PENDER
CORPORATE BOND FUND

THE MANAGER'S MONTHLY COMMENTARY – JULY 2018

The Pender Corporate Bond Fund returned 0.3% in July, a result fairly close to the underlying run-rate yield of the securities held. Strong performers for the Fund in July included our position in bonds and preferred shares of Aimia Inc., which rallied on unsolicited bids for the company's assets from Air Canada and AeroMexico. Further strength came from a rise in prices of convertible shares of Energy Fuels Inc., as mine closures in the uranium sector pushed the underlying stock price close to conversion parity. The gains above were offset, to a degree, by weakness in bonds of Global Brokerage which fell on a position liquidation by a significant holder, and also in convertible notes of SunPower Corp, where lingering tariff concerns weighed.

The Corporate credit market overall was relatively stable in July. Corporate credit spreads in both high yield and investment grade tightened somewhat, with the move being offset by rising benchmark government interest rates in both the US and Canada.

The Odds in Credit

Summer in investing is like winter in farming. It's quiet. The 'players' are out of town, cruising their yachts out of marinas in the Hamptons or sipping cool drinks lakeside in Muskoka. Absent the hum of normal seasonal activity we spend a little more time repairing the metaphoric broken fences and revisiting some important issues with implications that have longer term bearing on our business. One issue on our minds this summer relates to the long-term "odds" in the credit markets. Put simply, if you didn't know what stage in the market cycle you were in, what is the average return you might expect in the various tiers of the credit market?

The big levers of total return in the credit markets are spread, on the positive side, and defaults on the negative side. You don't get one without the other. To calculate more finely, defaults must be accounted for net of recovery, which is often substantial. And then there's the fact that post-petition, defaulted assets tend to perform quite well.

Taking the best long-term study on returns in high yield we are aware of[1], we see that although defaults are more frequent in the lower tiers of credit, additional spread more than compensates for losses. For the period 1982 through 2014, which includes several recessions, US investment grade corporate bonds had an excess return of 1.05% above Treasuries of similar duration. High yield credit has an even greater all-in excess return of 2.66% per year. And defaulted credits, the bogeymen of the bond universe, do even better. In a separate study[2] spanning from 1987-2016, defaulted corporate bonds and loans returned an average of 14%, compounded, in the first two years following default. So, over a cycle, additional risk is indeed compensated with higher return, and the further down the spectrum one goes, the higher the excess returns.

Although average returns for accepting credit risk are good, starting points and endpoints matter a lot. Following tight spread markets, three times in the past 20 years, the high yield index has experienced a total return drawdown in excess of 6%. In a market that has bumped along at an historically tight level of credit spreads for more than one year, we believe that the intermediate-term odds for high yield are less attractive than usual. Of course, we are not index buyers, and we have the ability to pick and choose credits, which is why we continue to hold some high conviction "yieldy" positions. But, overall, we continue to grow our investment grade weighting (now approximately 28% of the fund) and we continue to focus the unrated or below-investment grade rated weight in the portfolio on very low default probability issuers, and even within those issuers, towards senior and short-term obligations. We still devote most of our research efforts towards the high yield market due to its higher long-term return potential, but our general orientation in H2 2018 is towards safety.

New Positions

In July, we added a significant position in the 4.875% 2024 bonds of Lousiana-Pacific Corp (LPX), priced to yield approximately 5%. LPX is one of North America's largest producers of oriented strand board (OSB) a critical material for the building trades. Although the company's industry has been experiencing cyclically high levels of profitability lately, we like the longer-term safety provided by LPX's net cash balance sheet. The company holds over $800M cash vs only $350M in debt outstanding. We also are encouraged by management's intent to reclaim an investment grade credit rating (from the current BB status) which should support efforts to maintain fiscal discipline and continue in its efforts at product diversification. At a 1 year default risk that we estimate at less than 0.01%, we consider LPX to be an attractive risk/reward opportunity.

We also continued to extend our position in discounted US municipal bond closed end funds as, despite some rebound in the underlying securities, we continue to observe discounts to daily-calculated net asset value of close to 15%. This month we added to the Nuveen Quality Pennsylvania Municipal Income Fund (NQP) which trades at an approximate 15% NAV discount and anticipated yield of 4.78%.

We added weight in convertible notes of SunPower Corp, which came under pressure during July as concerns about tariff effects in solar power and continuing overcapacity in utility-scale solar panel production held sway with investors. We like the long-term prospects for SunPower as the premier player in the US commercial-industrial solar market. Moreover, we believe SunPower's 57% equity owner Total SA, which also holds a sizeable position in the company's debt, provides a degree of implicit credit support and we would expect Total to be in a position to backstop any short-term funding shortfalls, should they arise. Yielding in excess of 9%, we find SunPower's 4% convertible debentures maturing in 2023 to be particularly attractive here.

Fund Positioning

The Fund yield to maturity at July 31, was 5.3 % with current yield of 4.6 % and average duration of maturity-based instruments of 2.3 years. There is a 2.6 % weight in distressed securities purchased for workout value whose notional yield is not included in the foregoing calculation. Cash represented 4.6 % of the total portfolio at July 31.

[1] Erik Hinnink, Applied Working paper No. 2016-3, October 2016 Ortec Finance Research Center
[2] Altman/Benhenni, "The Anatomy of Investing in Defaulted Bonds and Loans," Journal of Credit Risk, July 2017

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For full standard performance information, please visit:
https://www.penderfund.com/funds/pender-corporate-bond-fund/