PENDER FIXED INCOME

THE MANAGER'S MONTHLY COMMENTARY – MARCH 2020

While managing the portfolio is our main focus, we want to start by saying that we hope you and your families are staying healthy in the crisis we find ourselves in.

The Pender Corporate Bond Fund declined sharply in March, participating in the large and sudden drawdown that engulfed credit markets worldwide. The proximate causes were the twin shocks of COVID-19's economic standstill and the oil-related market collapse. Holders of the Fund's US$ series (e.g., PGF 511) and unhedged series (e.g., PGF 518) fared somewhat better than other series as the Canadian dollar fell roughly 5% against the US dollar during March, although those series were still down considerably. As an indication of the magnitude of the shifts in the market, the Fund's yield to maturity, which was 4.95% at the end of February now sits considerably higher at 9.16%.

There were several specific vulnerable spots in the Fund, as various industries and sectors were impacted by the multiple factors. Bonds of oil and gas producers, which amounted to an approximate 6% weighting at February month-end, fell hard, with some securities declining by more than 50%. We believe this area, which still constitutes a 4% weight in the Fund, represents a potentially large rebound opportunity as production cuts come on-line to normalize inventory levels. Another area of weakness was floating rate or rate reset securities which fell in sympathy with rate cuts, and now trade lower than the 2015 lows. High yield bonds, regardless of industry, were also several points weaker as investors fled risk.

Relative strength in the Fund came from our holdings in Government of Canada bonds, and other high quality, short-duration credit from issuers such as CN Rail, Verisign and Apple. However, even the highest quality corporate names experienced a degree of spread widening through the period.

A Roadmap for Credit Investing in Our Chaotic Times
We find ourselves in a volatile and uncertain market. In these circumstances we rely on our investment process and are committed to a number of guiding principles that govern our actions:

<u>Keep the shape of the Fund</u>: In order to have the ability to take advantage of opportunities as they present themselves, as well as to keep investor confidence in the Fund, it is important to maintain the "shape" of the Fund in terms of our weighting by risk tier. Tempting as it may be to "back up the truck" on deeply discounted bonds, we need to preserve liquidity and flexibility by continuing to hold strong weightings in cash, government bonds and low default-risk securities.

<u>Manage for long-term fund holders</u>: Volatile markets bring the potential for broker quoted bond prices to differ materially from executable prices. Therefore, it is especially important in these times to promote full price discovery on the Fund's holdings, *regardless of whether doing so has a short-term negative impact on the Fund NAV*. We believe a rebound in the NAV will come eventually. But, in the near term, the Fund's price should not be artificially flattered by stale prices, or by prices that reflect our disproportionate buying activity. Purchasers need to know they are buying a high-integrity NAV.

<u>Buy the markets the Fed is buying</u>: These are extraordinary times for central bank market interventions. Numerous markets that had not previously been subject to direct Federal Reserve purchases are now at least partially backstopped by a buyer with theoretically infinite purchasing ability. Recent history has shown that major central banks can be successful in moving prices in markets that they are supporting. The Fed supported markets are not the *only* interesting markets right now, but central back activity does change the risk:reward equation in certain high priority credit areas such as investment grade corporates and municipal bonds. And who are we to fight the Fed?

<u>Be aware of the potential to be layered by senior debt</u>: While there are many low prices available in corporate credit, not every discounted bond is attractive. Even a strong corporate balance sheet may

look much worse after months of drastically reduced revenues. We believe it is a good approach to focus on the most senior series' of debt, given that many companies are drawing down credit facilities to fund losses as opposed to funding productive assets. Senior debt may outperform subordinated debt coming out of the crisis if the subordinated debt has been layered by large revolvers or senior liens.

New Positions

In March we entered into several closed-end fund positions, bringing our weight in that category from approximately 1% of Fund assets to approximately 5%. A key area we bought was US municipal bond closed-end funds, many of which traded to historic NAV discounts in the last month. We believe the financial functioning of state and local governments is critical in the emergency response to COVID-19 and therefore the Federal Reserve will likely do whatever it takes to support the muni bond market.

In particular we focussed on adding weight in large float, nationally-oriented closed-end funds. Buys included the Nuveen Quality Municipal Income Fund ($NAD) which traded to a discount of over 23% in March. We also bought the BlackRock Muni Intermediate Duration Fund ($MUI) and a few others.

Another area of closed-end fund purchases was in investment grade bonds, a market of particular focus by the Federal Reserve's open market operations. The BlackRock Limited Duration Income Trust ($BLW), which owns short-term investment grade corporate bonds, reached a 24% discount to daily NAV in March. In all of these cases, we believe that a double benefit of recovering underlying net asset value, combined with a gradually closing discount may allow us to earn a much higher return in the closed-end funds than in the underlying bonds themselves.

As far as individual credit positions are concerned, we added a position in the unsecured bonds of Micron Technology Inc, one of the world's largest suppliers of chips for personal computers. An emerging trend towards remote working, combined with active investment grade bond buying by the Fed, provided impetus for the Micron 5.327% of 2029, which had declined more than 20 points from early March levels. Micron's cash position of $8 billion exceeds its $6 billion in total debt, and the company's $45 billion market capitalization also gives comfort in terms of margin of safety to debt holders. We estimate 1-year default probability to be less that 0.1% for Micron, with a yield as purchased exceeding 6%.

Fund Positioning

The Corporate Bond Fund yield to maturity at March 31 was 9.16% with current yield of 5.72% and average duration of maturity-based instruments of 2.75 years. There is a 1.69% weight in distressed securities held for workout value whose notional yield is not included in the foregoing calculation. Cash represented 2.5% of the total portfolio at March 31.

Geoff Castle
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PenderFund Capital Management Ltd.