute Return Income Plus Fund

Kapstream
— JANUS HENDERSON —

KANGANEWS AWARDS 2018 WINNER – AUSTRALIAN CREDIT FUND MANAGER OF THE YEAR
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KANGANEWS AWARDS 2021 WINNER – AUSTRALIAN CREDIT FUND MANAGER OF THE YEAR
KANGANEWS AWARDS 2022 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 340m
Distribution frequency	Quarterly
Management fee	0.45% p.a.
Buy/sell spread	0%/0.2%

Fund statistics

Interest rate duration	0.27yrs
Credit spread duration	1.57 yrs
Yield to Maturity	6.46%
Average credit rating	BBB
Number of issuers	54

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

Daniel Siluk
Portfolio Manager

December 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)*	**0.70**	**1.05**	**1.52**	**1.71**	**1.71**	**1.96**	**2.83**
Fund Return *(after fees, before sell spread)*[1]	0.66	0.93	1.28	1.25	1.25	1.47	2.34
Fund Return *(after fees and sell spread)*[2]	0.66	0.93	1.28	1.25	1.25	1.45	2.33
RBA Cash Rate	0.25	0.69	1.13	1.25	1.25	0.56	0.78
Active return[3] *(before fees and sell spread)*	**0.45**	**0.36**	**0.39**	**0.47**	**0.47**	**1.41**	**2.05**
Active return[3] *(after fees and sell spread)*[2]	0.41	0.24	0.15	0.00	0.00	0.89	1.55
Ausbond Bank Bill Index	0.25	0.74	1.17	1.25	1.25	0.55	0.88

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, 31 December 2022.

Performance commentary

The Fund delivered a strong return in December of 0.70% (before fees), and 1.71% for the full 2022 calendar year. The largest contributor to returns was coupon income, while also additive was spread tightening, CDX widening and the Fund's modest duration exposure.

While falling short of its target return, this was a pleasing finish in the worst year for fixed income since the 1976 inception of Bloomberg US Aggregate Index which was down ~13%, and the worst for US Treasuries since 1793! Having successfully avoided erosion in 2022 (a feat *very* few liquid fixed income solutions achieved), we have high conviction in the Fund performing well in the year ahead, given a yield to maturity of 6.46%.

Portfolio strategy

The Fund added to investments in short dated ABS and NCDs, whilst we await a pipeline of new issues in early 2023. Despite the T2 calls from Challenger and AMP, we believe there remains a tail risk for non-call of T2 bonds, especially in low coupon and regional bank bonds. We have been reducing those bonds where favourable.

We continue to expect a 2023 US/European recession, and for risk assets to price this, driven by high inflation that has led to, aggressive and continued rate hiking, a moderately high US$ and a Europe wide slowdown. As a result, we hold CDX at ~5% and keep the credit book short-dated. Liquidity was maintained at the higher end of the range, 'Level 1' liquidity at ~22% (cash, CP, SSGA) and Level 2 liquidity ~14% (<1yr investment grade).

The Fund's yield to maturity was stable over the month at 6.46% which provides a strong tailwind for future returns. Physical spread duration ex. SSGA was stable at ~1.6yrs and ~1.4yrs net of CDX hedges. There is significant capacity to add attractive credits, largely due to the barbell strategy's success in limiting losses and providing liquidity at an opportune time. Repo exposure was nil. Duration was reduced to 0.27yrs from 0.35yrs.

The average credit rating of holdings was stable at BBB. High yield was stable at ~19%, where holdings are typically BB-rated, short maturity bonds where we have no concern around default risk. We continue to minimise or avoid exposure to companies unable to pass on higher refinancing costs and higher beta sectors such as commodities and energy. The portfolio is split across financials (~71%), corporates (~9%), and asset and mortgage-backed and warehouses (~16%), with the residual in cash and SSGAs. We have a ~93%/7% split between Australia/New Zealand and international issuers.

In rates, we have ~0.2yrs duration in the US and under ~0.1yr duration in Australia and New Zealand and other jurisdictions. We believe there is merit in maintaining some level of duration, as a hedge for the credit book. This would help to protect against a rapidly moving and unexpected risk-off scenario, and allow us to lock in attractive longer term interest rates, providing more certainty on future income.

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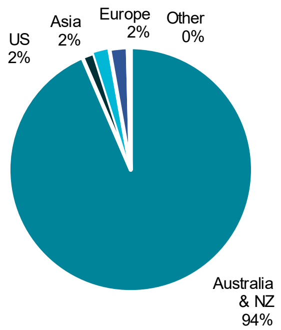
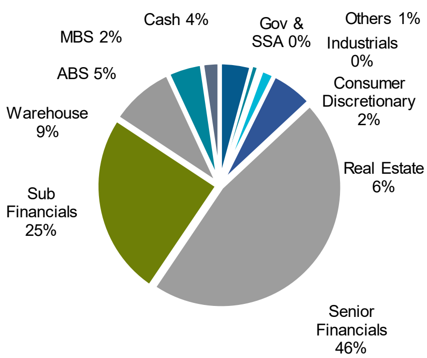
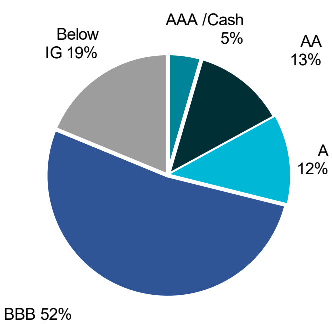
Geographic Allocation



Sector Allocation*



Credit Rating*



*Scaled to 100% for repo

Outlook

Global equities sold off, with the S&P 500 down 5.9%, leaving equities cumulative losses down ~20.9% from the peak over the year. The VIX was up 1.1ppts to ~21.7% and CDX widened 6bps to ~82bps. US physical credit rallied likely from seasonally lower issuance for the month. AUD credit was stable, except for T2s which retraced a portion of their previous APRA driven losses. US and AUD rates sold-off, whilst AUD swap spreads rallied. A contractionary ISM Manufacturing PMI of 49 vs expectations of 49.8, as well as continued hawkish Fed rhetoric, undermined any hopes of a Santa rally in risk assets. We continue to hold some concerns around heightened 2023 volatility given inflation remains well above central bank comfort levels and central bank hiking that is expected to continue. Furthermore, broader risks have not changed - war in Ukraine, increased economic uncertainty in Europe and potentially globally, as well as central banks grappling with an environment of persistent inflation and slowing growth.

Central bank tightening continued in December, but the pace was wound back from 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 projection than the market was expecting. The ECB similarly raised rates by 50bps to 2.50% and was also understandably hawkish given the tightening cycle started later and is less advanced. Both 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, though it also warned 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 calendar year as a whole.

Looking ahead, central banks are likely to continue hiking in early 2023, albeit at a slower pace and with an eye to the end to the tightening cycle. History shows that yields tend to peak around this time. It is only 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. Once enacted 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 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 weaker 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 after the expected recession. Given the recession hasn't even happened, we don't see markets as being at this point yet.