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## MANAGER'S COMMENTARY – Q1 2018 – DAVID BARR INCREASED VOLATILITY AND CONTINUED UNDERPERFORMANCE BY CANADIAN INDEXES

Fellow Unitholders,

### **The Moment We've All Been Waiting For**

That was an interesting quarter. One thing didn't change: Canada is out of favour. Canadian indices continued their lacklustre performance. What did change in the quarter was a dramatic spike in volatility and market turbulence. As a result, most major indexes are now down year to date in North America.

I started by saying it was an interesting quarter and, for the Pender investment team, interesting means we are finding investment opportunities that are actionable. As you might expect the volatility gave us a chance to deploy capital. Across the majority of our equity funds, we have taken down our cash positions quite extensively. In the Pender Value Fund for example, we decreased cash from 29% at the end of December to 6% at the end of March. And this is after we received cash equal to about 5% of the portfolio on the sales of both Key Technologies and Avigilon in the quarter.

Where have we been deploying this cash? In our ongoing quest for long term capital appreciation, we favour small cap companies as these businesses tend to have characteristics that can drive long term returns. Scalable business models with big markets that are in the early innings to allow for a long compounding period. This quarter we have increased our weighting in small cap stocks and, in particular, Canadian stocks. While Canada may be out of favour for some, mostly resource investors, it is providing wonderful opportunities for us in our non-resource universe.

### **Good Knight, Sleep Tight**

Two Canadian small cap stocks we added to our portfolios in the quarter are Knight Therapeutics and Sleep Country.

Knight Therapeutics is one of those holdings where having a long-term time horizon gives us an edge, and we initiated a position during an extreme market sell off. A relatively underfollowed name, given its billion dollar market cap, Knight Therapeutics is a specialty pharmaceutical company that acquires, develops and commercializes products in countries outside the US. The company is led by Jonathan Goodman, a proven capital allocator (an "Outsider"\* type CEO), who has elected to sit on over \$700 million of cash for nearly two years as he waits for the right opportunity to present itself. He has immense patience and is rightly aligned with shareholders as the largest single holder of common stock. However, the market has grown impatient with Mr. Goodman's patience. In contrast to the opinion on "the street", we see Mr. Goodman's patience as an admirable quality that should reward shareholders who remain patient beside him. With over 60% of the market cap in cash, the company today is an example of a cash box that provides the Funds with upside optionality and limited downside risk. Our investment thesis also takes into account how the high yield market has remained loyal to many of the world's troubled pharmaceutical companies and, in our opinion, it is a question of when, not if, attractive prices re-emerge.

Sleep Country was punished by the market in 2017 as a result of the liquidation of Sears Canada. Sears had a market share of about 15% in Canada and the prospects of having their inventory liquidated caused concern for Sleep Country's upcoming quarterly results. Having the intestinal fortitude to be able to look past short term quarterly reports, we viewed the Sears liquidation as a *positive* for Sleep Country. To us, Sears' market share was up for grabs and Sleep Country was well positioned to benefit from there being one less competitor moving forward. Although it's definitely not the most exciting name, Sleep Country is a great business, run by owner operators and trading at a very reasonable price. The company constantly generates an astounding 60%+ return on its tangible assets and is growing those earnings at a clip of around 20% per year. We view the Sears liquidation as a potential accelerator to both Sleep Country's long-term growth rate and its Canadian market share gains. This position helps us to sleep well at night which is one of the key objectives of our investment strategy.

David Barr  
April 30, 2018

\* [The Outsiders: Eight Unconventional CEOs and Their Radically Rational Blueprint for Success](#)

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