Kapstream
—JANUS HENDERSON—

Quarterly Report

Kapstream Absolute Return Income Fund

June 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)	0.46	0.41	1.31	2.96	3.23	5.09
Fund Return (after fees, before sell spread)[1]	0.43	0.31	0.80	2.50	2.79	4.75
Fund Return (after fees and sell spread)[2]	0.48	1.12	0.59	2.43	2.75	4.73
RBA Cash Rate	0.02	0.06	0.68	1.22	1.43	3.09
Active return[3] (before fees and sell spread)	0.44	0.34	0.63	1.74	1.80	2.00
Active return[3] (after fees and sell spread)[2]	0.46	1.05	-0.09	1.21	1.32	1.64
Bloomberg AusBond Banks Bill Index	0.01	0.06	0.85	1.53	1.73	3.36

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, 30 June 2020.

Performance & Market Commentary

The Fund performed strongly in June returning +0.43% (after I class unit fees but excluding any sell spread charged only to redeeming investors). Positives over the month included our corporate bond exposures and the portfolio's interest rate exposure, currently at 1.4 years' duration, which aided returns as yields fell slightly. Currency positions, generally long USD versus Asian currencies and the Euro, slightly detracted from value. For the third month, the portfolio's credit default protection detracted from returns as risk appetites remained strong. Our concern over longer-term growth, corporate profitability and the lingering effects of the global shutdown cause us to continue with more conservative positioning.

Much headline data over June pointed to a cautious tone, which included:

- the global COVID-19 pandemic hitting 10 million cases and 500,000 deaths, and markets continued to re-evaluate both near-term growth prospects and global leadership;
- US/China tensions in trade/COVID-19/human rights moved back into the spotlight putting further pressure on supply chains and trade;
- Biden's domination in US poll numbers caused markets to more seriously evaluate a Democratic led government, combined with Democrat gains in the Senate race allowing Democrats to potentially control of Executive and Legislative branches next year; risks that Biden would nominate an anti-business Vice President also worried markets.
- more bankruptcies with over 4,000 companies entering proceedings in H1 2020, similar to the first half of 2008; Chesapeake Energy filed for bankruptcy foreshadowing a further fall in the shale industry amidst low gas/oil prices.

Despite these negatives, the market's 'risk-on' tone generally continued as June US employment data added nearly 5 million jobs, and May data was revised to 2.7 million jobs added. The unemployment rate fell to 11.1%, lower than expectations. Reflecting a belief that central banks would continue to support the economy through a wide-reaching set of policies and programs, US 10-year yields remained near 0.66%, similar to levels at the end of March, near the height of the crisis. Australian 10-year bonds also remained near 0.9%, trading in a tight band over the past 3 months.

The US Federal Reserve disclosed it followed up in its previous ETF purchases and began purchasing the debt of US issuers including AT&T and Walmart as part of its Secondary Market purchase program, aimed at supporting the consumer sector.

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), however in the coming weeks and months we will look for opportunities to reduce the Australian bias, notably in US names where liquidity remains strongest. Importantly, we have no greater concern with default risk across any issuers in any portfolios we manage, than 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

Consistent with improving bond market conditions and heightened fund liquidity the sell spread was reduced during the period to 0.20% and at the time of writing further to 0.15%. 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 to ensure 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 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 at https://www.fidante.com/investment-managers/kapstream-capital.

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