Kapstream Absolute Return Income Fund

Kapstream
—JANUS HENDERSON—

KANGANEWS AWARDS 2017 WINNER – AUSTRALIAN CREDIT FUND MANAGER OF THE YEAR | KANGANEWS AWARDS 2018 WINNER – AUSTRALIAN CREDIT FUND MANAGER OF THE YEAR | KANGANEWS AWARDS 2019 WINNER – AUSTRALIAN CREDIT FUND MANAGER OF THE YEAR | KANGANEWS AWARDS 2021 WINNER – AUSTRALIAN CREDIT FUND MANAGER OF THE YEAR | KANGANEWS AWARDS 2022 WINNER – AUSTRALIAN CREDIT FUND MANAGER OF THE YEAR | KANGANEWS AWARDS 2023 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 2063.46
Distribution frequency	Quarterly
Management fee	0.40%
Buy/sell spread	Please contact us for latest spreads

Fund Statistics

Interest rate duration	1.31yrs
Credit spread duration	1.84yrs
Average credit rating	BBB+
No of issuers	74
Yield to maturity	6.04%

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

March 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)	0.59	1.21	6.07	2.68	2.52	4.55
Fund Return (after fees, before sell spread)[1]	0.56	1.11	5.60	2.24	2.08	4.18
Fund Return (after fees and sell spread)[2]	0.56	1.11	5.61	2.25	2.07	4.18
RBA Cash Rate	0.34	1.07	4.11	2.08	1.47	2.78
Active return[3] (before fees and sell spread)	0.25	0.15	1.95	0.60	1.05	1.77
Active return[3] (after fees and sell spread)[2]	0.22	0.04	1.49	0.17	0.59	1.40
Bloomberg AusBond Bank Bills Index	0.37	1.09	4.19	2.08	1.51	2.98

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 March 2024.

Performance Commentary

The Fund posted a solid return of 56bps in March (after class I unit fees). Risk markets improved modestly in the month against a backdrop of still strong economic growth, particularly in the US. Yield movements were more restrained compared to February, as we continue to edge closer to central bank rate cuts across the developed world, with inflation returning towards target. Portfolio duration positioning had little impact (positively or negatively) on performance but continues to provide an important ongoing hedge against unforeseen adverse changes to the credit environment. We continue to hold high conviction that positive duration positioning will add to performance in 2024 as central banks ease policy. Returns over the first quarter rose to 1.11% (after class I unit fees), held back a little as a result of rising yields in February. A longer-term picture, which also includes the larger and expected fall in yields of late 2023, shows strong returns over the past twelve months. The portfolio yield to maturity remains high at ~6%, modestly down in the month but still providing strong support for expected future returns. Portfolio liquidity remains high, in line with our strategic objectives and to enable us to take advantage of opportunities as they arise.

Market Commentary

We continue to edge towards an easing in monetary policy from central banks globally. Inflation continues to fall from the lofty heights seen in 2022 but is not yet at target. Furthermore, the pace of decline is uneven through time and across jurisdictions, meaning that the timing of the first easing in each region remains uncertain and varied. It can be argued that this aspect, combined with the performance of underlying economies and labour markets, will significantly influence the pace and extent of this easing.

Unlike February, the debate on timing and pace of easing did not change wildly in March. Yields finished the month largely where they started in the US and were modestly lower elsewhere. This consolidated the sharp rise in yields that was seen in February, after markets got too far ahead of themselves in late 2023 in terms of the extent of easing expected from central banks. The broader perspective reveals that yields currently sit at approximately the midpoint of their range over the last 18 months, below the highs of late 2023 as tightening cycles drew to a close, but above the over-stretched lows in January 2024 and in the aftermath of the US regional banking crisis in early 2023.

The US Federal Reserve Meeting came and went without too much reaction in markets. US inflation forecasts were raised for this year, in response to the strength seen in January and February, but the median amount of easing this year in the Fed's 'dots' stayed at 75bps. However, the Fed's expectations for where the Fed Funds rate will be beyond 2024 was increased, which was somewhat overlooked by markets. The expected June start to the easing cycle therefore remains on a knife's edge, with the US election later in the year. The European Central Bank also left rates on hold but remains committed to cuts beginning in June, with the Swiss National Bank being the first developed market central bank to ease, with a 25bps reduction to 1.5%. Central banks in Australia, New Zealand and Canada all showed a somewhat neutral bias, with inflation still too high above target to consider easing. That said, the resumption of a downtrend in inflation in Canada means that a move towards a dovish bias may be seen in coming months.

In March, risk markets were exceptionally well-supported, buoyed by the ongoing narrative of a soft landing. US GDP growth posted an above-trend 3.1% yearly gain over 2023. Early estimates for the first quarter are for a solid 2% annualised pace, supporting earnings expectations and the soft landing (or dare we say, no landing, theme). US equities posted a 3% gain and hit record highs. Credit spreads also declined, but the extent of this is limited by how low they already are. The US Bloomberg Corporate Aggregate OAS Credit spread series declined by 6bps to 90bps as at the end of March, well inside the historical average of 150bps. Australian physical credit spreads continue to lag the global backdrop, with the Bloomberg Ausbond OAS credit spread declining by 1bp to 142bps, but still remaining above its historical average of 133bps.

Outlook

The pace of decline in inflation and official interest rates remains the key focus of financial markets. Bond yields are lower than where they were towards the middle and end of last year and we have a high conviction view that this will continue to be a major theme over 2024. However, financial markets rarely move in a straight line, and the start of the year has been a good example of that. We also see the end point of the coming easing cycles as being too high. Once central banks begin to ease, we expect this to be reflected via the pricing in of a more aggressive cutting cycle than is currently anticipated.

The risks of a hard landing in the US have declined, but not disappeared. A lagged response to the official interest rate hikes seen over 2022 is still possible. Furthermore, economic activity outside the US has already slowed below trend, a point seemingly overlooked by financial markets looking at current pricing. In Australia economic growth has slipped to 1.5% in the year to Q4, below the trend number closer to 3%. New Zealand has slipped into a technical recession already, with two consecutive quarters of negative growth to finish 2023. Growth in the Eurozone has slipped to just 0.1% as at the end of 2023. We still believe some caution is therefore warranted on the economic outlook and consequently risk markets.

Portfolio Strategy

Interest rate duration remained above its historical average in March, ending the month at 1.32 years, compared to an historical average closer to 1 year. This reflects our high conviction view that we have transitioned from the central bank hiking phase to be nearer an easing phase. We do however continue to transition the mix of duration exposure away from the US and towards Europe, reflecting our assessment that inflation in Europe is declining more steadily and that economic activity is considerably weaker.

The portfolio's physical spread duration increased to ~1.9yrs, still retaining lower sensitivity to spread change than we have historically targeted. This was accomplished by actively purchasing primary deals, aiming to capitalize on the elevated new issue concessions resulting from high issuance levels, where AUD issuers were offering approximately 5 basis points in new issue concessions. We were pleased to continue to see strong credit compression over the month and year-to-date period adding to returns, outpacing the compression in broader Australian or US credit indices, evidencing positive security selection.

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 soft 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 long term averages, whilst US credit spreads are significantly tighter against 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 (~60%), corporates and REITs (~25%), 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 and was fairly stable as we chose to take profits on previous new issues to fund investments into 'new' new issues, mainly in AUD credits with 'Level 1' liquidity at ~9% (cash, commercial paper, SSGA) and at the high end of the range for 'Level 2' liquidity at ~17% (<1yr investment grade). We believe this mix provides the flexibility to buy attractive credits.