PENDER

CORPORATE BOND FUND

THE MANAGER'S MONTHLY COMMENTARY – MAY 2017

The Pender Corporate Bond Fund returned 0.5% in May. Leading this performance was our position in the distressed credit of Global Brokerage Inc, which surprised creditors positively with a $56M non-core asset disposition. We saw further strength in PRA Group 2020 convertible bonds as that company improved its liquidity through a new debt issue at good terms which created a positive "read-across" effect for the existing issue.

During the month, risk-free credit yields continued their recent decline with Canada's 5-year note month-end yield falling below 1.0% for the first time since October 2016. A market which was not too long ago primed for "reflation," appeared to settle back into a pattern of lower yields. The 5 year inflation breakeven expectation implied by US inflation-protected security pricing fell from 2.0% to 1.7%.

A Summer's Day in Credit…But There Are Other Seasons

By a lot of measures, the credit environment for North American corporations has rarely been better. The S&P 500 continues to hit new highs, the four-week moving average for US jobless claims has just printed the lowest nominal number since 1973 and Canadian house prices, an important measure for our nation of HELOC borrowers, continue to hit record highs (up, on average 19% in the past 12 months). It is not surprising then, to see high yield credit spreads tightening to 3.65%, a level not seen since the heady days of 2014 and, before that, back in 2006-07. Good times are here. Prepare for the bad.

We do not delight in our new role as killjoy. It was far more fun last year when we were at odds with a skeptical market in accepting a measured exposure to higher risk credits on the basis of good valuation and improving business prospects. This year we see some less comforting signals.

Beyond tight credit spreads, which is one of our key concerns, we are also attuned to the risks we see in Canadian mortgage and real estate markets. In Canada, we have recently seen the near-failure of a relatively significant financial institution (Home Capital Group), and this has occurred alongside at least a couple of high profile bankruptcies of property developers (SkyCity and Walton International). These are relatively unusual events, especially occurring, as they have, amidst a high-flying housing market. How 'contagious' these events are remains to be seen, but we believe Canada's credit cycle is still alive and well, and these events could easily be the beginning of a larger problem.

Outside of Canada, we note that the United States is now about 20 months into a Federal Reserve tightening cycle. Between raising short term rates and new plans by the Yellen Fed to shrink its balance sheet, gentle pressure is slowly being applied against leveraged enterprises around the world. At some point we expect we will hear a crack. Like the children's game, "What Time is it Mr. Wolf?" we have no particular insight into how long it will take for problems to emerge. But sooner or later, we expect the wolf will turn around and declare it's "time for dinner!" at which point we would hope to look as little as possible like a ham sandwich.

Preparing an All-Weather Strategy

We are in the business of growing our clients' capital, as well as preserving it through difficult periods. While the past eighteen months have been very strong on the "making money" side, the risks mentioned above represent reasons to emphasize the "preserving capital" side of the operation. So what are we actually doing?

First, we have been "high-grading" credit quality in the portfolio. As we have seen high yield issues mature, get called away or sold to a market bid, we have been replacing that weight with very high quality issuers. In the past six months, we have added material weight from issuers such as McDonalds, Coca-Cola, Costco, Alliance

Data Systems, Diageo, Verisign, Thomson Reuters, Walt Disney, BCE and George Weston. In all, securities from issuers with a Bloomberg 1-year default risk of less than 0.25% (a level tight enough to exclude hundreds of investment grade issuers) constitute more than 50% of the portfolio.

We have also been making other moves towards the cautious end of the spectrum. Our weighting in closed-end funds has been reduced to less than 5.0%, down by about half from last year's levels. Our positioning in Canadian preferred shares has moved almost exclusively to lower risk issuers like Thomson, BCE, Brookfield and Weston, and within this mix we have diminished our weighting of fixed-resets in favour of perpetual preferred shares. We will consider other adjustments as circumstances dictate.

Making Money in 2017

We continue to see opportunities in distressed and work-out securities, an area that moves somewhat independently from the general high yield market. What matters in these cases is typically the progress of restructurings, asset sales and occasionally, judicial processes. They are longer term positions that have high expected returns, although the timing and amount can be lumpy. While we have not reinvested in this category as fast as workouts have successfully completed, we still hold 13.0% of Fund assets in these "Special Opportunities". This month's performance boost from Global Brokerage was a good example of the upside in this area.

We also are focusing more on secured credit. This month we purchased a position in the first lien bonds of international cosmetics marketer Avon Products. Avon Products represents the ex-US portion of this well-known direct sales franchise. Its first lien obligations are senior enough within the structure that principal value is covered at a multiple of between 1- and 2-times trailing EBITDA. Nevertheless, we enjoy a yield to 2022 maturity of about 6.5%.

As we work to advance unit values of the Fund, while at the same time reducing risk exposure, we should note that the forward looking yield to maturity of the Fund is coming down. With that change, the monthly distributions from the Fund may also decline. As long-term investors, we must occasionally forego a degree of cash income for increased security of principal.

Portfolio Positioning

The Fund yield to maturity at May 31 was 5.5% with current yield of 4.2% and average duration of maturity-based instruments of 2.9 years. There is an 8% weight in distressed securities purchased for workout value whose notional yield is not included in the foregoing calculation. Cash represented 5% of the total portfolio at May 31.

Geoff Castle
June 5, 2017

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

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