PENDER FIXED INCOME

THE MANAGER'S MONTHLY COMMENTARY – JUNE 2021

The Pender Corporate Bond Fund gained 0.6%[1] in June, a gain which was made within the context of strong credit markets. For the half year, the Fund returned 7.4%[1] and its investment grade cousin, the Pender Bond Universe Fund, returned 1.4%[1].

Leading the way for the Pender Corporate Bond Fund in June were a couple of reorganized equity positions, American Tire Distributors and FTS International, both of which had previously existed as distressed debt positions. While many funds are either forced sellers of such securities or choose to quickly swap out of these into other bonds, we elected to hold onto these due to what we considered to be marked undervaluation. In June we were rewarded. Also contributing in June were the convertible bonds of Infinera Corp, as excitement grew over the company's 800 MHz optical networking products.

Offsetting the gains, to an extent, were a few decliners, most notably our position in the preferred shares of Fannie Mae, which fell sharply on an unfavourable ruling from the US Supreme Court. Fannie Mae, which was brought into a Federal Conservatorship in the wake of the 2008 financial crisis has, in operational terms, recovered strongly over the past decade as the US housing market has regained health. While the Supreme Court's ruling, which essentially upheld the US federal government's right to sweep profits from Fannie Mae into general revenues, was a negative development, we believe there is still considerable value in the preferreds. We expect that cases before two US district courts will, over the coming year, shed more light on the fair value of the Fannie Mae capital structure. And, upon the publication of court-approved enterprise valuations, we believe a settlement of the claims of preferred shareholders to be the next logical step, and that the settlement may be quite advantageous from the point of view of current preferred share prices.

May the Odds be Ever in Your Favour

Summertime in the investing business is a season of calm. The frenzied schedule of meetings and quick-turnaround research gives way to floating carelessly in lakes and pools. The interns have arrived to man the ramparts of the Bloomberg terminal on the lookout for sudden turns of fortune. And so, in a state of decidedly reduced tension, the mind can focus on more enduring issues. This is a time to think.

One of the areas for pondering in fixed income is which asset classes within the group deliver a higher average return. Does every type of bond end up with a similar return over time or are some classes better than others? To answer this question, for the US dollar credit markets at least, we turn to our friends at CreditSights whose record-keeping on these matters is of a high standard.

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[1] All Pender performance data points are for Class F of the Fund. Other classes are available. Fees and performance may differ in those other classes.

Comparative Total Returns										
May 28, 2021	Short-Term Cumulative Returns						Annualized Returns			
	YTD	WTD	1Mo	3Mo	6Mo	1yr	2yr	3yr	5yr	10yr
US										
Treasury	-3.53%	0.33%	0.27%	-0.15%	-3.77%	-3.78%	3.91%	4.65%	2.48%	2.81%
High Grade Corp.	-2.70%	0.49%	0.67%	0.47%	-2.04%	4.51%	7.04%	7.12%	5.06%	4.91%
High Yield Corp.	2.27%	0.34%	0.36%	1.53%	4.32%	15.07%	7.15%	6.75%	7.25%	6.25%
Leveraged Loans	3.00%	0.17%	0.59%	1.11%	4.51%	13.52%	4.67%	4.50%	5.11%	4.53%
Municipals	1.01%	0.22%	0.28%	1.99%	1.77%	5.38%	4.66%	5.25%	3.59%	4.47%
Convertibles	3.37%	2.42%	-3.57%	-3.98%	10.88%	55.06%	33.97%	22.93%	20.91%	13.89%
Preferreds	0.62%	0.37%	0.07%	3.32%	2.13%	10.05%	7.10%	6.97%	5.72%	6.27%
Mortgage Markets										
Mortgage Master	-0.85%	0.01%	-0.13%	-0.18%	-0.58%	-0.41%	3.31%	4.04%	2.50%	2.66%
US Equity Market										
S&P 500	12.61%	1.20%	0.66%	10.72%	16.42%	41.00%	24.66%	17.76%	17.12%	14.48%

Source: CreditSights, BofA/ML, S&P/LSTA, Bloomberg

Treasury = G0Q0, HG = C0A0, HY= H0A0, LL = SPBDPL, Muni = U0A0, Convert = V0S0, Pref = P0P1, Mortgages = M0A0, S&P 500 = SPX

For the decade ending May 2021, the hands down winner amongst fixed income categories was…convertible bonds, which returned an astonishing 13.9%, annualized, for the period between 2011 and 2021. While not every convert went into the money, evidently enough of them did to vastly outpace the other fixed income categories[2].

