PENDER FIXED INCOME

THE MANAGER'S MONTHLY COMMENTARY – MARCH 2021

The Pender Corporate Bond Fund earned 0.9% in March, a period in which high yield credit performed well but investment grade bonds continued to suffer from rising risk-free rates.

Strong credits for us in March included our position in the secured 10% PIK notes of Perth-based uranium miner, **Paladin Energy**. This recently acquired position was one of the ways we had planned to participate in the drive for zero carbon energy sources. And, coming as it did, at 85.5 cents on the dollar with comparatively low default probability, the price didn't seem too bad, either. However, in March the company did an equity rights issue to pay out our note at 102% of face value, and so this investment will turn out to be a much shorter-term hold than anticipated. Still, it was a happy outcome.

Other strong spots in the Fund in March included convertible notes of **Eagle Bulk Shipping**, and a number of rate reset preferred shares, a class where payouts stand to grow with rising yields on various benchmarks such as the 5-year Canada bond.

Offsetting the gains, to a degree, were high grade bond holdings that declined with rising rates. Also weak was our position in the busted converts of **Tricida Inc.,** a developer of medications for chronic kidney disease. Tricida was impacted by a negative FDA ruling that lengthened the runway for a drug approval. We added to this position as the company's entire debt structure now trades at a significant discount to its cash and short-term securities holdings.

High Grade, Longer Duration – A Study in Scarlet

In midsummer 2020, fear reigned. Investment grade credit, a magnet for the risk averse investor, was hot. And hottest of all was long-duration investment grade. But now, splattered all over the statements of then-defensive investors, are splashes of bright red ink. From the early August highs, the ETF tracking the duration-heavy Canadian bond universe has delivered a total loss in excess of 5%[1]. The triple-A rated 30-year Canada bond has delivered a loss of over 20%. With such blood already spilled, is it finally time to look at longer duration bonds?

We believe that, after a long period of answering "of course not," we are seeing enough price movement to offer a qualified "yes". We may not be at the point of maximum longer bond yields in this cycle, but we may be close enough to start shifting a bit of weight rightwards along the curve.

There are, of course, arguments for making the opposite trade. As we ourselves have noted: inflation is rising, yields are still historically low and the Fed has been slowly backing away from its emergency programs designed to hammer down bond yields. All true. But as the US 10-year Treasury yield closes in on 2.0%, the case for buying quality longer duration credit strengthens. Consider the following:

- **Higher Treasury yields, if sustained, may cap some asset values and slow economic activity:** As market action has shown in the last six weeks, it is not just long bonds that suffer from rising rates. A host of "long duration assets" are vulnerable. For instance, in a world where you can earn back the cost of buying a house from ten years of rental income, home prices are not particularly sensitive to 10-year interest rates that move from 1% to 2%. But when it takes 50 years of rental income to recoup your cost, a move in longer term yields to 2% is big. And 3% rates in that situation are a disaster. So, the knock-on effects of higher rates may be lower prices for some properties and businesses, and that may ultimately limit the scope for yields to rise.
- **Sentiment has gotten pretty lopsided:** Sentiment surveys are hardly foolproof, but we do tend to see market turns close to extreme readings. And, in the case of investor sentiment towards US treasury yields,

[1] iShares Core Canadian Universe Bond Index ETF (XBB)

recent readings are lopsidedly bearish. There are almost no bond bulls left. The hedgers have hedged. With such a consensus in place, the market may be primed for a result its participants do not currently expect.

- **The term premium has turned positive:** After years of negative term premiums, the instantaneous forward term premium 10 years hence, a key measure tracked by the US Federal Reserve, recently hit 0.3%, its highest level since 2018. In short, investors are getting paid something again for duration risk.
- **Many of the deflation drivers that existed before COVID are still in place or have further intensified:** We acknowledge that there are certain markets that are experiencing cyclically rising prices, particularly in the commodity area. However, other deflation drivers, more secular in nature, are still in place. Demographics still favour deflation. Some weaker balance sheets have added debt in the crisis. And many of the creative solutions to the pandemic, like Zoom, presage a future deflation in disrupted industries like office space, retail stores and business travel.

We haven't taken the Fund to an extra-long duration positioning by any means. But, considering the favourable moves in prices, and the shifting fundamentals of the duration trade, there have been a number of situations where we have picked up 1-2% in yield extending into the seven to 10-year tenors in issuers like Canadian Pacific, Fairfax, Gartner and MSCI.

New Positions

Outside of some duration-extending trading described above, we put on two significant new credit positions in March, both in the healthcare sector.

We added a position in the 1st lien secured term loan of Team Health Holdings. Team Health is one of the two largest companies involved in the outsourced provision of emergency health services in the United States. Notwithstanding the COVID-19 crisis, volumes in "normal course" emergencies have fallen off in the pandemic and revenues are still over 10% below 2019 levels. This trouble aside, we note the company's strong history of profitability, its sponsorship by Blackstone Group, management's focus on liquidity, and successful cost control measures. A floating yield of 6.3% in this paper represents attractive risk/reward in our view.

Another purchase in March was in the busted convertible bonds of Flexion Therapeutics. Flexion's core product, an injected anti-inflammatory for use in arthritic joints, represents a step forward in the treatment of this condition as its time release formula reduces the number of injections needed and improves outcomes as opposed to the existing standard of care. With growing sales and a strong cash position, we believe Flexion's downside is limited and that upside potential in the conversion feature may exist. A yield of nearly 7% in the context of default probability we estimate at around 1.0% seems attractive to us here.

Fund Positioning

The Corporate Bond Fund yield to maturity at March 31 was 4.9% with current yield of 5.0% and average duration of maturity-based instruments of 3.4 years. There is a 1.0% 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 March 31.

Geoff Castle
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PENDER
PenderFund Capital Management Ltd.