PENDER
CORPORATE BOND FUND

THE MANAGER'S MONTHLY COMMENTARY – FEBRUARY 2018

The Pender Corporate Bond Fund returned 0.5% in February, not a large gain but, within the context of generally weak market conditions, an acceptable result.

Strong performers for the Fund in February included our position in the distressed General Obligation bonds of Puerto Rico which rallied on investors' more positive view as the island's recovery and debt restructuring efforts showed progress. Our position in Rite Aid 2023 bonds rallied over 10% on the news of that company's merger with Albertson's, an event that triggers a work-out of this issue at (or above) 101% of face value. In addition, our position in the 2019 convertible notes of Synchronoss Technologies rose strongly on news of a credit-positive equity financing, combined with that company's progress in addressing corporate reporting issues. Our interest in post-petition claims of Samson Resources also rallied on expectations of higher recovery from legal claims.

The gains above were offset to a degree by some weakness in investment grade credit and certain closed-end funds.

Market Turbulence and a Test of our Defense

As we discussed at length in our commentaries of October, November and December, the market's tight credit spreads and high valuations had caused this Fund to take a more defensive positioning than we had adopted in prior periods, with increased weight in high quality bonds while maintaining short duration.

The late-January to early-February volatility episode provided the first opportunity in some time to test our durability under the stress of negative market conditions. Between January 26th and February 8th, the S&P 500 fell by over 10% and the TSX index declined by more than 7%. Bonds were also impacted. The North American high yield indices declined by approximately 2.5% in that period and the Canadian bond universe index declined approximately 1.0%. In this context, the Fund's performance in this two week period, a drawdown of 0.3%, was comparatively tame. And from the end of that shock through to the end of the month, the Fund recovered to fresh highs. We remain vigilant towards the potential risks in the market, but we were pleased with the success of our defensive positioning this month.

The Term Premium Awakens?

In the last few years we have not only been operating in an environment of low interest rates, but also in an environment of low term premiums. In other words, while short term yields have been historically low, long-term bond yields have only been slightly higher. Adjusted for the price volatility effect, longer term government bonds have actually had a negative term premium – long bond investors have received no real compensation at all for locking in for 10+ years. What we have begun to see lately is a reversal of this term premium, with the term premium on a ten year zero coupon US Treasury moving from -0.7% in 2016 to a level that approaches zero today.

There are many implications of a rising term premium. In steady state, higher term premiums make investing in longer duration bonds relatively more profitable than investing in short term bonds. But while the term premium is rising, short duration is the best place to be. Importantly, rising term premiums also raise every firm's cost of capital, a critical factor in valuing businesses. The higher a company's cost of capital, the lower the value is that one can place on future cash flows, and therefore a company is simply "worth" less. As a shorthand, higher term premiums tend to drive lower prices on long bonds, lower multiples on equities and lower prices on other assets such as real estate.

We do not know how the future path of the term premium will develop. However we do know that term premiums rose aggressively to a peak of 4% at the beginning of the 1980's and then declined more or less steadily into a 2012 low at -0.8%. Since then the trend has been up. In our view, it seems prudent to be positioned constructively for potential further rises in the term premium, especially in a market where participants are, by and large, unprepared for such a move.

Buying the Sirens, Selling the Trumpets

Notwithstanding changes in the term premium, we expect that deeply undervalued securities will continue to work in any environment. And so we press on with buying at the sound of sirens and selling at the sound of trumpets. To this end, one significant purchase was in the 2019 and 2020 convertible bonds of Element Fleet Management Corp. Element Fleet had disappointed investors several times in the past months as the company failed to sell itself in a strategic review process, while also writing down certain non-core assets, losing two customers and firing its CEO. And it was this situation that left Element Fleet converts trading at more than 10% yield to near term maturity.

Looking past the recent issues, we like Element's strong market leading position in North American fleet management and its stable of large "blue chip" corporate customers. We also see significant support to our credit position in terms of almost $2B of equity market cap sitting beneath us in the capital structure. Furthermore, while the recent auction process did not result in the sale of the company, we note that in December the company did receive multiple preliminary bids from private equity players at a time when Element Fleet stock was more than twice as high as current levels.

In February, we also added a small weight in preferred shares of Aimia Inc. As we have noted in prior updates, we believe Aimia's 1st lien credit is covered several times over by workout value, and we now believe this "excess" asset coverage is more than enough to fully support the par value of Aimia's three preferred share series as well. Trading under half of their $25 par value, we find these attractive and consider scenarios where dividends are reinstated or the company is sold.

We also added to our holdings of US municipal bond closed-end funds, with the purchase of the Nuveen Maryland Quality Municipal Income Fund. US municipal bond closed-end funds appear to have overreacted to the recent back-up in rates and in February several were trading at an approximate 15% discount to daily calculated Net Asset Value. In the case of the Nuveen Maryland Fund, its February 15% discount represented one of the widest discounts in the 25 years of that fund's history, and much lower than the life-of-fund average discount of 2.2%. Closing even half the discount in the next year could yield a total return in excess of 12% in this position when combined with the 4.7% underlying cash flow.

We also added to our Maple bond positions in February with purchases of C$ issues from both Pepsico and Walt Disney. We believe the scarcity of high quality non-financial C$ credit is under-appreciated by the market, and the yields of 3% or greater in these issues are relatively attractive.

Fund Positioning

The Fund yield to maturity at February 28 was 5.7% with current yield of 4.8% and average duration of maturity-based instruments of 2.5 years. There is a 4.6% weight in distressed securities purchased for workout value whose notional yield is not included in the foregoing calculation. Cash represented 4.9% of the total portfolio at February 28.

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

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