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

Quarterly Report

Kapstream Absolute Return Income Fund

September 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)	0.23	0.99	1.48	2.98	3.32	5.07
Fund Return (after fees, before sell spread)[1]	0.20	0.89	0.98	2.52	2.87	4.72
Fund Return (after fees and sell spread)[2]	0.23	0.96	0.84	2.47	2.85	4.71
RBA Cash Rate	0.02	0.06	0.48	1.11	1.34	3.04
Active return[3] (before fees and sell spread)	0.21	0.93	1.00	1.86	1.98	2.03
Active return[3] (after fees and sell spread)[2]	0.21	0.90	0.36	1.36	1.51	1.68
Bloomberg AusBond Banks Bill Index	0.01	0.03	0.58	1.40	1.63	3.30

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, 31 March 2020.

Performance & Market Commentary

The Fund returned 0.20% in September and 0.89% for the third quarter (after I class unit fees). Positives over the month included coupon income stemming from our corporate bond exposure and hedges protecting against widening corporate bond spreads. Currency positions were slightly negative as our long Norwegian krona position (versus the USD) detracted from returns while our long Asian currency and AUD positions slightly aided returns. Our concern over longer-term growth, corporate profitability and the lingering effects of the global lockdown 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. After reaching new record highs early in the month, US equity markets retreated about 8% post 2nd September, as prospects for a new fiscal stimulus plan appeared to fade. Global equity markets followed the US, and renewed concern over virus spikes in the US and Europe sparked fear of further lockdowns, particularly as colder weather hits the Northern hemisphere. Virus surges in France, Spain, the UK and the Netherlands suggested a return to normalcy is further off than expected.

In the US, the death of Supreme Court Justice Ruth Bader Ginsburg and nomination of Amy Coney Barrett proved divisiveness in the political process would continue through the November elections with little prospect for consensus, even over further critical fiscal stimulus.

Outlook & Portfolio Strategy

We remain concerned over further market turmoil and political divisiveness and will maintain conservative risk exposures. Penalty rates for holding cash have become too painful and we have invested 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 remains attractive and the portfolio remains protected against further market volatility. We will maintain high 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 even further. We'll 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 will 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 COVID-19 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 continue to maintain 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 with default risk across any portfolios we manage as we did before the turmoil in markets began.

For the coming period our main goal continues to be protection of the portfolio from a further sell-off in risk assets and corporate bond spreads.

A final note on fund sell spreads

The fund sell spread was reduced from 0.15% to 0.12%, reflecting lower transaction costs in fixed income securities. Sell spreads exist 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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