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 2465.83
Distribution frequency	Quarterly
Management fee	0.40%
Buy/sell spread	Please contact us for latest spreads

Fund Statistics

Interest rate duration	0.04yrs
Credit spread duration	1.65yrs
Average credit rating	BBB+
No of issuers	86
Yield to maturity	5.73%

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

January 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)	0.50	1.40	0.42	0.81	1.91	4.44
Fund Return (after fees, before sell spread)[1]	0.47	1.30	0.02	0.38	1.47	4.08
Fund Return (after fees and sell spread)[2]	0.47	1.30	0.03	0.35	1.46	4.08
RBA Cash Rate	0.27	0.74	1.51	0.63	0.90	2.69
Active return[3] (before fees and sell spread)	0.23	0.66	-1.09	0.18	1.01	1.75
Active return[3] (after fees and sell spread)[2]	0.21	0.56	-1.48	-0.27	0.56	1.39
Bloomberg AusBond Bank Bills Index	0.27	0.77	1.52	0.61	1.03	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 January 2023.

Performance Commentary

The Fund posted a monthly gain of +0.47% in January (after class I unit fees), taking the three month return to 1.30% as the higher yield environment which developed over 2022 continued to add to returns as anticipated. Australian physical credit spreads compressed in the month, supported by a more positive risk sentiment globally as inflation eased in some regions and central bank tightening cycles were seen to be closer to their end. Bond yields also fell on the same themes, further supporting the portfolio's returns given the modest but positive duration exposure. The yield to maturity fell by 5bps in January to still be near decade highs at 5.73%, which with the detrimental impact of a rising yield environment likely mostly behind us will provide a solid base for higher expected returns through 2023.

Market Commentary

Central banks have demonstrably begun to slow the pace of easing in most regions, although the month of January is one where central bank meetings are not often scheduled. The stepping down in the pace of increase reflects a number of influences, the most notable of which is a slowing in inflation. In the US the downward surprise in the CPI for three straight months has seen the 3-month annualised rate fall to 3.1% in December. This is a significant step down from the 6% figures pace seen regularly over 2022. The other factor slowing central banks down is that after the significant and rapid hikes in 2022, interest rates are approaching or into restrictive territory. This has seen comments from US Federal Reserve officials citing concerns about potentially over-tightening, with the associated negative implications for the economy and labour markets that operate with a lag. The Reserve Bank of Australia was one of the first to cite this as a reason to step down to a 25bps per meeting pace. The Bank of Canada also cited this factor in its decision to conditionally pause the tightening cycle after the 25bps increase to 4.50% in January.

Risk markets took heart from the fact that central banks were slowing the pace of rate hikes. The S&P500 rebounded by 6.2%, more than unwinding the fall seen in December and taking the decline from the December 2021 peak to around 15%. Credit spreads compressed in

sympathy, with the Bloomberg US Corporate Aggregate index down 13bps to 117bps, and the Bloomberg Australian Corporate index average spread in 16bps to 175bps. In a sign that a significant amount of cash was being put to work, new issue concessions in the US were reportedly negative. This was despite evidence that the US economy is slowing and earnings growth in Q4 (particularly excluding energy) was negative. It will be interesting to see how long this technical support for lower spreads will defy the weakening fundamental outlook. Australian Tier 2 spreads also benefited from the calling of a low coupon Westpac Tier 2 bond, after the local regulator warned against assuming that all such debt would be called.

With central bankers slowing the pace of increase, bond yields generally fell in January. The market winding back its rate hike expectations saw US 2 year yields fall by 23bps in the month, whilst Australian 3 year yields fell by a larger 32bps. These moves have seen the significant upward trend in global yields being broken, replaced with something more akin to a sideways range (albeit that yields finished the month towards the bottom of that range). The rally in bonds in January at the same time that risk markets recovered saw a continuation of the unusual positive correlation that was a hallmark of 2022, in contrast to the more common negative correlation between bond and risk markets of the preceding few decades. We expect that once central banks complete their tightening cycles to combat inflation that this unusual period of negative correlation will end.

Portfolio Strategy

The benefits to the portfolio from a higher running yield have become more evident in recent months. These combined with a positive market environment in January to further support performance. The credit exposures in the portfolio benefited from the narrowing in credit spreads and the long duration position benefited from the decline in yields. However, the more defensive positioning in both rates and credit that served the portfolio well over 2022 and that we have maintained in January given our view that significant risks still remain, did act to limit the positive impact on performance from these influences.

