THE MANAGER'S MONTHLY COMMENTARY – SEPTEMBER 2017

The Pender Corporate Bond Fund returned 0.8% in September, a decent result given that the bond market showed broad-based weakness. The Fund's short duration and positioning in discounted credits allowed us to make money in an otherwise difficult environment.

Strong contributors in September included our holdings in Primero Mining Corp convertible notes as investors began to focus on possible credit upside related to indications of multiple potential bidders for the company. Our holdings of Novavax Inc convertibles also rose as a key competitor ended its own respiratory virus vaccine development and suggested it would be open to partnerships with other companies, such as Novavax.

Holdings Update

In September the Fund added a number of key positions. In the lower risk band, we bought a chunk of the new McDonald's Canadian dollar "Maple" bonds, swapping out our USD denominated McDonald's holdings in the process. With the recent rise in Canadian rates all along the yield curve C$ investment grade bonds are relatively more attractive than they used to be compared to US investment grade. The Maple bond market has also seen foreign companies raise C$ debt at wider spreads to government rates than the same companies do in the United States. In this particular case we were able to pick up approximately 100 basis points of yield for the same underlying credit risk.

We also initiated a position in the McDermott International 8% Second Lien bonds of 2021. McDermott, is a major provider of infrastructure development services in the offshore oil and gas industry. Unlike many companies in that industry, McDermott has survived the difficult cycle with a very strong balance sheet. Net debt at McDermott of less than $150M is underpinned by equity market capitalization of more than US $2B. We like the company's strong order book, the secured status of the 8% notes and the company's unused $1B credit line, which expires after the maturity of this issue. With a Bloomberg 1 year default risk of 0.1%, the notes yield over 6.8% to 2021 maturity or 5.1% to a possible 2018 call.

After exiting our position in Sherritt International bonds earlier in 2017, we found an opportunity to re-engage at a lower price in the weakness of the late summer market. Sherritt is a company not without challenges, but we believe this producer of nickel and other commodities to be poised to improve credit quality significantly over the next 18 months. One of the major opportunities we see ahead for Sherritt is in the cobalt market. As demand for electric vehicle batteries grows, we believe that a structural shortage of cobalt may exist, which is good news for Sherritt, one of the world's largest cobalt producers. We believe that the company's expanding profitability, recently simplified capital structure and comparatively low net leverage (less than 4x net debt/EBITDA) will fuel a positive re-rating cycle for Sherritt whose bonds currently trade with mid-teens yield to maturity. At around 2%, this is definitely a higher default risk situation, but we believe the steep discounts to par create adequate valuation protection.

Also in September, we sold our position in the 1st lien bonds of Gogo Inc. While we still like the prospects of Gogo, which provides airline wifi services, we were concerned about expansion of senior debt levels. After earning over 25% total return in this position during the past year, we found ourselves looking at a comparatively low 6.4% yield to a 2019 call and decided to book the gain.

A Better Way in Credit

We are pleased that the success of the Fund has helped to validate some of the newer, progressive approaches to managing credit that we have employed over the last two years. In a world that is obsessed by the changing marketing "wrapper" of credit funds, we have focused on changing the engine. To us it doesn't really matter how a fund is marketed to clients - let Jeff Bezos drop bonds from the sky using drones if he wants to - what matters is how credit risks are assessed and how a fund manages its operations to optimize risk-adjusted returns. And in those core, critical functions, we like to think we are part of a movement that is working towards a better way.

We never cease to be amazed that, ten years on from the collapse of the "AAA" rated mortgage CDOs bond funds are still, by and large, run according to the method that simply compares the yield of two bonds with the same agency credit ratings and chooses the higher return. We are part of a different school that has pushed for a more objective "sorting system" for credit quality. Our use of Bloomberg default risk probabilities over agency credit ratings (as both an initial screening tool as well as risk band delineator) has helped us to identify dozens of great opportunities that have helped the Fund generate strong risk-adjusted returns.

We have also demonstrated the value of a structured, continuous rebalancing program in the management of a credit fund. This is not your grandfather's "bond ladder." Every week we reassess our holdings and watchlist for securities where a program sell has left a yield too wide, or a program buy has caused one to move too tight. Rather than sticking with a 5% note for a full four years, we rigorously sell them at 4% and buy them at 6%. We use a simple algorithm and it works. Analysis works. And, so long as you can guide activity with analysis, activity pays.

Of course, we make mistakes too. But, by constantly working on and refining our process, we believe we give ourselves the best chance to consistently earn our fees and perform for you, our client.

Fund Positioning

The Fund yield to maturity at September 30 was 5.4% with current yield of 4.6% and average duration of maturity-based instruments of 2.1 years. There is a 5.4% weight in distressed securities purchased for workout value whose notional yield is not included in the foregoing calculation. Cash represented 9.8% (temporarily elevated due to trade-in-process at month end) of the total portfolio at September 30.

Geoff Castle
October 3, 2017

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

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