PENDER
CORPORATE BOND FUND

THE MANAGER'S MONTHLY COMMENTARY – JANUARY 2019

The Pender Corporate Bond Fund returned 1.1% in January, and, in so doing, recovered fully from the small drawdown we experienced in the last part of 2018.

Leading the gains in the Fund was our position in US municipal bond closed-end funds, which rose strongly in the month. We also saw strength in some of the investment grade corporate issuers that we own, such as McDonalds and Pepsico as high-grade corporate spreads tightened. Some high yield issues also did well, including our positions in bonds issued by US homebuilders Beazer Homes and LGI Homes. A stronger oil market also helped drive gains in our W&T Offshore notes. Finally, confidence in Just Energy rebounded and the company's convertible bonds gained several points.

Offsetting the strength above, we saw a number of weaker marks in high yield credits, particularly in cases where the company in question was facing specific challenges. Negative contributors included our position in Dean Foods 2023 notes as investors reacted to a covenant waiver provided by senior lenders to give the company time to complete its plant rationalization activities. Navios Maritime bonds were also weaker. We continue to like the risk/reward proposition in these cases but note that the rebound in high yield index sentiment that we saw in January has not yet reached every far-flung corner of credit markets.

The Environment: Evidence of Slowing and the End of Tightening

Over the past couple of years, we have been inhabiting a world of tighter monetary conditions. The Bank of Canada and the United States Federal Reserve, amongst other central banks, were actively leaning against the economic expansion. We saw central bankers raise short term interest rates and do other things, such as tighten the availability of government insured mortgages or unwind balance sheet bond purchases, all of which are having the effect of making credit somewhat harder to get.

In 2018 we began to see the effects of this tightening activity show up in terms of slower growth in certain parts of the world and rising risk premiums, driven in some cases to extraordinary heights by trend-amplifying short-sellers. Early in 2019 even more of these effects are becoming evident. The Baltic Dry Index of shipping prices has fallen sharply. Here at home, weakening residential real estate markets have crunched the most indebted mortgagees, and in the United States consumer confidence readings took a sharp decline.

That is the history. But we care about the future, which looks a little more benign. With the Bank of Canada now in "data dependent" mode and the Powell Fed (as of its January 30 meeting) firmly on the sidelines in terms of future rate hikes, a lot of the pressure on credit markets has been relieved. Of course, popped manias will not necessarily spring back to life, but we are becoming increasingly constructive towards well-covered credit of issuers with reasonably good collateral value relative to debt outstanding. After a rather stormy night, we draw open the blinds and see the glimmering of a new dawn.

Diamonds in the Rough

In this market context we believe there is extra value to be found in select turnaround situations and other "diamonds in the rough." These are situations where current profitability may have evaporated for the issuer, but long-term productive assets exist in such copious quantities that management has a lot of room to raise capital or to re-assure investors in a way that is positive for bondholders. Two examples of this kind of name in the portfolio are Dean Foods and PHI Inc.

In the case of Dean Foods, we consider the potential for America's largest milk processor to right-size its capacity and sell non-core assets to be realistic. Dean Foods is suffering from two problems, the first of which is a slowly dwindling end-demand for milk and milk products, exacerbated by excess industry capacity including a recent new plant established by one important milk retailer entering the processing business. As difficult as current conditions appear, we believe that asset rich Dean Foods has the capacity to reduce its current 59 plant base to a level where supply and demand are in a closer balance. Excess cash raised from property disposal can also help to pay down debt. Starting with over $2.4 billion in assets and approximately $900 million in debt, we think Dean Foods bonds at 77c are sufficiently backstopped despite currently spotty operating earnings.

PHII Inc. is an owner-operator of heavy-duty helicopters that largely support offshore oil development. In the currently soft oil market, demand for PHII's helicopters has dwindled significantly. Although demand had been recovering somewhat since the oil crash of 2015-16, cash operating profit at PHII is not enough to cover fully the company's interest payments. However, we consider PHII's debt to be more than 2x covered by helicopter asset value. The company has only three major competitors in the Gulf of Mexico and so we believe that sooner or later competitor consolidation, or co-operation, can bring prices back in line with the level of profitability required to service debt. Add to that a gently rebounding market for deepwater oil development as demonstrated in 2019 producer budgets and we are cautiously optimistic that the bonds recently trading in the high 60's have a strong recovery or refinance value, despite the impending March 2019 maturity.

New Positions

In January we added several new positions to the Fund. Looking primarily in the area of performing credits with a high yield in comparison to the issuer's default probability, we added the unsecured obligations of US toymaker Mattel Inc. Mattel's last year has been difficult as it lost some money in the Toys R Us bankruptcy and has faced headwinds in various product lines including American Girl, while stalwart lines such as Barbie and Hot Wheels have been steady but unspectacular. With notes yielding above 7% and a 1-year issuer default probability that we estimate below 0.7%, we consider credit of free cash flow positive Mattel to offer good risk/reward.

We also built a position in Venator, one of the world's leading producers of titanium dioxide, which is a critical ingredient in some white coloured paints and coatings. Venator has stumbled recently on softer market pricing and a plant fire which, although covered by insurance, did impact production capacity. With over 8x trailing interest coverage we consider the 10% yielding notes good value, given a 1 year default probability we estimate at less than 0.7%.

Fund Positioning

The Fund yield to maturity at January 31 was 5.5% with current yield of 4.7% and average duration of maturity-based instruments of 2.2 years. There is a 2.3% weight in distressed securities purchased for workout value whose notional yield is not included in the foregoing calculation. Cash represented 4.2% of the total portfolio at January 31.

Geoff Castle
February 6, 2019

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