

Naughty or nice?

Concern that the European debt crisis was likely to drag on through the first half of 2012, hampering global growth, continued to dominate financial markets in December. While risk aversion remained high, European policy responses and more stable US economic data allowed risk assets to rally somewhat. The European Central Bank (ECB) reduced its benchmark rate by 0.25% to 1.00%, (a record low) and also increased loan availability to the banking sector, adding €489 billion in 3-year term loans as it expanded its balance sheet to a record €2.7 trillion. In response, short-term fears abated and risk assets rallied toward year end.

Further positive developments came in the form of an additional €30 billion in budget cuts in Italy. However, Italian 10-year bonds still ended the year yielding nearly 7%, the level which forced Greece, Portugal and Ireland to seek bailouts. With the need to raise about €450 billion in 2012, pressure on the new Italian government will continue as debt sustainability questions linger. Greater fiscal discipline appeared to be straining European growth as December manufacturing again contracted. Further signs of the tough road ahead were revealed with the announcement of Spain's 2011 budget deficit at 8% of GDP, significantly greater than the 6% government forecast.

By year end, the Euro had hit a one year low vs. the USD and an 11 year low vs. the JPY and was the worst performer among 10 developed currencies in 2011.

In Australia, core inflation remained low, affording the Reserve Bank of Australia (RBA) flexibility in reducing rates further amidst the global slowdown. The RBA reduced rates by 0.25% in November and another 0.25% in December as short-term rates hit 4.25%. While manufacturing was positive in December, consumer confidence and retail sales remained fairly weak.

10-year government yields fell by another 0.30% over the month, reaching a record low of 3.70% as markets priced in more than 1.00% in further rates cuts by the RBA over the course of 2012. Australian sovereigns were one of the world's best performing asset classes in 2011 as 10-year government rates fell by 1.80% over the year. 10-year sovereigns delivered over 19% in 2011, more than triple their 2010 gains. Offering the highest real yields in the developed world, Australian sovereigns continued to be purchased in record amounts by offshore investors, who increased their holdings to all-time highs. Despite considerable volatility in the 'risk-on, risk-off' market environment, the Australian dollar ended 2011 at 1.02 vs. the USD, almost flat for the year.

While the pace of Chinese manufacturing began to stabilise, December manufacturing data still showed a second straight month of contraction. The Shanghai composite index fell 22% over 2011 on concern that growth-limiting tighter monetary policy would be implemented in efforts to control spiralling property prices. With a 33% drop since 2009, the Shanghai composite index was the worst performer of the world's 15 biggest equity markets. By year end, the Chinese Yuan had climbed to a 17 year high (vs. the USD) on signs the central bank would favour currency appreciation to prevent capital outflows.

In the US, it appeared housing finally hit a bottom and would become less of a drag on the economy and job growth in 2012. The US added almost 1.5 million jobs in 2011 as the unemployment rate fell from 9.4% to 8.6%. While markets still expect it to take many years to recover the 8.7 million jobs lost over the course of 2008/2009, modest positive job growth was viewed as a signal the worst had passed. More recent data appeared to confirm a recovery trajectory, with new home sales,

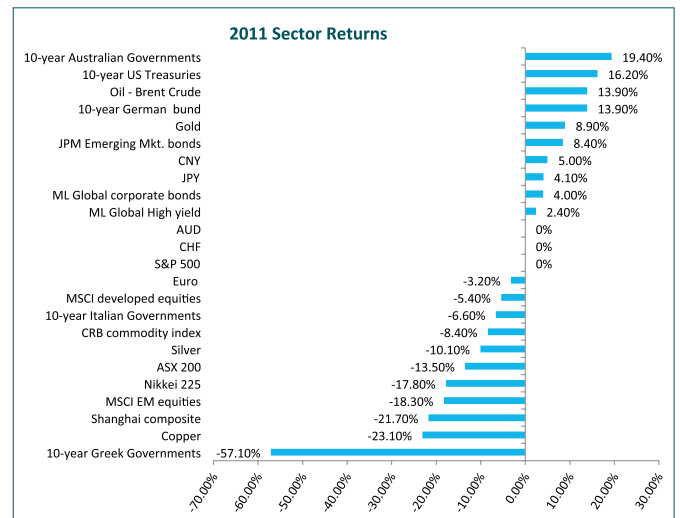
jobless claims, consumer confidence, manufacturing and construction data all being marginally positive.

More recent positive data allowed corporate bonds to recover some of their earlier losses - the iTraxx Australia investment grade credit default index ended at 180.5 bp, down -15 bp over the month, but still up +77 bp over the year. European corporate bonds followed a similar path, as the European investment grade credit default swap index ended the year at 173.5 bp, up +69 bp over the year. US Corporate bonds held up slightly better, with the US investment grade credit default index ending the year at 120 bp, up +35 bp on the year.

As 'risk-on' assets underperformed, the USD and JPY became safe havens in 2011's global turmoil. The US dollar index appreciated 1.8% in 2011 and 13% since its record low in March 2008, even as the Fed kept rates at 0% and added \$2.3 trillion to its balance sheet. The JPY index was up 6.4% in 2011 and 64% since its record low in June 2007.

