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 2060.98
Distribution frequency	Quarterly
Management fee	0.40%
Buy/sell spread	Please contact us for latest spreads

Fund Statistics

Interest rate duration	1.03yrs
Credit spread duration	1.59yrs
Average credit rating	BBB+
No of issuers	74
Yield to maturity	6%

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

January 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)	0.55	2.15	6.34	2.37	2.62	4.55
Fund Return (after fees, before sell spread)[1]	0.51	2.04	5.87	1.95	2.17	4.19
Fund Return (after fees and sell spread)[2]	0.51	2.04	5.88	1.96	2.16	4.18
RBA Cash Rate	0.39	1.07	3.97	1.85	1.38	2.76
Active return[3] (before fees and sell spread)	0.16	1.08	2.36	0.52	1.24	1.79
Active return[3] (after fees and sell spread)[2]	0.13	0.97	1.90	0.11	0.78	1.42
Bloomberg AusBond Bank Bills Index	0.37	1.09	4.00	1.83	1.44	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, 31 January 2024.

Performance Commentary

The fund continued its run of strong performance, returning 0.51% in January [(after class A/I unit fees)]. This takes the rolling 12 month return to 5.88%, 1.90% above cash [(after class A/I unit fees)]. The excess return over cash highlights the benefit of the structurally higher credit spread we have orchestrated in the portfolio over the past 12-18 months, given that market credit spread, and yield moves in particular over the month were muted (despite intra-month volatility). The yield on the portfolio ended the first month of the year more or less unchanged at 6%, which continues to support confidence in strong return expectations on both an absolute and relative to cash basis looking forward.

Market Commentary

Inflation remains the key driver of central banks and markets, as it has been for a few years now. More recently the fall in inflation across the developed world towards central bank targets has seen markets turn focus away from further tightening to the timing and magnitude of an expected easing cycle. For example, the 6-month core PCE inflation rate fell below the US Fed's 2% target on an annualised basis in December, leading to market speculation of a March start to the easing cycle and more than 150bps of cuts priced in by year's end. The pricing for other developed market central banks moved in sympathy, particularly in Europe where inflation is also rapidly moving towards target. It should be noted though that even with downward inflation surprises like that in Australia, with the RBA's preferred trimmed mean CPI measure coming in 0.3pps below RBA expectations, that at 3.9% over the year it remains significantly above the RBA's 2.5% midpoint target. The market's pricing of imminent rate cuts in these regions where inflation is coming down but is still too high therefore looks premature, which is also the case in New Zealand, Canada and the UK.

This confidence in the imminent nature and magnitude of the easing cycle that was seen in the first half of the month then saw a range of strong US economic data and global central bank push back in the second half. US GDP in the fourth quarter came in at a 3.3% annualised pace, resisting the impact of rate hikes to date and remaining well above trend of around 2%. FOMC Chairman Powell said a March rate cut was not his base case, reflecting the desire to see more evidence that inflation is returning to trend, as well as seeing evidence that the

strength of the economy and labour market mentioned above. ECB President Lagarde similarly pushed back on the idea of rate cuts in Europe until mid-year, despite the Eurozone only narrowly avoiding a technical recession with a flat outcome for activity in Q4. Bond yields therefore reversed most of the move lower early in the month to finish largely unchanged and were therefore not a key driver of returns in January.

The soft landing (or even the no landing?) scenario in the US gave risk markets a boost again in January. The S&P500 finished 1.6% higher in the month and is now over 17% above October lows. Credit markets, which are usually correlated with movements in equity markets, didn't quite show the same level of performance. This partly reflected the already low level of credit spreads, which acts as more of a floor to credit spreads than hitting new highs acts as a ceiling for equities. Also significant was the record amount of issuance in January, further inhibiting the amount of spread compression in the month. This saw most credit indices finish largely unchanged, with the US Corporate Agg OAS in 3bps to 96bps and the Bloomberg Ausbond Corporate OAS out 1bp to 145bps in January.

Outlook

January has proven to be a strong start to what is expected to be a solid year for fixed income. Yields are high by recent standards and with inflation easing and the easing cycle coming into sight for many central banks there should also be the potential for further gains from declines in yields. The start point may not be known for all central banks, the pace may be uncertain and even the end point is far from clear, but the direction of travel for central bank rates and yields is becoming more certain.

The strength of the US economy should also provide support to the credit elements of fixed income, but there remain a few clouds on the horizon. It should be noted that while economic growth in the US is above trend and the unemployment rate is low and rising gradually at best, that in other parts of the world activity is below trend and the unemployment rate is rising more quickly. Furthermore, monetary policy acts with a lag and the negative influence of the last portion of each central bank's tightening cycle may yet be felt, further reducing activity and earnings. Geopolitical tensions have also risen of late, raising upside risks to inflation if supply chains were again disrupted and potentially delaying the benefits of lower official interest rates. If these risks materialise and a hard landing scenario was to play out in the US and elsewhere, this could pose a risk to the credit spread related elements of the asset class.

Portfolio Strategy

As the lower inflation and easing cycle of central banks comes into sharper focus, we have added to duration to take advantage of the related move down in yields. After remaining on the lower side of our historical ranges while central bank rates and bond yields were rising, we have been adding interest rate risk, by more than 0.3 years in January, to just over 1 year. The vast majority of this risk remains in the US and Europe, given that these are the two regions where the greatest improvement of inflation relative to the central bank target has been seen. The move longer in structural duration is also understated given some tactical short duration positions in regions such as Australia, where the market's optimism around cuts by mid-year was seen as excessive. These positions were highly concentrated at the very front of yield curves and were able to take advantage of the pull back in market pricing of rate cuts in the second half of the month.

The portfolio's physical spread duration remained fairly stable below 2yrs, with CDX protection further reducing it to a net spread duration of ~1.6yrs, 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). 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 market nervousness, significant global and Australian issuance for, as well as elevated new issue concessions, whereby A$ issuers were paying 5-15bps new issue concessions fairly consistently.

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 continue to increase given strong GDP and unemployment data, we expect to continue gradually increasing spread duration incrementally from 1.6yrs over the coming months in Australian credit, as Australian 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 (~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 but reduced over the month as we deployed to take advantage of elevated new issue concessions mainly in A$ credits (and limited issuance over the seasonally quiet period) with ‘Level 1’ liquidity at ~10% (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.

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