Kapstream
— JANUS HENDERSON —

Monthly Report – I class units

Kapstream Absolute Return Income Plus Fund

KANGANEWS AWARDS 2018 WINNER – AUSTRALIAN CREDIT FUND MANAGER OF THE YEAR

KANGANEWS AWARDS 2019 WINNER – AUSTRALIAN CREDIT FUND MANAGER OF THE YEAR

KANGANEWS AWARDS 2021 WINNER – AUSTRALIAN CREDIT FUND MANAGER OF THE YEAR

KANGANEWS AWARDS 2022 WINNER – AUSTRALIAN CREDIT FUND MANAGER OF THE YEAR

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, absolute return-oriented global fixed income portfolio.

Fund details

Inception date	16 August 2018
Fund size	AUD 341m
Distribution frequency	Quarterly
Management fee	0.45% p.a.
Buy/sell spread	0%/0.2%

Fund statistics

Interest rate duration	0.30yrs
Spread duration physical	1.63 yrs
Yield to Maturity	6.51%
Average credit rating	BBB+
Number of issuers	57

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

March 2023

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)*	**0.44**	**1.54**	**2.60**	**1.54**	**3.00**	**2.88**	**3.02**
Fund Return *(after fees, before sell spread)*[1]	0.40	1.42	2.37	1.42	2.53	2.39	2.53
Fund Return *(after fees and sell spread)*[2]	0.40	1.43	2.37	1.43	2.53	3.19	2.52
RBA Cash Rate	0.29	0.81	1.51	0.81	2.04	0.77	0.91
Active return[3] *(before fees and sell spread)*	**0.15**	**0.73**	**1.10**	**0.73**	**0.96**	**2.11**	**2.11**
Active return[3] *(after fees and sell spread)*[2]	0.11	0.62	0.86	0.62	0.48	2.42	1.60
Ausbond Bank Bill Index	0.28	0.79	1.54	0.79	2.04	0.73	1.01

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 March 2023.

Performance commentary

The Fund performed well in the month returning 0.44% (before fees) in March, 1.5% over the 1st quarter. The largest contributor to returns was coupon income, aided by duration, offset partially by spread and CDX widening. This was a pleasing continuation of calendar year return momentum, despite global volatility. We remain positive on the outlook for 2023 returns given the fund's yield to maturity of 6.51%, close to historic strategy highs.

Portfolio strategy

The Fund invested in Big Four bank T2 and corporates which had attractive new issue concessions. We believe there remains a tail risk for non-call of T2 bonds, especially in non-AUD T2, low coupon and regional bank bonds. We will likely continue reducing those bonds and recycle into bonds with higher coupons and lower extension risk.

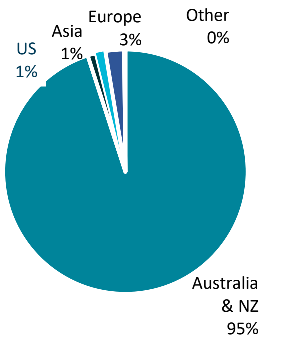
We continue to expect a 2023 US/European recession, and for risk assets to price this. This recession will be driven by high inflation that has led to aggressive and continued rate hiking, a moderately high US dollar and a Europe wide slowdown as well as negative S&P500 earnings growth (ex Energy) since Q2 2022, and including Energy since Q4 2022. As a result, we hold CDX tactically at ~6% and keep the credit book short dated. Liquidity increased despite buying attractive new issues, given maturities and it remains at the higher end of the range with Level 1 liquidity at ~18.4% (cash, commercial paper, SSGA) and Level 2 liquidity at ~18.1% (<1yr investment grade).

The Fund's yield to maturity reduced slightly 22bps to 6.51%, but continues to provide a strong tailwind for future returns. Physical spread duration ex SSGA was stable at ~1.6yrs and ~1.3yrs net of CDX hedges. There is significant capacity to add attractive spread risk. Repo exposure was nil. Duration was reduced to 0.30yrs from 0.36yrs.

