



Forward thinking. Finding value.

2016 – Summary of Performance and Process

Stocks rarely perform in the time frames we predict, which is why the market works best for investors who have a long-term portfolio focus. Volatility in short-term returns, especially with the relatively concentrated strategies we deploy, comes with the territory and we don't place too much emphasis on it in any given year. Nevertheless, despite a bumpy ride as various macro events shook the markets, 2016 was a great year for Pender.

We are pleased to report that most of our funds performed above expectations, with numerous mandates generating returns at or near the top of their respective categories.

At December 31, 2016 %, F Class	Inception Date	1 Year	Since Inception
Pender Canadian Opportunities Fund	November 2010	17.5%	7.0%
Pender Corporate Bond Fund	June 2009	23.7%	7.0%
Pender Small Cap Opportunities Fund	June 2009	27.4%	21.3%
Pender Strategic Growth and Income Fund	November 2010	17.2%	7.6%
Pender US All Cap Equity Fund	June 2013	0.2%	7.4%
Pender Value Fund	June 2013	19.5%	20.4%

All funds remain open to investors except the Pender Small Cap Opportunities Fund, which was closed to investors in February 2015 (note: new investors can still obtain partial exposure to this Fund through the Pender Strategic Growth & Income Fund which holds a 5-10% stake as part of its balanced mandate).

The Pender Investment Process: Assess True Risk and Invest with an Edge

While we can't control the markets and therefore fund performance in any given period, we can control our investment process which we believe increases the odds of good results over time.

At Pender, all investment evaluations begin with an assessment of **risk**¹ and we normally act only if we believe we have an investment "edge". To us, real investment risk is the risk of permanent loss of capital *and* the risk of an inadequate return, rather than stock price volatility. The second step to sound investing is putting capital to work when we believe there is a material mispricing of a security. We believe profitable anomalies exist in the market which tend to occur due to investor behavioural biases and the structural limitations of various market participants.

There is a big difference between markets that are *always* efficient and those that are *mostly* efficient. It is the periodic inefficiencies, or anomalies, that arise in *mostly* efficient markets that provides the rewards for disciplined investors. Finding opportunities overlooked by others is easier said than done. After all, for every buyer there is a seller and the market is full of smart, well-informed and incentivized participants seeking to maximize their wealth. When investing, we ask ourselves, "*Who is on the other side of the trade? Is it an informed buyer or seller or someone who is trading for non-fundamental reasons? How can we tilt the odds in our favour and take advantage of these anomalies? What is our investment edge?*"

Finding an **informational edge** in large cap stocks is challenging because armies of analysts and investors are constantly scouring around for actionable sources of information. In practice, this means that any mispricing based on an informational edge in larger companies tends to be small and gets closed relatively quickly. On the other hand, this edge can be found more frequently among small cap stocks due to the general oversight of institutional investors. It makes sense to look for advantages in those areas of the market which are largely ignored by the most capable competitors. This is information which could be material in our opinion, but is not yet priced into a stock. We have found uncovering such data generally profitable, however we need to remain mindful that information can be a two-edged sword. Daniel Kahneman, a leading behavioural economist, wrote *"We are prone to overestimate how much we understand about the world and to underestimate the role of chance in events"*. Indeed, studies have shown that more information doesn't necessarily contribute to better decision making and counterintuitively, may even have the opposite effect. Our brains are conditioned to interpret more information as better information, which leads to greater confidence, with no corresponding increase in accuracy. More information does not result in better decisions, but finding needle-moving information does, which dovetails us to the next investment edge.

In our experience, typically three to six key factors carry most of the weight when determining the outcomes of investments. Everything else is largely noise. As a result, it is important to have an **analytical edge**, which can be obtained by assessing readily available information differently than the crowd. For example, we find that a disproportionately large number of the market's overall returns and winners are produced by companies run by their owner-operators. Clearly this factor alone could have a huge impact on potential returns and explains our bias to owning companies run by accomplished founders who have already won in their respective fields.

