PENDER FIXED INCOME

THE MANAGER'S MONTHLY COMMENTARY – JUNE 2020

The Pender Corporate Bond Fund (PCBF) continued its rebound in June, gaining 2.9%[1] in the month. The PCBF's sister Fund, the Pender Bond Universe Fund, returned 1.6%[1] in June, closing at a new high for the Fund.

Gains in June were broad-based, with numerous sectors and asset classes performing well. Strong performers included Just Energy converts and preferred shares, which bounced from deeply distressed levels. Other gainers included resource-oriented credits such as Surge Energy and Taseko Mines. A number of busted convertible bonds in the technology area rebounded, with Infinera and Accelerate Diagnostics among the leaders in this area. Fairfax preferreds were also strong in June.

Offsetting general strength were a few spots of weakness. Avaya Holdings, a leader in call centre technologies for remote work-from-home environments, gave back a portion of the recent gains in its convertible notes.

Of Dreams and Daemons…Earning Points of Return in the Age of COVID

I find myself walking, as if in a daze, across a hot and dusty field. The barren soil beneath my feet crunches as I step on the dry seeds that lie idle on the ground. There will be no yield to harvest here. A faceless stranger in a hooded cloak appears before me. His hand gestures me to follow and I comply. Presently, we arrive at the edge of a deep canyon. I peer downwards to the valley floor. I see piles of skeletons, bleached white by a blazing desert sun. My companion raises his hand to point across the canyon. There, on the opposite rim, shines a field of lush green corn, stalks dancing in a gentle breeze. The stranger removes his hood. It is Jerome Powell. He says one word to me. "Jump."

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The dreamworld above, although a fiction, must be recognizable to the asset allocator of 2020. A Government of Canada 5-year bond, once a staple of a fixed income ladder, yields a paltry thirty-six basis points. A million dollars so invested would return, before fees, three thousand, six hundred dollars per year. It wasn't that long ago a gameshow asked gleefully, "Who Wants to Be A Millionaire?" But invested like that, these days, who can afford to be a millionaire?

Robbed intentionally of risk-free returns by the central banks, investors are gently encouraged to reach across the risk spectrum for a more attractive return. But where is one grasping at illusory value, and where can solid excess returns still be found? Such is the dilemma of this moment.

We understand that, not even fully recovered from the March COVID-19 drawdown, looking at risk assets of any type evokes the emotion of the dreamer looking down on the pile of skeletons on the valley floor. We were just face to face with what felt like existential risk. There are issuers losing money. It takes considerable resolve not to bail for cash in this market…except, well, cash has its job and we have ours. And so we turn over idea after idea looking for the right dynamic between price, risk and expected reward.

The best situations we find these days aren't particularly thematic. But a common thread that connects some good risk/reward anomalies in mid-2020 is securities that shelter high in the upper half of the traded value of a stressed company's capital stack. Let the market wake up one morning and chop the value of the entity in half. Invested with such a margin of safety one can still survive whole in the event. Is there a return to be had with such a buffer? Yield to maturity of 1st lien Intelsat is 7.5%. The top of the Frontier capital stack yields 7.8%. Paratek converts with equity value several multiples higher than net debt yields over 10%. Trulieve secured bonds yield over 10% despite sitting atop an equity buffer over

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[1] Class F

10x its debt. The prices of these securities can bounce around, be warned. But in a time where investors are still scared, we think the equities and subordinated securities underneath us in these cases are not materially overvalued. And in our more senior position, we like these risk/reward equations.

New Positions

In June we initiated and added to several positions within the Weston/Loblaws capital stack. We added significantly to our positions in Weston perpetual preferred shares, believing this particular level in Canada's leading food and drug retailer to offer solid income with capital appreciation potential that may come from future calls. We also bought positions in Loblaws and Choice Properties bonds that we believe to offer reasonably good relative value within Canadian investment grade credit.

Also in June, we initiated a position in Macy's 1st Lien 8.375% bonds of 2025. Secured by a number of flagship downtown department store properties, with an appraised valuation approaching twice the amount of the notes issued, we like this real-estate backed note. Macy's as a stressed entity may eventually restructure its junior debt, but we consider this layer of security to be sufficiently buffered and believe this bond to be a good vehicle to preserve capital while awaiting a more widespread economic re-opening.

Finally, we initiated a position in both A-series and B-series pass through trusts of Air Canada. We have come to appreciate the significant advantages of these asset backed obligations, which are structured to provide a priority return in the event of default, based on pledged pools of airplane assets. While it is possible that Air Canada survives the current crisis without filing for bankruptcy protection, our investment in these securities does not take that rosy scenario as a given. We expect, in the less optimistic outcomes, that a bailout of Air Canada would be made at a level that keeps the fleet from being liquidated, but not necessarily a level that makes whole investors in equity or unsecured debt obligations. Yielding as much as 8.9%, the Air Canada pass through trusts appear to be a sweet spot in that capital structure.

Fund Positioning

The Corporate Bond Fund yield to maturity at June 30 was 6.1% with current yield of 5.0% and average duration of maturity-based instruments of 2.9 years. There is a 4.8% weight in distressed securities held for workout value whose notional yield is not included in the foregoing calculation. Cash represented 5.2% of the total portfolio at June 30.

Geoff Castle
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PENDER
PenderFund Capital Management Ltd.