PENDER
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MANAGER'S COMMENTARY – Q1 2017 – DAVID BARR

Fellow Unitholders,

When talking to investors today, the questions we hear quite frequently revolve around one central theme - are markets expensive? We spend the majority of our time trying to figure out if an individual company is trading at a good price and, while our team has grown over the years, we still don't have the resources to have an opinion on every stock and hence the "market" as a whole.

That being said, major indices have done well since the financial crisis and as they continue to push forward, we definitely see industry sectors where we are uncomfortable with current valuations, as well as individual securities that we wouldn't touch with a ten-foot pole. When we look at it probabilistically, we can see scenarios where stocks continue to increase in value and scenarios where stock prices fall. At this point in time, we believe that the probability of a downturn in the market warrants a more conservative approach to allocating capital in our portfolios.

Which brings us to what we are doing in the portfolios. We have been building up cash. Either from the outright sale of companies that are fully valued or from decreasing the position size of companies that are approaching our estimate of intrinsic value.

It's great having cash on hand when the companies we want to own go on sale, and historically we have bought very aggressively when presented with such opportunities. August 2011 and from late 2015 to early 2016 are two good examples. Cash also serves us nicely to protect on the downside if markets do enter a downturn.

The opportunity cost we are always faced with is if markets continue to march forward the cash will act as a drag on the portfolio. This is particularly relevant today, so some discussion on how we view this is poignant.

First, our invested portfolio is in companies that are trading at a significant discount to their intrinsic value. Our job is to find 20-40 companies that we believe will produce a strong risk-adjusted IRR for the portfolio. If we had to buy 300 stocks we would be worried, but finding 20-40 is achievable in almost any market environment. With a large enough embedded IRR in the invested portion of the portfolio, we seek to at least keep up with market indices over the long term.

Second, as cash builds then we get more active on the special situations or "close-the-discount" side of the portfolio. When companies announce corporate events like a merger/acquisition, spin out or strategic review, there can be an opportunity to deploy capital for a defined time frame at an attractive IRR. The additional benefit is that these opportunities tend to have very low market correlation, so if we do have a market downturn, the capital can be moved quickly into a higher return, long term opportunity.

Just like planning for a long weekend in Vancouver, we are prepared for rain but hoping for sunshine.

David Barr
May 1, 2017

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