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 1999.29
Distribution frequency	Quarterly
Management fee	0.40%
Buy/sell spread	Please contact us for latest spreads

Fund Statistics

Interest rate duration	1.05yrs
Credit spread duration	1.82yrs
Average credit rating	A-
No of issuers	72
Yield to maturity	5.86%

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

July 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)	0.98	2.41	7.19	3.37	2.70	4.62
Fund Return (after fees, before sell spread)[1]	0.94	2.31	6.72	2.94	2.26	4.25
Fund Return (after fees and sell spread)[2]	0.94	2.31	6.73	2.94	2.24	4.25
RBA Cash Rate	0.39	1.08	4.29	2.55	1.68	2.81
Active return[3] (before fees and sell spread)	0.59	1.33	2.90	0.81	1.03	1.81
Active return[3] (after fees and sell spread)[2]	0.56	1.23	2.43	0.39	0.57	1.44
Bloomberg AusBond Bank Bills Index	0.37	1.10	4.37	2.56	1.69	3.01

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 July 2024.

Performance Commentary

The Fund added a solid 0.94% in July, taking 12 month returns to 6.73% (after accounting for Class I unit fees). This is the strongest monthly performance in over a decade, with the yearly gain around 2.43% above the performance of the RBA cash rate after fees, with the 2.90% excess return before fees towards the top end of the internal cash + 2-3% gross return target. The income derived from the underlying exposures to short-duration credit continued to add value. This was accompanied by the benefit from the long duration exposure, in the context of sharply falling bond yields as expectations around easings in monetary policy increased. A compression in Australian credit spreads also contributed, despite a softening in global risk sentiment towards the end of the month. Reported returns over 1, 3 and 5 years for the fund are in the top quartile against peers, whilst at the same time being in the lowest quartile in terms of volatility.* Correlations with other Australian fixed income indices and asset classes are generally below 0.2 over most time frames, continuing to provide strong diversification benefits to many portfolios.** The yield to maturity on the portfolio remain high by historical standards, providing a continued strong basis for expected returns looking forward.

Market Commentary

US bond yields fell sharply in July, providing a downward force to yields in other regions. Recent inflation outcomes in the US saw expectations of a Fed easing cycle beginning in September increase. This was further supported by FOMC Chair Powell's conference at the end of the month, where an easing was likely if economic data, in their totality, played out as expected. US 2-year yields declined by 50bps in the month, with a smaller 37bps decline in 10-year yields seeing the curve steepen. A Fed easing would see the US join Europe and Canada in easing policy, with the latter easing for a second successive meeting in July. Below expectations inflation data in Australia saw rate hike fears reversed. A shift in tone from the RBNZ saw expectations of cuts increase significantly, exacerbated by illiquidity, seeing front end yields in that region fall the most with NZ 2-year swap rates down 77bps. The one exception to the above is the Bank of Japan, which acted to raise rates in July and by more than expected.

Risk sentiment also had a reasonable month, as expectations of a hard landing in the US in particular were further wound back. US GDP for the second quarter came in above expectations at an above-trend 2.8% annualised, continuing to resist the negative influence from higher interest rates. The US S&P 500 was up 1.1% over the month, as we entered earnings season, although there was some weakness towards the end of the month. This saw US credit spreads continue to compress in July overall. Physical credit spreads, in the form of the Bloomberg US aggregate Corporate Average OAS, tightened 1bp to 93bps in July, remaining near the bottom of the post-GFC range. Australian physical credit spreads, compressed in line. For example, the Bloomberg Australian Corporate Average ASW compressed in 1bps to 87bps.

Outlook

Like financial markets, we expect the dominant market theme to be the easing cycles from a variety of central banks. Bond yields will fall mechanically as the very front end of the yield curve is reduced by the central banks. We expect an additional downward impetus to come from falling monetary policy expectations. This is not so much from expectations of easing this year, which appear adequately priced. However, it more comes from terminal rates where markets still aren't pricing a move even back to what is generally considered as being neutral in each of the major developed markets. If inflation is truly back to target, then a move back to neutral is what should be expected. In those regions where economic activity is soft and unemployment rates are rising, a move below neutral is likely.

Potential negative risks to economic activity and risk sentiment remain, whether it be a delayed response to the global tightening cycle, rising geopolitical concerns, rising unemployment or the generally low level of credit spreads in a long run valuation sense. Inflation is falling in most regions, but the pace is varied and it may yet still stabilise at an above target rate. This would see central banks pause the expected easing cycles.

Portfolio Strategy

Portfolio positioning did not change dramatically over July, which was already well placed to take advantage of the market moves in the month.

Duration had already been extended from close to flat a year ago when yields were rising strongly and the Fed was hiking, to above one year more recently. Duration was unchanged at a touch over 1 year. The mix was shifted away from Europe, where the easing cycle was more fully priced and concerns over a stabilisation arose. This was shifted to the US where inflation is more clearly falling and the Fed was closer towards an easing cycle that was less than fully priced. This addition has contributed strongly to performance in recent months.

The portfolio's physical spread duration increased slightly to ~1.82yrs, retaining lower sensitivity to spread change than we have historically targeted. Despite maintaining a fairly short-dated book, our asset allocation overweight to T2 and mezzanine securitised has allowed us to capture very strong credit spread compression compared to many short-dated credit indices over the last year.

We took profits on recent primary issuance after capturing significant spread compression in new issues. Spread performance in the portfolio continued to marginally add to returns over the month at a slightly faster pace than some global and local credit indices.

The high coupon is currently delivering a level of return stability not seen in nearly a decade driven by a portfolio credit spread that is above the average, even though it is primarily from shorter-term assets. This leaves us cautiously optimistic about the prospects of short-term investment-grade credit, buoyed by the high coupon.

However, our outlook becomes more cautious when considering longer-term credits, given the current landscape's various peculiarities. Notable among these are the significant losses incurred by Norinchukin, a domestic systemically important bank in Japan; defaults within AAA-rated Commercial Mortgage-Backed Securities (CMBS) in both the US and Europe; and the increasing popularity of more extreme political candidates globally. Under normal circumstances, any of these factors could trigger a 10% drop in equity markets, but the current optimistic market has, partially or completely ignored these issues.

We plan to maintain our spread duration towards the lower range of 1.8 to 2 years, and possibly even shorter in the upcoming months. This will be skewed towards Australian credit because credit spreads in Australia are closer to their long-term averages compared to the significantly tighter spreads observed in the US. Barring a severe global downturn and considering the sustained interest from yield-seeking high-net-worth and Asian investors, we anticipate that Australian spreads will likely play catch-up to the US by moving towards the lower end of their historical ranges.

In terms of asset allocation, the portfolio can be split across three major 'buckets'; financials (~59%), corporates and REITs (~22%), 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, with 'Level 1' liquidity at ~12% (cash, commercial paper, SSGA) and at the high end of the range for 'Level 2' liquidity at ~19% (<1yr investment grade). We believe the high level of liquidity provides the flexibility to buy attractive credits or take advantage of a better entry point should there be a sell-off.

** Kapstream's flagship and plus funds have placed in the top quartile of various consultant return universe over the past 1, 3 and 5 years as at July 2024 including Mercer and Zenith, whilst being ranked in the bottom quartile for volatility.*

*** Kapstream has calculated the monthly return correlation with the Australian based indices used in APRA's annual performance test for the Australian superannuation industry and analysed 1yr, 3yr and 5yrs of the Australian indices.*

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