Kapstream
—JANUS HENDERSON—

Monthly Report

Kapstream Absolute Return Income Fund

May 2020

Performance	Month (%)	3 Months (%)	1 year (%)	3 years (%) p.a.	5 years (%) p.a.	Since Inception[1] (%) p.a.
Fund Return (before fees and sell spread)	0.31	-1.61	1.22	2.88	3.11	5.09
Fund Return (after fees, before sell spread)[1]	0.26	-1.79	0.71	2.41	2.67	4.74
Fund Return (after fees and sell spread)[2]	0.31	-2.04	0.45	2.33	2.61	4.72
RBA Cash Rate	0.02	0.08	0.76	1.25	1.46	3.11
Active return[3] (before fees and sell spread)	0.29	-1.69	0.46	1.62	1.65	1.98
Active return[3] (after fees and sell spread)[2]	0.29	-2.12	-0.31	1.08	1.16	1.61
Bloomberg AusBond Banks Bill Index	0.31	-1.61	1.22	2.88	3.11	5.09

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 0.25% (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 May 2020.

Performance & Market Commentary

The Fund returned 0.31% in May and -0.71% calendar-year-to-date (after management fees but excluding the impact of any sell spread cost* charged only to redeeming investors). Positives over the month included our corporate bond exposures and the portfolio's interest rate exposure, currently at 1.2 years' duration, which aided returns as yields fell slightly. For the second month, the portfolio's credit default protection was the largest detractor from returns as risk appetites remained strong. Currency positions, generally long USD versus Asian currencies, slightly detracted from value. Our concern over longer-term growth, corporate profitability and the lingering effects of the global economic shutdown cause us to continue with more conservative positioning.

*Note on sell spreads below.

As protesters responded to the police killing of George Floyd by looting Cartier, Hermès and Prada stores nationwide (in search of designer face masks?), President Trump called for "weak" Democrat mayors to get tough "with decisive military action" and "dominate protesters", while he fled to the safety bunker five floors beneath the White House. In response, the US S&P reached new highs. While the New York mayor imposed a citywide curfew, he was unable to prevent bricks being thrown into Trump Tower windows. Trump proved more successful in domination by bringing in the military to teargas and shoot rubber bullets at peaceful protesters outside the White House as he declared himself the peaceful protesters' president, in a photo-op complete with a bible and church as props in the background. It is unclear whether market reaction to recent events is more puzzling than US domestic social policy, although neither would be described as entirely rational.

'MAGA' policies made headlines on the international front as the US sought to withdraw funding for the World Health Organization (WHO) and add Russia back into a G8 meeting at Camp David, which was subsequently cancelled following German Chancellor Merkel's reminder that WHO and international guidelines strongly discouraged travel during a pandemic. However, it became apparent that politicians were meant to be exempt from travel restrictions following news that Boris Johnson's corona virus laden aide travelled hundreds of miles around the UK, reportedly "to test his eyesight". Examples of this type of ingenuity, reminiscent of wartime sacrifices and resourcefulness, allowed UK markets to rally over the month.

Elsewhere, China tightened its control over Hong Kong by imposing a national security law which will effectively suppress protest and civil liberty. International protest raged, leading to a powerful joint statement complaining that the new law broke promises China had made and that the international community might limit future trade with Hong Kong. Chinese and Hong Kong markets rallied despite increasing prospects for them becoming one and the same. Phase 1 of the US/China trade deal remained on track although there was no word on the current status of Phases 2 through 20.

A win for science over politics appeared only in space as SpaceX successfully launched and docked with the International Space Station, signalling positives for public/private partnerships, international cooperation, technology and innovation. While SpaceX remains a private company, its further success added to the allure of one of the US' most famous immigrant CEOs. Coincidentally, President Trump announced plans for a 60-day moratorium on immigrant work visas in order to protect America's workers during the COVID-19 crisis.

May's financial markets rally signaled a market belief that the global economy had passed the low point and was on path for future recovery, albeit a long road but nonetheless underway. The US' inequality, embedded racism and resulting protests continue to be viewed by markets as mere speed bumps, with minor implications for long-term growth and profitability. Financial market results following prior parallel incidents including Ferguson in 2014 and Rodney King in 1992 reinforce this current market view. While lessons from the French Revolution would point toward a different result, financial market memories are not that long.

Outlook & Portfolio Strategy

We remain concerned over further market turmoil and will maintain conservative risk exposures. Penalty rates for holding cash have become too painful and we have begun to invest our excess cash into short-term commercial paper with attractive yields. While these securities will not benefit from price increases as a result of further market rallies, portfolio yield will remain attractive while remaining protected against further market volatility. We will maintain high credit default protection and hold interest-rate duration in the 1.2-year range. We also remain concerned that a longer than anticipated lockdown could stress corporate solvencies even further. We will await further information before materially increasing risk positions from here.

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. While market talk of negative US rates is premature, low short-term rates are a given for the next 12 to 18 months. We are not believers in the consensus view for a steeper yield curve as massive deficits fuel record Treasury bond issuance. Lessons from Japan and Europe demonstrate longer-term deflation risks combined with central bank purchases override supply concerns.

Bond market liquidity continues to improve. 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 regions worst affected by the COVID-19 pandemic. 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 (~30%), 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). We have no greater concern with default risk across any portfolios we manage as we did before the turmoil in markets began.

For the coming period our primary goal remains protecting the portfolio from volatility and 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 0.25%. 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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