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 2377.71
Distribution frequency	Quarterly
Management fee	0.40%
Buy/sell spread	Please contact us for latest spreads

Fund Statistics

Interest rate duration	0.23yrs
Credit spread duration	1.52yrs
Average credit rating	BBB+
No of issuers	78
Yield to maturity	5.75%

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

March 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)	0.23	1.42	1.81	1.48	2.03	4.45
Fund Return (after fees, before sell spread)[1]	0.19	1.33	1.40	1.06	1.59	4.09
Fund Return (after fees and sell spread)[2]	0.19	1.33	1.41	1.38	1.58	4.09
RBA Cash Rate	0.29	0.81	2.04	0.77	0.96	2.69
Active return[3] (before fees and sell spread)	-0.06	0.61	-0.23	0.70	1.07	1.76
Active return[3] (after fees and sell spread)[2]	-0.10	0.51	-0.63	0.61	0.62	1.40
Bloomberg AusBond Bank Bills Index	0.28	0.79	2.04	0.73	1.08	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 March 2023.

Performance Commentary

The fund continued to perform well despite an uncommonly turbulent period for markets, increasing by 0.19% in March (after class I unit fees). This takes returns in the first quarter of 2023 to 1.42%. The failure of a number of banks led to a significant amount of volatility in markets, with some sectors of the credit market particularly impacted and bond yields falling sharply as central bank hiking expectations were wound back. The yield to maturity has subsequently fallen slightly over the month, but still provides a considerable support to expected returns in the period ahead.

Market Commentary

The deposit run on Silicon Valley Bank (SVB), Signature Bank and Credit Suisse and eventual failures, as well as the bail-in of CHF16bn of Credit Suisse AT1 bonds (despite a payout to equity holders) were concerning developments. As a result many regulators have since come out to try and provide support to their AT1 markets by assuring them the equity/AT1 hierarchy would be respected, distinguishing themselves from the Credit Suisse situation.

Governments and regulators so far have largely succeeded in calming markets through government and central bank intervention. This was achieved in the US through the the creation of the Bank Term Funding Program (BTFP) allowing banks to pledge securities, including US Treasury and Agency debt, at par, so they can fund deposit outflows without realising losses on securities which are priced at a discount. Additionally, the guarantee of SVB and Signature bank deposits provided uninsured depositors with other regional banks some comfort over the higher likelihood of an implicit guarantee of their money in the current conditions. This allowed some sense of stability to wash through the US regional banks for now. Switzerland achieved this through the provision of liquidity and some government capital support with the purchase of Credit Suisse by UBS.

However, we continue to remain cautious around credit positioning given our view of the still high likelihood of a recession, whilst risk assets (such as equities and credit) do not seem to fully price this in yet. Increasingly there have been parts of the financial system breaking under

the stress of rate hikes and quantitative tightening including the UK gilt market/UK pension funds, US regional banks and now with Credit Suisse, a Globally Systemically Important Bank (GSIB) requiring a government assisted takeover from UBS. We expect that unless central banks pause in the near future, there will continue to be an increasing number of negative 'surprises' for markets as further parts of the financial system buckle under tighter monetary conditions.

Market reaction to the banking issues which arose in March was significant in many areas, although perhaps surprisingly mild in others. For example, the broader reaction in rates markets was arguably larger than that seen in the usually more sentiment driven equities and credit markets. The individual banks involved saw the greatest impact…. as well as those considered to be in the most similar situation. Parts of the subordinated debt market, in particular Additional Tier 1 investors, were also hit when the bail out terms for Credit Suisse made it clear that common equity would receive some form of payout but the lower debt-related parts of the capital structure would not. However overall risk sentiment focused markets like equities and credit spreads had only a modest and temporary deterioration under the circumstances, with the S&P500 down as much as 6.6% in the week following the news but recovering all of that and more to finish higher by month's end. Bond yields had a much larger move in a relative sense, with bond yields falling dramatically on the risk of possible contagion into the economy from a potential tightening of lending appetite. This was something that central banks noted too, with the Fed hiking by 25bps to 4.50%-4.75% on March 23rd (a move back to a larger increase was hinted at by Chairman Powell earlier) and the Fed Governors' projections of future rate hikes not being upgraded as would have otherwise been the case. The ECB still increased the Main Refinancing Operations rate by 50bps to 3.50%, but is somewhat behind in its tightening cycle relative to the US Federal Reserve. The Bank of Canada followed through on its pause in the tightening cycle on March 9th, keeping the overnight rate target at 4.50%. The RBA tightened by 25bps in early March, but the Minutes indicated that it may be looking for reasons to pause to allow the lagged impact of previous rate hikes to be felt before proceeding.

