PENDER
CORPORATE BOND FUND

THE MANAGER'S MONTHLY COMMENTARY – NOVEMBER 2018

The Pender Corporate Bond Fund was flat in November, returning precisely 0.0%. The neutral overall portfolio return was, in large measure, the result of gains in the AAA government bonds (as yields fell in the highest quality parts of the bond market) being offset by continuing pressure in the lower tiers of credit.

On a credit-by-credit basis the portfolio benefitted from its 15% weight in US Treasuries and Government of Canada bonds, as well as from specific contributions from the bonds and preferred shares of Aimia Inc, which rallied on the formal completion of the company's asset sale to Air Canada, and from strength in high quality Maple bonds such as our positions in McDonald's and Disney.

Offsetting the strength above, the Fund took a modest hit from our position in the senior bonds of bulk shipping line operator Navios, which fell approximately 8% in the month. Additionally, our positions in various preferred shares, despite their small portfolio weight of 3%, detracted over 15 basis points.

Surveying the Battlefield

In the last week of November, Federal Reserve Chairman Jerome Powell made statements that hinted at a slowing of the pace of rate hikes, an event which was cheered by equity markets. With this temporary "ceasefire" in effect, we emerge from our foxhole to survey key elements of the credit market.

Starting with credit spreads, we note that both the investment grade corporate bond spread (recently +148 basis points over US Treasuries) and the high yield bond spread (recently +433 basis points over US Treasuries) have widened significantly from their recent multi-year lows. The premium paid to high yield investors to compensate for the risk of default is now the highest it has been since 2016. Other areas we follow, including bank loans, preferred shares, convertibles and credit oriented closed-end funds, all show a similarly striking increase in the risk premium.

With the widening of spreads, sentiment in corporate credit has swung from general happiness to dark negativity. Bids are harder to find. One of the market's largest dealers is currently circulating a short-selling basket idea loaded with high-leverage BBB credits it sees as potential downgrade candidates. These are no joyous times.

Grim Reaper or Goldilocks? Finding Opportunity in Moderation

We feel no obligation to act as a public relations outfit on the part of capital markets. However, having been through a few cycles, we recall that there are usually silver linings in even the darkest cloud-filled skies. Against widespread expectations of a Grim Reaper arriving to lay waste indiscriminately across credit portfolios, we do consider areas that may benefit from slower American growth.

To begin, we believe the risk free rate looks attractive for a change. Thus we view AAA sovereign obligations of the US and Canada, of limited duration, as offering some of the highest probabilities of profit in the year that starts today. AAA strength may result from a softer economic outlook which includes credit problems for some companies struggling to refinance maturing debt. With TIPS markets pointing to falling inflation and with some dislocation in corporate credit, a year with at least stable pricing for government bonds seems to be a reasonable bet. We have no heroic assumptions about the level of return from AAA, but we do view this area constructively.

Taking a step forward into moderate risk, we still observe the closed-end funds that track the US Municipal bond market trading at discounts of 15-17% from daily struck-NAV. We believe that US states are, as a group, relatively low risk credits. Sticking with the better "AA" credit states, we see 4-5% portfolio yields in closed-end Municipal funds trading at over 15% discounts. This applies to national funds and also funds focused on very solid credits such as New York, Pennsylvania, Maryland and California. Closing these NAV discounts even halfway to average over the coming year could provide more than 10% total return to holders. This risk looks attractive.

Taking yet another step forward along the risk spectrum, we view with some excitement, the depressed state of securities prices in the area of US residential real estate. We think the fundamentals of US housing, given a moderated interest rate environment, are at least OK, and possibly very good. Good consumer debt service ratios on the part of Americans, a degree of pent-up demand in terms of household formation levels, decent asset valuations and a relatively strong current employment situation all support a stronger US housing market. Even in a slowdown scenario, we expect US housing to be resilient. We note that recently Berkshire Hathaway, a capital allocator with above average insight in our estimation, has increased its investments in the homebuilding industry.

The Goldilocks scenario (an inflation outlook that is cooler, but not cold enough to turn into a deflationary spiral) could reverse trends in some beaten up areas which may turn into 2019 winners. We are paying careful attention to USD credit of a number of emerging market issuers, as well as the credit of non-oil commodity producers and related shipping companies. If higher US dollar rates have hurt this part of the market, could lower rates help spur a revival? We have small toe-holds in these areas, waiting for confirmation of more robust fundamentals to expand position weights.

New Positions

Getting back to the opportunity we see in US residential real estate, in November we added a position in the 1.5% 2023 convertible notes of Zillow Group priced in the mid 80's. Zillow is the leader in online real estate information and home brokerage data, an area we expect to have secular growth within the real estate market. Zillow has a strong credit profile with less than $700M of debt sitting atop a $6B market capitalization and a net cash balance sheet. We estimate Zillow's 1 year default probability at less than 0.06%. Though busted, a four year conversion window provides further theoretical upside to a 5% yield.

Also in the US housing sector we invested in the senior unsecured bonds of Atlanta-based Beazer Homes. We previously owned Beazer bonds in 2016 and 2017 and are comfortable with the asset-rich profile of this homebuilder. Cash, finished inventory, land and other hard assets comfortably cover Beazer's issued debt in our view. Yield on Beazer debt was acquired in the range of 9% against estimated default probability of less than 1%.

In the past we have held 5-year rate reset preferred shares in the Canadian market. In November, we returned to a constructive stance in this area and began adding smaller positions in a number of heavily discounted reset issues. Issuers we added in November include Fairfax and Brookfield Office Properties.

Fund Positioning

The Fund yield to maturity at November 30 was 5.3% with current yield of 4.6% and average duration of maturity-based instruments of 2.5 years. There is a 1.5% weight in distressed securities purchased for workout value whose notional yield is not included in the foregoing calculation. Cash represented 2.8% of the total portfolio at November 30.

Geoff Castle
December 5, 2018

[1] *F Class*

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

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