PENDER SMALL CAP OPPORTUNITIES FUND

PENDER VALUE FUND

THE MANAGER'S COMMENTARY – JULY 2019

Fellow Unitholders,

At the risk of sounding like a broken record, equity markets continued their upward trend during July with the S&P/TSX index total return of 34 basis points and the Russell 2000 total return of 136 basis points. The same stocks that are in major indexes continue to go up as people shift into passive investment strategies. Drilling down further into the microcap market, the Russell Microcap index returned negative 1.36% in the month. There is no tailwind in this part of the market from ETF flows. That being said, both the Pender Value and Pender Small Cap Opportunities Funds had a negative month, down -0.8% and -0.7%[1] respectively.

Portfolio Updates

Positive contributions to both funds was fairly widespread whereas a couple of names dominated the negative side of the ledger.

Key contributors for the Pender Value Fund included large cap companies such as The Howard Hughes Corporation (NYSE:HHC), Zillow Group (NASDAQ:Z) and KKR&Co (NYSE:KKR).

Meanwhile, key contributors for the Pender Small Cap Opportunities Fund included Dream Unlimited Corp (TSX: DRM), Quorum Information Technologies Inc. (TSXV: QIS) and Real Matters Inc. (TSX: REAL)

Key detractors for the Pender Value Fund included SS&C Technologies Holdings, Inc. (NASDAQ:SSNC) and Carbonite, Inc. (NASDAQ:CARB) both hit the fund for slightly over 50 bps. Our thesis on each of these investments remains intact and I'll expand on Carbonite in a bit more detail below.

The main detractor for the Pender Small Cap Opportunities Fund was Carbonite, Inc. As we had a larger weighting in the small cap fund, the fund would have been essentially flat for the month without it.

For both funds, cash was once again in single digits with Pender Value having 2.6% cash and Pender Small Cap Opportunities having 1.0% cash in hand as of July 31, 2019. With the low cash balance, we continue to focus on higher quality companies and the weighting of compounders in each fund is 60% and 28% respectively.

What do we do when a stock sells off after a "missed" quarter?

We are in the middle of Q2 earnings season. Companies across the investment universe have reported their latest earnings. Many are up, but others are down. As a sign of current market sentiment in the small cap market, bad news surrounding a quarter or other material news drives stocks materially lower, whereas the same is not true on the other side of the coin with good news having minimal impact on share prices. Investors clearly are very sensitive to the drawdown experienced at the end of 2018 and are ready to hit the sell button at the slightest whiff of bad news.

The Street handles a missed quarter or a weak outlook poorly, through its short-term lens, resulting in alarmist selling. But for companies where business fundamentals are not impaired and our investment thesis remains intact, this downward pressure on prices can work in our favour and we can add to our weighting at a discount, increasing our margin of safety and potential return. However, we certainly acknowledge the increased volatility in fund performance caused by quarterly financial reporting.

Carbonite, Inc. (NASDAQ:CARB) is one such detractor from July for both the Pender Value and Pender Small Cap Opportunities Funds. Carbonite provides cloud-based data protection and endpoint security solutions to SMBs and consumers. Its share price dropped approximately 30% during the month of July as a result of three news items. As well as reporting its earnings, the company also lowered annual guidance for 2019 and announced the resignation of its CEO and appointment of an interim CEO, Steve Munford (current Chairman of the Board).

[1] *Refers to Class F units in the Fund. Source: Pender*

The market is concerned by the uncertainty surrounding the integration of recently acquired Webroot (an endpoint security company) and the weak organic growth of Carbonite's core data protection business. These concerns are legitimate, but we believe the market has overreacted. The business fundamentals remain intact, with potential growth opportunities from cross selling and cost synergies resulting from the Webroot acquisition. The Street is also not factoring in Steve Munford's track record in leading security software companies. We have watched Munford several times and admire his track record. We welcome him to his new role as Carbonite's interim CEO as we believe he is the right person to streamline operations and direct the company to growth. At one time he served as the interim CEO of long time / prior Pender holding Absolute Software (TSX: ABT). During his tenure there, we witnessed improved performance and a corresponding increase in ABT's share price.

History does not repeat itself, but it does rhyme. Carbonite shares were oversold in our opinion. The margin between market price and intrinsic value has widened and thus our conviction on Carbonite is higher. We took this opportunity to increase its weighting in both funds.

Earnings season is ongoing and there is a lot of volatility in and around our holdings. Our philosophy remains the same: Buy quality businesses at a discount to intrinsic value and hold them over the length of our thesis. If you have any questions on the funds, please reach out to us.

David Barr, CFA
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PenderFund Capital Management Ltd.