Kapstream Absolute Return Income Fund

Kapstream
— JANUS HENDERSON —

Monthly Report - Class A Units

Fund Objective

The Fund aims to provide a steady stream of income and capital stability over the medium term while aiming to outperform its benchmark through market cycles.

Fund Details

APIR code	HOW0052AU
Inception date	31 May 2007
Fund size	AUD 2,013m
Distribution frequency	Quarterly
Management fee	0.55%
Buy/sell spread	0.00%/-0.07%

Fund Statistics

Interest rate duration	1.03yrs
Credit spread duration	1.85yrs
Average credit rating	A-
No of issuers	71
Yield to maturity	5.79%

Fund Guidelines

Target return	cash plus 2-3%
Target volatility	<1.5% annualised
Duration limits	-2 to +2 years
Credit quality	>85% investment grade

Fund Platform Availability

AMP North
BT Panorama
CFS Edge
FirstChoice
FirstWrap
HUB24
Insignia - eXpand
Macquarie Accumulator
Macquarie Wrap IDPS and Super
Mason Stevens
Netwealth
Powerwrap
Praemium

Portfolio Managers

Daniel Siluk
Portfolio Manager

Dylan Bourke
Portfolio Manager

October 2024

Performance	1 month %	3 months %	CYTD	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Inception % p.a.
Fund Return (Net)[1]	0.53	1.93	5.58	7.16	3.50	2.44	2.73	4.06
RBA Cash Rate[2]	0.36	1.08	3.65	4.36	2.91	1.85	1.76	2.83
Active Return[1]	0.17	0.85	1.93	2.80	0.59	0.60	0.97	1.23

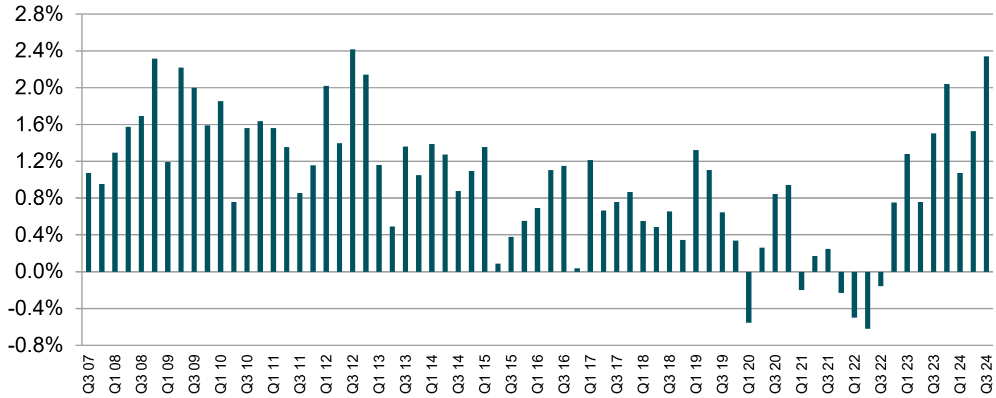
Past performance is not a reliable indicator of future performance

[1] Performance figures are calculated after fees have been deducted and assume distributions have been reinvested. No allowances are made for tax when calculating these figures. After fee returns inclusive of annualised total expenses for Class A Units. Prior to 1 October 2019, annualised total expenses were 0.70%. From 1 October 2019, annualised total expenses are 0.55%.

[2] From 1 February 2014 to 30 September 2019, the Fund's benchmark was a composite benchmark comprising 50% Bloomberg Ausbond 0-3 Yr Index & 50% Bloomberg Ausbond Bank Bill Index. Prior to 1 February 2014, the Fund's benchmark was the RBA Cash Rate.

Source: Fidante Partners Limited, 31 October 2024

Quarterly Performance History[1]



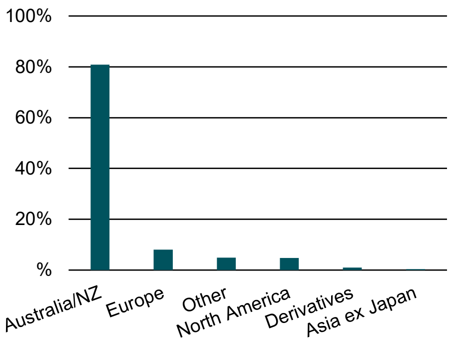
[3] **Source: Kapstream Capital, 31 October 2024**

Performance Commentary

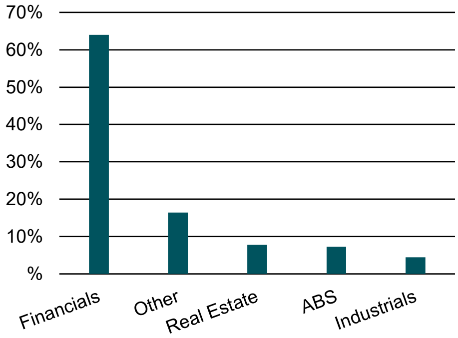
The fund added a solid 0.53% in October, taking 12 month returns to 7.16%.

Physical credit spreads continued to compress in the month, supporting performance and allowing coupon income to again contribute strongly. Bond yields rebounded sharply in October, as financial markets unwound overly-aggressive rate cut expectations as well as positioning shifting ahead of the US election. Duration therefore detracted from performance in October, but this was significantly reduced by the near halving of duration undertaken in August and with our global relative value framework focusing on regions where yields rose the least. Active risk management therefore allowed the fund to outperform its cash rate benchmark in October, with the now higher yield to maturity of 5.79% providing an even stronger basis for returns looking forward.

