

**Presenting
debate on
contemporary
and emerging
portfolio
construction
issues**



portfolio
construction

CONFERENCE

15 & 16 August 2007 | AJC Convention Centre, Randwick, Sydney

The changing face of fixed interest – From benchmark returns to absolute returns



Agenda

- Why invest in bonds?
- Six key changes in bond markets
- Achieving alpha in a changing environment
- New risks to be wary of
- Kapstream Capital – Absolute Return Income Fund

Why bonds?

- Bonds still play an integral role in portfolios
- Bonds provide:
 - Capital preservation
 - Income generation
 - Diversification when applied correctly

What now?

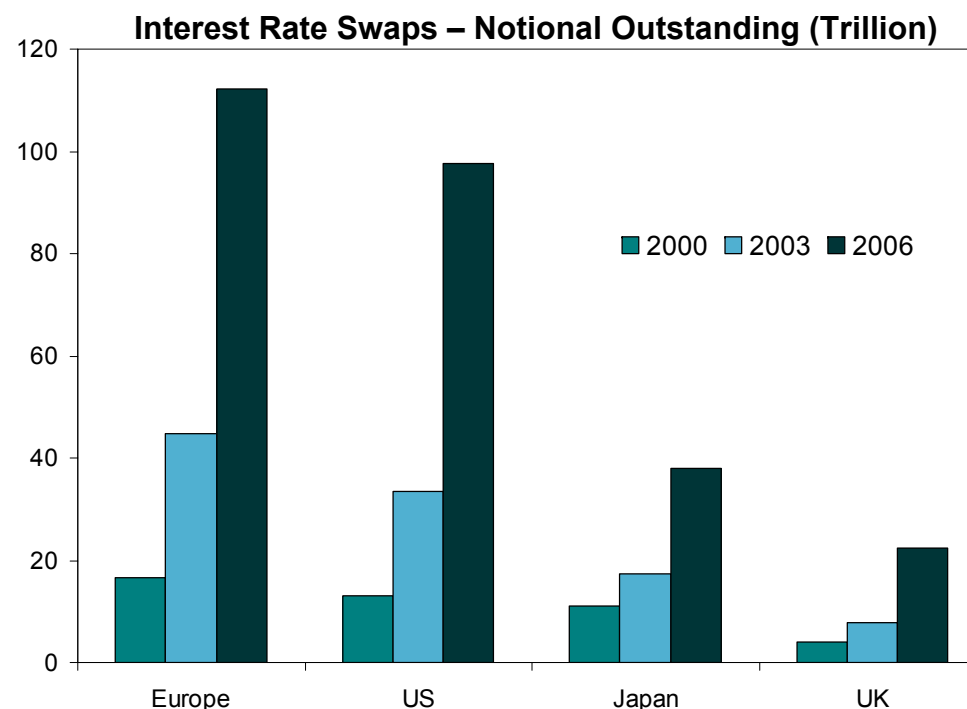
- A fixed income allocation has more dimensions than ever before
- There are six major areas of change facing bond markets:
 1. New issuers entering the market
 2. Instruments used
 3. Benchmark composition
 4. Measurement of performance
 5. Effect of globalisation
 6. Changing economic environment
- Evolution of the “New – New” bond fund manager

Issuers – Who are you lending to?

- The US, Euroland, and Japan make up nearly 90% of the global debt market
- More recently, emerging markets have utilised bonds as a source of financing
- This proliferation has increased the opportunity set for investors
 - These opportunities do not come without risk

Instruments – Anything but bonds

- “Plain vanilla” instruments such as governments, corporates, and mortgages play less of a role
- Derivatives are more common
 - Increased stability/liquidity
- Risks are no longer the same
 - Leverage