Another "edge" can arise if one is able to act as a **provider of liquidity** when capital flows to different asset classes suddenly reverse for non-fundamental reasons. Changes in fund flows to formerly "hot" or "cold" ETFs, inclusions and exclusions to various indices and reversals in other crowded strategies have provided lucrative opportunities for alert investors. Forced buying or selling by ETFs for formulaic reasons can create very interesting opportunities. We hold relatively high cash levels and other liquid assets in a number of our fund mandates on an opportunistic basis for this very reason.

Finally, we seek an edge with **time horizon arbitrage**, or being alert for opportunities that become available because market participants have different levels of patience when investing. Securities with poor short-term outlooks often get sold-off indiscriminately down to bargain prices, irrespective of the longer-term fundamental value. The patient investor provides liquidity to the impatient investor and obtains the potential for above average performance in return after conditions normalize and reversion to the mean restores valuation levels. We believe the single greatest edge an investor can have is a long-term orientation, in part because such an outlook is increasingly scarce in today's market. Numerous studies have found that portfolio turnover and returns tend to be inversely correlated – the higher the turnover, the lower the returns, so by definition, patient investors who maintain portfolios with lower than average turnover should be able to earn higher returns. We are reminded of the old investment adage, *"An investment portfolio is like a bar of soap: The more you touch it, the smaller it gets"*.

What helped last year?

No one knows in advance where the opportunities will arise in any given year. Each year provides a new opportunity set which must go through our investment process. Investor pessimism generally provides a good springboard for potential returns and 2016 started on a sour note. In addition, last year the growing wave towards passive and ETF investing created notable anomalies in the market. Research shows that the rise in passive investing has led to prices that are less informationally efficient. For example, companies that are added to the S&P500 see their price-to-book and P/E ratios increase

immediately. Did those companies become more fundamentally valuable after being added to the index, or did formulaic buying by valuation-agnostic index funds drive prices up? We believe the growing presence of passive funds and index strategies that trade with little regard for fundamental valuation are actually advantageous for investors who do. An entity that will sell to us when a stock is cheap and buy from us when it is expensive is an ideal trading partner. Rather than worrying about the impact of ETFs and passive investing, investors looking for mispriced securities in the market should welcome such developments. It's hard to argue with Warren Buffett's logic when he mused, "*What could be more advantageous in an intellectual contest - whether it be bridge, chess or stock selection - than to have opponents who have been taught that thinking is a waste of energy?*" For example, we were able to take advantage of non-fundamental, formulaic-driven trades by ETF investors in both our credit and equity mandates (read about Energy XXI² and Wi-LAN³). At the same time, risks were clearly rising in certain industry sectors as prices were decoupling from their underlying fundamentals (read about Utilities⁴). These are a few examples that show the benefits of true active management in a world going increasingly passive⁵. They also highlight another "edge". In the new world where investment vehicles are increasingly restricted by the rules conforming their structure, Pender has an **organizational edge**. We are flexible, opportunistic, have fewer boundaries and have set up our mandates to better capitalize on this new world.

Some final thoughts

The future is always uncertain, but we believe opportunities will continue to exist in 2017 and beyond. While our approach does not guarantee outperformance, and certainly not in every time period, we believe our investment process raises the odds of favourable results over time. Our portfolios have little in common with the composition of popular indices and most passive strategies, as evidenced by our high active share⁶ (holdings that are far different than the index). We are not driven by benchmarks, but by the opportunity set. Research shows that fundamental asset managers, who take a long view and are truly active can deliver excess returns. Whatever uncertainty exists in markets, economies, politics or elsewhere, we believe taking the road less travelled, while incorporating thoughtful, evidence-based strategies, is more important than ever.

"Patience and discipline can make you look foolishly out of touch until they make you look prudent and even prescient." – Seth Klarman

We wish you a happy and prosperous 2017.

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