PENDER

CORPORATE BOND FUND

THE MANAGER'S MONTHLY COMMENTARY – DECEMBER 2018

The Pender Corporate Bond Fund returned -0.1% in December and 6.5% for the full year 2018[1]. The Fund's slight decline in December was the result of a decrease in the value of high yield positions, which fell in sympathy with a major blow-out in the high yield index spread against Treasuries, offset by a smaller rise in the value in the Fund's AAA government bond holdings, investment grade corporates and certain recently acquired securities, including some rate reset preferred shares.

On a credit-by-credit basis the portfolio saw declines in some holdings related to commodities, including Energy Fuels convertibles, as the underlying stock fell below parity, and W&T Offshore, where credit reacted to a lower oil price. Our position in Dean Foods 2023 bonds was also notably weaker in December, as the market continued to be skeptical of the company's turnaround potential despite recently rationalized production capacity. We expect 2019 to be a more positive year for these positions.

Offsetting the weakness mentioned above, the Fund benefitted from a recently expanded weighting (now approximately 5%) in preferred shares, which rallied into the end of the year. Investment grade credit, both government and corporate, also provided a positive boost, including our large positions in the 2025 Maple bond of McDonalds Corp and our weight in shorter maturity bonds of the major Canadian railways, Canadian National and Canadian Pacific.

Everything You Ever Wanted to Know About High Yield Credit But Were Afraid to Ask
After an epic 230 basis point blowout in high yield credit spreads over the last couple of months (that saw index-tracking high yield ETFs decline more than 5%) we have noticed the tone of questions from clients shift away from opportunity towards risks. Some frequently asked questions:

Is this a high yield fund? The Fund is really a blended portfolio that includes high yield. It is not an entirely high yield mandate. We try to lean against the prevailing market cycles by adjusting the risk weightings. At year-end, 34% of the Fund was invested in investment grade bonds. A further 10% of the Fund was invested in investment grade securities held inside closed-end funds or was invested in preferred equity of investment grade credits. And much of the remaining weight in the Fund is invested in credits which, despite the lack of investment grade rating, possess, in our opinion, the fundamental characteristics (such as excess equity valuation coverage, low debt-to-cash-flow, high cash balances etc) that provide an equally low probability of default when compared to some of the highest investment grade rated credits. However, high yield credit does form a key part of our strategy to earn an above average credit return.

Why do you have any high yield exposure? In a world where it appears that investor time horizons are continuously shrinking, we feel oddly old-fashioned to return to the peer reviewed academic studies that establish the long-term odds of this business. And the long-term view is clear: through decades of experience, including all booms, busts, credit losses and recoveries, the total return of the lower tiers of the credit market is significantly higher than the investment grade universe[2]. Indeed, the highest returning class of securities, using long-term averages, is freshly defaulted credit[3]. Now that credit spreads in high yield have returned to historically average levels, we believe the odds now favour significantly higher returns in high yield as opposed to higher rated credit.

It looks like we are in a spread-widening environment – how bad can it get? In the past twenty-five years, we have seen five spread-widening events, where the HY index spread against US Treasuries has blown out beyond 500 basis points (currently we are at approximately +540 bps). If you exclude the unique events of 2008, the average of the other cycles topped out around 850 basis points and the duration of the event from the beginning to its climax was a little less than one year. We are not the decrepit resort owners of a Scooby Doo mystery trying to scare meddling kids away from our Fund, but we want all our unitholders to be aware…although the last few months have been shaky, high yield market conditions can get choppier than this. But what we have learned about markets is that in order for any asset class to earn higher than average returns over a meaningful horizon, it must house, periodically, scary levels of volatility. You don't get cuddly kittens in a world without the occasional hairball. High returns and occasional volatility are part of a package deal.

How do you know when it's the right time to increase risk exposure? Although index spread levels provide us with a rough guideline as to whether the credit market is cheap or expensive, real life is actually a little more complicated than this. The market, it turns out, is really a vast collection of sub markets that track to various industries, securities, geographies and so on. And so, one security at a time, we eventually stumble across situations that seem to be discounting a worst-case scenario for a company that is not justified by the facts of the matter. As we have done this December, we have often added when sellers are focused on tax loss crystallization or window-dressing a more conservative looking portfolio for year end. Widely divergent price/value relationships make us get out of bed in the morning…and we are starting to find them.

New Positions

December presented a number of highly interesting opportunities. One area where we added weight was in US municipal bond closed-end funds. As the market shook in December, we saw underlying municipal bond holdings rise in price but discounts-to-NAV expand to levels not seen outside of a few weeks in the middle of the 2008-09 financial crisis. Positions added in this area include the broad-based Nuveen Quality Municipal Income Fund (NAD US Equity).

Rate reset preferred shares were similarly taken to the woodshed. We acquired shares of Brookfield Office Properties Series G preferreds at a price that provided a current dividend of 6.5% and an implied floor dividend also of 6.5%, yet with free upside exposure to any increase in the Canadian 5 year yield. The tax-equivalent credit yield of Brookfield's preferreds is 8.5%, a level considerably wider than the company's debt yield, indicating a cross-asset class valuation opportunity.

We built a position in the convertible 2022 notes of GoPro Inc. GoPro makes the world's most popular mobile cameras for recording live video by athletes and adventurers. With a significant cash position, and management newly focused on cash generation and debt retirement, we consider the notes' 10% yield to maturity attractive in the context of a 1 year default probability we estimate at 1.0%.

Fund Positioning

The Fund yield to maturity at December 31 was 6.3% with current yield of 5.1% and average duration of maturity-based instruments of 2.5 years. There is a 1.3% weight in distressed securities purchased for workout value whose notional yield is not included in the foregoing calculation. Cash represented 1% of the total portfolio at December 31.

Geoff Castle
January 4, 2019

[1] *F Class*
[2] *Erik Hinnink, Applied Working paper No. 2016-3, October 2016 Ortec Finance Research Center*
[3] *Altman/Benhenni, "The Anatomy of Investing in Defaulted Bonds and Loans," Journal of Credit Risk, July 2017*

For full standard performance information, please visit: http://www.penderfund.com/funds-and-performance