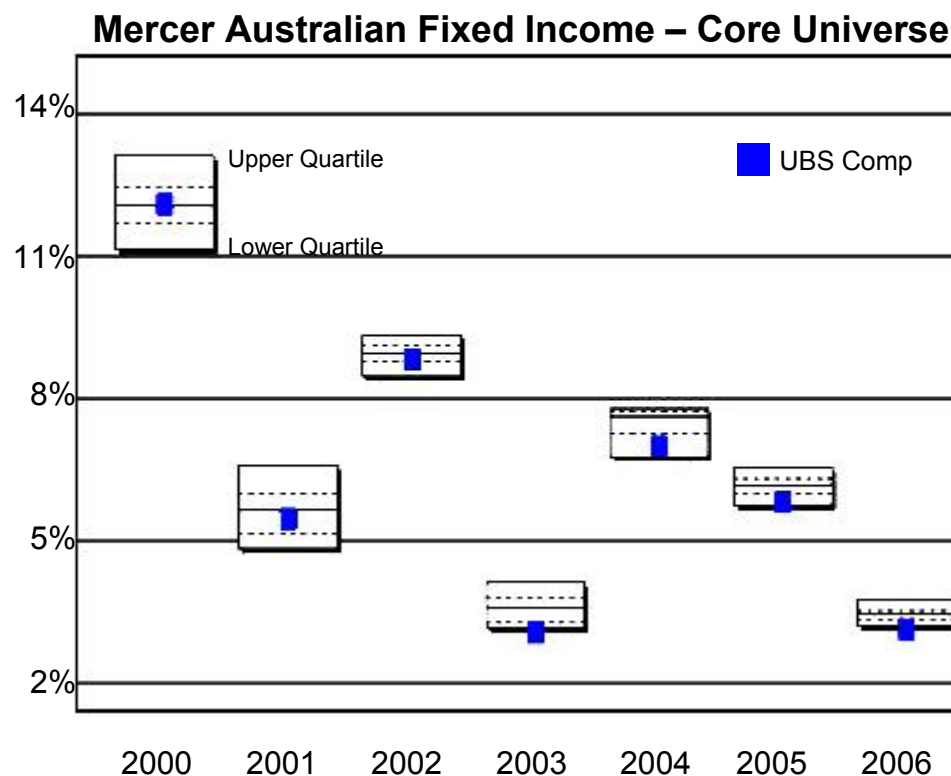
Source: "The Global OTC Derivatives Market Activity in the Second Half of 2006" BIS

Benchmarks – A bunch of baloney

- Benchmarks have nothing to do with an investor's objective
 - The larger the debtor, the larger the portion of benchmark
- In many cases, benchmarks do not provide a hedging mechanism to an investor's liability stream
- Managers result to “hugging” indices to avoid business risk
- YOUR benchmark, YOUR problem!

Performance – Your alpha, my fees!

- A marked convergence of managers relative to the median
- Absolute levels of returns have declined
- Correlation between many “active” managers and the benchmark is high
- Fat cats!



