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 2137.20
Distribution frequency	Quarterly
Management fee	0.40%
Buy/sell spread	Please contact us for latest spreads

Fund Statistics

Interest rate duration	0.74yrs
Credit spread duration	1.51yrs
Average credit rating	BBB+
No of issuers	78
Yield to maturity	6.55%

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

September 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)	0.33	1.64	4.94	1.87	2.25	4.48
Fund Return (after fees, before sell spread)[1]	0.30	1.53	4.50	1.44	1.80	4.11
Fund Return (after fees and sell spread)[2]	0.30	1.53	4.50	1.46	1.79	4.11
RBA Cash Rate	0.32	1.01	3.49	1.39	1.20	2.73
Active return[3] (before fees and sell spread)	0.01	0.64	1.45	0.48	1.05	1.74
Active return[3] (after fees and sell spread)[2]	-0.02	0.53	1.01	0.08	0.59	1.38
Bloomberg AusBond Bank Bills Index	0.34	1.08	3.56	1.36	1.28	2.94

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, 30 September 2023.

Performance Commentary

The Fund continued to post solid returns in September, returning 0.30% (after class I unit fees). Market dynamics in September worked against the portfolio, with risk sentiment deteriorating after a near 12 month trend improvement. However, while the fall in equities and widening physical and synthetic credit spreads detracted from our credit holdings, CDX hedging, asset allocation and stock picking shielded returns. A marked increase in yields to fresh cyclical highs was again a feature but was unusually driven by the back end of the yield curve, which is less about near term monetary policy expectations. While shorter duration exposures mitigated the negative impact to return, the resulting yield to maturity increase augurs well for expected returns looking forward.

Market Commentary

September was another month marked by both risk and bond markets retreating. This had a generally negative impact on a wide range of asset classes.

Whilst yields continued their uptrend setting fresh highs for the cycle, the catalyst this month was somewhat different. The majority of the increase in yields over the past two years has been driven by advancing monetary policy expectations, lifting the front end of the yield curve. However, in September it was the back end of the yield curve which led the way, bear steepening the curve. US 10yr yields rose by 47bps in September, much more than the 20bp increase at the 2yr part of the curve. The increased supply of US Treasuries amidst big fiscal deficits was the most often cited driver, as was long positioning by many anticipating the end of the tightening cycle being unwound as we continue to make fresh highs.

That is not to say that monetary policy expectations weren't also a driver. The US Federal Reserve implemented a hawkish hold in September, with the projected 'dot plot' of interest rate expectations maintaining another hike this year and halving the amount of cuts in 2024 from 100bps to 50bps. Elsewhere the European Central Bank hiked rates by 25bps, with core inflation not declining significantly, and despite activity slowing sharply. The Bank of England surprised by not hiking, following a lower-than-expected CPI outcome for August. The Bank of Canada remained on hold, but core inflation is no longer declining. The Reserve Bank of New Zealand is also on hold, but recent economic activity data were stronger than expected.

Synthesising the above in a single phrase: we are not yet convinced that the global tightening cycle has come to an end.

The higher yield environment contributed to weaker risk sentiment in September causing the S&P500 to fall 4.77%. Credit markets sold off marginally in sympathy, with US credit spreads (Bloomberg US Corporate Aggregate index OAS spread) out 3bps to 121bps. CDX spreads were out about 5bps to 74bps (after removing the impact of the roll from the change). Australian credit spreads (in the form of the Bloomberg Australian Corporate Average OAS series) widened by 3bps to 90bps.

Portfolio Strategy

We remain defensively positioned, with no significant changes in the month. Collectively, central banks are not yet ready to declare the war on inflation won, and bonds continue to trend lower in price with yields rising. As a result, we continue to remain lightly positioned in terms of duration relative to historical averages. Duration remained at ~0.7 years, lower than the one year neutral level the fund tends to oscillate around.

The portfolio’s physical spread duration remains below 2yrs, with CDX protection further reducing it to a net spread duration of ~1.5yrs, resulting in the portfolio continuing to have a lower sensitivity to spread change than we have historically targeted (when spread duration was closer to 2.75-3yrs). The high coupon continues to provide a return robustness which hasn’t been seen for around a decade. The quality of this coupon is strong given it is comprised of a higher than average credit spread, despite being focused on shorter dated assets. Given this high coupon we remain cautiously optimistic, despite expecting a potential economic downturn in the US in H2 2023/H1 2024.

In terms of asset allocation, the portfolio can be split across three major ‘buckets’; financials (~44%), corporates and REITs (~33%), 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 <5% is held in non-AUD denominated securities.

Portfolio liquidity remains high and stable over the month with ‘Level 1’ liquidity at 8% (cash, commercial paper, SSGA) and at the high end of the range for ‘Level 2’ liquidity at ~20%+ (<1yr investment grade) as under two year bonds have become under one year. We believe this mix still provides the flexibility to buy discounted credit driven by market volatility.

Outlook

We remain of the view that a likely recession due to the impact of higher interest rates hasn’t yet had enough time to play out. The usual lag with which monetary policy operates on the economy is normally around 12-18 months and central banks have still been hiking all the way up until quite recently. The slowing in the economy to date from the super-strong rates of growth seen post-COVID has been consistent with the historical experience and suggests further softness is yet to come. Other reliable leading indicators, such as yield curve inversion, the ISM survey and the Senior Loan Officer Opinion Survey ('SLOOS') all suggest the same thing: a recession is likely to occur around the turn of this year. Although risk markets softened this month, they do not fully price this expectation and seemingly just look at conditions as they stand today, taking an overly optimistic view of what the usual relationships suggest may be coming down the track. This is why we have positioned the portfolio to have a low sensitivity to potential spread movements, but in a way that still delivers strong carry to achieve the portfolio’s return objectives. Similarly, we remain cautious around adding rates duration, but do intend to move beyond neutral only when we approach the next easing cycle. Given the persistence of inflation above target and the strength in labour markets, there may be an extended period between the end of the tightening cycle and the start of the easing cycle. Financial markets are not fully reflecting this possibility, but then again markets have shown a tendency to not like to sit still so perhaps this should not be overly surprising!

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