PENDER
CORPORATE BOND FUND

THE MANAGER'S MONTHLY COMMENTARY – SEPTEMBER 2018

The Pender Corporate Bond Fund returned -0.1%[1] in September. While increasing investor risk appetites were positive for credit in general, rising yields across the curve in both Canada and the United States were enough to cause price bond price declines in our holdings that marginally exceeded coupon income earned for the month.

On a credit-by-credit basis, the Fund experienced strength in SunPower Corp, where a positive ruling related to a United States tariff exemption led to a rally in our convertible note holdings. The successful refinancing agreement announced by Just Energy Group Inc also contributed positively as our holdings rallied. Some weaker credit positions included Aceto Corp, where the company's quarterly earnings missed some estimates and Twitter, where equity reaction to a security breach impacted convertible prices.

Signs of the Times…Quality Bonds are Hated and Risk Assets are Popular

Since we initiated our management of this mandate a little over three years ago, we have observed a striking change in market sentiment with respect to bonds and high yield credit. It was not that long ago that Germany's 10 year bonds were priced to deliver a negative yield and markets expected negative yields would spread all over the world. In fact 2015-16 might be remembered as the height of risk free asset "mania". But on the flip side, in 2016 investors in high yield bonds demanded a massive premium of more than 850 basis points over treasuries.

Returning to our current environment, a time traveller from 2016 might be shocked to find that high yield credit spreads have collapsed to the lowest level since 2007. Investment account cash positions are at the lowest level since before the financial crisis. Sentiment surveys indicate investors are more negative on government bonds than at any point in the last decade. Indeed, speculative futures contract volumes suggest a record level of bearish bets on US 10 year treasuries. In a nutshell, few are worried about credit and many expect risk free rates to rise. We don't know the future. But, given the extremes of sentiment, we raise the possibility that the "crowd" might, again, be wrong.

Our strategy in this environment has been to add significant weight to risk free credit, with Government of Canada Bonds now representing almost 8% of the Fund. Beyond the sovereign positions, we have focused on safety, adding weight to senior bonds and to bonds of issuers with very low default probability. All this being said, we remain open to well-covered, higher yielding credit where we see a clear path to repayment.

How long the current market dynamics stay in place, we have no idea. But we remain at a high level of preparedness for less hospitable market conditions.

New Positions…Tesla and Others

In September we added to our position in the credit of Just Energy Group, extending our holdings beyond the July 2019 maturity to the 2021 and 2023 convertible notes. We were pleased with the company's announcement of a new credit facility from well-respected Sagard Capital, which establishes a clear path to repayment for the 2019 notes. We were also pleased with the progress the company has made in increasing its gross margins through successful price increase initiatives. We are very positive on the whole Just Energy Capital structure and note that our combined weight in this issuer exceeds 3% of the Fund.

Also in September we added a position in the 7.5% 2021 2nd Lien notes of Century Aluminum, priced to yield over 6%. Century Aluminum is a refiner of primary aluminum products, with predominantly US-based production. We believe the earnings profile of Century will improve with the restarting of previously shutdown capacity. The company is a beneficiary of increasingly protective trade measures in the United States which add further tailwinds. The company has equity market capitalization over $1 Billion and cash balances of over $120 Million, compared to debt of $250 Million. Trailing twelve month interest coverage by EBIT was approximately four times and we estimate one year default probability at below 0.5%. All factors considered, we consider Century an attractive risk/reward situation.

We also initiated a position in the 5.3% 2025 notes of Tesla Inc, which fell in price to the mid 80s in the month of September. Tesla's business is sometimes overshadowed by the antics of its often-controversial Chief Executive, Elon Musk. Tesla has created a very valuable brand and suite of products in the electric car business, and with or without Elon Musk, would be a very attractive acquisition candidate for a number of global automakers who lack such an offering. We believe the company's equity capitalization of more than $50 Billion is too high, but that ultimately a take-out is likely at some price much higher than the current Tesla full-recourse debt levels of $6.5 Billion. The security we own, a $1.97 Billion senior unsecured bond, carries a par change-of-control covenant that provides an interesting degree of optionality for this note, yielding in excess of 8%.

These somewhat interesting and exciting positions discussed above were only part of the additions to the Fund in September as we continued to add weight in the 3- 4- and 5- year tenors of Government of Canada obligations. In an environment where it is not inconceivable that spreads against government benchmarks could rise, ownership of those same government benchmarks appears to deserve some increased weight.

Fund Positioning

The Fund yield to maturity at September 30 was 5.0% with current yield of 4.6% and average duration of maturity-based instruments of 2.3 years. There is a 2.1% weight in distressed securities purchased for workout value whose notional yield is not included in the foregoing calculation. Cash represented 5.1% of the total portfolio at September 30.

Geoff Castle
October 4, 2018

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