KANGANEWS AWARDS 2017 WINNER – AUSTRALIAN CREDIT FUND MANAGER OF THE YEAR
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Kapstream
— JANUS HENDERSON —
Monthly Report

Kapstream Absolute Return Income Fund

July 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)	0.60	1.38	1.44	3.04	3.28	5.11
Fund Return (after fees, before sell spread)[1]	0.57	1.27	0.94	2.58	2.84	4.76
Fund Return (after fees and sell spread)[2]	0.62	1.41	0.78	2.52	2.80	4.75
RBA Cash Rate	0.02	0.06	0.61	1.18	1.40	3.07
Active return[3] (before fees and sell spread)	0.58	1.31	0.84	1.86	1.88	2.03
Active return[3] (after fees and sell spread)[2]	0.60	1.35	0.18	1.34	1.40	1.67
Bloomberg AusBond Banks Bill Index	0.01	0.03	0.73	1.49	1.70	3.34

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 0.15% (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 July delivering 0.57%, a welcome continuation of the recovery that has occurred since the March pandemic-driven sell-off, and helping return the Fund to a positive calendar-year-to-date performance of 0.29% (after I class unit fees). Positives over the month included our corporate bond exposure as spreads continued to re-tighten, and interest rate exposure of 1.7yrs duration, which aided returns as yields fell. Currency positions were mixed. Our long Norwegian krona position (versus the USD) aided returns while our long Euro and AUD positions detracted. Long USD positions versus Asian currencies were neutral. Credit default protection detracted from returns as risk appetites remained strong, however our concern over longer-term growth, corporate profitability and the lingering effects of the global shutdown cause us to continue with more conservative positioning. The market's 'risk-on' tone continued over the month with US payrolls adding 1.76m jobs and the unemployment rate falling to 10.2% from June's 11.1%. That said, payrolls remain well below pre-pandemic levels and uncertainty surrounding future fiscal stimulus continued to weigh on interest rate markets. Reflecting a belief that central banks would continue to support the economy through a wide-reaching set of policies and programs, US 10yr yields fell 0.10% to 0.56%, a near record low. Australian 10yr bonds also fell 0.10% reaching 0.81%.

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 invested 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, yields remain attractive and the portfolio continues to be protected against further market volatility. We will maintain high credit default protection and hold interest-rate duration in the 1.7-1.9yr range. We also remain concerned that a longer than anticipated lockdown could stress corporate solvencies even further, and we will await further information before materially increasing risk positions.

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 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 and commercial paper. 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 portfolios we manage as we did before the turmoil in markets began. For the coming period 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

Consistent with the pattern over the past 3-4 months of improving bond market conditions, in July the sell spread was reduced 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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