# PENDER
ALTERNATIVE ABSOLUTE RETURN FUND

## MANAGER'S COMMENTARY – DECEMBER 2021

Dear Unitholders,

The Pender Alternative Absolute Return Fund finished December with a unit price of $9.99 and distributions of $0.03 per unit[1].

December was a buoyant month for risk assets, with credit markets participating in the dramatic turnaround as they took comfort in the relative lower virulence of the Omicron variant of COVID. All this, while shrugging off a hawkish pivot and an accelerated taper from the Federal Reserve. Aided by a strong seasonal technical dynamic with no new issues pricing in the second half of the month, the Bloomberg Barclays High Yield Index returned 1.87% for its best month of 2021. The Option Adjusted Spread (OAS) compressed 54bps to finish the month at 283, while the iBoxx Liquid High Yield Index returned 2.12%.

**Portfolio Update**

In response to oversold market conditions, the Fund opportunistically covered some risk hedges in December while maintaining relatively limited exposure to broad market moves. Although we were not surprised by the strong seasonal rally into year end, we maintained a defensive portfolio positioning with a view to the risks that market participants will be assessing early in 2022. Ultimately, opportunities and valuations are the primary drivers of portfolio positioning. While there were select pockets of value in credit markets at year-end, both OAS and Yield to Worst (YTW) on the Bloomberg Barclays High Yield Index were through their lowest values of the 2009-2020 credit cycle, with YTW starting 2022 at 4.21% compared to a bottom of 4.83% in June 2014. We believe our more defensive portfolio positioning is prudent in this environment.

The Fund participated in two Canadian-dollar, high-yield new issues in December that we viewed as attractively priced. We added positions in Shawcor Ltd.'s (TSX: SCL) 5-year new issue that priced at a yield of 9% and Ritchie Bros. Holdings Ltd.'s (TSX/NYSE: RBA) 8-year new issue that was priced at a yield of 4.95%. After meeting with both management teams as part of our due diligence on the companies, we came away impressed and continue to hold both issues. Our Ritchie Brothers position looks quite cheap and trades at a materially wider spread than the 10-year USD tranche that was part of the same transaction. Normally, for a high-quality BB issuer like Ritchie Brothers, we would expect an 8-year bond to trade at a spread of about 10-20bps lower than a 10-year issue. However, due to market technicals, the 8-year Ritchie Brothers bond that we own trades at an OAS of more than 50bps higher than the 10-year that has the same senior unsecured ranking in their capital structure. Given the relatively tight basis between USD and CAD tranches from several well-established high-yield issuers, we expect this relationship to normalize in the coming months, especially with generic market spreads at historically tight levels.

The Fund sold positions in December in both our Relative Value and Current Income strategies. In the Relative Value strategy, we sold out of our Lamb Weston Holdings Inc.'s (NYSE: LW) 8 and 10-year bonds which we initially purchased at issue in October, as well the Bath & Body Works Inc.'s (NYSE: BBWI) 7.5% 2029 bond that we had purchased in November at levels we thought were compelling. In the Fund's Current Income strategy, we sold out of secured bonds in Scientific Games International Inc. (Nasdaq: SGMS) and Bausch Health Companies Inc. (TSX/NYSE: BHC) as both had generated attractive income for the Fund but no longer offered compelling risk-adjusted returns on a go-forward basis, in our view. We hope to add new positions to the Current Income strategy in January as liquidity picks up after a quiet holiday season.

At year-end, the Fund was 112% long with 62% of these positions in our Current Income strategy, 35% in Relative Value and 3% in Event Driven positions. The Fund had a 29% short exposure that included 16% in government bonds, 8% equities and 5% in credit. The Option Adjusted Duration was 0.6 years which we believe effectively limits the portfolio's exposure to rising interest rates as we begin 2022.

We believe that current portfolio positioning should protect capital in both a risk-off and "taper tantrum" market dynamic. While there are some relative value opportunities available, with the strong market rally in December, generic market risk does not look attractive to us, and we expect incremental capital to be focused on our Current Income strategy as we wait for better opportunities.

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

**Market Outlook**

There are reasons to be optimistic about economic growth in 2022. Recent economic data points to a very strong demand environment for both labour and goods, while corporate profits and balance sheets are in solid shape. The fast-spreading but milder nature of the Omicron variant may lead to an accelerated return to business and leisure travel once the current wave of cases recedes. While there is potentially a lot of good news on the horizon, our view is that it has largely been priced into markets already.

The government bond market does seem somewhat disconnected from the optimism we see in risk assets. Risk assets saw through the brief Omicron scare and absorbed the hawkish pivot from the Federal Reserve in December. Still, the 10-year Treasury finished 2021 at a yield of 1.51%, down from 1.64% immediately prior to the discovery of Omicron in late November. Perhaps more concerning was the significant flattening of the yield curve, with the gap between 2 and 10-year Treasury yields reaching their lowest point in 2021 on December 28. In December, risk assets and interest rates present different pictures: either interest rates need to reset higher to reflect strong economic fundamentals, or risk assets need to reset lower to reflect a yield curve that is reflecting that the cycle doesn't have much runway left in it. Neither is particularly bullish for near-term credit market returns.

In December, a strong bid for risk assets, combined with low government bond yields, created a perfect environment for high-yield. In early January 2022, we are already seeing indications that this set up will not persist. In 2021, the high-yield market, as measured by the Bloomberg Barclays Index, produced solid returns of just over 5% from a starting point of 4.18% YTW. The market was able to perform better than the running yield due to spread tightening of about 80bps. Additionally, many of the high coupon financings from the spring of 2020 were taken out early at make-whole premiums. We view the problem going forward is that the market is running out of basis points to tighten, and underlying yields appear to be biased to move higher.

While not front-page news, we are concerned with the potential for a material slowdown in housing in China. Based on official state figures, the price trend for existing homes has been worsening in each sequential month since April 2021. Real estate is autocorrelated, with price movements feeding on their own momentum. As a result, we are avoiding exposure to commodities that are closely tied to demand from China's building sector, in particular iron ore and metallurgical coal. Bloomberg reported last month that in several regions, property developers are now barred from selling units prior to completion, due to the fact that millions of customers who had spent years of savings are currently in limbo, with projects halted and developers undergoing restructuring[2].

Finally, we think there is a material risk to markets in 2022 that inflation does prove to be higher than expected. Despite inflation being top-of-mind for many market participants, a benign outcome is being priced in. While this could be the case as some consumer price index components, particularly used vehicles and potentially energy, should see price pressures easing, other components, like shelter, are likely to be persistently high, potentially escalating in 2022. Experimental monetary policy, not supply chains, have been the primary driver of shelter cost pressures in our view. The market may have taken the view that inflation is a "nothing burger" for 2022, but while this is possible there is also a possibility that it could be a big juicy "something burger".

*Justin Jacobsen, CFA*
*January 10, 2022*

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PenderFund Capital Management Ltd.

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[2] https://www.bloomberg.com/news/articles/2021-12-12/abandoned-projects-shatter-confidence-in-china-s-housing-market