

PENDER PENDER

VALUE FUND

SMALL CAP OPPORTUNITIES FUND

THE MANAGER'S COMMENTARY - SEPTEMBER 2019

Fellow Unitholders,

Looking back on the month of September, things may have seemed relatively benign. The Pender Small Cap Opportunities Fund was up 3.1%, while the Pender Value Fund was up 1.5%¹. These results are pretty much in line with the parts of the market we look at. However, it was far from smooth sailing.

Early in the month we saw a fairly significant rally in the small cap value sector. So much so that many industry “experts” were predicting the beginning of the “value” cycle: “Given that the S&P 500 is heavy in bond proxies and secular growth, we would expect higher upside potential in small caps, cyclicals, value, and Emerging Market stocks than the broad S&P 500” [said JP Morgan's Marko Kolanovic](#). We'd really like to agree as Small and Value have been the two worst performing factors for each of the past three years. Clearly, I wasn't listening to my mom when she told me to choose my friends wisely.

“All we want is an unfair competitive advantage or no competition”

Who doesn't? Felix likes to use this quote to remind our investment team to seek out opportunities where we have an edge – it's the starting point for generating ideas for every one of our funds. With the continued underperformance of active management and in particular small cap value, we find ourselves in an environment where competition has decreased significantly. In Canada this year we have witnessed the departure of at least six portfolio managers who would look at companies in our universe through a value lens. In the US, long short hedge funds with a value discipline have been under fire too. This has implications for our portfolios, both in the short and long-term.

First the short-term implications. We have witnessed increased volatility in our space over the last 18 months. Capital moving out of the space has created selling pressure on a wide range of names in the small and microcap universe. We point to the performance of microcap or value-based indexes. The results aren't pretty, but it is to be expected when there are more “sellers than buyers”. The other impact we are seeing is the volatility around quarterly results. We touched on this in [our last commentary](#) when talking about Carbonite and the volatility we have witnessed around reported results. Price moves in these stocks are becoming increasingly detached from the business fundamentals. We have watched first-hand, both in our portfolio and on our watchlist, companies that have gapped down significantly further on minor issues in their results. Where historically we would have expected a stock to trade down 10-20%, some have traded down 40-50%. We attribute this to a lack of fundamental buyers willing to step in and buy the stock when it is down. Either they aren't there, or they are too nervous.

However, the long-term implications are much more positive. We are able to position the Pender Value and Pender Small Cap Opportunities portfolios in companies that our fundamental analysis shows us and we believe to be incredibly attractive for the long-term. The lack of other buyers of these businesses today creates a wonderful opportunity for us as we can pick them up at the discount prices caused by the short-term downward pressure and build in an attractive potential long-term return.

While we have focussed our discussion in this commentary on small cap value stocks these trends are not unique to small cap value but capture what we are seeing across the board in “non-index” names.

¹ F Class; source: PenderFund

Portfolio positioning

We continue to position our portfolios to take advantage of these market dislocations. The Pender Small Cap Opportunities Fund is essentially fully invested with less than 2% cash. In the Pender Value Fund we have been decreasing large cap exposure and increasing exposure in the mid to micro cap part of the market. Cash has been approximately 9% over the past couple of months, not only because we are happy with the current potential return profile of the Fund, even with the cash weighting, but also to have the dry powder to buy more of our watchlist companies in the small cap space as we anticipate them gapping down to our buy targets.

*David Barr, CFA
October 15, 2019*

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PenderFund Capital Management Ltd.

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