Kapstream

—JANUS HENDERSON—

Kapstream Absolute Return Income Fund

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 2,453.09m
Distribution frequency	Quarterly
Management fee	0.40%
Buy/sell spread	Please contact us for latest spreads

Fund Statistics

Interest rate duration	0.34yrs
Credit spread duration	1.54yrs
Average credit rating	BBB+
No of issuers	84
Yield to maturity	6.02%

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

February 2023

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)	0.69	1.83	1.19	0.87	1.98	4.46
Fund Return (after fees, before sell spread)[1]	0.65	1.74	0.79	0.44	1.54	4.10
Fund Return (after fees and sell spread)[2]	0.66	1.74	0.80	0.41	1.53	4.10
RBA Cash Rate	0.25	0.76	1.75	0.69	0.92	2.69
Active return[3] (before fees and sell spread)	0.44	1.07	-0.56	0.18	1.06	1.77
Active return[3] (after fees and sell spread)[2]	0.41	0.98	-0.96	-0.28	0.60	1.41
Bloomberg AusBond Bank Bills Index	0.24	0.76	1.76	0.66	1.05	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, 28 February 2023.

Performance Commentary

The fund continued to benefit from the higher yield environment, posting a monthly gain of 0.66% in February (after class I unit fees) and taking three month returns to a strongly positive 1.74%. The yield to maturity rose again in February to be near ten-year highs, providing a solid base for expected returns through 2023 in an absolute sense and also relative to the current cash rate of 3.35%. In addition, Australian physical credit spreads compressed in the month, supported by more positive risk sentiment globally. This was despite rate hike expectations increasing, an influence that saw bond yields reverse January's falls to finish at or near recent highs. Our still conservative approach to adding duration avoided any notable erosion of the benefits coming from coupon carry and spread compression.

Market Commentary

Inflation and the central bank response remains the main game in town. Central banks generally remained in tightening mode, even if in some instances the pace has subsided from that seen a few months ago. The Fed increased their target range by 25bps to 4.50%-4.75% on February 2nd, also indicating there was still more work to be done. The Bank of England hiked by 50bps on the same day, whilst the following day saw a similar sized move from the European Central Bank. The Reserve Bank of New Zealand also increased rates by 50bps later in the month, despite the devastating impact of the recent cyclone. The Reserve Bank of Australia continued with its lower 25bps per meeting increase in February, despite being later to start the tightening cycle than many other central banks. February therefore failed to see a pause from these developed market central banks, with **the Bank of Canada** (who has indicated it will pause) not meeting in the month, their next meeting being scheduled for March 9th.

Whilst inflation remains the main focal point, the kick start to the significant move higher in global bond yields in February came after the US labour market related data. These data saw a strong rise in payroll numbers, upward revisions to history and a fresh cyclical low in the unemployment rate of 3.4%. The uptrend in yields continued when the January CPI data then came in above expectations, which despite still pointing to an easing of inflationary pressures,

was not consistent with the market's expectations of a drop in the CPI to around 2% by year's end. When PCE came out later in the month, the upward revisions to recent history cast further doubt on the pace of decline in inflation. The market's terminal rate for the Fed therefore shifted up to 5.41% by month's end - almost a full 50bp increase over the course of February and now above the FOMC's December projection of a peak in the terminal rate of 5.00-5.25%. Bond yields elsewhere followed suit, as markets extrapolated the increase in expected official rates to other central banks around the globe. Even in Canada, the market has moved to once again price in a 25bp hike, albeit admittedly only by September and from pricing in around 9bps of tightening as at the end of January.

Risk markets initially ignored the upward revision to rate hike expectations, rising strongly in the first week of the month before pulling back to close the month down 2.6% (S&P500). Credit spreads also deteriorated, with the synthetic CDX IG index widening by 5bps to 76bps and physical credit indices such as the Bloomberg US Corporate Agg series up 7bps to 124bps. Australian physical credit still had some catching up to do from the previous month so that it bucked this trend with the Bloomberg Ausbond Credit index narrowing 10bps to 165bps to swap. Bigger picture, the market has remained resilient in recent months, despite the very recent upgrading of rate hike expectations globally and the prospects for a recession later this year. It appears that risk markets have priced in the recovery for a recession that hasn't even happened yet!

Portfolio Strategy

Overall we have been satisfied with the portfolios ability to deliver on the considerable increase in the yield to maturity which took place over 2022. The porfolio outperformed cash benchmarks by ~1% over the past three months, reflecting this development as well as the positive exposure to the improvement in Australian physical credit spreads (although being defensive in this regard limited these gains). The similarly low and defensive positioning on duration also limited losses from this component, given that yields have generally risen over that time.

The AUD credit spread rally seems to have caught up to the USD rally as it tightened over the month whilst US spreads widened. We took profits on some financials and longer dated tighter corporates, switching into attractive short dated AUD ABS & MBS in primary, given very wide spreads which were reminiscent of COVID 2020 reopening, AAA spreads being only ~20bps tighter for some deals. We continue to see a strong pipeline in securitised, and expect to buy select primary deals with short WALs and high spreads. Corporates remain tight given the competitive funding available in the loan market, and as such these issuers are generally unwilling to pay new issue concessions. We expect to continue to see the theme of rotating out of corporates and rotating towards financials or securitised with more attractive coupons. The higher starting carry is continuing to provide a robustness to the portfolio which hasn't been seen for around a decade, and we are cautiously optimistic, despite an expected upcoming US recession in second half.

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 96% of the portfolio is held in AUD-denominated securities.

Portfolio liquidity remains slightly above target with 'Level 1' liquidity at ~10%+ (cash, commercial paper, SSGA) and 'Level 2' liquidity at ~15%+ (<1yr investment grade). We are comfortable running liquidity slightly above target in 2023, as we believe this will provide the flexibility to buy discounted credit at very attractive levels as recession fears start to intensify in the back half of the year.

On the rates front we did cautiously add to duration in February, but only marginally so. The increase from around 0.25 years to around 0.35 years came on the back of the recent upgrading in market expectations, which have moved from being below the Fed's most recent dots by December to well above. Overall we believe that it is better to add duration more aggressively later in the cycle, reflecting that the peak in yields is often close to the time of the last hike in the cycle and that markets (including **ourselves) have** often underestimated how far central banks have needed to hike rates to combat inflation. We will therefore likely remain at a relatively low level of duration compared to our historical average until global tightening cycles are not just closer to being complete, but when the certainty of this increases far more than is currently the case.

Outlook

The key uncertainty remains exactly how far central banks will hike in the current cycle. There is growing evidence that inflation may have seen its peak, but insufficient evidence that it's falling enough to satisfy central bankers, given how far inflation remains above target. Related to this is whether the rise in yields seen over February is best characterised as a move from the bottom to the top of a developing sideways range, or if it is the resumption of the uptrend seen over 2022 (albeit at a potentially slower pace).

We expect those questions to be the dominant ones in the first half of 2023, but other questions are likely to take centre stage in the second half of the year about how the economy will fare due to the lagged impact of the significant rate hikes seen in 2022 . Economic indicators and earnings have already pointed to a slowdown, but not one so significant that is yet in recession territory. We expect that this evidence will begin to accumulate in coming months, which in turn will then see labour markets weaken to the point that central banks may not just cease tightening but consider easing to meet the full employment component of their objectives. This switch in focus looks to be an awfully long way into the future at this stage given central banks are still tightening. As the proverb goes, we are taking this one step at a time.

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