Portfolio Strategy

The portfolio's defensive positioning held it in good stead through this recent turmoil, particularly through avoidance of those names directly impacted and a reduced sensitivity to the widening in credit spreads. However, the light exposure to duration meant that it was not able to capture more of a benefit from the decline in bond yields.

On the duration front, FOMC Chairman Powell's hawkish overtones and fresh highs in bond yields saw us reduce duration positioning slightly, from around 0.35 years to 0.25 years. Our process is largely based on fundamental macroeconomic positioning, and with the Fed indicating that it was going to increase the extent, if not the pace, of future tightening we felt this response was warranted in light of the implications of this pointing towards higher bond yields. Our plan to add duration as we approached the end of the tightening cycle was therefore delayed. This made it particularly difficult to respond to what was effectively a three business day decline in bond yields of over 100bps (in the case of US 2 year yields), particularly as we now see the market as overreacting to the banking issues, if they were not expected to completely derail the economy. This balancing act of wanting to add duration as we approach the end of the cycle but not wanting to do so when the market has too little priced in remains a difficult and much-discussed question.

The portfolio's physical spread duration remained at historical lows of <2yrs, with CDX protection further reducing it to a net spread duration of ~1.4yrs, resulting in the portfolio having a lower sensitivity to spreads than we have historically had (when spread duration was closer to 2.75-3yrs). Despite spread widening, the portfolio was able to post a positive return, as the higher starting carry is continuing to provide a robustness to which hasn't been seen for around a decade, and we are cautiously optimistic, despite expecting a US recession in second half.

In terms of asset allocation, the portfolio can be split across three major 'buckets'; financials (~41%), corporates and REITs (~32%), and asset and mortgage-backed securities (<15%) with the residual in cash and liquids. Close to 90% of the portfolio is held in Australian & New Zealand names, and by currency 95%+ is held in AUD-denominated securities.

Portfolio liquidity remains slightly above target with 'Level 1' liquidity at ~14%+ (cash, commercial paper, SSGA) and 'Level 2' liquidity at 10%+ (<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.

Outlook

Possible contagion to other banks remains the most significant near-term risk. Headline risks remain significant and market liquidity is lower than normal, both of which is likely to keep interest rate volatility at elevated levels. Over the longer term, the magnitude of the impact from a possible contraction in bank lending on the economy is now the biggest question mark, but this is unlikely to be known or show up in the official data for several months. Until then, central banks globally will be keen to keep their focus on getting inflation lower - it has either plateau'd or moved gradually lower in most jurisdictions, but not at a pace that is consistent with each region's respective inflation targets. If the risks of contagion to other banks diminishes, we would therefore expect that central banks will be keen to hike official interest rates further, or at least keep them at an elevated level, more so than is currently priced into financial markets.

We believe this year will be the year of the analyst, as portfolios holding passive indices may continue to be subject to painful tail risks

such as the defaults or AT1 write-offs. As such we are pleased the portfolio held no exposure to SVB, Signature Bank, Credit Suisse, nor US regional banks or AT1 bonds. We do not hold any AT1 positions as a result of observing the significant equity-like volatility it can suffer during a crisis, notably during the onset of the COVID-19 pandemic where we saw AT1 bonds from Big 4 Australian banks sell-off up to 30%, fairly close in magnitude to the equity sell-off. Our philosophy is to run a 'sleep-at-night' portfolio where if we have any serious concerns around an investment, we choose to sell it quickly to minimize potential price impacts, noting that capital preservation is of paramount importance to our investors.

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