Kapstream
—JANUS HENDERSON—
Monthly Report

Kapstream Absolute Return Income Fund

May 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)	0.12	0.21	2.76	2.67	3.05	4.92
Fund Return (after fees, before sell spread)[1]	0.09	0.11	2.34	2.21	2.60	4.57
Fund Return (after fees and sell spread)[2]	0.09	0.11	2.51	2.18	2.59	4.56
RBA Cash Rate	0.01	0.03	0.17	0.81	1.09	2.90
Active return[3] *(before fees and sell spread)*	0.11	0.19	2.59	1.86	1.96	2.02
Active return[3] *(after fees and sell spread)*[2]	0.08	0.08	2.35	1.37	1.49	1.67
Bloomberg AusBond Banks Bill Index	0.00	0.01	0.06	1.01	1.33	3.14

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, 31 May 2020.

Performance & Market Commentary

The fund returned +0.09% in May (after I class unit fees), with coupon income remaining the primary driver of returns. Interest rate exposure of 0.9 years' duration was neutral for returns over the month but remains a negative calendar year to date as rates remain elevated. While increasing inflation expectations led by prospects for US fiscal stimulus and supply-chain constraints have driven bond yields higher over 2021, we don't believe in material inflation risks and expect to continue to predominantly own bonds with 2-7 year maturities, with expectations that central banks will keep rates low for the next 2-3 years. Corporate positions slightly aided returns as spreads slightly narrowed over the month. Default risks in high-quality corporate bonds remain small although current pricing more accurately reflects this decreased risk. We implemented a small US dollar short position vs. the CAD, GBP, JPY and Euro, which cost the portfolio about 1bp to performance over the month.

Outlook & Portfolio Strategy

We remain optimistic on global recovery, perhaps seeing global GDP return to pre-COVID levels by Q3 2021, the primary driver being further good news on the vaccine front. We expect greater levels of vaccination will enable businesses to open sooner and permeate to further pockets of the global economy. However, the effects of the pandemic will remain with us throughout 2021 and 2022, particularly in Australia as the border remains closed through the first quarter of 2022. Although we expect a temporary spike in inflation, persistently high inflation is not a story for 2021, given it will take many years to reach full employment globally. We remain confident being on the front end of the yield curve given steepness, as there has been less volatility there which we believe will remain the case, allowing bonds to 'roll down' the curve.

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. In Australia, the Reserve Bank 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 5.5%, that may take years to reach.

We have maintained low cash levels given penalty rates. Strong consumer balance sheets, fiscal expansion and expectations for solid employment data (as the vaccination pace picks up) add to our more optimistic outlook. The ability for US Democrats to pass budget legislation including greater COVID relief programs mean both fiscal and monetary stimulus will be running on all cylinders in the shorter-run. Whilst we believe bond yields have risen beyond our medium-term expectations, we will maintain slightly shorter interest-rate duration in the 1 year range as volatility has risen.

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 maturity 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 creep back toward pre-COVID levels. We remain 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 COVID 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 remains simply split across three major ‘buckets’; financials (~45%), corporates (~30%), and mortgage-backed (~15%) 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) given greater relative value domestically. 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 sell-off in risk assets and any widening of corporate bond spreads.

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