Kapstream
—JANUS HENDERSON—

Kapstream Absolute Return Income Fund

KANGANEWS AWARDS 2017, 2018, 2019, 2021, 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 (IG), absolute return-oriented global fixed income portfolio.

Fund Details

APIR code	HOW0165AU
Inception date	31 May 2007
Fund size	AUD 2130.45
Distribution frequency	Quarterly
Management fee	0.40%
Buy/sell spread	Please contact us for latest spreads

Fund Statistics

Interest rate duration	0.69yrs
Credit spread duration	1.55yrs
Average credit rating	A-
No of issuers	78
Yield to maturity	6.7%

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

October 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)	0.58	1.55	5.56	1.95	2.30	4.49
Fund Return (after fees, before sell spread)[1]	0.54	1.43	5.11	1.52	1.85	4.13
Fund Return (after fees and sell spread)[2]	0.54	1.43	5.11	1.54	1.84	4.12
RBA Cash Rate	0.35	1.02	3.64	1.50	1.24	2.74
Active return[3] (before fees and sell spread)	0.23	0.53	1.92	0.45	1.05	1.75
Active return[3] (after fees and sell spread)[2]	0.19	0.41	1.47	0.04	0.59	1.38
Bloomberg AusBond Bank Bills Index	0.33	1.04	3.66	1.47	1.31	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, 31 October 2023.

Performance Commentary

The fund continued to perform strongly in October, returning 0.54% (after class I unit fees), despite unfavourable market conditions with risk sentiment modestly deteriorating and bond yields generally rising. Performance evidences how the portfolio's broadly defensive positioning, being maintained though this stage of the economic cycle, and the additional spread incorporated into the portfolio, is continuing to add value. The yield to maturity on the portfolio rose again, pointing to a strong forward-looking expectation of absolute and relative returns. The rolling one year return now stands at 5.11% (after class I unit fees).

Market Commentary

The end of the tightening cycle in developed markets draws closer. The rise in inflation has turned in most regions, even if the pace of decline varies and inflation rates remain above central bank targets. Official interest rates have risen from well below inflation rates to above, raising ‘real’ interest rates to what is generally considered restrictive territory. Economic growth has responded to this (and other influences) and fallen to below trend levels in the European Union, United Kingdom, Canada, Australia and New Zealand. Only in the US has growth remained strong, where we have seen annualised growth remain above trend for five successive quarters, with a particularly strong recent data print of 4.9% annualised for Q3. Calls for a recession have remained premature for this country. Nonetheless, central banks in almost all these regions have left rates on hold at their most recent meeting or meetings, even if they retain somewhat of a hawkish bias.

Normally the end of a tightening cycle sees a stabilisation, if not a fall in bond yields, as the market moves to anticipate the next easing cycle. To be fair, expectations around near term monetary policy and yields at the front end of the curve did not move much in most regions. However, October was characterised by a sharp rise in longer dated yields, led by the US. It’s not clear what the dominant influence was, with many reasons put forward to explain this unusual steepening of the curve. This included rising term premiums from increased bond supply from the US Treasury, selling of bonds from offshore investors, or an increase in the longer term ‘neutral’ interest rate that the US economy could handle. In any case, US 10yr yields rose by 36bps in October, far outpacing the 4bp rise at the 2yr part of the curve and lifting longer-dated yields globally.

There were some exceptions to this combination of almost no move at the front end of the curve combined with large rises at the back end. In Australia, Q3 CPI came in around a quarter of a percentage point above RBA forecasts, with headline inflation at 5.4% over the year and the underlying measures at 5.2%. Furthermore, this is one region where the official cash rate , which stands currently at 4.1%, has been less than elsewhere and not increased to above the inflation rate. Therefore, even with GDP growth having slowed below trend already, further rate rises are likely in coming months. Australia's large rise in 10yr yields of 44bps was therefore accompanied by a 32bp increase in front end yields. In NZ and Europe, the converse happened, where the likely end of the tightening cycle was accompanied by a more usual decline in front end yields as further rate cuts were taken out. The 2yr bond yield in these regions actually fell in the month, by 15bps and 19bps respectively.

Risk markets, which had been responding positively to the possible end of official tightening cycles, gave back some of their recent gains under the weight of sharply higher longer end yields. In equities, the S&P 500 was down 2.2% in October to just under 4,200 points. Credit spreads widened with this decline in risk sentiment, both in physical and synthetic form. The Bloomberg US Corporate Agg OAS series widened 8bps to 129bps, although the increase was smaller at 2bps to 154bps for the Bloomberg Australian Corporate Average OAS series. Investment grade CDX spreads in the US rose by 5.6bps to still be reasonably low at 79.5bps.

Portfolio Strategy

We remain defensively positioned which continues to help support returns. The possible global recession in the economy and earnings, associated with an environment where the tightening cycle is drawing to a close, remain the key factors in our positioning.
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 H1 2024.

In terms of asset allocation, the portfolio can be split across three major 'buckets'; financials (~44%), corporates and REITs (~30%), 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 10% (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 rise in yields that we associate with tightening monetary policy may be drawing to a close, but was coupled with the unusual increase in longer-dated yields in the US in October. These moves often tend to be short-lived. As a result the lower-than-usual level of duration exposure in the portfolio, and its concentration at the front end of the yield curve, did protect the portfolio from adverse moves in October. That said, with the increased certainty that the global monetary policy cycle is drawing to a close, we are likely to begin adding to duration as the opportunity arises, to capture the trend decline in yields that will eventually occur once inflation moves further toward central bank targets and as labour markets weaken.

Outlook

Geopolitical tension, which flared during the month with a terrible personal toll, initially took the oil price with it. However, outside this, the conflict to date has not had a significant impact on financial markets. This is primarily due to the limited impact on central banks, as they have been prioritizing the task of stabilizing inflation levels back to the desired trend, which in turn drives bond yields. However, this benign impact would be reassessed if the conflict were to spread to include other nations.

Whilst economic growth in the US has remained above trend, we do expect activity to eventually slow like other regions. The lagged impact of significant monetary policy tightening seen in 2022 is yet to come into full effect, even if the impact may be a bit slower than some recessions in the past. Labour market pressures are then expected to ease, with a slowing in employment growth and rise in the unemployment rate leading to further weakness as consumer incomes decline in aggregate. Earnings tend to not fare well in such environments, taking global risk sentiment lower with it. Risk markets have resisted this possibility to date.

For rates markets the likely end of the tightening cycle should see yields top out, particularly once this unusual rise in longer-end yields for this stage in the economic cycle runs its course. This is where the 'high for longer' mantra put forward by central banks becomes important. Financial markets will inevitably move towards thinking about rate cuts once the end of the tightening cycle is confirmed, but history suggests these initial reactions often get reversed. High for longer, if the central banks can stick to plan, would likely see something of a sideways ranging environment occur for yields. This remains our base case for now.