PENDER VALUE FUND PENDER SMALL CAP OPPORTUNITIES FUND

## THE MANAGER'S COMMENTARY – FEBRUARY 2020

Fellow Unitholders,

Welcome to our February monthly commentary – it's already feeling a little outdated! These are certainly volatile times as we watch markets react to the potential impact of the COVID-19 virus and now the breakdown of OPEC. Long term partners know that we welcome volatility. It allows us to buy the businesses we like when they are well priced or to sell them when they are dear. That's what we do. Analyzing the underlying causes of market volatility and trying to predict it are not our forte. We'll leave that to the investors at Hindsight Capital. We are going to be our usual boring selves and carry on digging into the businesses we understand as we continually evolve our understanding of the opportunities, their risk factors and what their private market value may be. That being said, market volatility can indicate a change of business value so we know that we need to continually evaluate our investment theses, particularly when the market tells you to!

An example from February was our investment in Wynn Resorts. Given the news flow regarding COVID-19, we determined that the risk of owning Wynn had become too high. Almost two-thirds of Wynn's intrinsic value is based on its operations in China and a significant portion of its earnings potential was cut off when Macau was shut down[1]. We exited the position during the month.

As with the rest of the markets, we had negative returns for both funds in February. On a relative basis, the Pender Value Fund performed in line with a loss of -6.6% while the Pender Small Cap Opportunities Fund outperformed major indices for both large cap and small cap universe with a -5.1%[2] loss as against the S&P 500 which lost -6.9%, the S&P/TSX which lost -5.9% and the Russell 2000 which lost -7.1%[3]. On a year to date basis (ending Feb 29), the Pender Small Cap Opportunities Fund has recorded a more noticeable outperformance with a loss of -1.6%[2] compared to the above-mentioned indices, which dropped somewhere between -4.3% to -8.4%.

**Playing the Volatility Game**

It was interesting looking back on the changes we made to the portfolios through the month of February. Early on in the month we were more on the sell side. Some of our core positions had increased past our target weightings and so we trimmed them to bring them back in line. Now as I write this just after month end, we are back on the buy side on some of the same stocks. Historically we have always been active, trading around the same names, we just don't expect to switch sides of the trade this quickly!

Felix wrote a piece a few years ago about what to do in a market downturn[4] and we are holding true to these core principals in this environment. Over the past 12 months we had increased our cash positions in the Pender Small Cap Opportunity and Value Funds. We are putting that cash to work now. The Pender Value Fund is down from 7.3% to 3.1% cash on hand and the Pender Small Cap Opportunities Fund is down from 9.4% to 8.5% cash from a month ago. We have been deploying capital into compounders (or in the case of small caps, emerging compounders). An example of one such company is Diversified Royalty Corp. (DIV) which is one of our largest positions in both funds. The business today trades with a dividend yield of 8.4%. The payout ratio is ~85%[5]. As the company has acquired additional royalties and diversified its business, the stability of its cash flow has increased. This increase in quality has not captured the imagination of most small cap investors in Canada yet. DIV is illustrative of many opportunities we are seeing today.

| *Source: Capital IQ, Pender March 10, 2020* | **Expected Earnings Growth** | **Trailing FCF Yield** | **Dividend Yield** |
|---|---|---|---|
| Company A | 10% | 8.6% | 5.2% |
| Company B | 14% | 12.9% | 2.1% |
| Company C | 14% | 10.1% | 9.6% |
| Company D | 10% | 8.4% | 1.0% |
| Company E | 9% | 15.3% | 3.2% |
| Company F | 10% | 19.6% | 4.1% |

[1] To read more about our exit of Wynn Resorts, please refer to our latest Pender Strategic Growth & Income Fund Commentary.

[2] F Class; source - PenderFund

[3] Bloomberg

[4] Re-released: Four Potential Investment Strategies in a Stock Market Correction

[5] Source – CapitalIQ, March 10, 2020. The growth rates in the table are based on consensus estimates.

The current environment is ripe with opportunities in small cap non-index names. This table illustrates what is under the hood of several of Pender's small cap portfolio holdings. As I write this, 5-year treasuries are currently yielding ~0.61%[6]; comparing this to the free cash flow yield or dividend yield of these companies - if we get any sort of mean reversion here, we could have a strong move. Great if it happens, but you can't count on that. What we do count on is that by owning a portfolio of companies where the expected free cash flow yield and expected earnings growth can drive double digits over the long-term, we believe this is the type of portfolio we want to own today and for a very long period of time moving forward.

We always try to have multiple ways in which we can generate returns on an investment. At this point in time free cash flow, earnings growth, multiple expansion and takeovers are all potential tailwinds we see for the next five years. In the meantime, we sleep well at night with the belief in what our analysis has shown the business is worth today and holding the business at a substantial discount to its intrinsic value.

**Portfolio Updates**

ProntoForms Corporation remained one of the key contributors for both funds during the month of February. We talked about it in the last commentary[7]. Zillow was the top contributor for the Pender Value Fund since its stock price surged post strong Q4 results. Importantly, Zillow's advertising business has rebounded nicely and is growing again from a soft patch in late 2018. We continue to like Zillow's long-term prospects while being fully aware it is a battle ground stock. Strad Inc. was one of the top contributors for the Pender Small Cap Opportunities Fund as they received a management take private offer at a 30% premium. Strad also marks the first Pender holding to be acquired in 2020.

On the flip side, as you can imagine many of our holdings were down for the month. Larger positions with higher dollar values would be expected to become the key detractors. For the Pender Value Fund these were CCL, The Howard Hughes Corporation and Onex, which are among the top ten holdings in the Fund. For the Pender Small Cap Opportunities Fund, Sangoma, Freshii and PAR Technology were key detractors.

We have said this many times, but we would like to reiterate that: we focus on the business quality of our holdings in the long-term and monthly performance is often too short a time period for us to change our view on the true underlying economics of any business. We continue to like many of these holdings, despite the added downward pressure to the portfolios for the month. For example, we think PAR Technology is a wonderful business and we have a great deal of respect for its CEO Savneet Singh. We have invited him to be a key-note speaker at the Pender Investment Conference in June in Toronto. We believe that with his capital allocation capability, PAR Technology could generate strong long-term returns for our unitholders. Again, we believe that the share price volatility presents us with the opportunity to buy when the business is undervalued and trim when exuberance sets in.

*David Barr, CFA*
*March 11, 2020*





[6] As of March 6, 2020

[7] Manager's Commentary – January 2020 – David Barr