PENDER FIXED INCOME

THE MANAGER'S MONTHLY COMMENTARY – APRIL 2020

In April, the Pender Corporate Bond Fund continued a rebound of unit values that began in the latter part of March. We have a lot of work left to do to recover from the drawdown that arrived coincident with COVID-19's economic shock, but we do see a gradual firming of conditions combined with low securities prices. The future, to us, looks brighter.

Leading the Fund's recovery in April were some of the worst performing securities of March, as investors, with a gentle nudge from the Fed, reconsidered their liquidity-driven sell-off. Husky preferred shares, Zillow convertible notes and W&T Offshore 2nd lien notes all recovered more than 10% in the month, with most of the Fund's other holdings also participating, albeit in a more modest fashion.

Offsetting the Fund's gains, to a degree, was our position in SunPower credit, which fell as the company announced reduced deliveries of solar power systems concurrent with halted construction activity. While we recognize the temporary challenges that SunPower faces, we continue to like the notes which are due in June 2021 and were priced recently to yield 17%. We note that this issue is 62.5% owned by SunPower's majority owner, Total S.A. of France, an entity with a $100 billion market capitalization whose A+ rated 2021 US dollar bonds yield 1.4%. Another weak area for the Fund was the credit of other construction-related companies such as Tutor Perini and LGI Homes, where business activities are subject to interruptions. We consider the financial strength of these entities to be sufficient to withstand a reasonable duration of reduced activity.

Rebounders and New Growth…Where We are Looking for Recovery

The current investing environment is beset with economic problems that have arisen due to the pandemic. Yet each day now brings signs of new hope. Governments and central banks around the world continue to bring forth new economic rescue and asset purchase programs. On the medical side, we are seeing progress. Diagnostics tests for COVID-19 are getting better, faster, and are more widespread. COVID treatments such as plasma therapy or anti-viral drugs such as Remdesivir, while perhaps not fully ready, are beginning to show some good results in patient trials. And the march towards a viable vaccine continues. Oxford's vaccine formulation is already being administered to test patients, while the Gates Foundation is pre-building a vaccine manufacturing capacity to be ready once an effective compound is discovered. Six weeks ago we had hope alone. Now, the necessary ingredients for recovery are coming into clearer focus. While disappointments and setbacks may arise here and there, there is hope that a recovery is coming.

As we look for financial recovery, we are focussing on two areas: rebounders and new growth. Some rebounding securities, we believe, are to be found in the areas directly impacted by the pandemic's economic standstill, such as travel, oil & gas, construction, food service, and commercial real estate. Other areas of rebound potential relate to securities whose issuers were relative bystanders in the economic disruption, but bonds priced much lower as part of a general liquidation event. Our enthusiasm here, while strong, is nuanced according to capital structures. In some cases, the performance of senior debt in hard-hit industries may be significantly better than equity. But, speaking generally, we like companies participating in enduring industries that should expect a profit recovery.

Our chief considerations in evaluating rebounders include the *magnitude* of price recovery as well as our degree of *confidence* in price recovery for the particular security. By magnitude we are really thinking in terms of "points" of recovery in a credit. Two securities can have the same yield, but the lower priced security may have a greater percentage return potential. As for confidence, we believe we can improve the potential of realizing a good recovery by focussing particularly on secured credits or on securities that sit above a large buffer of equity. Particularly when dealing with companies that are stressed, we like secured credit or credit with large buffers of subordinated security value.

With respect to securities offering exposure to growth sectors, we look to a few areas which stand as beneficiaries in the current environment. One of these areas is healthcare, particularly in areas that have a relevant product offering to the virus. Accelerate Diagnostics Inc, where we hold convertible debt, is one such example. Another area is precious metals miners including silver producers. We see some future potential for increased precious metals investment demand arising from concerns related to large creations of fiat cash and the potential for future debt monetization. A third area is communications technologies, particularly those supporting remote work or e-commerce, such as our investment in Avaya Holdings. In these "growthier" areas, our securities focus relies more on buying bonds possessing near-the money equity conversion rights. Our long-term holding of convertible bonds in Osisko Gold Royalties is an example of this type of growth-oriented position…a solid credit, underpinned by an equity value of several times total debt, but which also offers upside through convertible strike prices that are close to the current market.

New Positions

In April we added several new positions that included several rebound-oriented theses, along with others that were more growth-oriented. Some of the new stakes are outlined below.

We added a stake in the first lien term loan of Chesapeake Energy Corp at a deep discount to face value. Long-term holders of the Fund will recall our successful investments in Chesapeake debt in 2016. We consider the valuation of all the debt and equity securities of Chesapeake, at market, over the past five years to have been never less than $5 billion until the COVID crisis. We see the company's seniormost $3 billion 1st lien credit currently priced at 37c on the dollar or slightly more than $1 billion. Our investigations of likely valuations of Chesapeake assets indicate the potential for full recovery. The headlines may get ugly and our expectation is that the company will file for creditor protection shortly. However, we expect any workout of Chesapeake first liens to deliver a strong recovery.

We added a stake in the first lien 2027 bonds issued by Transocean Poseidon priced in the mid 70s percent of par value. This bond is the secured creditor against all revenues and assets of a group of offshore oil producing platforms that are leased by Royal Dutch Shell on a long-term contract. Outside of the bankruptcy of Royal Dutch Shell, we believe there is very little that can interfere with the note's income stream. We note that Shell maintains a strong investment grade rating, with its own 2026 US dollar credit priced to yield 1.8%.

We bought a position in the preferred shares of Thomson Reuters. The Thomson series B preferreds recently traded below $10/share to yield more than 5% on a running basis, adjusted to take into account their newly lowered dividend that floats off of the Canadian prime rate. This security has a long history and tends to perform well on expectations of increasing rates, having traded as high as $20/share less than 2 years ago. A snowshovel in July, perhaps? No one is anticipating higher interest rates now. And that is the point. With 1-year issuer default probability we estimate to be less than 0.01%, the company is a very strong credit. Over $35 billion in equity market cap in Thomson Reuters is subordinate to the series B preferreds. So we hold and await a different market.

Also in April we acquired a position in the convertible bonds of First Majestic. First Majestic is one of the world's largest focussed silver producers. The company has a market capitalization of almost ten times its outstanding debt and it holds about the same amount of balance sheet cash as it has debt. The 2023 convertible bonds traded recently at a small premium to par where we acquired our position. The convertible notes have a strike price of $9.50 and shares ended April at $8.07. We consider this investment to be an asymmetrically positive risk/reward proposition.

Fund Positioning

The Corporate Bond Fund yield to maturity at April 30 was 8.6% with current yield of 5.5% and average duration of maturity-based instruments of 3.0 years. There is a 3.6% weight in distressed securities held for workout value whose notional yield is not included in the foregoing calculation. Cash represented 2.8% of the total portfolio at April 30.

Geoff Castle
May 6, 2020