PENDER
CORPORATE BOND FUND

THE MANAGER'S MONTHLY COMMENTARY – FEBRUARY 2019

The Pender Corporate Bond Fund returned 0.8% in February, amidst a positive backdrop of stronger market conditions.

Leading the gains in the Fund were two "busted" convertible bond positions. These included our position in Zillow's convertible debt which rallied on stronger earnings and outlook from the real estate data company. GoPro convertible bonds also performed well on good earnings and strength in the underlying share price. Further strength came from our position in Venator bonds as the company reported stronger than expected cash generation. Finally, our weight in closed-end US municipal bond funds continued to contribute to performance, with some of those positions now ahead over 8% year to date.

Offsetting the strength above were some notable areas of weakness. Canadian rate reset preferred shares were weak in February, and we added more on the weakness. Other challenging positions included Dean Foods, which disappointed some analysts on earnings, and Aceto Corp, which filed for Chapter 11 protection in conjunction with an announced $338 million sale of one of the company's key operating divisions. We bought more Aceto notes as we believe the ultimate disposition of the company's assets could result in recoveries close to or exceeding par value of all debt, while the notes currently trade around 47% of that value.

A Plunge and then a Surge – Staying Moderate in a Period of Extremes

So far in 2019, in an almost mirror image of the panic of the last quarter of 2018, credit and risk capital markets in general have been very strong. In credit, a large rally in BB bonds has powered a High Yield Index return of more than 5% year-to-date.

Alongside the swing in index performance we note large changes in short positions in the largest high yield exchange traded funds. HYG and JNK, the two large High Yield ETFs both touched record short positions during the 4th quarter of 2018. Since then, more than $4 billion of short covering has reverted these short positions to more average levels. And this trading volume, possibly occurring alongside other similar trades by index-tracking participants, may have been behind the large moves we saw in some index-type names that we held. We took advantage of the opportunity from the price surge to exit positions in Netflix and Tesla bonds which had appreciated quickly.

With the move in prices, high yield credit spreads have receded somewhat, moving down from over 530 basis points over Treasuries at year-end to slightly less than 400 bps at the end of February. And so market yields rather quickly moved from an average risk pricing environment back to a below average risk price environment. Our own positioning, which currently involves holding more governments and investment grade bonds than our "normal" stance, didn't really change much in all of this. On the margin, we were able to add some risk at the cheaper points and trim back at the dearer points, but these successes were fairly small within the context of the Fund. Mostly, we just held.

Buy on Mystery – Sell on History

We sometimes put into practice one of the old traders' aphorisms, "Buy on mystery, sell on history". In theory, we find markets underpay in situations of uncertainty and perhaps overpay in situations where all substantial doubts regarding outcomes have been resolved.

One recent case in point was the situation involving the preferred shares of Canadian loyalty program operator, Aimia Inc. In the summer of 2017, Aimia received notice from its main airline partner, Air Canada, that its contract to operate the popular Aeroplan points program was being discontinued in 2020. Our calculations suggested to us that not only was the likely liquidation value of Aimia's assets worth more than all the debt, but that, under even fairly pessimistic assumptions, the liquidation value covered the preferred stock of Aimia as well. Indeed, we believed the coverage was enough to provide substantial room for error. The complication was that no one knew how or when the planned liquidation of assets would occur. A "buy on mystery" was required.

It was in this spirit that we accumulated over $4 million in face value of Aimia preferred shares, which at the time had dividends suspended and, as a consequence, were trading at less than half of their $25 par value. We waited for the planned liquidations to be effected and then, last month, we celebrated the press release heralding the re-establishment of dividends from Aimia. Ultimately, we were able to dispose of our entire stake for a gain of more than 100% from our cost in 2017. "Sold on history".

New Positions

During February we added a position in the 2nd lien 4 7/8 2025 notes of consumer staples player Kraft Heinz. Kraft Heinz, which most of us know for products like ketchup and peanut butter, has been under fire recently as the company missed estimates, slashed its common dividend and disclosed an SEC investigation into its accounting practices. Despite these issues, our take-up of these notes hardly resembles bravery as they represent the top 1/50th of the traded capital structure of the consumer products company. Trading as they were, at a yield of approximately 4.5%, we felt the Kraft Heinz 2nd liens were offering interesting extra yield within the context of extremely low risk to our capital. While we do not view the challenges the company faces as trivial, we believe these issues do not come close to reaching the 2nd liens of 2025.

Within the more adventurous part of the Fund, we also re-established a position in the 2023 6.125% bonds of US drug store retailer Rite Aid Inc. We owned this same bond issue in late 2017 and 2018, selling upon the announcement of a sale to Albertsons which caused the bonds to trade close to their make-whole premium for a while. As it turned out, the Albertsons deal fell through and the 6.5s of 2023 were recently available (again) to buy in the mid 80s. Since 2017, we observe that the trading performance of Rite Aid has actually improved, powered by strong performance in the company's online prescription filling offering. We believe management is resolutely focused on effecting dispositions of the company's assets and we are confident that there is enough value in Rite Aid assets to cover the full extent of this obligation.

Fund Positioning

The Fund yield to maturity at February 28 was 5.0% with current yield of 4.6% and average duration of maturity-based instruments of 2.8 years. There is a 1.9% weight in distressed securities purchased for workout value whose notional yield is not included in the foregoing calculation. Cash represented 5.2% of the total portfolio at February 28.

Geoff Castle
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