PENDER FIXED INCOME

THE MANAGER'S MONTHLY COMMENTARY – SEPTEMBER 2020

The Pender Corporate Bond Fund gained 0.5%[1] in September, continuing the positive trend that the Fund began after March 2020. The Fund's performance came amidst an environment of modestly declining risk-free interest rates and a more challenging high yield market that saw spreads widen.

The Fund's return in September was aided by a gain in Just Energy, as we realized some profits from participation in the rights issue that accompanied the energy marketer's recent recapitalization. Other gainers included the convertible notes of SunPower, which rallied on increased investor focus on zero emission power generation, and Weston perpetual preferred shares, which benefitted from a new scarcity of high quality Canadian preferred shares in the wake of some bank preferred share redemptions.

Offsetting the month's gains, to a degree, were a few positions in areas with demand affected by pandemic-era changes. These included the preferred shares of Brookfield Office Properties and Husky Energy. While the pandemic continues to frustrate any expectations of an early or swift resolution, we are inclined towards the view that the eventual resolution of the COVID crisis will lead to a rebound in relatively well capitalized issuers such as these.

Hunt for Yield, Meet Managing for Value

The major decline in yield from risk free or high-grade fixed income securities has created a real problem for income-oriented investors. As recently as a year ago, government bonds paid out over 2% and GIC's or investment grade credit delivered 3-4%, depending on the tenor. In early 2019, an investor hoping to generate income from a million dollars of capital might have expected approximately $30,000 per year without the need to accept much credit risk. Such days are no more.

The yield curve tells a story about market expectations of future interest rates. Every point on the Government of Canada yield curve under 20 years of duration is below 1%. And even if inflation does re-ignite, central bankers are committed to using their balance sheets to manage rates near the current level. So conservative, income-oriented investors are presented with two alternatives: either accept a significant reduction in income or start to invest in other areas.

No doubt, many will choose just to accept less income, or eat into capital, but many more are likely to choose the path of investing in other types of securities. To the GIC Refugee Class of 2020, welcome to our world.

As investors move from a guaranteed income footing to seeking income from more price flexible capital markets, it is important to put other tools to work than just a simple "greater than" sign. Done properly, a hunt for yield is much more than just sniffing out the highest coupon or highest yield to maturity. What good income investing in our era involves is an understanding of the total enterprise value of companies issuing securities. The best investment opportunities in our market deliver a combination of coupon returns and capital returns as securities prices move to reflect the fundamental value of the whole enterprise.

Sometimes, unlocking the fundamental value of a business involves walking a company through a restructuring to realize the value on the far side of a Chapter 11 filing. Sometimes it involves looking through a closed-end fund to see a deeply discounted set of securities trading in an out of favour

[1] Class F; PenderFund

wrapper. Sometimes it involves taking advantage of an undervaluation by owning a convertible bond that can deliver far more than 100c on the dollar. There are many ways to take advantage of discounts in fixed income securities. And the best of these involve not just hunting for yield, but truly managing for value.

New Positions

In September we added a position in the straight debt of the popular ride hailing operator, Uber Technologies Inc. Like other transportation companies, Uber has seen a degree of weakness during the pandemic, with sales declining by almost 50% in the quarter ending June 30. However, the company had previously been on a favorable trajectory with respect to turning its strong sales growth into improved profitability. With normalization coming sooner or later and with a significant $64B equity cushion, and $7B of cash supporting its $7B in debt outstanding, we find Uber's debt attractive. Uber's 2026 notes yield over 6% against the context of a 1-year default probability we estimate at less than 0.5%.

Also in September, we added a position in the senior unsecured debt of Coty Inc. Coty manufactures and distributes a wide range of beauty brands such as Wella, Max Factor, Clairol, Miu Miu and others. Cosmetics is another industry that has suffered in the pandemic as work-from-home has resulted in reduced use. While the cloud over the industry may persist for a while, we expect an ultimate rebound in use as social interactions recover. Coty's recent sale of certain hair care businesses to KKR for $2.5B and a $1.0B investment by KKR into preferred shares, we believe is sufficient to bolster the company's balance sheet to endure the pandemic pressures. We view 1-year default probability for Coty at around 2%, which makes the 12% yield on Coty's 2026 senior unsecured notes attractive within the context of portfolio risk management.

Fund Positioning

The Corporate Bond Fund yield to maturity at September 30 was 5.7% with current yield of 5.0% and average duration of maturity-based instruments of 2.9 years. There is a 6.0% weight in distressed securities held for workout value whose notional yield is not included in the foregoing calculation. Cash represented 5.4% of the total portfolio at September 30.

Geoff Castle
October 5, 2020

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PenderFund Capital Management Ltd.