Kapstream
— JANUS HENDERSON —
Monthly Report

Kapstream Absolute Return Income Fund

August 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)	0.15	1.22	1.22	2.98	3.30	5.09
Fund Return (after fees, before sell spread)[1]	0.11	1.08	0.63	2.31	2.61	4.47
Fund Return (after fees and sell spread)[2]	0.12	1.22	0.56	2.47	2.83	4.73
RBA Cash Rate	0.02	0.06	0.54	1.15	1.37	3.06
Active return[3] (before fees and sell spread)	0.13	1.15	0.68	1.84	1.93	2.03
Active return[3] (after fees and sell spread)[2]	0.09	1.15	0.02	1.33	1.46	1.67
Bloomberg AusBond Banks Bill Index	0.01	0.03	0.66	1.44	1.66	3.32

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 sell spreads (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 & Market Commentary

The Fund returned 0.11% in August and 0.41% calendar-year-to-date (after I class unit fees). Positives over the month included coupon income stemming from our corporate bond exposure and capital gains from the small rally in corporate bond spreads. Currency positions were mixed. Our long Norwegian krona position (versus the US dollar) aided returns while our long Euro, Asian currencies and Australian dollar positions slightly detracted. The Fund's credit default protection also slightly 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.

Markets continued to balance global economic carnage caused by COVID-19 and further lockdowns, against prospects for a vaccine and central bank support until global recovery. US equity markets reached new record highs as the S&P climbed 7.2% over the month. Global equity markets continued to rally despite a weak consumer, employment and growth. The German DAX was up 5.1% while the Australian ASX gained 4.0% and the UK FTSE gained 1.8%. Commodities continued to rally, led by silver which was up 15% on the month and 58% calendar-year-to-date. Oil gained 5% though remained down 31% calendar-year-to-date. The US dollar fell to a 2-year low (down 1.3%), falling for the 5th consecutive month. The Australian dollar ended the month at 0.738, up 3.3% vs the US dollar on the month and 5.1% on the year.

With a 2nd quarter GDP print of -7.0% following a 1st quarter print of -0.3%, Australia's 28+ year record run of avoiding a recession was broken. Having avoided recessions in periods including the 1997-1998 Asian crisis, the 2000-2001 dot.com bubble and the 2008 global financial crisis, the streak came to end as COVID-19, the Victorian lockdown and resulting impact on consumers took effect. Australia's Treasurer stated it would take five years to get the economy back to where it was pre-crisis. The RBA remained highly accommodative, holding cash and 3-year rates at 0.25% and increasing the size of its Term Funding Facility to A$200 billion (and extending out to June 2021), or about 10% of GDP, ensuring low cost financing for banks, consumers and businesses. In Europe, consumer inflation turned negative for the first time in more than four years and core inflation fell to its lowest level since the introduction of the Euro in 1999.

In what many would consider a major evolution of US Federal Reserve policy, in subtle language the Fed announced targeting "deviations" from average inflation of 2%, versus prior language of "shortfalls" of inflation, implying that inflation should be above 2% for years when it was below 2% for years. While messaging a more dovish long-term stance, we expect little impact of this change in the short run given inflation has remained well below the Fed's 2% target and unemployment is above 10%. The Fed will keep rates at zero for many years, however appear to be acknowledging a "flattening" of the Phillips curve (or the assumed trade-off between lower employment and higher inflation). Newer statements such as "a robust jobs market can be sustained without causing an outbreak of inflation" imply a belief that unemployment can be too high but not too low. Further dovish signs include the consideration of altering Fed priorities to explicitly target racial disparities in wealth and employment, further signalling low rates for many years.

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, the portfolio yield remains attractive and the portfolio will remain protected against further market volatility. We will maintain credit default protection and hold interest-rate duration in the 1.6 to 2.0 year range. We also remain concerned that a longer than anticipated lockdown could stress corporate solvencies further and 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. 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 a little, notably in US names where liquidity remains strongest. Again, 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

Sell spreads remain at 0.15%, existing 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 still modestly elevated transaction costs of a withdrawal. 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 https://www.fidante.com/investment-managers/kapstream-capital.

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