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 2033.57
Distribution frequency	Quarterly
Management fee	0.40%
Buy/sell spread	Please contact us for latest spreads

Fund Statistics

Interest rate duration	1.33yrs
Credit spread duration	1.67yrs
Average credit rating	BBB+
No of issuers	73
Yield to maturity	6.14%

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

February 2024

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)	0.07	1.54	5.69	2.44	2.54	4.54
Fund Return (after fees, before sell spread)[1]	0.03	1.42	5.22	2.02	2.10	4.17
Fund Return (after fees and sell spread)[2]	0.03	1.42	5.22	2.02	2.08	4.17
RBA Cash Rate	0.34	1.07	4.07	1.96	1.43	2.77
Active return[3] (before fees and sell spread)	-0.27	0.47	1.62	0.48	1.11	1.76
Active return[3] (after fees and sell spread)[2]	-0.31	0.36	1.15	0.06	0.65	1.40
Bloomberg AusBond Bank Bills Index	0.34	1.09	4.10	1.95	1.47	2.97

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, 29 February 2024.

Performance Commentary

The Fund, like all fixed income instruments, was challenged in February with an upward move in yields globally. Detraction from positive rates duration exposure - even if modest at circa 1yr - offset most of the continued strong positive contribution from coupon income, and as a result the overall portfolio return was muted at +3bps (after class I unit fees). This outcome reflects not just the higher level of yields generally, but our conscious decision to structurally increase portfolio spread to provide more of a buffer against adverse rate movements. We see the rise in rates in February as a short term blip, a partial unwind of the overly aggressive rate cut expectations which formed late in 2023, rather than an ongoing detractor from performance. Over the past 12 months as a whole, the Fund has returned 5.22% (after class I unit fees), well above the return on cash. Looking forward we continue to expect returns to be strong, the 'silver lining' of the February move higher in rates lifting overall portfolio yield.

Market Commentary

Risk markets continued to perform strongly in February on robust economic activity and earnings in the US and despite the market unwinding some of the overly optimistic rate cut expectations that had been factored in late in 2023. Some equity indices hit new all-time highs, such as the S&P 500 which closed the month up 5.2% to 5,096.27 at the end of February. This index is now up over 23% since the recent lows in October. Credit spreads narrowed accordingly, but performance is limited by credit spreads already being at the lower end of the (post-global financial crisis) range. Investment grade synthetic credit spreads (CDX IG) were in 4bps to 52bps in February, against a recent low of 45bps. Physical credit spreads, such as the Bloomberg US Corporate Aggregate, were unchanged at 96bps, under-performing the move in other risk markets on the back of a record amount of supply in February, at over USD200bn.

As mentioned above there was a sizeable reassessment of how quickly and how significantly central banks would cut rates in February. Primarily this reflects markets having over-estimated how soon and how much the Fed would trim, pricing in a high probability of a March easing and over 150bps of easing this calendar year. However, several Fed speakers pushed back on this, so when expectations for January CPI numbers were released, the market saw fit to push out the first cut out to June and limit the amount of easing this year to just over 75bps (in line with the Fed's median expectation).

Bond yields rebounded accordingly in the month, gaining back around half of the decline seen since October. The significant amount of corporate issuance also weighed on US fixed income markets, as has the significant amount of supply from US fiscal deficits. US 2yr yields rose 41bps to 4.62%, with US 10yr yields up a smaller 34bps. These increases were echoed elsewhere but to a much smaller degree, with Australian 10yr yields up 12bps, NZ 10yr yields up 14bps and German 10yr yields up 25bps (Eurozone rate cut expectations have also become quite advanced). This reflects that central bank rate cut expectations were not as advanced in these regions, so therefore had less ground to claw back.

Outlook

Two key narratives will shape the outlook for markets: whether we will see a hard, soft, or no (economic) landing in the US in particular; as well as the pace of disinflation and the timing of its return to target. The probability of a hard landing in the US continues to be reduced, with US economic growth remaining solid at around 3% year on year. Economist estimates of the probability of recession, according to Bloomberg, have therefore fallen from around 65% in the middle of last year to be 40% currently. The soft-landing scenario has become the base case. This is particularly important for the outlook for risk markets, as credit spreads widen in a hard landing scenario and may remain more stable in a soft-landing scenario (or narrow in a no landing scenario). The shifting probabilities therefore have a significant influence on whether you want to be overweight or underweight these elements in the portfolio.

It is worth noting that the strength of the US economy is the exception and not the rule. Other economies have seen economic activity slow below trend and the unemployment rate rise, under the weight of increases in official monetary policy rates. We expect this point to gain more prominence going forward as the differences between economic performance across different regions become larger. The normal correlation between central banks globally and risk and bond markets would therefore be challenged. Active managers should be able to take advantage of these divergences.

For bond yields the pace of disinflation and when inflation returns to target remains the dominant question. A hard landing may impact the timing of rate cuts at the margin, but until inflation returns to be closer to target, with confidence it will decline to target, thereafter central banks will be reluctant to move from their current restrictive settings. That said, it will be the state of the economy and labour market that will determine how deep those cuts will be. Regions such as the Eurozone where economic activity is below trend and the unemployment rate is rising are more likely to see central banks take official rate not just back to neutral but to stimulatory settings. Correctly weighting how central banks will respond to inflation and economic activity trends will therefore be critical in determining the outlook for bond yields from here.

Portfolio Strategy

Positioning in the portfolio was made less defensive on both the rates and credit sides of the portfolio.
On the rates side we continue to lengthen duration as we transition from the global tightening cycle which appears to have ended in 2023, to the easing cycles which are likely to begin sometime in 2024. After remaining well below our average duration of around 1 year for some time, duration has lengthened of late to sit close to 1.5 years at the end of February. Most of the addition in duration positioning in the past six months has been in Europe, where inflation appears to be rapidly falling and activity is well below trend. Inflation may be falling in other regions such as Australia and Canada, but it is by no means close to target, so we are less inclined to be positively exposed as central banks are more likely to act later.

The portfolio's physical spread duration increased to ~1.8yrs, still having lower sensitivity to spread change than we have historically targeted. This stability in spread duration belies significant portfolio activity, evident in annualised turnover rates over the month of close to 2-3x normal levels, where we sought to take advantage of significant global and Australian issuance, as well as elevated new issue concessions where AUD issuers were paying 5bps new issue concessions fairly consistently.

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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. Additionally as the odds of a softer landing (rather than hard landing) in the US continues to increase given strong GDP and unemployment data, we expect to hold spread duration around 1.8-2yrs over the coming months in Australian credit, as home market credit spreads remain around or even above long term averages, whilst US credit spreads are significantly tighter than long term averages, and our view that if the global macro environment remains stable, Australian spreads will eventually follow the US lead.

In terms of asset allocation, the portfolio can be split across three major 'buckets'; financials (~55%), corporates and REITs (~28%), and asset and mortgage-backed securities (<15%) with the residual in cash and liquids. Close to ~85% 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 but reduced over the month as we deployed cash to take advantage of elevated new issue concessions, mainly in AUD credits (and limited issuance over the seasonally quiet period) with 'Level 1' liquidity at ~8% (cash, commercial paper, SSGA) and at the high end of the range for 'Level 2' liquidity at ~18% (<1yr investment grade). We believe this mix provides the flexibility to buy attractive credits.