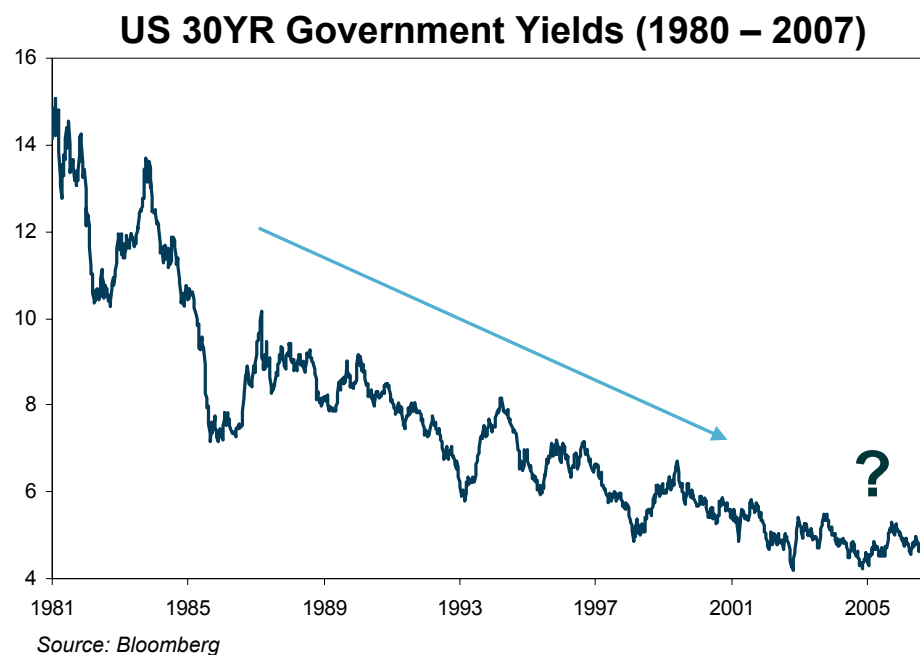
Source: Mercer

Globalisation – Borders are disappearing

- A more interconnected world
- Greater communication/transfer of information yields increased opportunities
- Depth and stability of new markets
 - Offers investors additional options for value added

Economic environment – Bull market is OVER!

- Investors are faced with:
 - Low returns
 - Inverted yield curves
 - Stable fundamentals
- Investors must find innovative strategies to generate returns



Conclusions: Investors must be innovative!

- Expand investment guidelines
 - Force managers to take business risk
- Shed benchmarks
 - Manage “total risk” not “index risk”
 - Ensure a “high water mark” is achieved
- Ditch home country biases – Go global
- Be open to complexities in performance

Conclusion: Risks in the Brave New World

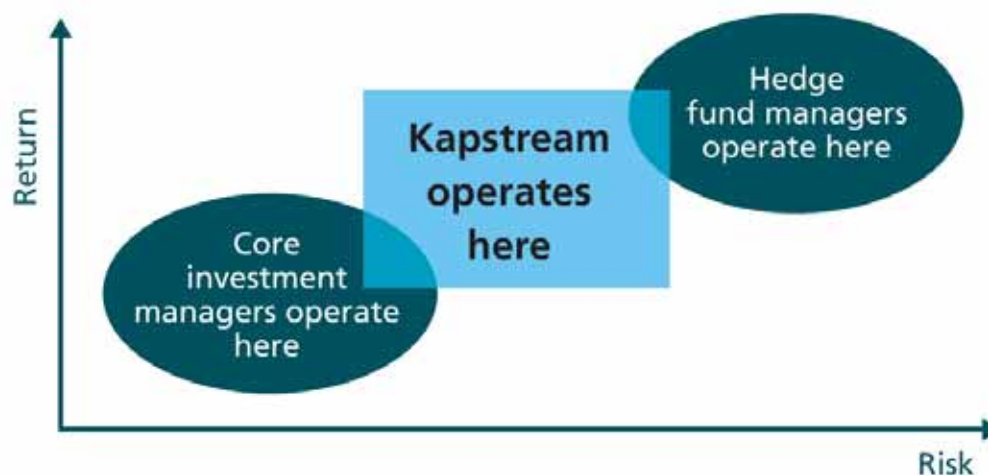
- Excess leverage in the system (Sub-prime, CDO, CDO²)
- High commodity / oil prices
- China stops buying US Treasuries
- Tight labour markets / high inflation → tighter monetary policy
- Unfunded pension liabilities in the West

Why Kapstream?

- An innovative alternative to traditional fixed income
- Provide clients with an absolute return (no benchmark)
- Align strategy with clients' targets and liabilities
- Efficient investment via a rigorous and proven investment process
- An experienced and seasoned investment management team
- Flexibility of a small fund
- Generate an attractive yield – RBA Cash Rate + 2.50%

Differentiation From Other Managers

- Manage “total risk” as opposed to “index risk”
- Accept more risk than core managers and less risk than hedge funds
- Small size allows for greater maneuverability, versatility, and responsiveness to clients’ needs



The Kapstream Portfolio

- Separate the systematic risk (beta) and the active risk (alpha) decisions
- Incorporate high quality alpha generating trades

