

PENDER

SMALL CAP OPPORTUNITIES FUND

MANAGER'S COMMENTARY – Q1 2019 – DAVID BARR

Fellow Unitholders,

In our last commentary, we started by being thankful that 2018 was in the rear-view mirror and we were looking forward to 2019. It turns out that forces beyond our control have conspired to make us all feel better about the world today. Better, but not great. Speaking with investors over the past few weeks, we have found a high degree of residual caution. More than once we have heard, “stocks have rallied so quickly, we’re worried about a sell off”. Well, as the saying goes, “there is nothing as bullish as a bull market full of bears”.

While markets have bounced back to start the year and indexes are at, or near, all time highs, the Pender Small Cap Opportunities Fund and Pender Value Fund have bounced back nicely. Headline grabbing talking points capture the performance of only a handful of companies and we continue to look for, and find, opportunities outside of this hyped-up universe. The Russell 2000 was up only 3.2% over the last 12 months, trailing the 9.8% gain in the larger cap S&P 500. Canada didn’t fair any better with the TSX up 5.8% and TSX Small Cap down 3.3% over this period (ending March 29, 2019). That being said, the sell off in Q4 presented us with many [“tide goes out”](#) opportunities and we are still closer to this environment for small cap stocks than a [“needle in the haystack”](#) climate.

Our current conviction level stems from two key characteristics of our portfolios, value and quality.

Value: As mentioned above, we still view valuations in the portfolio favourably. This can help set the portfolio up nicely as companies that are undervalued today can become fairly valued tomorrow. We have witnessed this in our positions in Espial and BSM as both companies announced they were being acquired in Q1.

Quality: Quality is the key driver for “long term” performance, as share prices over the long term tend to track the returns from the underlying business. Last year we were able to rotate our portfolios into higher quality companies, what we call [“compounders”](#), as well as other growing small cap companies or “emerging compounders” where there is still a higher level of uncertainty than more proven companies. It is a wonderful thing when both factors play out in your favour!

As mentioned above, two of our longer held small cap positions announced they were to be acquired in the quarter. A key part of the Pender process is developing outcome scenarios for the companies we invest in. With these two companies, we had developed three different scenarios, a base case, a bull case and a bear case. In general, our base case is our view on private market value today, the bull case is if the company executes and delivers on their plan and the bear case is effectively a distressed or liquidation sale. Unfortunately, neither of these companies delivered on the bull case. In the event one was close to our base case and one was close to our bear case. Given we made a positive return on one and lost money on the other I’ll leave the industrious analysts out there to figure out which one is which.

The point to highlight is that a key part of our process is less about what happens when things go right and more about when things go wrong. I will generalize for the entire portfolio here, but when companies deliver on plan, either the market recognizes it, or another company does, and you should be able to generate a return. This was certainly the case for our investment in Solium, another company

that announced it was being acquired in the quarter. In this case, it is sad to see the company go, as we were hoping to participate in the growth of the business for years to come! The harder part is when things don't materialize according to the bull case. You may have heard us refer to this as our thesis being "impaired". When this happens, it is important to scramble out as fast as you can. Sometimes you sell your stock in the market, and sometimes the company gets sold.

David Barr

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