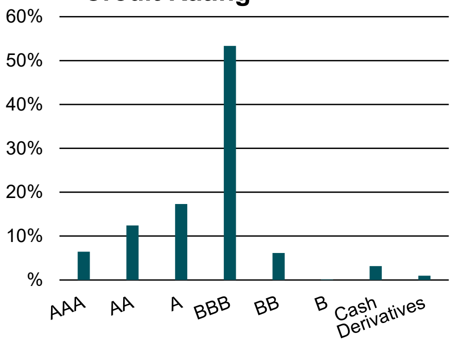
Geographic Allocation



Sector Allocation

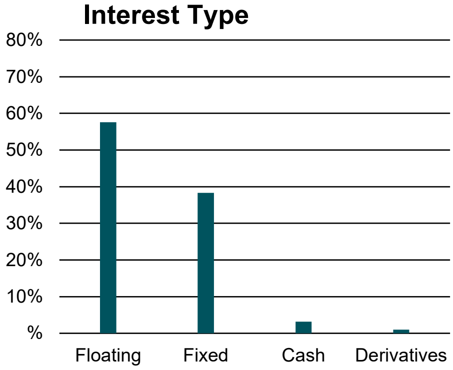


Credit Rating



*of which 3.23% of Investment Grade and 0.49% of High Yield were internally rated

Interest Type



Market Commentary

Markets moved to price out a number of rate cuts that it had overly aggressively priced in back in July. At that time, the Federal Reserve was preparing for an out-sized 50bps easing and rate hikes from the Bank of Japan were being taken out after carry trade unwinds saw equities decline and volatility rise.

Since that time, inflation, economic growth and the labour market have all come in on the positive side of expectations, leading to a reassessment of how aggressively the US Federal Reserve would ease monetary policy. Furthermore, the Republicans improving chances in the weeks leading up to the election also had a positive impact on yields.

These influences saw the terminal rate in the US rise from around 2.80% in early August to around 3.60% at month's end, with two year US Treasury yields rising by a staggering 53bps in the month of October alone to close at 4.17%. Australian front end yields rose a similar amount, with three year Australian Government Bond yields up 48bps to 4.02% as near term rate cut expectations were dashed. However, other regions where central banks have already started easing had a much more muted reaction, with German 2yr yields up 27bps, Canadian 2yr yields up 16bps and NZ 2yr swap rates rising just 6bps.

Risk market themes were generally more balanced. Both US election candidates were seen as a positive for fiscal spending and economic activity, supporting the outlook for earnings. However a very late re-assessment of a Harris victory saw all these gains eroded with the S&P 500 down 1% over the month. Synthetic credit indices were a touch wider in sympathy, but of more relevance for Kapstream's investments, physical credit spreads compressed noticeably, particularly in Australia.

The Bloomberg US Corporate Aggregate series contracted 5bps to 84bps to be at the bottom of the post Global Financial Crisis range. Australian credit spreads were not as close to their historical tights, allowing a greater compression in the Bloomberg Ausbond credit ASW spread series of 6bps to 84bps.

Portfolio Strategy

Reducing interest rate duration in August significantly supported performance in October, as did the mix of where that duration was held. Given the around 50bps increase in yields seen across the curve in Australia and the US, each year's worth of duration would have subtracted around half a percent from returns.

Fixed income indices with several years worth of duration therefore performed particularly poorly, with the Australian Composite Bond index falling 190bps as an example. In the case of Kapstream's funds, we actively reduced duration from above 1.1 years at the end of July to around 0.6 years in following months. This halved the negative impact of duration on the portfolio.

Furthermore, the exposure was only modestly weighted towards the US directly and with short duration exposures in Australia, with a far greater weight to Europe, Canada and New Zealand. This action effectively halved the negative impact of rising yields on the portfolio. After the yield increase in the month, duration was largely returned to close to the one year point by the end of October, continuing to add exposure as global easing cycles continue.

Credit continued to support returns in October, in particular the overweight to Australian credit. The portfolio's physical spread duration was fairly stable at c1.9 years, retaining lower sensitivity to spread change than we have historically targeted. Despite maintaining a fairly short dated book, we have captured strong credit spread compression compared to many short dated credit indices over the last year. This month we saw some attractive issuance in AUD denominated financials which rallied.

The fund's high coupon is providing return stability not seen in nearly a decade, due to an above-average credit spread from shorter-term assets and an attractive cash rate. This makes us cautiously optimistic about future return prospects.

We plan to maintain our spread duration at around 1.8 - 2.2 years in the upcoming months which is a wider range dependent on the outcome of the US election, which in the case of a Republican victory would likely extend the credit cycle. 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 (~64%), corporates and REITs (~18%), and asset and mortgage-backed securities (<15%), with the residual in cash and liquids. Close to ~84% 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 ~17% (cash, commercial paper, SSGA) and at the high end of the range for 'Level 2' liquidity at ~17% (<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.

Outlook

The US election result represents the key near term risk to markets, but beyond that the question is to what extent will it disrupt how far central banks will ease policy. Tariffs and tax cuts that boost demand could see inflation stop declining below trend or even increase, leading to the Fed retaining some restrictiveness in its policies.

However, terminal rates are already pricing in this outcome. Furthermore, a continual rise in yields as was seen in 2016, when the Fed was tightening policy, is less likely when monetary policy is heading in the opposite direction. More interesting perhaps is that these policies may see lower economic growth outside the US, leading to more rate cuts elsewhere. A global focus for active duration would allow these trends to be captured. For risk markets the fiscal spending promises significantly reduce the near-term prospects of a recession, taking away a key downside risk for declines in sentiment.