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, absolute return-oriented global fixed income portfolio.

Fund details

Inception date	16 August 2018
Fund size	AUD 386m
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	1.86 yrs
Yield to Maturity	6.93%
Average credit rating	BBB+
Number of issuers	66

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

December 2023

Performance (%)	1 month	3 months	calendar year to date	1 year	3 years annualised	5 years annualised	since inception annualised
Fund Return *(before fees and sell spread)*	**0.96**	**2.44**	**7.14**	**7.14**	**3.84**	**3.68**	**3.62**
Fund Return *(after fees, before sell spread)*[1]	0.92	2.32	6.64	6.64	3.35	3.19	3.13
Fund Return *(after fees and sell spread)*[2]	0.92	2.32	6.64	6.64	3.41	3.18	3.12
RBA Cash Rate	0.34	1.04	3.85	3.85	1.73	1.33	1.34
Active return[3] *(before fees and sell spread)*	**0.62**	**1.40**	**3.28**	**3.28**	**2.11**	**2.35**	**2.28**
Active return[3] *(after fees and sell spread)*[2]	0.58	1.28	2.79	2.79	1.69	1.85	1.78
Ausbond Bank Bill Index	0.37	1.06	3.89	3.89	1.71	1.40	1.44

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 December 2023.

Performance commentary

The Fund returned 0.96% before fees in December, lifting the rolling one year return to 7.14%. We note that this is now the highest 1mth, 3mth, 1yr, 3yr and 5yr return for the fund in its history, which is pleasing in light of the tightly managed risk budget used to achieve it. The largest contributor to returns was coupon income followed by rates contribution as rates rallied. Credit spreads were also additive. December marks 15 straight months of positive absolute returns, underpinning the robustness and resilience of the portfolio. Over the year, despite maintaining a low risk/short spread duration, we estimate credit contributed ~375bps to returns above rate curves/cash rates. Our conviction on the outlook for 2024 remains strong given the fund's yield of 6.93%.

Portfolio strategy

The Fund invested in primary issuances with attractive new issue concessions mainly across financials and secondary in financials and securitised. We continue to position for a mid-2024 US/European slow down, and for risk assets to eventually price this. A slowdown may be driven by the recent aggressive rate hiking and delayed impact of interest rate hikes. However, strong recent US GDP prints, a recovery in large S&P500 firms' technology companies' earnings, and lower inflation PCE prints have increased the odds of a soft landing. Nevertheless, a soft landing is still a landing of sorts, and we expect volatility along the way, which should provide better entry points in credit. We continue to hold low levels of CDX at ~2.6% and have kept the credit book short-dated. Level 1 liquidity reduced slightly and remains at the higher end of the range at ~10.6% (cash, commercial paper, SSGA) and Level 2 liquidity at ~23.3% (<1yr investment grade).

The Fund's yield to maturity reduced by 21bps to 6.93% and continues to provide a strong tailwind for future returns. Physical spread duration ex. SSGA increased 0.1yr to ~1.7yrs 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 0.79yr from 0.76yr as we believe the US rate hiking cycle is likely complete.

The average credit rating of holdings remained stable at BBB+. High yield reduced to ~17%, where holdings are typically BB-rated and short maturity. We continue to minimise or avoid exposure to companies with material default risk, those unable to pass on higher refinancing costs, and higher beta sectors such as commodities and energy. The portfolio is split across financials (~62%), corporates (~14%), and asset and mortgage-backed and warehouses (~21%), with the residual in cash and SSGAs. We have a ~93%/7% split between Australia/New Zealand and international issuers.

In rates, we have 0.51yr duration in the US, 0.26yr in EUR, 0.09yr in NZD and -0.07yr in AUD. We believe there is merit in maintaining some 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.

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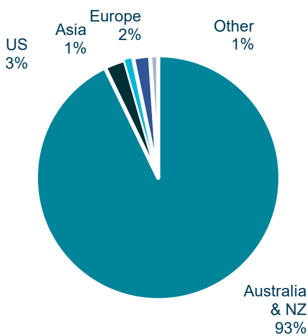
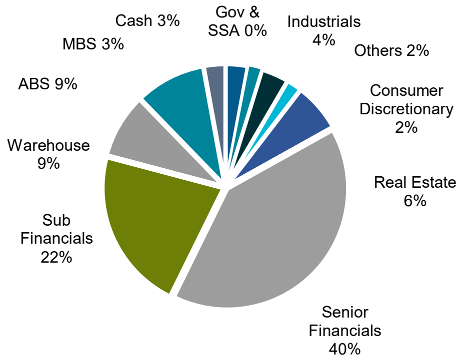
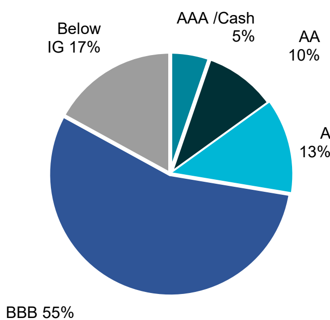
Geographic Allocation



Sector Allocation



Credit Rating



Outlook

December was marked by both risk and bond markets rallying. The S&P500 rallied ~4.4% to within ~1% of its all-time high and 15% above the late October lows. This was driven by the rate rally, due to moderating US inflation prints and a dovish tilt to Fed minutes. Credit markets rallied in sympathy, with US credit spreads (Bloomberg US Corporate Index) and CDX both tightening ~5-6bps. Australian credit spreads (Bloomberg Australian Corporate Average ASW series) tightened 0.5bps.

The soft landing thesis gained prominence in December 2023, as inflation reduced faster than anticipated, with goods inflation below target in many regions while service inflation was stickier. This led to the belief that central banks would ease rates, alleviating inflation fears and avoid a recession or sharp rises in unemployment. Bond yields fell dramatically in December, as the focus shifted from rate hikes to rate cuts. US 2yr yields fell by 43bps, with 10yr yields down 45bps. Similar declines were seen in Australia and Europe, while the UK experienced larger declines due to sharply slowing inflation. New Zealand saw smaller declines, as the Reserve Bank of New Zealand expressed discomfort with the slower pace of falling inflation.

This lower rates sentiment created a Goldilocks scenario for risk markets. Lower rates would relieve pressure on business interest payments, and when combined with a stable economy, implying unchanged top line revenue would imply higher net income. However, the soft landing scenario is not guaranteed or universally expected. Economic activity in most developed market regions was below the level consistent with unchanged unemployment rates, except for the US, where GDP growth remained above trend. Unemployment rates had turned a corner and increased in various countries. If this trend continues, central banks may be prompted to take rates below neutral.

The outlook for 2024 suggests that it may be 'The Year of the Bond' given the high underlying level of yields and greater certainty around future monetary policy direction. The possibility of rate cuts opens up the potential for further capital appreciation, depending on whether central banks aim for a neutral setting (soft landing) or a stimulatory stance (hard landing). We believe an increased exposure to fixed income in 2024 is advisable. The outlook for risk markets is less clear, and the amount of exposure to risk markets should be carefully considered in portfolios.

Regardless of soft or hard landing scenarios, adding duration to portfolios appears increasingly attractive as yields are expected to fall. However, credit positioning depends largely on which scenario unfolds. A hard landing would require significant underweighting of risk assets like credit, while a soft or no landing scenario, where economic activity remains around trend would suggest avoiding being underweight. The economic response to higher rates will be a key consideration in 2024.

We believe the uncertainty around soft or hard landing in 2024 will continue to reinforce the importance of active investment in conjunction with strong analysis, 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 in 2023, 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 minimize 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, reinforcing our cautious optimism for returns in the period ahead.

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