PENDER
CORPORATE BOND FUND

## THE MANAGER'S MONTHLY COMMENTARY – OCTOBER 2018

The Pender Corporate Bond Fund returned -0.4%[1] in October. During the month the Fund faced several headwinds, including rising risk-free rates, a widening spread environment across all bands of corporate credit, and also particular weakness in the markets for Canadian convertible bonds and preferred shares. The Fund has taken several steps this year to prepare for market conditions such as these, including reducing exposure to the riskier bands of the credit market, reducing weight in convertibles and preferred shares, and adding significant weight into shorter-term investment grade corporates and sovereign bonds. Despite these preparations, we were not completely immune to the hostile market conditions that October presented.

On a credit-by-credit basis, the Fund was most impacted by a significantly lower mark in the distressed debt of Global Brokerage Inc, which although now only a 0.2% weight, did decline in value by about one-third. While we maintain our belief that the company has a reasonable chance of recovery in 2019, October was no time for turnaround stories. We experienced lesser, but noticeable, declines in a few other specific issues including PHI Inc 2019 bonds, where we also reduced weight, and in the preferred shares of Brookfield Renewable Partners.

Offsetting the weakness we experienced were a few bright spots. Our position in Tesla 2025 notes rallied on a strong earnings report from the electric car maker. The Fund also benefitted from a tender offer for our relatively large position in 2nd Lien notes of W&T Offshore, which were taken out at 102.6% of face value, resulting in a total return in excess of 20% from our purchase in August 2017.

**Tough Sledding and our Game Plan**

Rising interest rates and low credit spreads, as we have noted earlier this year, are a difficult mix. Sooner or later, the competition of higher risk free rates causes risk premiums to rise in corporate credit and the increased interest burden that higher rates bring creates an environment more prone to defaults and other credit stress. This is the "tough sledding" part of the business cycle. There are fewer sugarplums to pick, and many more ways to make mistakes.

We cannot control the business cycle, or even predict the progression of the business cycle with much accuracy. But, having been through a few, we do remember the moves that allowed us to survive to this point without too many blemishes. In this kind of market, we do have a clear game plan:

- **Stay liquid**. We have worked hard not to become painted into a corner with too heavy a weight in illiquid positions. The weight of the Fund is today disproportionately in large issuers of lower default risk (or risk free) bonds. Our "AAA" weighting of over 14% is well above average in our category. Our investment grade weighting is now more than one third of the Fund. And 70% of the Fund by issuer weight is in our lowest default risk category. Combined with short, 2.4 year duration, the Fund has an ample weighting in high quality liquid instruments.
- **Manage exposure to the bottom part of the capital structure**. This is not a time for hoping, it is a time for knowing. And it is also a time for having a clear margin of safety. Only a handful of issues in the Fund, less than 5% overall weight, were in the lower half of the issuer's traded capital structure by market value. While we believe in these particular instances that liquidation value support is firm, we have a limited appetite for this type of exposure in a low spread market, where there are reasons to believe that spreads may move higher.

- **Accept losses, should they occur, quickly and unemotionally**. Shaky positions are not propped up with fund flows but cut quickly to prevent further losses. Positions that can't be sold are written down. We are not overly concerned about looking foolish based on things we may have said in the past about a particular security. If the facts change, we can change.
- **Remain alert to opportunity**. We realize that choppy markets create panic sellers. There is always a cheap security to bid. The more volatile things get, the more there will be opportunity. The worse the tape gets, the more prospective returns improve. This can be especially true heading into the often-volatile tax-loss selling season, where, we are hopeful of a much richer selection of opportunities.

**New Positions…Netflix and Chill**

In October, we initiated a position in the front-end maturities of Netflix Inc, maturing in 2021 and 2022. We consider Netflix to have been successful in its bid to displace advertising-funded, cable television programming with a superior selection of on-demand streaming video entertainment sourced from its large and growing library of popular content. As a subscription business, we consider the company's revenue profile to be more stable than average. Although not currently generating free cash flow, we believe Netflix's aggressive program development budget is largely discretionary. Reducing programming investment, or raising prices, could generate substantial excess cash should the company need to bolster its balance sheet in the future. With a 1 year default probability that we view as less than 0.02% and yields between 4-5%, we consider these Netflix bonds to provide an attractive level of income at relatively low risk.

The "Chill" side of the equation for this month's new positions is United States Treasuries, where we added significant weight at the 3-, 4- and 5-year tenors. We recognize that, in this particular market, the trend is not on our side. Treasury yields have been rising, driven by the Powell Fed's determination to rein in inflation in the relatively "hot" US economy. It may be that yields continue to rise for a while, but now we are seeing Treasury yields in the 3's, the risk free rate has become significant competition for risk assets, and we are inclined to add weight to the instruments against which credit spreads are measured, rather than in the riskier bands of credit obligations.

**Fund Positioning**

The Fund yield to maturity at October 31 was 5.3% with current yield of 4.5% and average duration of maturity-based instruments of 2.4 years. There is a 1.7% weight in distressed securities purchased for workout value whose notional yield is not included in the foregoing calculation. Cash represented 4.6% of the total portfolio at October 31.

*Geoff Castle*
*November 2, 2018*

[1] *F Class*
*For full standard performance information, please visit: http://www.penderfund.com/funds-and-performance*



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