PENDER
CORPORATE BOND FUND

THE MANAGER'S MONTHLY COMMENTARY – MAY 2019

The Pender Corporate Bond Fund had a small loss of -0.2% in May. In the broader context, high yield was weaker and government bonds were stronger.

Strength in May came from our holdings in AAA positions including US and Canadian sovereigns, as well as our weighting in highly rated issuers such as Microsoft, McDonald's and CN Rail. Some credit positions fared well, including Dean Foods bonds which recovered several points on increasing investor confidence in the company's liquidity position. Our small position in the preferred shares of Fannie Mae rallied strongly as the White House announced as yet undefined plans to restructure that entity.

Offsetting the strength above, we experienced weakness in lower rated holdings with activities in resource or materials industries, such as metals producer Coeur Mining and Texas oil producer W&T Offshore. While by no means timely, this type of credit is becoming increasingly cheap, and we continue to focus due diligence efforts in such areas. The other source of weakness was in our fairly small weighting (approx. 4%) of rate reset preferred shares from issuers such as Bell Canada, Husky Energy and Brookfield Properties. The math behind the undervaluation of rate resets is very compelling here, although we have found arguing with a stampeding herd to have limited effect. Nevertheless, we added to these lines where we found pre- and estimated post- reset yields in the 6-7% range of issuers whose five-year bonds yield in the 2's and 3's.

Don't Stop Thinking About Tomorrow

There are a great many headline worries in the early summer of 2019. Start with a lack of consumer demand in many global markets and add to that inverted yield curves, chaotic political fights and even distant drums of war. And, beneath the headline earnings numbers, there are further issues that relate to rather high multiples in the market and the quality of earnings being reported. Were Marie Antoinette alive today she might have said, "Let them eat adjusted EBITDA."

With such ingredients, it is understandable to see volatility in the market. From the eye of the storm we are not surprised to see the sudden popularity of certain asset classes including treasuries and other low risk securities that deliver a consistent, low risk income stream. But this, too, shall pass. Our experience has been that our best purchases have been made in the midst of such storms, when the difference between a security being "no bid" and having any bid at all was just little old us.

Putting our "tomorrow" hat on, government rates will one day not be in freefall. On that day, the panicked investors of mid 2019 will be contemplating the thin gruel of 1-handle yields. What we may be looking for tomorrow is exposure to the relatively few commodity producers that invested in production capacity when it was difficult and expensive to finance projects. What we may be looking for tomorrow is drug companies that were able to develop and produce the next generation of therapies with new 14-year patent runways. And what we may be looking for tomorrow is securities that protect us from drawdowns related to rising interest rates. No investor will miss owning these today. But tomorrow is another day.

In approaching the less well bid parts of the credit market today, we give much thought to the staying power of cyclically exposed issuers. We look for robust balance sheets that give issuers the flexibility to manage through periods of closed "refi" windows. We look for surplus assets, things to sell in a pinch… of course in combination with great credit yields and strong mid-cycle profitability levels that can comfortably support debt.

New Positions

During May we initiated a position in the debt of copper producer **First Quantum**. We are starting to become more positively inclined towards the copper business, which, in the event that end demand stays near current levels, may be in structural production deficit in the near future (i.e. mine production may not keep pace with end demand). First Quantum faces some uncertainty related to the start up of their Panamanian mine, as well as heightened political risk in Zambia, the home of their largest operation. First Quantum 2026 notes priced in the mid-80s have a greater than 10% yield, which we view as attractive relative to a default probability we estimate at slightly more than 1% on a 1 year basis.

April also saw us initiate a position in the convertible bonds of **Avadel Pharmaceuticals PLC**, which trade at approximately 45c per dollar of face value. Avadel is in the late stages of developing a drug in the sleep apnea market that would materially improve outcomes for patients currently taking Jazz Pharmaceuticals' blockbuster drug Xyrem. We believe Avadel's chances of realizing value in this market are relatively good. With current Avadel cash balances being greater than the market value of the company's debt and, with the company being a potential M&A target, we view this position as a relatively strong risk/reward proposition.

We also made significant additions to our holdings of the preferred shares of **Husky Energy**. We consider Husky, a smaller integrated oil and gas player, to be materially misunderstood by the market. Although the company's upstream operations in the Canadian prairies are subject to the famous price discount that has become a recent "cause célèbre" in Canadian political circles, investors miss the degree to which Husky's downstream operations, such as its refineries, benefit from low input costs from these areas. Husky is a strongly cash generative producer at much lower oil prices than those currently prevailing and its very strong balance sheet provides ample capacity to support fixed charges. With various preferred share series yielding well over 6%, even considering lower future resets, we like the combination of junk-type coupons and investment grade credit fundamentals that Husky preferreds represent.

Fund Positioning

The Fund yield to maturity at May 31 was 5.0% with current yield of 4.7% and average duration of maturity-based instruments of 2.5 years. There is a 4.8% weight in distressed securities purchased for workout value whose notional yield is not included in the foregoing calculation. Cash represented 1.0% of the total portfolio at May 31.

Geoff Castle
June 5, 2019

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

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PenderFund Capital Management Ltd.

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