PENDER FIXED INCOME

THE MANAGER'S MONTHLY COMMENTARY – MAY 2020

The Pender Corporate Bond Fund gained 3.6%[1] in May, continuing to rebound from the COVID-related drawdown. North American credit markets continued to be well bid as both the Bank of Canada and the US Federal Reserve began to make good on their promises to purchase a variety of credit securities and ETFs. In addition, a recovery in oil prices drove improved sentiment for credit in the resource sector.

Leading the Fund's gains in May were our three largest oil and gas positions; W&T Offshore second liens, our recently added stake in the Chesapeake FILO term loan, and Talos second lien bonds, all of which rallied more than 40% from their April closing levels. Most other positions saw more modest gains. However, returns over ten percent were seen in bonds of civil construction contractor Tutor Perini, which delivered a strong earnings report; secured debt in fuel refiner Par Pacific, which completed a successful new financing; and recently added convertible notes of silver producer First Majestic, which rallied with underlying metals prices.

Offsetting the gains above, to a small degree, was weakness in rate reset preferred shares, some of which fell over 5% on investor sentiment respecting the direction of long-term interest rates. Although a negative contributor lately, we value the diversification effect this asset class has in the Fund. We believe resets are cheap, even stress tested against a 0% 5-year Government of Canada yield. We remind holders that our earlier round of investing in resets played an important role in the Fund's success during the rising rate environment of 2017 and 2018.

Our View from the Trenches…Credit Markets are Recovering

The recovery in bond markets has been thus far robust, even if it has been unevenly distributed. The US BBB Rated Index's effective yield to maturity, after spiking to as high as 5.6% on March 23, closed the month of May at just a tick over 3.0%, which is approximately the same level that prevailed at the beginning of the year. Government bonds, helped in no small way by limitless central bank interventions, have been bid to record low yields in North America. So, our view is that "high grade" has recovered.

Looking down the table, lower tiers of credit have begun to rebound, but much less completely. Single-B credits ended May at an effective yield of 7.09%, which does represent a significant improvement from over 12% at the peak of the crisis but is still about two yield points wider than in early 2020. And the CCC and below index, which is home to the markets most distressed (and lowest priced) bonds has scarcely recovered at all. Touching 20% effective yield on March 23, the BoAML CCC Index still sports a yield of over 16.7%, which is more than 5 points wider than where things stood on January 1. In a nutshell, the recovery in deeply discounted credits is at a much earlier stage.

We read things. We know many experts are warning about an inevitable second wave of the virus and they also suggest markets may retest levels touched earlier this year. But we are also traders. We know what it is like to be bidding for bonds in this market. Where bond buying in the middle of March felt like the priceline.com "name your price" feature, recent days in the higher end of the bond market have been more like doll shopping during Cabbage Patch mania of the 80's. A "lift-a-thon" some of the brokers call it. Will this pass quickly? Perhaps. But judging by the limited amount of Congressionally authorized "ammunition" that the Fed has deployed to date (as little as 5% of the authorized bond and ETF-buying in the corporate credit area), our sense is that high grade may continue to tighten.

Such momentum in the higher-rated tiers has begun, in our view, to spill over to the lower tiers and less liquid corners of credit markets. Anyone who remembers the seemingly miraculous recovery of the Greek and Spanish markets from the PIGS crisis of 2012 would recognize what is going on in North American wide spread credit

[1] F Class; source - PenderFund

today. Deals are getting done. Bids are appearing in names that were bereft of interest for months. We promise, we haven't abandoned our discipline, but it sure feels like a recovery.

New Positions

In May we built a position in the first lien 8% notes of Intelsat S.A. which the company announced will remain current through its court adjudicated recapitalization. Intelsat is set to receive over $4.8billion in compensation for a portion of its spectrum, an amount that exceeds the company's $4.4billion in first lien obligations. Beyond that value, we expect Intelsat will emerge from bankruptcy with operating profitability of as much as $1billion per year and a significantly lower debtload that will come from equitizing large portions of subordinated debts. Priced just over par, the Intelsat Jackson 8% notes of 2024 represent strong risk reward given the small amount of continuing senior debt in the pro-forma entity.

Also in May we added weight to callable perpetual floating rate securities issued by JP Morgan and Morgan Stanley. We believe the US money centre banks are well capitalized in the wake of a decade of tighter regulation and balance sheet repair, and that aggressive Federal Reserve support in the current cycle further underpins these entities. Higher credit provisions are offset to a degree by much stronger capital markets activity. These notes, yielding just below 5%, represent relatively expensive capital for the banks and, upon further recovery, we view par calls as a possibility. The upside from current trading value (in the high 80's percentage of par) appears attractive.

Until this year our involvement in the marijuana sector was limited to two successful "flips" of short-duration Aurora Cannabis debentures. One in 2018 and another in 2019. Finally, however, we believe a combination of price correction and industry consolidation has made the sector more long-term investable, at least from the point of view of debt investing. And growth, given the prospect of expanding legalizations and innovative new product development, seems to be underpriced. As such we acquired a stake in the secured debt of Trulieve Cannabis Corp., which has demonstrated strong levels of profitability in its integrated Florida medical cannabis operations. With $213 million in debt sitting atop an equity structure valued at over $1.4billion and cash balances of over $100million, we feel the Trulieve 9.75% 2024 notes are attractive in the context of a 1-year default probability that we consider to be less than 0.2%.

Fund Positioning

The Corporate Bond Fund yield to maturity at May 31 was 6.9% with current yield of 5.2% and average duration of maturity-based instruments of 2.9 years. There is a 3.4% weight in distressed securities held for workout value whose notional yield is not included in the foregoing calculation. Cash represented 3.5% of the total portfolio at May 31.

Geoff Castle
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