PENDER FIXED INCOME

THE MANAGER'S MONTHLY COMMENTARY – JULY 2020

The Pender Corporate Bond Fund gained 2.4%[1] in July, continuing the positive trend that the Fund began after the March 2020 lows. The positive performance was within the context of improving overall credit market conditions that saw tightening spreads and an active primary market for corporate debt issuance. Government bond markets remained well bid with yields drifting slightly lower in July.

The Fund's gains in July were broad-based, with most issues appreciating. The largest moves occurred in several convertible bonds that rallied significantly in sympathy with equities that neared or broke through conversion strike prices. This group included our position in Opko Health's 4.5% notes of 2025 which reacted strongly to the company's success in attracting COVID-19 testing business in its diagnostic health division. While we continue to like Opko's prospects, we did sell most of our position in July as the notes, which had traded a couple of months ago at 80% of face value, rallied as high as 150. Less spectacular, but still significant, were gains made in the convertible bonds of First Majestic, Infinera, Zillow and Twitter, as strong individual fundamental developments in these companies pushed convertible notes towards "in the money" status.

Another area of strong performance in July was preferred shares. This market benefited from positive sentiment relating to Royal Bank's new AT1 note issuance program that we believe may result in a number of bank preferred share issues being called at $25 par. This action appeared to drive higher prices and lower yields in other preferred share structures that included Fund holdings Bell Canada, Husky Energy and Thomson Reuters, amongst others. We continue to like the Canadian preferred share market.

Offsetting the positive moves, to a degree, was weakness in a few distressed issuers as restructuring and recapitalization efforts drove some security-level volatility. In particular, Just Energy notes declined as the market digested the company's proposed equitization plans. We continue to work on achieving the best possible outcome for our unitholders and other holders of these notes.

Canada's Preferred Share Market - Royal Bank's AT1 Issue Highlights the Cheapness

We've said this before, but it bears repeating, we view the Canadian preferred share market as extremely cheap. Weston perpetual preferred shares that used to be priced to yield the same nominal yield as Weston corporate bonds now pay approximately 5.5% while tax-disadvantaged Weston 2032 bonds yield 3.2%. Fairfax preferred C's, a reset series, pay out 7.8% while Fairfax bond yields are in the low 3's. Even assuming resetting at current record low rates, the Fairfax C's would still be paying out almost three times the after-tax yield as the corporate debt.

We were apparently not alone in considering prefs cheap for holders and expensive for issuers. In July we watched with interest the machinations of the Royal Bank in creating its AT1 preferred equity substitute. Looking somewhat like a bond, the AT1 notes were snapped up by fixed income investors desperate for Canadian fixed coupon issues paying out more than 4%.

We can understand the CFO of the Royal Bank's calculus. If you can replace qualifying equity capital, which costs over 5% in after-tax dollars, with similarly qualifying 4.5% AT1 notes, whose **pre-tax** distributions can be deducted against the bank's tax bill, that is a significant advantage to the bank. But why investors would readily surrender higher after-tax yielding pref shares for lower yielding "bond-like" 4.5% preferred notes is another question altogether.

[1] Class F; source: PenderFund

Essentially the Royal Bank accessed a cheap pool of capital (the C$ bond market) and is using the proceeds to redeem securities in an expensive pool for issuers (the C$ pref share market). The situation to us seems analogous to a case where two nearby lakes exist at different altitudes, say 500 feet and 1000 feet. If you can dig a canal between the two bodies of water, then water will flow from the higher lake to the lower lake, at least until the point at which the water levels equalize.

Consider Royal Bank's investment bankers to be modern-day Paul Bunyans, digging a channel that starts to equalize risk-adjusted yields in the bond market with those of the pref share market. The more pref share issues that are called away, the scarcer the existing pref share issues become. And, eventually we believe this cycle will begin the long-overdue process of lowering yields in the pref share market towards more fundamentally appropriate levels. In other words, we like prefs!

New Positions

In July we initiated a position in the busted convertible bonds of New York-based Intercept Pharmaceuticals, a leader in the therapeutic area of liver afflictions. Although it has established a strong revenue base in its flagship Ocaliva drug, Intercept hit a pothole recently as the FDA denied its request for accelerated approval of the compound for use in the large and untreated market for NASH liver disorder. We acquired Intercept 2023 convertible notes between 70-80% of face value, levels that imply yield to maturity in excess of 12%. With a $1.5B equity valuation and over $500M of balance sheet cash, we believe Intercept is well positioned to manage a debtload of less than $700M. We estimate 1-year default probability at less than 1.0% for Nasdaq-listed Intercept.

Also in July we acquired a position in the convertible notes of Canadian oil and gas producer Kelt Exploration in the wake of an announced transaction that leaves the company with a net cash balance sheet. Kelt's recently announced $510 million disposition of its Montney exploration acreage to US oil major ConocoPhillips appears likely to close shortly and our position in Kelt's 5% notes of 2021 are expected to be redeemed in full.

Fund Positioning

The Corporate Bond Fund yield to maturity at July 31 was 5.6% with current yield of 4.9% and average duration of maturity-based instruments of 3.1 years. There is a 4.1% weight in distressed securities held for workout value whose notional yield is not included in the foregoing calculation. Cash represented 4.2% of the total portfolio at July 31.

Geoff Castle
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PenderFund Capital Management Ltd.