PENDER

CORPORATE BOND FUND

THE MANAGER'S MONTHLY COMMENTARY – JULY 2019

The Pender Corporate Bond Fund returned 0.6% in July, a month that was characterized by a strong credit bid that anticipated the Federal Reserve's rate cut announcement and then disappointment on the actual cut announcement on July 31.

Strength in the Fund was broad based in July, led by our position in Infinera convertible notes. Infinera notes rallied into the mid-70s from the 60s in part due to the acquisition of competitor Acacia Communications by Cisco and a consequent increased investor focus on valuations of optical networking companies. Other strong positions included discounted bonds of Mattel Inc. that rallied on better than expected earnings. Finally, various precious metals related credits, such as Osisko Gold converts, and bonds of Eldorado gold, gained multiple points on higher underlying commodity prices.

Offsetting the strength above, to a degree, was our position in Fannie Mae preferred shares, whose prices retreated on diminished expectations of speedy US Administration action to restructure the entity. Also weak was our position in Just Energy convertible notes, where an accounting restatement cast a degree of doubt on the company's strategic review and possible sale. In neither of these two cases do we consider value to be permanently impaired.

Oil the Trouble in the World … Yet Still a Few Places to Invest

There are plenty of things wrong with the oil business. To raise an obvious point, companies in this business are producing the main ingredient of climate change, a carbon-based fuel whose combustion releases an atmospherically persistent gas (CO_2) that traps radiant heat from being released from the Earth's atmosphere. While there exist a few doubters to this idea, that number does not include an overwhelming majority of scientists whose theoretical work over the past decades is now regularly reinforced by a steadfast pattern of new record high temperatures, melting ice caps and frequent wildfires. We are not breaking any major news when we wonder aloud whether popular efforts to address climate may, eventually, render this industry a lot smaller than it is today. It is not as if cleaner, less wasteful substitutes don't exist.

However, while the foregoing may be true, we recognize the degree to which virtually every facet of our lives, as we currently live, depends at least somewhat on the use of oil or petroleum-derived products. There may be a few readers whose summer holidays this year did not involve using gasoline or jet fuel. There may be some reading this note by means other than on a computer monitor formed with plastics. But these are exceptions. Despite the public external costs of pollution and carbon, there is still much private good in the world that results from the use of oil. And the equipment that uses oil, the cars and planes, is already built. Demand, while perhaps moderating, is not plummeting.

Beyond the overarching trend, we also observe the oil market as a typical commodity market with periodic booms and busts. The most recent of such booms, which culminated in $100 per barrel pricing at West Texas in 2013 and 2014, has long since reverted into a gruelling challenge to corporate survival. Accounting smoke-and-mirrors games may have propped up belief in the apparent profitability of some marginal producers longer than otherwise might have been the case. But, ultimately, it has become clear that oil priced in the $50s per barrel cannot be produced profitably by entities with all-in-sustaining costs in the $70s or $80s. The shake-out is on. And, one by one, the overleveraged and under-profitable players are shaking out. Producers such as Sanchez, Jones Energy and Halcon have been hitting the wall while suppliers to the industry like Weatherford and PHI Inc. have also been pushed to restructure.

With a cloud over the industry, and possibly weak longer-term fundamentals, it is tempting to give the sector a miss, as we ourselves did for much of 2017 and 2018 with scarcely 2% oil credit weight. But more recently we have found a few areas where we believe a credit investor can profit from a cyclical bottoming. We look to invest in places where capital is scarce, acting on the belief that where capital is scarce it tends to earn higher returns.

One of the areas we like is small, cash-profitable producers. Perhaps because so many oil juniors are cash burning wrecks, some free cash generating smaller producers like W&T Offshore and recently added Surge Energy have been shunned. In these names we consider ourselves to be poised to earn yields of 8-10% with annual default probabilities of less than 1%. We also own 1st lien debt of FTSI Inc., a hydraulics-oriented oilfield supplier, where we see similarly attractive risk-reward characteristics.

Rounding out our interest in this sector, we include a position in the distressed debt of PHI Inc., the offshore helicopter operator, where we are hopeful for a good result driven by industry consolidation. And in the downstream business, we consider the near term 2021 and 2022 maturities of Parkland Fuels to be relatively safe opportunities to pickup yield points without committing to the industry for an extended term. Adding up all our oil positions, we are still less than 10% invested in the sector. Due to the lower priced nature of many of these credits, they do weigh slightly more in terms of the Fund`s prospective returns than the headline weight suggests. At a point we believe to be near to a cyclical low for producers, we believe these credits can deliver strong risk-adjusted returns.

New Positions

During July we re-initiated a position in the convertible notes of Twitter Inc. Long time followers of these updates will recall our prior ownership of other Twitter positions. We continue to like the company's unique position as an emergent global "newswire" and believe its progress in growing cash from operations is strong evidence of future business value expansion. Sitting atop more than $30B in equity market capitalization and supported by over $6B in balance sheet cash, we believe the credit risk of Twitter's $3B of convertible debt is minimal. Moreover, with common shares in the $40s and convert strike prices in the $70s, we believe Twitter's 2021 1% convertible notes offer reasonably good optionality on the common stock, in combination with a headline yield in the 2% range.

Also in July we purchased a position in the convertible notes of Avaya Inc., a leading player in contact center communications software and services. Avaya is a company in an active strategic review process where we believe a take-out is highly possible. While the standalone credit profile is strong, a pending acquisition could create a boost to par for the convertible notes we acquired in the mid 80s prices during July.

Fund Positioning

The Fund yield to maturity at July 31 was 5.0% with current yield of 4.6% and average duration of maturity-based instruments of 3.0 years. There is a 4.7% weight in distressed securities purchased for workout value whose notional yield is not included in the foregoing calculation. Cash represented 2.8% of the total portfolio at July 31.

Geoff Castle
August 7, 2019

[1] F Class
For full standard performance information, please visit: http://www.penderfund.com/funds-and-performance