PENDER
CORPORATE BOND FUND

THE MANAGER'S MONTHLY COMMENTARY – AUGUST 2018

The Pender Corporate Bond Fund returned 0.5% in August, a result slightly above the run-rate securities yield. Strong performers for the Fund in August included Aimia preferred shares, which rallied on the sale of that company's Aeroplan business back to Air Canada; a profitable trade in Aurora Cannabis debentures; and strength in Energy Fuels debentures that rallied on increasing uranium market optimism. The gains above were offset, to a degree, by lower marks in bonds of Global Brokerage and Eldorado Gold, although all these impacts, both positive and negative, were rather small.

The corporate credit market overall was relatively stable in August. Credit spreads maintained their current historically tight levels, and the benchmark government interest rates declined slightly both in the US and Canada. As we pass the three year anniversary of taking over the reins of this Fund, we remark upon how extraordinarily calm the current credit environment is now in comparison to the third quarter market of 2015. Perhaps stormier weather lies ahead.

Strategies in Credit and Factors that Drive Success…Value and Safety

While our colleagues on the equity side of this house have written very good pieces about "predictive attributes"[1] in the stock market (that is, measurable factors that can, predictably, identify a higher probability of market outperformance), there are similarly powerful factors that have been demonstrated to drive outperformance in credit. Whereas last month we covered the ground related to expected full-cycle total returns from the various tiers of the credit market (spoiler alert – taking credit risk pays over a full cycle), this month we wanted to highlight the wisdom of using various security selection strategies. What strategies or styles are most related to success in credit?

In this area, we are indebted to a good, recently published study by Ronen Israel and two colleagues in the Journal of Investment Management[2]. Israel et al looked at almost two decades worth of US corporate bond market data. They determined that a strategy by which credit investors chose bonds with the highest spread ***relative to the issuer's default probability*** was a significantly more effective strategy than any of the others they analyzed. They called this style, for shorthand, a ***"value"*** approach. And the researchers suggest that a mechanical application of a value approach in credit over the years 1997-2015 delivered over 1% incremental total return in comparison to the credit index generally, considering all coupons, credit costs and other factors. Followers of this monthly letter will recognize the value approach in our regular emphasis of seeking very high levels of return ***per unit of default probability***.

The whole study bears a reading, in our opinion, and we refer all curious readers to the note referenced in the footer. It is also worth noting that the second most successful approach the researchers studied was a strategy that invested chiefly in very well covered credits that were near to maturity, a strategy for which the authors used the shorthand description of ***"safety"***. To the extent that we have pulled back slightly from value-type credit positions this year, we have done so in order to increase our weightings in what is in our opinion, the safest spectrum of corporate credits.

A simple stress-test we do to measure ***safety*** in the holdings in our Fund is to perform a quick "divide by two" calculation on Fund holdings. The test assumes that the market wakes up tomorrow morning and decides to cut the value of the entire "capital stack" of our issuers (that is the market value of all debt plus all equity value) to 50% of the current trading level. In that event, our corporate credit positions are weighted approximately 92% in securities that would experience no principal impairment in liquidation by a 50% total business valuation cut. When we do the same analysis on the 70 largest high yield index components that are related to a publicly listed equity, only 52% would survive the stress test without impairment on liquidation. Put simply, we have more equity buffer underpinning our positions than the index has.

New Positions … and a Smokin' Trade

In August, we initiated a position in the front-end senior unsecured notes of Parkland Fuels (PKI CN Equity) maturing in 2021 and 2022 respectively. Parkland is a distributor and refiner of gasoline in Western Canada and the United States, including the British Columbia Chevron retail business. While we expect gasoline retail to decline eventually, the state of the electric car industry is not so well developed for us to expect the company's operations to deteriorate materially over the next four years. The company has recently shown determined efforts towards reducing its debt load and the most recent quarter showed the company generating $6.97 of EBITDA for each dollar of interest. Using a default probability model, we estimate the 1 year default probability for Parkland at less than 0.01%, which makes these bonds, yielding between 4% and 5%, relatively attractive.

Another new position was initiated in the first lien 3.4% 2021 notes of CF Industries, purchased below par to yield approximately 4%. CF Industries is a major North American producer of fertilizer, with particular strength in nitrogen-based fertilizers that are used in the production of many field crops. The 2021 first lien notes form part of the $1.2 billion of first lien obligations that sit atop CF Industries' $12 billion capital stack of face-value debt and equity market capitalization. First lien debt at CF is roughly two times trailing twelve months free cash flow. We consider these notes to be comparatively safe, relative to other credits of a similar duration and yield.

We also added a bit of weight in the lower risk area of the Fund, expanding our nearer term Government of Canada positions to a total in excess of 6% weight. AAA-rated City of Vancouver bonds also were added to a weighting between 1% and 2%.

August brought us, for the first time, into a position in the marijuana industry. In the middle of the month we bought somewhat more than $2 million face value of January 2020 5% convertible notes issued by Aurora Cannabis at a level just above 95% of face value to yield slightly less than 9%. Originally intended to be part of a larger position, our thesis was based primarily on the juxtaposition of Aurora's massive $7 billion market capitalization in comparison to its small $250 million debt load. Our calculation was that it would take almost superhuman efforts at value destruction on the part of management to eliminate over 95% of this company's enterprise value in less than eighteen months. As it turned out, we didn't have to wait. We ended up selling to a 101.5 bid less than two weeks later for a gain of more than 6%. It was a small 'win' in the scheme of things, and evidence that it pays to keep an eye on some inefficient markets populated by participants who do not do meticulous analysis.

Fund Positioning

The Fund yield to maturity at August 31, was 5.1% with current yield of 4.7% and average duration of maturity-based instruments of 2.3 years. There is a 2.3% weight in distressed securities purchased for workout value whose notional yield is not included in the foregoing calculation. Cash represented 4.3% of the total portfolio at August 31.

Geoff Castle
September 5, 2018

[1] Manager's Quarterly Commentary – Felix Narhi, June 19, 2018

[2] Israel, Palhares, Richardson, "Common Factors in Corporate Bond Returns," ***Journal of Investment Management*** Vol 16, No. 2, (2018)

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