Kapstream
— JANUS HENDERSON —
Monthly Report

Kapstream Absolute Return Income Fund

February 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	0.22	0.89	2.73	3.33	5.00
Fund Return (after fees, before sell spread)[1]	-0.18	0.10	0.40	2.27	2.88	4.65
Fund Return (after fees and sell spread)[2]	-0.15	0.13	0.32	2.25	2.87	4.64
RBA Cash Rate	0.01	0.02	0.22	0.93	1.19	2.95
Active return[3] (before fees and sell spread)	-0.15	0.19	0.66	1.81	2.14	2.05
Active return[3] (after fees and sell spread)[2]	-0.16	0.11	0.10	1.32	1.68	1.69
Bloomberg AusBond Banks Bill Index	0.00	0.00	0.21	1.17	1.45	3.20

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 0.07% and management fees. 3) Active return of the Fund compared to Benchmark (RBA Cash Rate).
Source: Fidante Partners Limited, 28 February 2021.

Portfolio Commentary

The fund returned -0.18% in February (after I class unit fees). While coupon income remained the primary positive contributor, this was entirely offset by detraction from the funds' interest rate exposure of 1.1 years' duration, given the surprise move higher in rates amidst renewed inflation concerns. Increased prospects for US fiscal stimulus and stronger jobs data led markets to believe growth would rebound quicker than anticipated, leading to increased inflation expectations. We don't believe in material inflation risk and expect to continue to hold bonds predominantly with 2-7 year maturities, with expectation that central banks will keep rates low for the next three years. 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.

The yield on the 10-year US Treasury bond rose 0.33% from 1.07% to 1.40%. Longer dated Treasuries touched levels not seen since before the pandemic. Australian government bond yields increased even more, with 10-year yields rising 0.77%, reaching 1.91%, while 20-year bond yields rose 0.75%, reaching 2.68%. Commodities and value-oriented equities benefited from the moves as their perceived role as inflation hedges appealed to investors. Similarly, financials were back in vogue as a steepening yield curve theoretically boosts their profitability.

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 vaccination rollout front. We expect greater levels of vaccination will open businesses sooner and permeate to additional pockets of global economies. However, we do not expect this to be a rapid shift and the effects of the pandemic will remain with us throughout 2021 and 2022. Although we expect a temporary spike in inflation, persistently high inflation is not a story for this year, given it will take many years to reach full employment globally. We remain confident being on the front end of the yield curve as there has been less volatility, and believe that will remain the case.

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 bond purchases and keep rates at zero for the intermediate term. The Reserve Bank of Australia will also maintain low rates while continuing its 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 that.

Whilst maintaining a cautiously ample allocation to highly liquid securities and instruments we are mindful of penalty rates on cash. A clear US election outcome, strong consumer balance sheets and expectations for solid employment data (once wider vaccine distribution begins) all add to our more optimistic outlook. The ability for Democrats to pass budget legislation including greater COVID-19 relief programs mean both fiscal and monetary stimulus will be running on all cylinders. Whilst we believe bond yields have risen beyond our medium term expectations, we will maintain slightly shorter interest-rate duration in the 1.0-1.5 year range as volatility has increased.
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-pandemic 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 turmoil in markets began.

For the coming period our main goal remains protecting the portfolio from a further sell-off in risk assets and corporate bond spreads.

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