PENDER FIXED INCOME

THE MANAGER'S MONTHLY COMMENTARY – AUGUST 2020

The Pender Corporate Bond Fund gained 1.5%[1] in August, continuing the positive trend that the Fund began at the March 2020 lows. The Fund's performance came amidst an environment of modestly rising risk-free interest rates and credit spreads which were slightly tighter.

The Fund's gains in August were led by a significant move in Chesapeake Energy, as prospects for recovery to the FILO term loan position improved with stronger natural gas prices and a favourable court ruling. Other strong lines for the Fund in August included Avaya Holdings, as the call centre software company's securities rallied on positive earnings, and Just Energy, whose convertible notes gained on the success of an activist campaign, in which we participated, which led to an improved deal for convert holders in the company's recapitalization efforts. Preferred shares were also a source of strength during the month.

Offsetting the positive performance, to a degree, was weakness in first lien Transocean notes as the company engaged in negotiations with unsecured holders, creating some uncertainty for that issuer. We continue to like our participation in these notes, which are backstopped by contractual obligations of investment grade credits, Royal Dutch Shell and Equinor. Some investment grade corporate bonds also declined in price as rates rose.

Four Themes to Power the Next Five Years

With the turning of the calendar page into September, this management team celebrates the completion of five years at the helm of the Pender Corporate Bond Fund. While we were by no means perfect, the five year performance, net of all fees and costs, of 7.2%[1] p.a. has more than met our objective of providing unitholders with an acceptable return well in excess of the prevailing rate of inflation.

As we look forward to the next five years, we consider some changes in the market environment, as well as some enduring factors to guide our approach:

- **Focus on Real Return:** The financial environment we find ourselves in is governed by two important policies – unlimited market interventions by central banks to keep a lid on interest rates, and aggressive fiscal policy designed to promote economic stability. Print money as they will, however, governments will find it much harder to create actual wealth, and inflation is a highly possible outcome. In this environment, we are increasingly drawn to a few categories of security that can deliver real returns after considering inflation. Such securities include convertible bonds linked to quality businesses, discounted bonds with strong valuation coverage, and a range of misunderstood or out of favour hybrid securities including preferred shares and closed-end funds. In all of these cases, strong excess returns appear possible.
- **Commitment to Liquidity:** The dramatic market correction of March 2020 underscored the importance of maintaining a decent liquidity position in the Fund. Although the Fund did face some redemption activity at the height of the crisis, our discipline with respect to position sizes and risk bands enabled us to maintain an opportunity-focused posture throughout the market's meltdown. This focus on liquidity is part of our business-as-usual process. Tested twice in the past five years, we continue to integrate liquidity planning in all portfolio decisions.
- **Be Active and Flexible:** One of the principal advantages that this mandate has is our ability and inclination to act in ways that passive credit mandates simply cannot do. Sometimes this can mean negotiating improvements in outcomes for securities we own, as recently achieved in the case of Just Energy. On other occasions it can include having the flexibility to walk a deeply discounted holding through a bankruptcy or re-organization in order to achieve gains on the other side, as we did recently in Aceto and are in the process of with Chesapeake Energy. In a low coupon world, returns don't come for free. We believe our active and flexible disposition will be increasingly important in the coming years.

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[1] Class F; source: PenderFund

- **Units of Return per Unit of Risk:** Our job, positioned in the more defensive side of an investor's portfolio is not only to make money. It is also to preserve wealth. As such, our day-to-day management does not simply consist of comparing a long list of bonds using a "greater than" sign to determine the highest yield-to-maturity. We are continually assessing probability of default of the issues in which we are invested and considering loss (or gain) given default in situations with higher risk. For example, one of the reasons we like so much the wide-spread resets of an issuer like Bell Canada is not that the 6% running yield is so high, but that in the context of such a low default probability, it is a relatively rare risk/reward trade-off. This theme, while not new for us, remains a key driver in our quest to deliver strong risk-adjusted returns.

New Positions

In August we initiated one position, and expanded another, in the engineering and construction industry, a sector we believe to be the focus of excessive pessimism. Engineering and construction businesses in this cycle have struggled with losses on fixed price contracts. Moreover, concerns regarding weak free cash flow dog this industry as accounts receivable balances have been slow to materialize as actual cash receipts. We are inclined to believe that the worst is nearing an end for the sector, where many companies now trade at or below tangible book value. Improving terms of trade, and cash-focused management efforts, combined with strong bookings of new business may be what the industry needs to regain historic levels of capitalization.

Our new position was in the senior unsecured notes of Fluor Corp, priced currently below 80c per. Fluor currently operates under a cloud of uncertainty related to delayed issuance of financial statements that has driven its bonds down more than 20 points from levels that the investment grade issuer enjoyed earlier in 2020. We like the company's historically demonstrated ability to generate cash and its strong liquidity position. The investment grade issuer's bonds would still be eligible for Federal Reserve purchase upon downgrade, were that to occur; another factor in our decision.

A second engineering and construction holding where we added weight was in the convertible debt of Granite Construction Inc. Focused more on civil projects such as highways, bridges and tunnels, we expect Granite to be a key beneficiary of enhanced infrastructure spending initiatives in the United States as governments focus on employment in the wake of COVID-19. Granite's 2024 convertible notes recently traded at 82% of face value to yield approximately 7.5% to maturity, a yield we believe is interesting in the context of an annual default probability we estimate at approximately 0.5%.

The Pender Corporate Bond Fund yield to maturity at August 31 was 5.3% with a current yield of 4.7% and average duration of maturity-based instruments of 4.8 years. There is a 4% weight in distressed securities held for workout value whose notional yield is not included in the foregoing calculation. Cash represented 5.6% of the total portfolio at August 31.

Geoff Castle
September 4, 2020