PENDER FIXED INCOME

THE MANAGER'S MONTHLY COMMENTARY – FEBRUARY 2020

The Pender Corporate Bond Fund declined -0.7% in February, as coronavirus fears and falling commodity prices hit credit hard in the latter half of the month. North American high yield credit spreads spiked to more than 500 basis points over Treasuries, an increase of about 150 basis points from levels observed in mid-February. Government bond yields fell, which pulled investment grade bonds largely higher, while at the same time hurting floating rate securities and rate reset preferred shares.

Despite the broad market weakness, we enjoyed significant gains in certain securities. Avadel convertible notes gained on an equity financing to more than 110% of face value, adding more than 20% in the month, which provided us a very profitable exit. Similarly, Paratek Pharma convertible notes rallied on a renewed interest in novel antibiotics, gaining several points. Other gainers included Zillow convertible notes, which rallied on the back of quarterly results ahead of expectations, and 1st lien bonds of oilfield services player, FTSI, which also surprised investors with good quarterly cash generation.

Notable weakness came in Just Energy securities, where the company disappointed some investors with earnings that were below expectations. We continue to maintain a productive dialogue with the management team of Just Energy and believe that the right actions are being taken to shore up the company's credit profile.

Uncharted Waters

Risk can happen quickly. The acceleration in the coronavirus case count in February was an example of that fact. Lots has been written on the potential impact of the virus on various industries and economies, and we understand from our reading that the specific magnitude of the impact is fairly uncertain. In sailing terms, there's a degree to which we have entered uncharted waters.

Finding ourselves without a ready reckoner to measure the impact of the crisis, we tend to look overhead to guiding stars or principles to inform our approach. On the defensive side, we continue to focus on liquidity. We think a number of factors drive liquidity including default probability (lower is better), issue size (bigger is better), maturity schedule (shorter is better), and the presence of a well-articulated path to liquidity from the issuing company on a security-by-security basis. Bonds related to public issuers are more liquid than similar credits associated with private issuers. And, of course, our own position size as a percentage of issues is a further factor in considering liquidity.

On the more opportunistic side, we look to value. Assuming a given level of liquidity in an instrument, where can we find an attractive return profile relative to our risk of default? In the panicked environment of the moment, we are looking through many securities. Our analysis involves calculating a likely liquidation value of entities which include stress tests against what we believe to be a large, but transitory, impact. There will be costs and foregone revenues related to a pandemic. But we believe this, too, shall pass.

Case Study in Calculated Risk: Avadel Pharmaceuticals

At this time, when market participants are perhaps overly focused on risk, we thought it might be helpful to recount the story of our recent successful exit of our position in Avadel. There's a reason that we heed the scary media headlines and "tut-tutting" of the risk managers at various client organizations as we represent securities not rated investment grade. And that reason is the potential for outsized returns, especially in relation to what is often a small degree of capital exposure.

We first came across Avadel Pharmaceuticals in May 2019, when one of our New York brokerage contacts highlighted to us the presence of a large block of convertible notes offered in the mid 40s percentage of face value. We were struck by the fact that the notes, the only debt on the balance sheet, were trading at a value that approximated the company's cash balance. The actual business, therefore, was valued in the market at **nothing at all** through the convertible notes. A quick review on the Bloomberg terminal showed an enterprise value that was as high as $900 million in 2014 had completely evaporated.

During our due diligence we discovered that there was a very viable prospect in the company's drug development pipeline. Avadel was close to concluding a phase 3 study on a patent-extending compound that would, if approved, be the only competitor to Jazz Pharmaceuticals' blockbuster sleep apnea drug Xyrem. Consulting a variety of external experts, we concluded that the Avadel drug was a comparatively low risk development, as it was comprised of two previously approved compounds. And what would be the value, if approved, of extending the patent runway of a billion dollar medication? Well, that seemed to be large in the context of the trading value of Avadel's convertible bonds.

To make a long story short, Avadel management executed on the things it needed to. Even before the FDA was asked to make a judgement on whether to approve Avadel's compound, investor consensus has rewarded the company with a presumed success. Convertible notes have followed the Avadel stock higher, to the point where the notes traded as high as 113% of face value in February. Prices like this changed the risk equation for us and we exited the stake in January and February.

This is just one story of a position that was about a 1% weight in the portfolio at cost. But at a time that investors are reaching for the sell button and focusing on downside, a little reminder of the upside opportunity in credit is perhaps apropos.

New Positions

In February, we tended to concentrate on existing lines in the portfolio, but we did add a new position in the Canadian dollar 7.35% notes of Bombardier. In assessing the possible break-up value of Bombardier, we believe that the sum of the parts is indeed greater than recently assigned valuation measures for the whole business. The Canadian dollar bonds, trading several points lower than pari passu USD notes presented a unique opportunity, in our view.

Fund Positioning

The Corporate Bond Fund yield to maturity at February 29 was 4.9% with current yield of 4.6% and average duration of maturity-based instruments of 2.8 years. There is a 3.8% weight in distressed securities purchased for workout value whose notional yield is not included in the foregoing calculation. Cash represented 2.5% of the total portfolio at February 29.

Geoff Castle
March 4, 2020