PENDER
CORPORATE BOND FUND

## THE MANAGER'S MONTHLY COMMENTARY – DECEMBER 2019

The Pender Corporate Bond Fund had a positive result of 1.2%[1] in December, and a total return of 5.6%[1] for the full year, 2019. Credit markets ended the year buoyantly with the exception of longer dated investment grade bonds, which declined somewhat as yields rose along the curve.

Strong contributors to returns in December included Paratek Pharmaceuticals whose convertible notes gained as the company announced over $200 million in grant awards and purchase orders from the US government. Other gainers included Briggs and Stratton 2020 bonds as investors looked more favourably on refinancing prospects, and our basket of rate reset preferred shares, which gained on a higher outlook for 5-year Government of Canada yields.

Offsetting December's gains, to a degree, were the convertible notes and preferred shares of Just Energy, which fell as the energy marketer suspended its preferred dividend as part of a covenant amendment agreement with its senior lenders. We continue to like our prospects for full recovery in this case, given the commitment of strategic equity owners and the company's continued operating profitability.

**The Cream Puffs of Credit ... And Other Things That We Seek**
We have long appreciated this planet's rare species, the most elusive of which may be the infamous side-hill gouger. Possessing two short left legs and two slightly longer right legs, the side-hill gouger is ideally proportioned for grazing on the steep inclines of grassy hilltops. Unfortunately, though we have detected a scent and have occasionally even seen distinctive tracks, the animals have never been seen. Side-hill gougers, alas, prefer to remain on the other side of the hill.

Almost as elusive are the "cream puffs" of the credit market. Offering returns multiple points higher than the going rate, the "yieldy" cream puff also occupies the closest thing credit markets can get to a fireproof house. A case in point, we believe, is the surprisingly interesting 0 7/8ths SunPower convertible notes of June 2021. The notes were recently priced at 92 to yield about 7% to a maturity now 15 months away.

SunPower, as our regular readers recall, is actually a majority-owned subsidiary of the French energy behemoth, Total, S.A., an entity which itself sports a $140 billion market capitalization and is rated "A+" by the careful clerks employed by Standard & Poors. SunPower 2021 convertible notes, while not formally guaranteed by the parent, nevertheless seem to have strong sponsorship due to the fact that over $250 million of this $450 million issue are held by Total.

Further buttressing the case for repayment is a relatively cashed-up balance sheet. Sitting on 189 million at September 30, the company recently entered into a series of transactions that, once settled, will raise cash balances to $425 million. From a cash flow perspective, things also look good for SunPower, now that it has spun out its capital intensive manufacturing operation. We estimate the company, the market leader in commercial and residential solar power solutions, will generate a further $100 million in free cash flow prior to its maturity date.

Nothing in this life is certain, except perhaps that side-hill gougers will remain steadfastly on the other side of the hill. But we are confident enough in the payout probability of the SunPower front end notes to confer the title "cream puff" to these securities.

**New Positions...An Opportunity in Floating and Variable Rate Securities**
In December we were drawn by low prices to initiate positions in a number of floating rate securities. Although a disinflationary trend has driven the risk-free rate generally lower for the better part of the past 40 years, we now see a number of positives for floating rate securities, at least for the moment.

---

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

We begin with price. While much fixed rate credit appears priced for perfection, many floating rate markets have been beaten to tatters. Consider the double-digit discounts to NAV in US closed-end funds that specialize in floating rate senior loans, or the huge discounts to par in Canadian rate reset preferred shares. We also see sizeable discounts to par in long dated floating rate notes issued by US financial institutions. And all of these discounts exist despite much higher current yields available in these instruments compared to fixed rate instruments of comparable credit quality.

Comparatively, current market prices offer an historically unattractive risk/reward proposition to long-term fixed rate bond investors. The US Treasury 10-year forward term premium, which measures the incremental yield that investors receive for extending duration, is extraordinarily low. This index whose average value was approximately 2% over the past decade ended December at -0.5%, within striking distance of its historic minimum level.

In addition, the cycle of debt underwriting, which we view as a contrarian indicator, is possibly overheating for longer term fixed rate securities. The only instances in history of US high yield issuers raising 8-year maturity money below 4% occurred in 2019. Meanwhile, floating rate term loan issuance has been relatively weak. If you subscribe to the idea that Wall Street tends to sell its clients things they want as opposed to things they need, then floating rate securities may soon be making a comeback, and long bond buyers may live to regret their enthusiasm of 2019.

Finally, the underlying trend of treasury yields appears, possibly, to be changing. For all the talk of negative yields sweeping the globe, it's important to remember that the record low 5-year US Treasury yield (0.58%) was observed more than seven years ago in 2012 and from that point through today has risen by a factor of almost three times. The 10-year yield record low of 1.37% dates back to July 2016, with current levels 40% higher at 1.92%[2]. After considerable panic about recession in 2019, the US 30-year yield did hit an all time low, under 2%, but has since risen more than 20% to 2.39%[2]. If the risk-free rate is in free fall, you wouldn't know it from watching the yield curve! If anything, the trend appears to be moving higher.

**Fund Positioning**

The Fund yield to maturity at December 31 was 5.6%, with current yield of 4.5% and average duration of maturity-based instruments of 2.8 years. There is a 1.9% weight in distressed securities held for workout value whose notional yield is not included in the foregoing calculation. Cash represented 6.4% of the portfolio at December 31.

*Geoff Castle*
*January 7, 2020*



[2] Year to date until December 31st, 2019; source – PenderFund, Bloomberg