



THE MANAGER'S MONTHLY COMMENTARY – OCTOBER 2017

The Pender Corporate Bond Fund returned 0.6% in October, a fairly good result consistent with the Fund's more cautious recent positioning. The monthly return was approximately equal to coupons received with a small portion of capital appreciation.

Contributors in October included our position in Sherritt International bonds, which rose as attention intensified on tightness in the market for cobalt and other materials connected to electric vehicle batteries. Other strong performers were recently acquired credit positions in Aimia and W&T Offshore. Offsetting these gains to a degree were lower marks in a couple of names in the distressed area that we consider normal volatility.

Tighter Spreads and Tougher Choices

During the month the spread to treasuries of the BAML HY Index continued to tighten, returning to levels near June 2014 lows of approximately 3.5%. By way of contrast, this spread index was over 8.5% in early 2016. So, relatively speaking, high yield credit is expensive and we have made further moves to de-risk the portfolio.

Our de-risking game plan includes a number of facets. First, we have again adjusted down the default risk probabilities that qualify for our top two portfolio tiers. While last year, a one year Bloomberg "DRSK*" of 0.5% or less qualified as top tier credit, now we are holding 0.2% as the line. Second, we embarked on a process of rooting out credits in companies that have not been showing progress in growing cash flows or where we have lost a significant portion of the equity buffer below the debt. In this light, during the month we exited our position in Jakk's Pacific Inc convertible notes where we were able to book a gain against a deteriorating credit position. We also sold our position in the convertible notes of Vitamin Shoppe, an entity whose equity valuation had fallen significantly, shrinking our margin of safety as creditors.

On the buy side, we have been more constructive with respect to investment grade credits. Unlike high yield, where effective yields have been coming *down*, in the investment grade universe, yields have been heading *up*. So, while we are sure that no spontaneous parades will erupt on the knowledge that CN Rail bonds due in 2021 can now be bought to yield 2.1%, we do point out that last year at this time the same bond only yielded 1.4%. Here is the big picture - high quality credit has been paying progressively more and lower quality credit has been paying progressively less. It is always tough to sell high coupon to buy lower coupon, but that tough choice seems more attractive to us now than it has at any point in the last two years.

** Default Risk*

Manage for Payout or Manage For Value?

An unfortunate part of migrating towards the investment grade universe is that the weighted average coupon of what we own should be lower. And, consequently, the monthly cash distribution going forward may come under pressure until such time as we see more "fat pitches" emerge in the corporate credit market. As large holders of the Fund ourselves, we have no problem with this. We would far rather manage our funds to protect and grow our unit value, than risk our capital on lower probabilities

of success in the hope of preserving an arbitrary level of payout. We raise this issue in the spirit of full disclosure. You can't make a silk purse from a sow's ear!

Holdings Update

During the month we made some important portfolio changes. On the top end of the portfolio we took on significant positions in the Canadian dollar bonds of both CN Rail and CP Rail. We like railway credits as a less competitive industry structure affords a degree of operating stability. Moreover, each of the companies possesses a significant amount of hidden assets in the form of urban real estate, the disposition of which is available to supplement operating earnings as required. We purchased four- and five- year maturities of these issuers respectively, both of which are investment grade credits with Bloomberg one year default probabilities below 0.02%.

We remain attuned for exceptional opportunities in distressed credit if and when they develop. In this regard, we initiated this month a measured position in the General Obligation bonds of Puerto Rico. We believe Puerto Rico, which was unfortunately subject to the damage caused by hurricane Maria in September, is an opportunity for credit investors with a reasonable time horizon. Putting ourselves in the mindset of 2019, we expect that a federally subsidized rebuilding of Puerto Rico's infrastructure, combined with a reasonable principal haircut of the island territory's outstanding bonds, can position Puerto Rico for an eventual economic recovery. On this basis, we felt comfortable purchasing a position in the 8% General Obligation Bonds of 2035 at a substantial discount to par, keeping in mind the constitutional recognition of this bond series as Puerto Rico's senior credit obligation. Closing the month around 30 cents on the dollar, we consider the Puerto Rico bonds to be fair valued above 50c, which provides an interesting forward looking opportunity for investors getting in at these levels.

Fund Positioning

The Fund yield to maturity at October 31 was 5.5%, with current yield of 4.8% and average duration of maturity-based instruments of 2.5 years. There is a 5.8% weight in distressed securities purchased for workout value whose notional yield is not included in the foregoing calculation. Cash represented 4.7% of the total portfolio at October 31.

Geoff Castle

November 2, 2017

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



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