PENDER
BOND UNIVERSE FUND

THE PENDER BOND UNIVERSE FUND – YEAR ONE

Having passed the one-year mark since the Fund's inception at the end of January 2020, we are now in a position to report the first full year investment return of the Pender Bond Universe Fund. After experiencing a drawdown through to March 23, 2020 of 3.93%[1], the Fund rounded off its first year in operation with quite a respectable 7.48%[2] return for the one-year period from inception to January 31, 2021. On a relative basis, yield to maturity of 2.32% currently remains quite competitive in this space.

The Pender Bond Universe Fund differs from its sister Fund, the Pender Corporate Bond Fund, in one significant respect – a predominant weight in investment grade corporate or government bonds has been added so that the Fund is compliant with more restrictive, credit-rating focused standards that apply within certain advisory organizations. The high yield credit allocation of the Fund, therefore, is achieved by virtue of the Fund's approximately 30% weight in the Pender Corporate Bond Fund and the balance of the Fund consists of investment grade Canadian dollar bonds.

Making Lemonade

As we construct an investment grade bond portfolio in an interest rate environment where the government of Canada 5-year yield is only slightly greater than 40 basis points and US triple B corporate bond yields, although having risen to approximately 5.5% towards the end of March 2020, hover now at just over 2%, we are faced with a bitter reality. Our goal is currently to achieve an optimal risk adjusted return, without taking on much duration, in an effort to avoid the potential impact to capital preservation should inflation return and rates increase - all while operating within the constraints of a 75% investment grade weighting in order to meet the needs of those looking for only the lowest risk rating. From these acerbic ingredients, the goal is to make lemonade.

Factors Impacting Fund Positioning

The positioning of the Pender Bond Universe Fund remains contingent on the behaviour of credit spreads and the term premium, along with adjustments made to specific holdings in response to changes in the credit worthiness of the underlying businesses we hold. Maintaining shorter relative duration remains a central theme with regard to positioning of the Fund. While interest rates may well stay low for an extended period of time, with this certainly being the main intention communicated by North American central banks, certain factors while by no means conclusive in their individual suggestion, combine to propose a possibility that informs our decision making relating to the duration we maintain in the Fund. Fundamentals, inflation expectations, technicals, along with the money supply and velocity of money, all play a role.

The term premium provides the fundamental justification for maintaining short duration at this time. The US 10-year term premium has been positive for the majority of the period stretching from the early 1960s to current day, dipping into negative territory for only several weeks in the 1960s and then not again until 2016, with brief episodes spent below 0 in 2017 along with 2018. The term premium however has remained persistently negative since 2019 to the current day. Through much of the 1980s investors were well compensated, through extra economic yield, for holding longer dated securities with the term premium reaching between 4 and 5 percent over this period. This has not been our experience since 2019. With a negative term premium, there is currently no incentive through excess yield to take on the risk of a larger price decline inherent in longer term bonds for a given increase in yield. Current fundamentals therefore justify shorter duration holdings.

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[1] Class F from Jan 31 - March 23, 2020; Morningstar

[2] Class F; PenderFund

Inflation expectations also inform this decision-making process. By using the US 10-Year inflation linked swap as a proxy for these expectations, we see that at several points through history – for instance in 2009 coming out of the financial crisis, and again in 2017, a rise in US 10-Year inflation linked swaps have served as a leading indication of higher nominal bond yields. In both instances, when inflation expectations rose, it wasn't long before nominal bond yields followed suit. We have recently seen upward movement in this indicator and although things may prove to be different through this period, a look at the past does allow us to glean insights that may help to reduce price risk within our portfolio.

Technical indicators by no means play a central role in our decision-making process; however they are interesting to note when piecing together a larger picture. From a technical perspective, bullish patterns, characterized by points in history when the short-term moving average of the US 10-year yield has broken above its longer-term moving average, have materialized several times through history – in 2009, 2011, 2013 and in 2017. The period following each "golden cross" was characterized by a significant move higher in the US 10-Year Yield. As this phenomenon has occurred again recently, the possibility exists that yields may be poised to move higher.

The relationship between the money supply (the total amount of money in circulation) and the velocity of money (the rate at which money is exchanged in the economy) are also of interest currently in relation to our decisions regarding overall fund duration. Increases in both have in the past led to a rise in inflation. Quantitative easing, which began in the US during the financial crisis, and which was stepped up again through the COVID-19 response, has pushed the money supply to all time highs. The velocity of money however, has shown a very different trend – it has decreased fairly steadily over this period and then plummeted to all time lows through COVID-19. Although the money supply has increased substantially, this liquidity has seemingly not circulated through the general economy. If however this were to shift, through initiatives such as the Biden administration's $1.9 trillion COVID-19 plan which includes direct payments to households and jobless benefits, it is possible that the velocity of money could change direction.

With a look at factors such as fundamentals, inflation expectations, technicals and the relationship between the money supply and the velocity of money amongst others, the reward for holding a longer dated bond, should yields decrease, is not justified in our opinion, given the declines we could see should rates move in the opposite direction. As a result, the Pender Bond Universe Fund remains positioned with relatively tight duration of 3.7 years.

Emily Wheeler & Geoff Castle
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