PENDER VALUE FUND PENDER SMALL CAP OPPORTUNITIES FUND

THE MANAGER'S COMMENTARY – MAY 2020

Fellow Unitholders,

We hope you and your families continue to be safe and healthy.

Stock markets continued to push higher in May and small caps led the way this month. The Russell 2000 (CAD) and Russell Microcap (CAD) were up 5.4% and 5.5%, outperforming S&P 500 (CAD) by approximately two percentage points. Our funds delivered even better performance than small cap indices, with the Pender Value Fund up 6.4% and Pender Small Cap Opportunities Fund up 15.1%[1]. Nevertheless, on a year to date basis, small cap stocks continue to lag the performance of large cap peers in the US markets. Year to date, the S&P 500 (CAD) reversed losses and had a positive return of 0.8% while the Russell 2000 (CAD) and Russell Microcap (CAD) remained underwater with double digits losses.

Our Favourite SandBox

Our improved performance in May was driven primarily from our exposure to the technology market. We have utilized the volatility over the past few months to increase our exposure to one of our favourite sandboxes, technology, and in particular, growing small cap tech companies. When we talk about volatility, most investors think of share price volatility and we saw our fair share of stock price volatility in recent months. But the abrupt changes in the global economy as a result of COVID-19 have also driven some fairly dramatic "intrinsic value" volatility. The velocity at which intrinsic value was both significantly impaired for some companies and significantly increased for others is not something we have witnessed before. This has created a tricky investing landscape where we've been focusing on moving on or decreasing our weighing to the former, and increasing our exposure to the latter. Velocity during volatility is of the essence.

You don't have to look much further than the performance of the Nasdaq since late March to understand that certain technology stocks have potentially benefitted from the economic changes driven by the global pandemic. In conversations we talk a lot about what Microsoft CEO Satya Nadella said, "We've seen two years' worth of digital transformation in two months". Pulling forward high incremental margin, sustainable cash flows not only increases the value of the company as defined by the net present value of the company's cash flows, in certain situations it can dramatically deepen a company's competitive advantage. Microsoft is a great example of this. They make good software. But what they also do really well is develop relationships with the technology teams who make buying decisions at corporations. Their product suite, including Office 365, Azure, SharePoint and Teams had gained significant traction over the past few years. In early March, when businesses large and small around the world were confronted with the challenge of creating a stable work-from-home environment, the head of IT or the CTO had to make a quick decision. A lot of companies that were already using Microsoft products leaned on that familiarity to adopt additional Microsoft solutions, even if other solutions are technologically superior. If this adoption had followed the traditional curve, Microsoft may have been more deeply impacted by the competition. However as a result of the rapid adoption, their ecosystem has become stronger and customers even more entrenched in their offering. The competitive landscape tilted in their favour relative to where it had been and it seems it will stay that way for the foreseeable future.

The combination of increased intrinsic value and decreased share price, particularly in the technology sector has created an environment where we believe the margin of safety is attractive and we have moved back into the

[1] F Class; source - PenderFund

space. Since mid March it's even more pronounced as we've added six tech names to the Pender Value Fund and two tech names to the Pender Small Cap Opportunities Fund. Our exposure to the tech sector has increased from approximately 21% to 25% in the Pender Value Fund and from 28% to 35% in Pender Small Cap Opportunities Fund. With attractive growth rates, high incremental margins, and long runways, we are happy to have moved back into the tech space, and we are continuing to evaluate other new opportunities which you may read more of in the months to come.

Portfolio Updates

Echoing what we have discussed above, some of our technology holdings were the main contributors to fund performance in the month of May. Sangoma and eGain once again were among the top contributors to both the Pender Value Fund and Pender Small Cap Opportunities Fund. In last month's commentary we discussed how these two businesses were accelerated as a result of COVID-19 and how their intrinsic value has increased as secular trends have provided tail winds. Other notable contributors included Zillow and JD.Com for Pender Value Fund, and Leaf Group and Photon Control for Pender Small Cap Opportunities Fund. Athabasca Oil Corp. (debt) was also among the top contributors for both funds. Athabasca Oil Corp. (equity) was one of the detractors in March. We noticed a significant dislocation in the distressed debt of the company which provided a favorable risk to reward profile compared to the equity. We sold the equity and bought the 2022 Notes for Athabasca Oil Corp. This is a great example of how a flexible fund mandate has provided us with the option to choose the asset class we believe has the better upside by leveraging our cross-structural knowledge of the business.

On the flip side, key detractors for Pender Value Fund included Burford Capital. Burford Capital is a pioneer and leading global litigation finance company. COVID 19 is expected to drive a significant increase in litigation finance demand. We still like the potential of the business and its share price rebounded in the first few days of June. Crown Capital and Indigo Books and Music were among the key detractors for Pender Small Cap Opportunities Fund.

Stock markets seem to be on a recovery path. Nonetheless, there remains many uncertainties which could cause markets to turn rapidly and unexpectedly. No one knows what's going to happen. We need to be prepared. On the one hand, we continue to assess the risks and opportunities our current portfolio companies are facing; on the other hand, we are constantly looking for new investments that are attractive from a risk/reward perspective. As Howard Marks put it in his recent memo, "we may not be able to predict the future, but that doesn't mean we're powerless to deal with it."

David Barr, CFA
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PenderFund Capital Management Ltd.