AUD credit spreads lagged the December USD rally and as such offer attractive value and started to compress faster in January, catching up some of it. We expect the addition of a ~10% weight in AUD bonds to the J.P. Morgan Asia Credit Index for the first time will provide some technical buying support from new Asian buyers, who are now forced to cover or at least consider AUD bonds in the context of their benchmark over coming months. In particular we expect large, highly rated liquid names - typically financials - to benefit most.

We deployed excess liquidity by adding short dated AUD financial bonds in primary given attractive new issue concessions, good liquidity and wide spreads. We continued our theme of tapping into new issues of Mutual banks from December, which affords attractive carry, decent liquidity given RBA repo eligibility, and good new issue spreads. We are also seeing value and a strong pipeline in securitised, and expect to buy select primary deals with short WALs and high spreads when they issue in February. Corporates remain unwilling to issue in the Australian market given the competitive funding available in loans, and as such are unwilling to pay new issue concessions. Therefore we expect to continue to see the theme of rotating out of corporates and rotating towards financials who pay more attractive concessions. 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 a likely 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 80% of the portfolio is held in Australian & New Zealand names, and by currency around 95%+ of the portfolio is held in AUD-denominated securities.

Some portfolio liquidity was utilised on attractive new issues but 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.

Core duration positioning was not significantly altered in January, remaining relatively low at around a quarter of a year. Yields tend to rise until close to the end of global tightening cycles and whilst the pace of tightening is slowing this does not automatically mean a pause is imminent. We have therefore not rushed to add duration at this time. Some very short-dated short positions around upcoming central bank meetings were added, to take advantage of the fact that a 50bps hike from the US Federal Reserve was given a less than 10% chance and a 25bps rate increase by the RBA was given a 60% chance. We assessed the chances of both as being above what the market was pricing in, particularly in the case of the RBA where the Q4 CPI showed an increase in the trimmed mean measure of underlying inflation to 6.9% over the year (against an RBA forecast of 6.5%). These positions had what will be a short-lived effect of reducing reported duration towards zero as at the end of January.

Kapstream

—JANUS HENDERSON—

Kapstream Absolute Return Income Fund

Outlook

As noted above, the market's focus has shifted to the end of what has been an aggressive tightening cycle, if not looking beyond this to a possible easing cycle later this year. This may be premature. We await further confirmation on both fronts with central banks still tightening at this stage. Once the evidence accumulates, yields will further track sideways, if not trend lower and our plan is to add to duration over the course of this year as a result. The return of the defensive qualities that fixed income normally exhibit will also support lengthening duration, as a hedge for the credit exposures contained in the portfolio.

It is worth reiterating though that a pause does not mean a pivot towards easing. Many central banks have warned that they may not ease policy when economies slow if inflation remains sticky or above target. We expect the lagged impact from the global tightening cycle will see activity slow materially into recession across several regions, which later this year will test central bankers resolve on their commitments to keep official interest rates higher for longer. Risk sentiment does not tend to fare well during recessions, with our analysis showing it is fairly common for equities to fall ~30-35%. With US equities down around 15% at this point there is potentially more to go. This will be one of the biggest challenges for markets and portfolio positioning when it occurs, given the market has recently taken an optimistic view around a soft landing. This is where the distinction between a pause and a pivot becomes important, as it is usually only when central banks begin easing policy that risk markets tend to fully recover. We don't see ourselves at that point yet, given that the recession, which an easing of policy would be a response to, has not even begun.

Unless otherwise specified, any information contained in this publication is current as at the date of this report and is provided by Fidante Partners Limited (ABN 94 002 835 592, AFSL 234668) the issuer of the Kapstream Wholesale Absolute Return Income Fund (ARSN 124 152 790) (Fund). Kapstream Capital Pty Limited (ABN 19 122 076 117, AFSL 308870) is the investment manager of the Fund. It should be regarded as general information only rather than advice. It has been prepared without taking account of any person's objectives, financial situation or needs. Because of that, each person should, before acting on any such information, consider its appropriateness, having regard to their objectives, financial situation and needs. Each person should obtain the relevant Product Disclosure Statement (PDS) relating to the Fund and consider that PDS before making any decision about the Fund. A copy of the PDS can be obtained from your financial adviser, our Investor Services team on 13 51 53, or on our website www.fidante.com.au. If you acquire or hold the product, we and/or a Fidante Partners related company will receive fees and other benefits which are generally disclosed in the PDS or other disclosure document for the product. Neither Fidante Partners nor a Fidante Partners related company and our respective employees receive any specific remuneration for any advice provided to you. However, financial advisers (including some Fidante Partners related companies) may receive fees or commissions if they provide advice to you or arrange for you to invest in the Fund. Kapstream Capital, some or all Fidante Partners related companies and directors of those companies may benefit from fees, commissions and other benefits received by another group company.