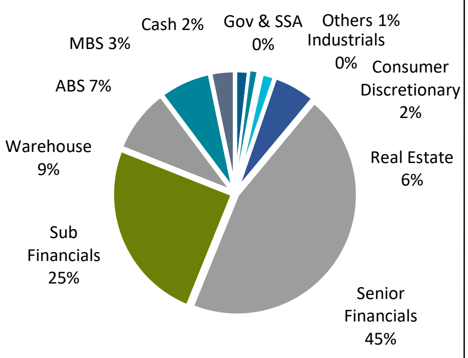
The average credit rating of holdings improved one notch to BBB+. High yield was stable at ~20%, where holdings are typically BB-rated and short maturity where we have no concern around default risk. We continue to minimise or avoid exposure to companies unable to pass on higher refinancing costs and higher beta sectors such as commodities and energy. The portfolio is split across financials (~66%), corporates (~11%), and asset and mortgage-backed and warehouses (~19%), with the residual in cash and SSGAs. We have a ~95%/5% split between Australia/New Zealand and international issuers.

In rates, we have ~0.26yrs duration in the US and 0.04yr in AUD. 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 allows us to lock in attractive longer term interest rates, providing more certainty on future income.

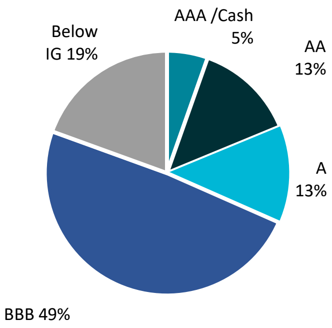
Geographic Allocation



Sector Allocation*



Credit Rating*



*Scaled to 100% for repo

Outlook

Global equities rallied, with the S&P 500 gaining 3.5%, reducing cumulative losses to ~15% from the 2022 peak. The VIX dropped 2ppts to ~18.7%, and CDX widened 1bp to ~76bps. US & AUD physical credit widened due to SVB & Signature Bank's collapse and the bail-in of Credit Suisse AT1 bonds. We remain concerned about heightened 2023 volatility from inflation, central bank hikes, the Ukraine war, and global economic uncertainty.

The deposit run on SVB and Signature Bank prompted US government intervention which opened up the US Bank Term Funding Program (BTFP) and guaranteed SVB and Signature Bank's deposits. At the same time, following the collapse of Credit Suisse and the write off of their AT1, many regulators expressed support for their own AT1 markets, reassuring investors of the equity / AT1 hierarchy. Switzerland stabilised its markets though liquidity provisions and Credit Suisse's acquisition by UBS.

We maintain caution around credit positioning due to the high likelihood of a recession and risk assets not fully pricing this in. Financial system stress is increasing, with UK gilt market/UK pension funds, US regional banks, and GSIB Credit Suisse experiencing difficulties under tighter monetary conditions. Market reactions to the banking issues in March were significant in some areas but mild in others. Bond yields fell dramatically, while equities and credit markets only experienced temporary deterioration. Central banks globally continue to focus on reducing inflation, with rate hikes expected if contagion risks diminish.

The Fed hiked by 25bps to 4.50%-4.75% on March 23rd, while the ECB increased the Main Refinancing Operations rate by 50bps to 3.50%. The Bank of Canada paused its tightening cycle, keeping the overnight rate target at 4.50%. The RBA tightened by 25bps, but minutes indicated a potential pause to assess the impact of previous hikes.

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 0.30 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.

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 are 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 plateaued 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 passive index portfolios may face painful tail risks, such as defaults or AT1 write-offs. Our portfolio held no exposure to SVB, Signature Bank, Credit Suisse, US regional banks, or AT1 bonds. We avoid AT1 positions due to their equity-like volatility during crises, as seen in the COVID-19 pandemic when Big 4 Australian bank AT1 bonds sold off up to 30%. Our philosophy is to run a 'sleep-at-night' portfolio, quickly selling investments with serious concerns to minimise potential price impacts and prioritise capital preservation for our investors.

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