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 2112.48
Distribution frequency	Quarterly
Management fee	0.40%
Buy/sell spread	Please contact us for latest spreads

Fund Statistics

Interest rate duration	0.72yrs
Credit spread duration	1.54yrs
Average credit rating	A-
No of issuers	78
Yield to maturity	6.34%

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

November 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)	0.67	1.59	5.99	2.00	2.43	4.51
Fund Return (after fees, before sell spread)[1]	0.64	1.49	5.55	1.57	1.98	4.14
Fund Return (after fees and sell spread)[2]	0.64	1.49	5.55	1.59	1.97	4.14
RBA Cash Rate	0.34	1.02	3.76	1.61	1.29	2.75
Active return[3] (before fees and sell spread)	0.33	0.57	2.24	0.39	1.14	1.76
Active return[3] (after fees and sell spread)[2]	0.29	0.47	1.80	-0.02	0.68	1.39
Bloomberg AusBond Bank Bills Index	0.35	1.03	3.76	1.59	1.35	2.95

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 November 2023.

Performance Commentary

The Fund continued to perform strongly in November, returning 0.64% (after class I unit fees). Performance in the month benefitted from an exceptionally strong risk environment and a decline in bond yields globally. Coupled with the additional spread we have consciously built into the portfolio and the underlying higher interest rate environment, November was the second strongest month of performance this year. Returns over the past year now stand at 5.55% (after class I unit fees). With the falling yield environment globally, the yield to maturity on the portfolio fell slightly to 6.34%. This still supports an appealing forward looking return forecast.

Market Commentary

Risk markets posted an exceptionally strong performance in November. Equities had one of the strongest rises on record, with the S&P 500 rising by 9.6% in the month. Unsurprisingly, credit spreads narrowed accordingly, with US investment grade credit spreads (in the form of the Bloomberg US Corporate Bond index) in by 25bps to 104bps. Synthetic measures of credit spreads, such as the CDX IG, were in by 17bps to 62bps. In this context, the 1bp widening in Australian credit spreads (the Bloomberg Australian Corporate Average OAS series) was unusual and reflected the usual lag with which Australian spreads reflect offshore moves. We expect Australian credit spreads to show an element of catch up next month.

Part of the reason that risk had such a strong month was further evidence that the end of the global tightening cycle and the related rise in yields is behind us. The rising inflation catalyst behind higher interest rates over 2022 is reversing. Yearly core PCE inflation in the US is down to 3.5%, after reaching as high as 5.6% in mid-2022. Six month inflation rates for the same series is down to 2.5% in October, just half a percentage point above target and suggesting further declines in the yearly rate are to come. A similar story can be said for Europe. This saw US yields fall by 41bps in the 2yr part of the curve, and 60bps in the 10 year part of the curve, unwinding some of the sharp rises in long-dated yields seen in the months leading up to October.

Inflation isn't as close to target in other regions, such as New Zealand or the UK, or has stalled at something above target in the case of Canada. Nonetheless, official interest rates are now

meaningfully above core inflation in these regions, which economists broadly interpret as suggesting that monetary policy is in restrictive territory. The combination of policy being restrictive and inflation returning to target suggests that most central banks are likely finished tightening for this cycle.

Not all developed market central banks are finished tightening. After being on hold since June, the Reserve Bank of Australia (RBA) resumed its tightening cycle in November with a 25bp increase to 4.35%. The key catalyst was an above-expectations quarterly CPI outcome for Q3, which showed that trimmed mean inflation at 5.2% is not coming down as quickly as forecast. Australia also remains a region where core inflation is above the official policy rate, suggesting to the RBA that monetary policy is not yet restrictive enough to be sure that inflation will return to the 2-3% target in a timely manner. It was therefore somewhat surprising that the RBA used neutral language in the statement accompanying the rate hike, but it will not take much in terms of upside surprise for the RBA to act again given it only just forecasts inflation to return to the 2-3% target range at the end of its forecast horizon.

Portfolio Strategy

We remain defensively positioned on both the rates and credit sides of the portfolio. Whilst not negatively impacting performance in November (and being supportive for most of the past year) this defensive positioning arguably limited positive performance in November.

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 an economic slowdown in the US in H1 2024.

In terms of asset allocation, the portfolio can be split across three major ‘buckets’; financials (~1/2), corporates and REITs (~1/3), 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 ~15% (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.

In terms of interest rate duration, the fall in yields remains in its infancy. Just last month, a strong rise in back end yields was the key theme. In other words, the decline in yields over November did not lead to us adding to our duration positioning at this early stage. Duration remains around 0.7 years, only slightly below the historical average of around one year’s duration. Nonetheless the end of the tightening cycle in many regions suggests we are nearing the time to add, particularly so in regions like North America and Europe where inflation is returning rapidly to target and less so in Australia where the central bank may yet hike official interest rates.

Outlook

If the market's focus is turning away from inflation and the global tightening cycle, then it is likely to turn toward how the economy responds to the higher level of rates. This will determine how far the eventual easing cycle has to extend, once it begins. In the US, there is strong evidence that we are seeing a soft landing - this was another reason risk markets posted such a strong outcome in November. Economic activity remains above potential of ~2%, being strongly supported by consumer spending. If inflation is able to return to target in this context, then the Fed may eventually only cut rates from restrictive territory back towards neutral (although this is still a series of cuts totalling 200-300 basis points potentially).

However the strong economic activity results in the US are the exception and not the rule. Economic activity has already slowed below trend in a number of regions, most notably in Europe but also Canada, Australia and NZ. Even in the US, the lagged impact from tightening as recently as July may yet see the economy slow below trend, particularly if the slowing in employment and wage growth limits consumer income, and therefore spending. In this instance, where the rate hikes prove successful not just in slowing inflation, but also the economy to a point where unemployment rises significantly, then central banks will have to cut rates not just to neutral, but below.

Whether the soft or hard landing scenario plays out, adding duration into your portfolio is beginning to look more viable as yields will fall. However, which of the two scenarios plays out will be of much greater concern for credit positioning. The hard landing scenario would mean you would want to be significantly underweight exposure to risk assets, such as credit. A soft landing scenario where economic activity stays around trend would mean you would not want to be underweight. The economic activity response to higher interest rates will be one of the key questions to consider over 2024.

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