PENDER

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CIO'S FIRST HALF COMMENTARY – FELIX NARHI

"If interest rates go to zero and all the governments in the world print money like crazy and prices go down – of course I'm confused. Anybody who is intelligent who is not confused doesn't understand the situation very well. If you find it puzzling, your brain is working correctly." – Charlie Munger

In this commentary we cover:

- Thoughts on the record levels of global negative yield
- A few intelligent things to do – Zillow Group and Howard Hughes

The Stranger Things happening to yield

A lot has been written recently about negatively yielding bonds, both by the press and by industry pundits. For the time being, this phenomenon is outside of North American markets. But it could come closer to home, according to luminaries like former Fed Chairman Alan Greenspan, who recently predicted that it's only a of matter of time before negative rates spread to the US. To better frame our perspective, it's helpful to revisit how Pender thinks about risk. To summarize, we believe real investment risk is two-pronged - the risk of permanent loss of capital *and* the risk of an inadequate return. At the end of August 2019, roughly 30% of the bonds issued by governments and companies worldwide were trading at negative yields, or *about $17 trillion of outstanding debt*. This number had nearly tripled since October 2018. Holders of such securities are promised a return of less than nothing, if held to maturity. Absent the use of derivatives[1], the result could be both a permanent loss of capital and a negative return for the long-term investor. The Merriam-Webster dictionary defines investment as *the outlay of money usually for income or profit*. Perhaps we are too old fashioned in our definitions of investment and risk, but only by loose definitions could one call a security that *guarantees you a loss* an "investment".

At one extreme, some have rationalized today's negative yields by arguing that this is normal in a world of excess savings and wealth, and extended lifespans. This explanation relies on the theory that investors care little about return and are seeking *safety* instead. At the other extreme, some argue that today's negatively yielding bond markets mark the top of the bond bubble, not unlike the dotcom crash in tech stocks in 2000. In fact, the global bull run that began in the mid-eighties is now one of the most intense in the debt market's 700-year history. Skeptics argue that the only reason to own negative yielding securities is continued faith in the greater fool theory[2], which works until the greatest fool finally buys in, which marks the top.

Who is buying such securities? And why? There is at least one specific group buying negative yielding bonds – index bond funds such as the Vanguard Total International Bond ETF. This may have future ramifications for investors. The virtuous cycle of easy monetary policy and low inflation following the 2008/09 financial crisis has attracted capital into sovereign bond funds at a furious pace. Trillions of dollars of capital have been created out of thin air by central banks. An ever-growing percentage of those bond market holdings are held by both retail funds and many institutional investors through low cost, passive indexed bond funds and ETFs. As one might expect, the manufacturers of these index funds must do precisely what they say they will do as outlined by the terms of their prospectus. When there

[1] Through the use of sophisticated currency hedging derivatives, you can convert the low or negative yields into positive yields, but such financial alchemy comes with its own risks.

[2] "The greater fool theory states that it is possible to make money by buying securities, whether or not they are overvalued, by selling them for a profit at a later date. This is because there will always be someone (i.e. a bigger or greater fool) who is willing to pay a higher price." Investopedia.com

are inflows, they must buy individual bonds according to the weight in the index, regardless of price or future return prospects. Our sense is that a large proportion of bond buyers are probably buying index funds on autopilot, paying scant attention to yields. And as long as the price of the bond is going up, it is hard to argue against doing more of the same since the value of the holder's account is probably going up.

This recurring pattern should not come as a surprise to anyone who has observed a market cycle or two. Incremental capital is usually attracted to what has been working best recently, but especially late in the cycle. A memorable investment adage warns, *what the wise man does in the beginning, the fool does in the end*. Are the inflows to indexed bond funds primarily from the wise men seeking safety? Or from fools buying what has worked recently? Are we entering a new economic paradigm? Is it different this time? On balance, we tend to side with the greater fool theory, but we just don't know for certain. Nobody does. Even the so-called "wise men" are very confused by today's macro environment.

Only time will tell whether buying bonds at record low yield levels and record high prices will be a good investment. But as long as there are reasonable alternatives, we will pass on such securities. Investing is inherently a probabilistic endeavour. Periodic losses are an inevitable part of almost any investment strategy. But we strongly prefer to minimize loss when possible. Avoiding securities which are guaranteed to lose seems like a sensible plan. There are plenty of attractive alternatives available for investors who feel the same way.

For example, we believe corporate bonds and preferred shares remain fertile hunting grounds for those seeking yield and solid total returns, while offering downside protection. In addition, durable and growing businesses that are able to refinance their debt at extremely low interest rates should be amongst the top beneficiaries of today's low interest rates. Many of these companies have attractive dividend yields, often with potential to increase payouts over time, which is a great alternative for investors seeking income. And let's not forget that interest rates act like gravity on valuations. If interest rates are sustainably near zero, valuations can be almost infinite. In theory, this interest rate gravity should apply to all asset classes. But it hasn't. Hence the opportunity. In our view, there are plenty of compelling stocks in different parts of the market worth considering. Many investors complain that the stock market is too expensive and they can't find "cheap" stocks. That may be so, but perhaps they are just not casting their net wide enough. There is a world of opportunity beyond the attention-grabbing large cap S&P500 stocks.

Below are some thoughts on two Pender holdings which have made headlines recently. One holding started the year hot but has gone cold recently (Zillow), while the other started slow, but has perked up of late (Howard Hughes).

