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

January 2021

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)	0.14	0.88	1.54	2.90	3.34	5.04
Fund Return (after fees, before sell spread)[1]	0.10	0.77	1.06	2.44	2.90	4.69
Fund Return (after fees and sell spread)[2]	0.11	0.79	0.95	2.40	2.87	4.68
RBA Cash Rate	0.01	0.03	0.27	0.96	1.22	2.97
Active return[3] (before fees and sell spread)	0.13	0.86	1.27	1.94	2.12	2.07
Active return[3] (after fees and sell spread)[2]	0.10	0.76	0.67	1.44	1.66	1.71
Bloomberg AusBond Banks Bill Index	0.00	0.01	0.29	1.21	1.48	3.22

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 0.10% (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 December 2020.

Performance & Market Commentary

The Fund returned +0.10% in January (after I class unit fees). Coupon income was the primary driver of returns but interest rate exposure, at 1.6 years' duration was a small negative as rates moved slightly higher amidst renewed inflation concerns. Democrats gaining control of both the Executive and Legislative branches of government led to increased prospects for US fiscal stimulus. We don't believe in material inflation risks and expect to continue to predominantly hold bonds with 2-7 year maturities with expectations that central banks will keep rates low. Default risks in high-quality corporate bonds remain small although current pricing more accurately reflects this decreased risk. Continuing to capitalize on attractive opportunities whilst maintaining an attractive yield will remain our biggest challenge over 2021.

Outlook & Portfolio Strategy

We remain optimistic on global recovery, perhaps seeing global GDP return to pre COVID-19 levels by Q3 2021, the primary driver being good news on the vaccine front. Nonetheless, it will take years for US jobs to fully recover the more than 20 million lost over the crisis. We expect the Federal Reserve to continue its US$120bn/month in bond purchases and keep rates at zero for the intermediate term. In Australia, the Reserve Bank will also maintain low rates while continuing its A$100 billion purchase program, preventing any sharp rise in yields. Job growth will be the key, with the RBA maintaining ultra-accommodative policies until unemployment falls below 5%, a minimum target for inflation to move into the RBA's 2-3% target range. With unemployment currently at 6.8%, it may take a few years to reach target.

As telegraphed, we have maintained very low cash levels given penalty rates. Now having clarity over the US election outcome, strong consumer balance sheets and expectations for solid employment data (once the vaccine begins wider distribution) add to our more optimistic outlook. The ability for US Democrats to pass budget legislation including greater COVID-19 relief programs mean both fiscal and monetary stimulus will be running on all cylinders. However, stronger than anticipated COVID-19 reinfection rates, new lockdowns and the resulting negative impact to businesses in Europe and the US, will continue to make us cautious in the short-term. We will maintain interest-rate duration in the 1.6-2.0 year range.

Whilst we remain biased for lower short-term rates, they have already been priced in. Low short-term rates are a given for the next 12-18 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. Nonetheless 2-7 year bonds remain attractive given their yield advantages over cash rates and prospects for 'roll-down' gains or yields falling as these bonds move closer toward maturity.

Bond market liquidity continues to improve toward pre COVID-19 levels. We remain 100% investment grade, biased toward shorter dated (<7yr) 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 (~18%) with the residual in governments and 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). Again, we have no greater concern with default risk across any portfolios we manage as we did before the 2020 turmoil in markets.

For the coming period our main goal will continue to be about 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 0.10%, reflecting lower but still moderately elevated 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. 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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