PENDER
CORPORATE BOND FUND

THE MANAGER'S MONTHLY COMMENTARY – JANUARY 2018

The Pender Corporate Bond Fund returned 2.2% in January, a very strong result which was aided by a few key catalyst events that allowed us to overcome somewhat difficult credit market conditions.

Strong performers for the Fund in January included our position in the heavily discounted convertible notes of Primero Mining, which rallied towards par on a takeover. Inotek convertible notes also moved up strongly on the company's merger with Rocket Pharmaceuticals. Still more strength came from our positions in a number of floating rate Canadian preferred shares as this group rose sharply on a higher Bank of Canada overnight rate.

Offsetting the strong performance, to a small degree, was generally weaker pricing in investment grade bonds, particularly those of more than three years in duration.

Reaping the Fruits of Exuberance

Before getting to the drivers of January's performance, it bears noting that the emotional state of market participants in early 2018 is striking. We are old enough to remember markets that drove stocks "to the moon" on press releases announcing a name change to whatever-dot-com. We recall fondly the breathless neophyte of 1999 on the phone to their brokers bidding up JDS Uniphase – "I don't care what price it's at, just buy it!" Who would have thought we would see something like that again so quickly? Yet here we are. Between marijuana and crypto-currency promotions, the market appears to be creating billion dollar entities faster than snowflakes can fall from the prairie sky. Exciting? Absolutely. But this, too, shall pass.

The benefit to our portfolio this month has been that the market's exuberance has created lots of exit opportunities. Primero Mining, which we initiated last March at a price below 60c on the dollar, was able to sell itself to First Majestic, in a transaction that triggers the 100c put right on change of control. Inotek, which we initiated in July traded into the 90's from the 70's on the strength of the company's merger with an early stage gene therapy business. Novavax convertible bonds, which we considered to be fairly covered by balance sheet cash at 45c on the dollar, rallied strongly into the 70c range as a street broker raised their equity price target from $2.50/share to $10, facilitating an "at-the-money" equity raise by the company. Sherritt bonds rose more than 10 points in January as the company issued equity (with stapled "cobalt ratchet warrants"), with proceeds earmarked for debt paydown.

Without getting too deeply into the "ins and outs" of our trading, we have been generally leaning against the prevailing exuberance. As a result, consider that much of the rise in the portfolio this month is "booked," instead of merely marked.

On the Other Side of the Store, Tuna's on Sale

While market conditions in distressed credit and high yield bonds have been generally good, over in investment grade credit, prices continue to erode as yields soar. In less than two years the 5 year Government of Canada bond yield has risen from just over 0.5% to more than 2.0%. There aren't many issuers who have raised dividends four-fold since 2016, but two entities that have raised payouts at that level are the governments of Canada and the United States. On the high grade corporate side, the story is similar. Where McDonalds 2 year debt was yielding about 1% in 2016, now it pays more than 2.5%.

When yields go up, prices go down, and holders of investment grade bond portfolios are now in the midst of their third consecutive year of negligible or negative returns. The pain has become unbearable for some retail clients and many investment grade bond managers are seeing dollars flee out the door by the boatload.

It is a remarkable thing about investment products that when prices go down, customers generally do not take advantage of the discount. If one is in the habit of buying cans of tuna and one happens to see the price marked down from $1.99 to $1.09 per tin, the normal customer reaction is to buy more. Why this logic does not apply to bonds, we do not know. When we look at high quality bonds in 2018, it looks clear to us that tuna is, indeed, on sale. Starting from a very low weight in this area in 2016, we find ourselves buying more and more.

New Positions

During the month, we continued to expand our holdings of the McDonalds Canadian dollar "maple" issue which yields more than 3% on a slightly longer 7 year tenor. We also made purchases of several Bell Canada preferred share series where the dividend is indexed off the Canadian prime rate. We believe the scarcity of high quality non-financial Canadian dollar credit is under-appreciated by the market.

In the higher yielding parts of the Fund, we continue to find very well covered credit positions that provide interesting return opportunities. In January we initiated a position in the 2019 0.75% convertible notes of Synchronoss Technologies, priced to yield in excess of 8% on a one year basis. Synchronoss, which provides critical cloud data management and wireless phone activation services for major US mobile telecom operators, has a number of serious, but we believe transitory, issues relating to the delayed release of financial statements and potential past misconduct by management. These are serious issues, but we believe the problems are overwhelmed, from a credit perspective, by a rich net cash balance sheet and copious quantities of unencumbered business value.

Another somewhat distressed credit position we initiated was our purchase of the 2019 9.5% convertible note of Amyris Inc, priced below 70c on the dollar of face value. California-based Amyris, makes specialty plant-based ingredients for cosmetics, food and other industrial applications, primarily in its Brazilian facilities. Its recent partnership with multi-billion dollar Dutch industry leader DSM, cemented by large equity investments from the larger company, gives Amyris access to the substantial deep pockets required to bring its new facilities into profitable operation. With $250M of equity market capitalization below its total $160M debt, and a 1 year default risk that we estimate at below 1%, the yield to maturity of 50% seems quite attractive for this admittedly idiosyncratic issuer.

Fund Positioning

The Fund yield to maturity at January 31 was 5.4% with current yield of 4.8% and average duration of maturity-based instruments of 2.4 years. There is a 4.0% weight in distressed securities purchased for workout value whose notional yield is not included in the foregoing calculation. Cash represented 5.4% of the total portfolio at January 31.

Geoff Castle
February 2, 2018

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

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