Kapstream

— JANUS HENDERSON —

Monthly Report – I class units

Kapstream Absolute Return Income Plus 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

Inception date	16 August 2018
Fund size	AUD 361m
Distribution frequency	Quarterly
Management fee	0.45% p.a.
Buy/sell spread	0%/0.2%

Fund statistics

Interest rate duration	0.79yrs
Spread duration physical	1.81 yrs
Yield to Maturity	7.26%
Average credit rating	BBB
Number of issuers	63

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

September 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)*	**0.48**	**1.80**	**3.00**	**4.58**	**5.68**	**3.57**	**3.32**
Fund Return *(after fees, before sell spread)*[1]	0.44	1.68	2.75	4.22	5.19	3.08	2.83
Fund Return *(after fees and sell spread)*[2]	0.44	1.68	2.75	4.22	5.19	3.19	2.81
RBA Cash Rate	0.32	1.01	1.95	2.78	3.49	1.39	1.21
Active return[3] *(before fees and sell spread)*	**0.16**	**0.79**	**1.04**	**1.80**	**2.19**	**2.18**	**2.11**
Active return[3] *(after fees and sell spread)*[2]	0.12	0.67	0.80	1.44	1.70	1.80	1.61
Ausbond Bank Bill Index	0.34	1.08	1.99	2.80	3.56	1.36	1.30

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, 29 September 2023.

Performance commentary

The Fund returned 0.48% before fees in September, 4.58% CYTD and 5.68% over the last year. The largest contributor to return was coupon income, credit spreads were stable with CDX being additive, offset by rates which detracted. Despite global volatility, September marks 12 straight months of positive absolute returns, underpinning the robustness and resilience of the portfolio. Our conviction on the outlook for 2023 remains positive given the fund's yield of 7.26%, close to historic highs.

Portfolio strategy

In September, the Fund invested in primary issuances with attractive new issue concessions. We continue to expect and position for an early 2024 US/European recession, and for risk assets to eventually price this. This recession will be driven by the recent aggressive rate hiking, negative S&P500 earnings growth (ex. Energy) since Q2 2022 and including Energy since Q4 2022. As a result, we hold CDX at ~5.5% and have kept the credit book short-dated. As expected, Level 1 liquidity reduced from buying attractive bonds but remains at the higher end of the range at ~8.7% (cash, commercial paper, SSGA) and Level 2 liquidity at ~23.5% (<1yr investment grade).

The Fund's yield to maturity increased by 31bps to 7.26% and continues to provide a strong tailwind for future returns. Physical spread duration ex. SSGA increased c0.1yr to ~1.8yrs and ~1.5yrs net of CDX hedges. There is significant capacity to add attractive spread risk but we remain cautious on longer-dated credit. Repo exposure was nil. Rate duration increased slightly to 0.79yrs from 0.75yrs.

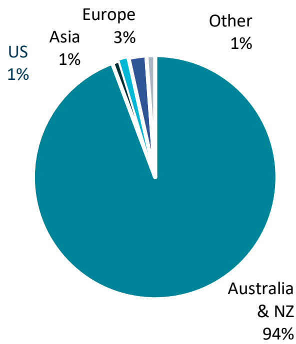
The average credit rating of holdings reduced 1 notch to BBB. High yield was increased to ~20.4%, where holdings are typically BB-rated and short maturity. We continue to minimise or avoid exposure to companies where we expect they have material default risk, are unable to pass on higher refinancing costs and higher beta sectors such as commodities and energy. The portfolio is split across financials (~64%), corporates (~15%), and asset and mortgage-backed and warehouses (~21%), with the residual in cash and SSGAs. We have a ~94%/6% split between Australia/New Zealand and international issuers.

In rates, we have ~0.6yr duration in the US, 0.06yr in EUR & 0.06yr in NZD and 0.06yr in AUD. We believe there is merit in maintaining some level of duration, as a hedge for the credit book. This should 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.

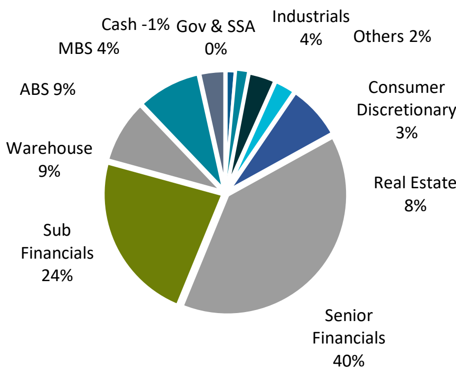
Kapstream
— JANUS HENDERSON —

Outlook

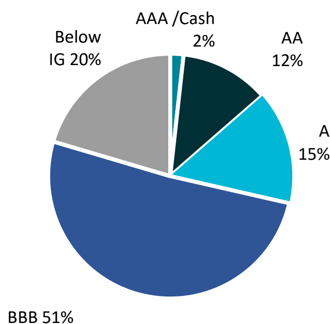
Geographic Allocation



Sector Allocation*



Credit Rating*



*Scaled to 100% for repo

September was marked by both risk and bond markets retreating. 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.

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 with stronger than expected recent economic activity data. In short, we are not yet convinced that the global tightening cycle has come to an end.

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.

We believe this year will be the 'year of the analyst' and the active investor, as passive index portfolios may face painful tail risks, such as defaults or AT1 write-offs leading to increased fundamental differentiation and dispersion of returns. Our portfolio held no exposure to US regional banks, Credit Suisse, or AT1 bonds, which we have historically avoided due to their equity-like volatility during crises. Our philosophy is to run a 'sleep-at-night' portfolio, quickly selling investments with serious concerns to minimise potential price impacts, as we expect the attractive yield to generate a meaningful return for investors. Nevertheless, we remain positive on the outlook for stable and attractive portfolio returns as the yield to maturity bounces around 7%, providing a rich buffer to the uncertainty of the macro backdrop. Additionally, the elevated levels of available portfolio liquidity and volatility budget provide us with ample ability to pounce on any opportunities in weakness, adding to our cautious optimism for returns in the period ahead.

The information has been prepared on the basis that the Client is a wholesale client within the meaning of the Corporations Act 2001 (Cth), is general in nature and is not intended to constitute advice or a securities recommendation. It should be regarded as general information only rather than advice. Because of that, the Client should, before acting on any such information, consider its appropriateness, having regard to the Client's objectives, financial situation and needs. Any information provided or conclusions made in this report, whether express or implied, do not take into account the investment objectives, financial situation and particular needs of the Client. Past performance is not a guide to future performance. Neither Kapstream Capital (**"Kapstream"**) (ABN 19 122 076 117 AFSL 308 870) nor any other person guarantees the repayment of capital or any particular rate of return of the Client portfolio. Except to the extent prohibited by statute, Kapstream, or any director, officer, employee or agent of Kapstream, do not accept any liability (whether in negligence or otherwise) for any errors or omissions contained in this report.