Kapstream
—JANUS HENDERSON—

Quarterly Report

Kapstream Absolute Return Income Fund

March 2020

Performance	1 Month (%)	3 Months (%)	1 Year (%)	3 Years (%) p.a.	5 Years (%) p.a.	Since Inception (%) p.a.
Fund Return (before fees and sell spread)	-1.63	-0.48	2.12	3.08	3.19	5.16
Fund Return (after fees, before sell spread)[1]	-1.66	-0.58	1.67	2.64	2.76	4.82
Fund Return (after fees and sell spread)[2]	-2.65	-1.58	0.65	2.30	2.55	4.73
RBA Cash Rate	0.04	0.16	0.97	1.32	1.52	3.15
Active return[3] (before fees and sell spread)	*-1.67*	*-0.64*	*1.15*	*1.76*	*1.67*	*2.01*
Active return[3] (after fees and sell spread)[2]	*-2.69*	*-1.74*	*-0.32*	*0.98*	*1.03*	*1.58*
Bloomberg Ausbond Bank Bill Index	0.10	0.26	1.23	1.66	1.83	3.42

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 1% (see additional note on sell spreads at the end of this report), and management fees. 3) Active return of the Fund compared to Benchmark (RBA Cash Rate).
Source: Fidante Partners Limited, 31 March 2020.

Performance

The Fund returned -1.66% in March and -0.58% calendar-year-to-date (after management fees but excluding the impact of any sell spread cost* charged only to redeeming investors). This is disappointing by our standards but against the backdrop of significant capital market losses a relatively resilient outcome. The Fund's corporate bond positions were the largest detractor from returns as the record sell-off in all risk assets hit even our most conservative exposures. We remain concerned about further market turmoil and have acted to continue to reduce risk. Positives over the month included our interest rate exposure, which at 1.5 years' duration aided returns as yields fell. Currency positions, generally long USD versus Asian currencies, also added value. Credit default protection, on US and Australian investment grade assets and Italian banks also aided in limiting losses on our corporate holdings. At month-end we maintained an approximate 25% position in credit default protection.

* Note on sell spreads below.

Outlook & Portfolio Strategy

We continue to sell liquid corporate positions, maintain high credit default protection and hold interest-rate duration in the 1.5 year range. Cash and liquidity remain our number one priority. While corporate bond yields look very attractive from a fundamental perspective given March's sell-off, the new liquidity premium for these securities make us reluctant to buy over the shorter term.

US policymakers delivered their first phase of massive fiscal support. The US Federal Reserve delivered on monetary policy, quantitative easing and a wide-ranging set of programs meant to support both financial markets and the wider economy. Whilst we remain biased for lower short-term rates, they have already been priced in and we have little conviction in overall direction of interest rates or equities from where we stand today.

Bond market liquidity is still very poor, although with US Federal Reserve programs supporting commercial paper, corporate bonds, municipal bonds and mortgage and asset-back securities, liquidity is better in the US. A lack of similar RBA support makes the Australian bond market less liquid, although Big 4 senior paper appears to have reasonable two-way trading at this time. Nonetheless, we hold nothing in any of our portfolios today that we are uncomfortable with, and therefore are fortunate in not feeling compelled to make major changes. We remain 100% investment grade, biased toward shorter dated (<5yr) issues, and with a continued avoidance of more volatile or higher beta sectors (such as commodity, energy, gaming, tourism and autos) as well as the worst affected regions. We maintain only a modest exposure to China (and only in USD-denominated quasi-sovereign issuers), and otherwise nothing in emerging markets. Our portfolio can be simply split across three major 'buckets'; financials (~40%), corporates (~35%), and mortgage-backed (~20%) with the residual in cash. Geographically, we have maintained a roughly 2/3rds to 1/3rd split between Australian and international issuers (the latter divided between the US and developed Asia). Again, we have no greater concern today with default risk across any portfolios we manage as we did before the turmoil in markets began.

For the coming month our main goal will remain protecting the portfolio from a further sell-off in risk assets and corporate bond spreads.

A final note on fund sell spreads

Given terrible bond market liquidity, the worst we've seen in more than 30 years, we implemented the Fund's first sell spread, which at month end was 1%. This spread exists solely to protect unitholders from the impact of higher trading costs that the whole fund would otherwise face in meeting requests from the few investors who on any given day wish to withdraw any of their investment. It is not a manager fee, rather a mechanism that pays directly back into the Fund that ensures only withdrawing unitholders meet the currently elevated transaction costs of a withdrawal. Markets remain volatile and liquidity conditions change on a daily basis. While we all look forward to an eventual return to some normalcy, the sell spread currently remains in place as necessary protection for unitholders from the adverse environment we all face. Please stay abreast of current sell spread levels which are published as a Continuous Disclosure Notice on our Responsible Entity's website https://www.fidante.com/investment-managers/kapstream-capital.

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