PENDER
CORPORATE BOND FUND

THE MANAGER'S MONTHLY COMMENTARY – MARCH 2018

The Pender Corporate Bond Fund returned 1.2% in March, a good result within difficult market conditions.

Strong performers for the Fund in March included our position in convertible notes of Amyris, which rallied more than 20% on a positive earnings report and improved cash flow outlook. We also saw strength in our investment in KeyW Holdings, where strong quarterly results boosted convertible note prices. Further, our position in Puerto Rico bonds continued to rally, as the island's fiscal authority forecast better than anticipated bondholder recoveries.

The gains above were offset to a degree by generally softer prices for investment grade bonds and specific weakness in a few individual credits. Orexigen converts fell as the company announced a Chapter 11 filing in conjunction with the announced auction of its business. We continue to be hopeful of a good outcome in this small position once the sale has been completed.

The Hiking Cycle Continues … How We Invest in a Rising Rate Environment

Probably the most anticipated event in the credit markets in March was the first Federal Open Markets Committee meeting chaired by Jerome Powell. As expected, the Fed continued with the rate hiking cycle initiated under Janet Yellen and continues to guide markets toward a Fed Funds rate of more than 3% in 2020. Different chair, same tune. We continue to be in a tightening cycle with higher short term rates expected.

In our view, the potential for central banks to quickly "normalize" rates from the post-financial crisis lows is limited. Overhanging the market is a large amount of consumer and corporate debt that was assumed in the past decade at very low rates. As rates rise, borrowers must refinance at higher cost, and we believe that we will eventually start hearing some "cracks" in various sectors of the debt markets. Where the next major cracks occur is uncertain, but we have a few ideas. Canadian housing, where buyers have been assuming massive mortgage debts on properties bought at arguably overvalued levels, appears to us likely to develop stress. High yield debt of companies that were either over-levered or where the issuer is domiciled in an industry subject to disruption, is another possible area of stress.

If we see the emergence of credit stress, we believe the increases in "risk free" government rates at the middle tenors (e.g. three to seven years) may stall. If that were to happen, it would be quite good news for high quality corporate bonds of these durations. And so we have been building a position in this kind of holding, not knowing when these positions will stop declining in price, but confident in an eventual turnaround. Our favored trade here has been Maple bond (CAD debt) issuers like McDonalds, Pepsi and Walt Disney. In this vein we added a 2025 bond from consumer products giant Mondelez this month. Another investment with similar characteristics is US municipal bond closed end funds, where we own significantly discounted closed end funds covering Pennsylvania, Maryland and New York credits.

Notwithstanding our build-up in the investment grade area, we still focus a large portion of the fund on a selection of well-collateralized, short-duration high yield bonds. These generally perform well in a rising rate environment because the spreads are wide enough that small moves in the government curve matter much less to the credit than the market's view on the value of the issuer's assets. We continue to find good opportunities with attractive yields where asset valuation coverage is very strong. These bonds position us to deliver a reasonable level of income (and potential for some capital gain) with a decent margin of safety. Amyris 2019 notes, which performed so well this month, are a good example of this type of investment. As long as we continue to find this type of risk/reward payoff, we will allocate capital here.

New Positions

In March we bought the December 2020 $6\frac{1}{8}$% notes of Eldorado Gold. Eldorado is currently embroiled in controversy surrounding the permitting of its Greek gold property, and is simultaneously experiencing production shortfalls at its mine in Turkey. To add to Eldorado's problems, the company recently announced it would be parting ways with its chief financial officer. As a coup de grace, some street analysts (one of whom was calling for Eldorado stock to outperform at over five times its current level) cut ratings to sell. We think sentiment has become overly negative on Eldorado. With balance sheet cash of $490 Million and mining assets last reported at $4.2 Billion, we believe there is ample value to cover the $600 Million debt of this producing miner. Note that Eldorado has generated positive operating cash flow in each of the past 11 years. Debt yielding over 7% seems cheap to us here.

We also took a position in the convertible notes of California-based SunPower Corp. One of the few major producers of panels and infrastructure for utility-scale solar power installations, SunPower faces a degree of uncertainty due to US tariff action against foreign panel makers. With some plants based in the Philippines and Mexico, we accept the possibility of a negative US trade action affecting SunPower. However, even without its home market, we believe SunPower's production capacity could be fully utilized in this rapidly expanding global industry. Moreover, the implicit backing of SunPower's majority owner, Total SA ($150 Billion market cap) suggests that insolvency is a very remote risk. Convertible bonds yielding in excess of 9% appeared to be very attractive, given the circumstances.

On the more conservative side, we added a position in National Grid Plc's 2.9% Maple bonds of 2019 trading slightly over par. This CAD issue is the obligation of the owner of the British electrical grid, a market in which it operates as a monopoly provider. National Grid's business is fundamentally stable and the company is extremely well capitalized, with one year default risk estimated at less than 0.01%.

Another position initiated was in the convertible notes of California-based FireEye Inc. FireEye is one of the leading companies in the business of providing cyber security software and services to corporate networks. Benefitting from strong demand growth, FireEye expanded its operating income last year by over 40%. With a net cash balance sheet and over $3 Billion in equity market cap below our convertible notes, we estimate FireEye's one year default risk at below 0.02%. The converts are busted with a cash yield of around 3.5% to a 2022 put date. However, given the very strong growth in the market for FireEye's services, and a reasonable four year runway, we consider potential upside equity conversion value in the FireEye converts to be attractive.

Fund Positioning

The Fund yield to maturity at March 31 was 5.6% with current yield of 5.0% and average duration of maturity-based instruments of 2.4 years. There is a 3.9% weight in distressed securities purchased for workout value whose notional yield is not included in the foregoing calculation. Cash represented 4.8% of the total portfolio at March 31.

Geoff Castle
April 4, 2018

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