THE MANAGER'S MONTHLY COMMENTARY – DECEMBER 2021

The Pender Corporate Bond Fund ended 2021 with an annual return, after all fees and costs, of 10.3%[1], including a gain of 0.5% in December. Our investment grade (IG) mandate, the Pender Bond Universe Fund, posted a positive return of 2.0%[1] in 2021, including a return of 0.5% in December.

The performance of the funds was within the context of a credit market that was challenged by rising yields in government benchmarks, which was offset only somewhat by spread compression. In this update we answer some frequently asked year-end questions.

What drove differential performance in 2021?

The Pender Corporate Bond Fund capitalized in 2021 on decisions made in the depths of the panic in the spring of 2020. One of our most beneficial moves was in picking up a series of deeply distressed securities, many of which were priced below 50 cents on the dollar in mid-2020 and riding those to much higher levels. Examples here include our purchase of a Chesapeake Energy Corporation (NASDAQ: CHK) term loan at less than 40 cents on the dollar, walking the position through a Chapter 11 filing and disposing of our position at prices as high as $1.20.

Another category of strength for us was rate-reset preferred shares, which not only benefitted from falling credit spreads, but also from a higher outlook for interest rates that increased the anticipated dividends. People don't often think of BCE Inc. (TSE: BCE) as an issuer that can deliver double-digit returns on preferred shares, but the total return on a line like Bell Canada Preferred Q was over 35% in 2021. We had the good fortune to buy these when the movement towards higher rates was viewed as unlikely. Now, it is consensus.

Something else that helped us, particularly in the Pender Bond Universe Fund, was keeping our durations tight. We didn't know the 10-year Canada bond was going to move from a 0.7% yield to 1.4%, but anyone could calculate that if it happened, the capital loss would be about 7%—a big potential loss in comparison to a 0.7% yield to maturity! So, we maintained much shorter duration than passive index followers and it paid off for us.

How has the environment changed in 2022 vs 2021?

The biggest difference is just the stance of the Fed. We began 2021 with the assurance that, through their actions, the Fed had our backs. They were buying bonds like there was no tomorrow and very few people were talking about rate hikes. Now, there is a general expectation that central banks will still keep a ceiling on rates, but no one knows exactly where. In the meantime, the dot plot is telling you that rate hikes are coming.

Yield-wise, things are about the same. Spreads tightened last year, but this compression was balanced out by rising government bond yields. For instance, the ICE BoA US High Yield Index effective yield, which started 2021 at 4.3%, remains within 0.1% of that level at year end[2].

Investment-grade yields are a little higher this year compared to 12 months ago. For instance, the BBB index yield is about 2.6% compared to 2.1% last December[2]. That being said, IG yields are still below the measured recent rate of inflation.

Another feature of the current environment is a very low level of corporate distress after a spike in defaults in 2020-21, as COVID drove numerous corporate entities into bankruptcy. However, the recovery in the past 12 months has substantially cleaned up the inventory of fresh defaults and CreditSights is forecasting default rates well below average for 2022[3]. That doesn't mean we need to drop our guard against future distress, but an anticipated absence of defaults suggests there will be a little less work-out activity in 2022.

So how are you approaching 2022 in comparison to 2021?

There is going to be a lot of similarity in our approach between any two years. In many ways, being a Portfolio Manager is a bit like being Bill Murray's character in "Groundhog Day," in that we are continually waking up to the same task of scouring the market for unpopular credits which offer a higher-than-average yield with a low or manageable risk of default. This approach causes us to move between sectors as we tend to "follow the misery". We have therefore been

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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.*

[2] *FRED – St. Louis Federal Reserve online. December 31, 2021*

[3] *US Investment Grade and High Yield 2022 Outlook: Use it or Lose It, Winnie Clear, CreditSights December 2021*

phasing out our positions in the oil and gas sector, as spreads have tightened up, while expanding weight elsewhere, particularly in the convertible market, where some equity prices have been crushed and yields have soared. Examples of the latter include a position in the convertible bonds of internet marketer Groupon, Inc. (NASDAQ: GRPN), issued at par early in 2021 but which traded as low as 75 cents in September 2021.

One way that we are approaching 2022 a bit differently to prior years is to more assertively use our scale to create return opportunities for the Fund. In 2021, we worked with three issuers with whom we had larger positions to exchange discounted bond positions for more valuable securities. These were win/win transactions: the issuers were able to reduce debt and/or extend maturities and we were able to increase the value to the Fund—and therefore clients—from the deal. We will look for more opportunities like these in 2022.

Another focus for this year will be adding weight into conventionally desirable cap structures. Over the last couple of years, we found that anticipating that cash flows for a certain company might improve with a cyclical rebound has proven beneficial. Finding ourselves at the midpoint in the cycle means there is an argument to be made that many industries are now operating near their full potential. So traditional tests like interest coverage and debt/EBITDA are assuming more importance for us and we are less interested in blue-sky potential.

What are you buying now?

We have been adding to the secured 2026 4.5% notes of Beacon Roofing Supply, Inc. (NASDAQ: BECN). We like Beacon's business. It distributes shingles, siding and gutters across North America. The industry's demand profile is relatively consistent as most demand stems from maintenance and replacement as opposed to new builds. Secured debt is less than the value of the company's inventory and EBITDA covered interest expenses approximately 7x in the most recent 12 months. For some reason, the good folks at Standard & Poor's continue to rate Beacon as "B+", but we estimate this company's one-year default probability is less than 0.05%, better than a lot of investment-grade credits. We don't get rich on 3.6% yield to maturity in the Beacon 26's, but in the event of stormy weather, investors may gravitate to such stable securities (and guttering!).

On the juicier side, we have been adding to the 4% 2025 convertible bonds of Esperion Therapeutics, Inc. (NASDAQ: ESPR), which priced recently around 52 cents on the dollar. Esperion makes a next generation statin for anyone who has high cholesterol and is at risk of a heart attack. The FDA has approved the drug on the basis that there is a lower side effect profile and an overall higher efficacy than for Lipitor, which has long been generic. Launching a preventative medicine at a time when people have stopped routine visits to their GPs due to the pandemic was not perfect timing. But the company has persevered and sales in the last quarter of 2021 were triple what they were a year ago. Here is a company with more cash than debt and a very useful product that is ramping up its sales, but with bonds trading at roughly half of par and a 23% yield to maturity. In a liquidation scenario, we believe the drug's value is worth more than the debt. Insiders are buying the stock. What's not to like?

How are you positioned?

The Pender Corporate Bond Fund yield to maturity at December 31 was 5.3% with current yield of 4.6% and average duration of maturity-based instruments of 3.6 years. There is a 2.5% weight in distressed securities held for workout value whose notional yield is not included in the foregoing calculation. Cash represented 2.4% of the total portfolio at December 31.

Geoff Castle
January 10, 2022

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PenderFund Capital Management Ltd.