Globally, the first quarter of 2011 was characterised by a continuation of the 'risk-on' themes of 2010, however, a flight to quality theme encompassed markets by April of 2011 which continued toward year end. In addition to the escalation of European turmoil, a series of new Australian and global risks materialised with the Queensland floods, Japan earthquake and resulting negative impact on the global supply chain - and then continued with the Arab Spring and the US loss of its AAA credit rating.

Unsurprisingly, safe haven assets such as government securities and gold were the best performers over 2011, and oil performed well with the rise of the Asian consumer and increasing supply concerns amidst Middle East turmoil. 'Risk-on' assets were the worst performers, with Euro peripherals and equities among the worst performers over 2011.



2011 Fund commentary

Exposure to global financials and Asian corporates were key risk positions over December and much of the year. As the year progressed and market sentiment turned increasingly negative, we gradually reduced portfolio risk by selling more volatile corporate holdings and increasing cash positions. While the Fund's overall long duration position (averaging approximately 0.85 years) was positive for the year, short futures positions implemented to reduce the duration stemming from the Fund's bond holdings reduced the gain. The Fund's currency positions aided returns over December and the year, with a long CNY vs. USD position and short CHF vs. NZD position being the main positive contributors. A quarter-by-quarter summary of the Fund's performance is below.

Quarter 1

The bullish market tone positively impacted the Fund's corporate debt holdings, which were mainly focused on the global banking sector, Asian industrials, Australian MBS/ABS and global BBB-rated securities. The Fund maintained a long Australia/short US 10 year spread trade which was moderately positive for performance, as was the long position in Canada position relative to the US. The Fund remained long the Chinese Yuan versus the US dollar over the first quarter, and this also contributed to performance. The Fund's short position in the Euro

detracted from returns, however consistent stop-loss orders prevented the loss from becoming larger. Over the quarter we added a small allocation to high yield securities (2% of the Fund), and began increasing our exposure to Asia.

Quarter 2

Global yields began to fall amidst falling risk appetites and flights to quality. The portfolio's higher quality corporate positions added to returns while lower quality corporate and high yield positions detracted from returns. The Fund's overall positive duration of approximately one year had a positive impact on performance, however the negative duration hedges (through futures) for our corporate bond positions somewhat detracted from performance. A curve flattener in Australia also helped performance, but US duration positions based upon our view that rates would remain range-bound (between 3% and 4%) over the course of the year detracted from performance. Options positions which would benefit from rising interest rates were also a negative for performance. Towards quarter end, we reduced portfolio risk by cutting selected corporate bond positions and increasing cash positions.

Quarter 3

Amidst the weakening global backdrop, we continued to maintain a fairly high cash position (reaching a high of about 27%) which aided performance in the risk off environment. We continued reducing portfolio risks with selective sales of corporate bond positions and purchases of protection on credit default indices. As global yields fell, our small interest-rate duration position aided returns. However, the Fund's corporate bond positioning detracted from performance with the US banking sector and Asian corporate positions the hardest hit. Our worst performers in the banking sector were senior floating rate debt of Goldman Sachs, JP Morgan, Citigroup, ANZ and NAB, while holdings of Royal Caribbean Cruises, China Oriental and Telstra also detracted from performance. There were positives on the corporate holdings front, with

fixed rate holdings of Dell, Rabobank, Korea National Oil and Sydney Airport contributing to positive performance. We had also reduced our natural short futures positions used to reduce overall portfolio duration resulting from our fixed-rate assets, which also aided performance. As the Swiss Franc rose to record highs, we implemented a short position versus the Kiwi dollar. This position moved very quickly in our favour (by a total of about 10%) and we took profits which greatly aided performance over the quarter.

Quarter 4

Exposure to financials and Asian corporates were key contributors to performance over the quarter. The Fund's long position in the CNY vs. the USD, long position in AUD rates and short credit default protection on sovereign Australia also aided returns. A small short AUD position vs. the USD, implemented in October (as a hedge against the Fund's long credit position) aided returns as the AUD weakened amidst the deteriorating global environment.

2012 Outlook

While global data is likely to remain mixed, we believe in the eventual recovery of the global economy, albeit at a slower pace than markets currently expect. We believe global recovery is at least 2 to 3 years away. Significant global risks remain in Europe. European policymakers will remain behind the curve and we foresee the European crisis getting considerably worse before it eventually gets better. With little leadership and the lack of agreement in a comprehensive bailout plan, we anticipate higher probabilities of both peripheral country and banking sector defaults. While the ECB's 3-year term repo will ease banking sector liquidity concerns in the short run, political paralysis will remain, eventually re-awakening sovereign default risks as yields again move toward unsustainable levels. Greater global volatility and further flights to quality will continue over the next few months.

Within this context we expect to maintain risk averse positions including high cash allocations and the preservation of credit default protection. We intend to maintain positions in US banks and Asian corporates given their attractive yields. Given the low level of both government yields and cash rates and the near record-wide levels of credit spreads, we will begin adding to selective corporate positions as the first quarter unfolds.

We remain reluctant to own most of Europe as the risk relative to return is still not warranted. We believe the extent of Australian rate cuts priced into markets is unlikely and will continue to favour floating rate assets due to more attractive yields in an inverted yield curve environment. We expect the US to keep interests on hold for the remainder of the year and likely through to 2014.

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