PENDER

CORPORATE BOND FUND

THE MANAGER'S MONTHLY COMMENTARY – DECEMBER 2017

The Pender Corporate Bond Fund returned 0.5% in December and 7.8% for 2017. While there are always a few missed opportunities, we are generally pleased with how the year turned out. The Fund enjoyed another strong year of above benchmark returns with comparatively little volatility.

Leading performers for the Fund in December included our position in Global Brokerage Inc, where a debt exchange deal agreed between the issuer and noteholders drove a 10% increase in the value of our holding. Also performing were Sherritt International, whose 2025 bonds rallied 7% on strong prospects for cobalt producers, and Moduslink Global Solutions, where an acquisition boosted convertible note values. Offsetting these gains, to a degree, was weakness in a few investment grade securities that reacted to a back-up in government bond yields.

2018 Outlook

As we turn our thoughts to 2018, we consider a mix of factors, some which seem to encourage caution, while others that support a more constructive view towards taking credit risk.

By far the most important factors we consider in the credit market environment at the moment are that credit spreads are relatively low and business enterprise valuation multiples are relatively high. Experience has taught us to be careful in such circumstances.

Offsetting positive factors appear to be that some economic leading indicators are quite strong, and that certain central banks continue to support credit markets with purchases of securities made with freshly created cash. So there may be some durability to high multiples and low spreads. However, given the overall expensive picture in high yield credit, we continue to adopt a somewhat cautious positioning.

2018 Positioning

Our general strategy for approaching 2018 markets has three main components. To start, there is defense. Defense in the Fund is ensuring that as many of the positions as possible sit atop deep buffers of equity cushioning, junior security valuation and cash…anything that can shield our position from losses in the event that market conditions turn against us. Our preferred way of measuring this buffer is through default risk probability models. At year-end, over 60% of the total portfolio is comprised of securities from issuers whose Bloomberg one year default risk of less than 0.2%. Our weight in this lowest risk group has rarely been higher.

Our second focus for 2018 is tight duration. We are not entirely immune to the impact of rising interest rates, were that to occur, but at an effective duration of 2.6 years, we are amongst the least exposed portfolios in the "income" category.

The final leg of our strategy is to construct a portfolio with "room to run" on the upside. We achieve this in a few different ways. One way we do this is through ownership of several convertible bonds which are within reasonable striking distance from profitable equity conversion. We generally buy convertibles "busted" – typically where the related equity has fallen far enough below the conversion price that the convert price has drifted below par. However, if company fortunes later improve, the convertible option may regain its value, and a rather boring "busted" yield proposition becomes a more exciting conversion play.

We have other ways of creating "room to run" upside. We also own a few distressed bonds, purchased at a significant haircut from their full par value, in situations where we estimate that recovery value is materially higher than the trading price. In addition, we own some closed end funds which hold bonds we might otherwise hold directly in the Fund, but which trade at a meaningful double-digit discounts to daily-reported net asset value. Finally, we hold a number of discounted preferred shares, which trade well below their $25 par value due to unfavourable rate resets that occurred in the past.

Although many of the securities in the "room to run" category have the cash and equity buffers that make them wonderful defensive picks, they also provide critical upside optionality to our Fund. Across the Fund, we believe that almost 50% of the holdings weight has the potential, under the right circumstances, to return more than 10% in 2018.

Positions That Can "Move the Needle"

While we have an overall plan, we find our best decisions are usually made despite our strategy, rather than because of it. That is to say, our one-by-one credit work on individual securities has generally been far more profitable and effective for us than our ability to make an overall market call. Below we highlight a few positions that we believe offer superior value in the current market context.

Just Energy 6.5% notes due July 2019. Sitting atop the hierarchy of Mississauga-based Just Energy's drawn capital structure, these convertible notes offer points of extra yield for no particularly good credit reason. Credit investors, in our view, have ignored the enormous liquidation value in Just Energy, which makes money by capturing the wide spread between wholesale and retail energy prices. With well over $1B in "embedded gross margin," which is effectively the gross margin dollars of existing contracts with customers, the worst-case wind-down of Just Energy still provides more than five times coverage of this USD$150 million obligation. Not that wind-down appears likely, as we believe management's efforts to grow margins and sales will bear fruit. Currently priced to yield more than 7% to their 2019 maturity, we think the return potential of these notes is excellent in the context of fairly immaterial credit risk.

KeyW Holding 2.5% notes due July 2019. Similarly short-duration KeyW convertible notes are trading at too low a level, in our view, given the stable and growing earnings profile of this issuer. KeyW delivers critical defense and security-related IT consulting services to agencies of the United States government. With market expectations for cash earnings currently lower than the level the company considers its hard book of contracted 2018 business, we see significant upside surprise potential KeyW in 2018 as any new contract wins should cause market participants to raise projections. Added with a yield of approximately 10% to 2019 par maturity, the convertible notes also offer potential further upside in the event the equity regains its highs of 2016.

Bell Canada Series J preferred shares. We like Canadian prime rate floaters as a class, because we consider them cheap in comparison to the short-term CAD corporate bond curve. The BCE "J's" are particularly so, yielding over 4.0% on a current dividend basis or more than 5.2% on a tax-adjusted basis. That is well ahead of the 1.75% yield of the BCE "front end" bonds maturing in 2018. Over time, we expect the gap between the BCE floaters and short term credit to close in a manner that enhances the price of the preferreds. Currently trading at $19.85/share, we can certainly imagine a market that would trade the BCE J's at par and still consider them to offer superior value to the company's short term bonds. With one year default probability of the issuer of less than 0.01% we are highly comfortable with both the issuer and the position.

Fund Positioning

The Fund yield to maturity at December 31 was 5.1% with current yield of 4.5% and average duration of maturity-based instruments of 2.6years. 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 7.1% of the total portfolio at December 31.

Geoff Castle
January 3, 2018

For full standard performance information, please visit: http://www.penderfund.com/funds-and-performance

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