Zillow Group – This digital real estate disruptor is a battleground stock

Led by co-founder Rich Barton, Zillow Group (ZG) is the leading operator of US real estate marketplaces and home-related portals. South of the border, Zillow is a real estate powerhouse. More Americans google "Zillow" than "real estate" which is an incredible testament to the brand. Today, Zillow is in the middle of a major business model transition as it attempts to disrupt the real estate industry. It is providing consumers with a new way to sell their home without the hassles and uncertainty that comes with traditional home sales. Specifically, Zillow is buying and selling homes directly from and to consumers while also providing adjacent home-related services such as mortgages. It turns out even if consumers seek, but don't accept Zillow's offer, they still like to know the "floor" value of their home. And those who want to sell their home the traditional way instead can ask Zillow to recommend a "Best of Zillow" agent. Upon the successful completion of a sale, Zillow will earn a referral fee. It is still early days, but initial interest in this home-buying service is far greater than Zillow expected and the roll out in new markets is being accelerated which is proving to be controversial amongst investors.

Given this business model transition, we view the stock partly as a bet on its legacy advertising business, but with the sizable upside optionality of a venture capital-like investment[3]. Zillow is playing a high stakes game of "pain now, gain tomorrow" which will not appeal to everyone. It is particularly ill-suited to those stock market investors who want certainty and are focussed on short-term trends.

Time will tell if the transition will be successful. Zillow is in the hard-earned but fortunate position relative to the massive opportunity to transform the real estate industry. No other company in real estate comes close to the brand awareness, audience size, technology, data science, industry partnerships and operational know-how that we believe is required to emerge as the leader in this new industry. In the bull case, we believe the stock has significant potential over a multi-year time horizon, given the massive addressable market. But there is certainly execution risk. Those fears are playing out as we write. After a massive run earlier this year, the stock has essentially round tripped. The valuation is back down to the levels at which we valued the legacy ad business or the firm as a potential strategic acquisition target, which should provide some downside protection. We believe the stock remains very compelling at recent price levels and are bullish on the long-term outlook but expect Zillow to be a "battleground stock" for years to come.

Howard Hughes – Strategic review announced to unlock value

The Howard Hughes Corporation (HHC) represents an investment in a unique business model in the real estate industry, consisting of Master Planned Communities (MPCs), where it owns land for residential and commercial development and operating assets consisting of commercial real estate.

There are three complementary business segments that create value in a virtuous cycle. Its MPCs, which essentially control all the land in numerous small cities, generate cash flow from land sales to third party homebuilders. These builders then build and sell homes to new residents. This growing population naturally increases the demand for commercial amenities within these small cities. To meet this new demand, HHC leverages the capital from these land sales to deliver commercial amenities such as office, retail and entertainment facilities sourced from its massive development pipeline. Collectively, these new developments generate attractive risk-adjusted returns, producing consistent and growing streams of income for the company. Once these amenities are in place, it increases the overall desirability of the community, which increases the value of the remaining land as more people seek to live there. Of course, HHC owns all of the land in those small cities, which they can then sell at higher prices to homebuilders in the future. This self-funded virtuous cycle will repeat itself over and over again in the coming decades, compounding shareholder wealth along the way. We view it as a relatively low-risk strategy to compound wealth, assuming one has a long-time horizon, as we do.

Such a strategy may be fine with private owners. But most public shareholders don't care that much about the coming decades. And, to be fair, there have been some hiccups on one notable project (Seaport in New York). Nevertheless, over the last five years or so, the stock price and intrinsic value have diverged widely for reasons unrelated to fundamentals in our view. The underlying value of the business has steadily marched up while the stock price continued to sink.

In our experience, prolonged underperformance of a stock often triggers a strategic review or potential sale of a company. We took some comfort from the fact that Bill Ackman, a well-known activist investor himself, was both the Chairman and aligned owner of Howard Hughes. For better or worse, he has a history of getting involved with targeted companies to unlock shareholder value. Who is better placed to try to unlock value at HHC than Ackman himself? In June 2019, frustrated by the increasing gap between their perceived intrinsic value and the stock price, the Board of Directors announced a review into potential strategic alternatives to maximize shareholder value. All options are on the table with no timetable set. According to a Bloomberg story last summer, management believes the shares are worth

[3] Albeit one backed by a profitable advertising business and enormous clout in the real estate ecosystem.

about $200 per share, well north of today's $129 per share[4], and more than double the stock price in late June 2019[5] just prior to announcement of the strategic review. After roundtripping for the first half of the year, the stock is up 32% year to date on the back of this announcement. We believe the stock remains undervalued and look forward to the findings of this review.

A few intelligent things to do

We do not normally delve deeply in macro-driven topics. We think macro factors are important, but largely unknowable. Instead, we spend the vast majority of our time on micro-factors trying to research and understanding individual businesses and securities. That is challenging enough! After all, individual businesses are complex adaptive systems that cannot be modeled with much certainty. Nevertheless, occasionally we uncover a few ideas that fall within our circle of competence, pass the scrutiny of our investment process and where the likelihood of a decent outcome seems favourable. Our micro vs macro view is probably best summed up by Charlie Munger, *"Our job is to find a few intelligent things to do, not to keep up with every damn thing in the world."*

Please do not hesitate to contact me, should you have questions or comments you wish to share with us.

Felix Narhi
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[4] Closing price on September 17 19 was $128.76
[5] Closing price on June 26 2019 was $92.59