Now from the back of the room we hear someone calling out the classic heckle of return comparisons… "Ending point bias!" And it is true that the last year especially has been very good for stocks, and some convertible bonds have been pulled along on the ride. But if we were to move the period end to a less favourable spot on the equity market calendar, say December 2016 or December 2018, the results for this class still best the other classes of credit. For instance, the ten years ending May 2016 (a period including the Great Financial Crisis) saw US convertible bonds return 7.6% annualized[3], still a faster clip than other bonds or loans.

Another high returning category, according to the averages, is bonds which have defaulted. For the period encompassing the 29 years between 1987 and 2016, Professor Ed Altman, in his exhaustive study done in cooperation with the NYU Salomon Center, calculates the return from defaulted bonds as 13.6% annualized[4], during the first 24 months from the point of default. Subsequent to important changes in the US bankruptcy code in 2006, which served to speed corporate reorganizations, the rate of returns on defaulted bonds has increased. Between 2006 and 2016, defaulted bonds in the first 24 months following default grew in value at an annual rate of 19.9%[4].

With such strong returns in both convertible bonds and defaulted securities why, you might ask, do so few fixed income mandates include such securities. We ask ourselves the same question. Volatility is sometimes offered as a reason. But when you look at the statistical volatility of a mandate like the Pender Corporate Bond Fund and compare it to, say, the volatility of mandates focused on long duration government bonds, taking the TLT US Exchange Traded Fund as an example, one actually observes lower volatility in recent five-year periods[5].

We believe that the more likely explanation is that including converts and defaulted securities just amounts to too much work for the big passive or near-passive strategies that dominate the fixed income category. There are no ratings to hang your hat on, so investors need to do their own evaluations of

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[2] CreditSights, May 28, 2021

[3] CreditSights, December 2016

[4] Altman/Hotchkins, Corporate Financial Distress, Restructuring and Bankruptcy, 4th edition, Wiley, 2019 see pp 289-291

[5] Morningstar (5-yr standard deviation as of June 30, 2021)

these entities. Especially with distressed securities, where there is a lot of process involved. A distressed credit investor needs to read filings, vote their proxies and sometimes negotiate with the issuer or other investors.

Of course, past performance, as any good lawyer will tell you, is no indication of future results. And we ourselves do not invest blindly in these areas without considerable due diligence on our particular investments. But, like Katniss Everdeen, we live in the hope that the odds may be ever in our favour.

New Positions

In June we added a position in the unsecured term loan of Royal Caribbean Cruises which matures in the first half of 2022. With the re-opening of a wide variety of travel activities and with the substantial progress that this issuer has made in terms of accessing liquidity and managing its balance sheet obligations, we believe that the yield in excess of 5% on this paper is attractive, given the risk. The company sits with over $5B of balance sheet cash, which is more than adequate to address approximately $400MM in 2022 maturities. This loan trades significantly wider than the company's unsecured bonds maturing in November 2022 which yield approximately 2.7%. We believe the reason for the wider spread in the RCL 2022 loan relates to technical factors involving cruise line operator ownership rules and we are confident of repayment on maturity.

Another position we added in June was in the 4-year duration Government of Canada bonds. While there are more "yieldy" securities that we like in this market, we are always conscious of the potential for a more attractive opportunity set to arise at some point in the future. There is the opportunity set we know now, and we have invested in our best expected return ideas. But there is also the opportunity set of six months or a year from now that we do not know. In anticipation of new, interesting ideas coming along in the near future, we consider the Canada bond investment to be building our reserves of dry powder.

Fund Positioning

The Pender Corporate Bond Fund yield to maturity at June 30 was 4.9% with current yield of 4.8% and average duration of maturity-based instruments of 3.8 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 4.7% of the total portfolio at June 30.

Geoff Castle
July 6, 2021

PENDER
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