PENDER FIXED INCOME

THE MANAGER'S MONTHLY COMMENTARY – JANUARY 2022

In the tumultuous opening month of 2022, the Pender Corporate Bond Fund declined -0.9%[1]. A result not in the direction we would have hoped but, still, relatively solid given the market context. January saw fairly steep declines in both high-yield and investment-grade credit as investors came to terms with a new Fed tightening cycle.

The Fund's relative strength in January was due in part to its weight in short duration bonds as well as exposure to variable-coupon asset classes such as term loans and rate-reset preferred shares. However, there were also a few credit bright spots that supported the NAV, including Groupon, Inc. convertible notes that rallied over 13% on news of a substantial write-up in the company's investment portfolio. Our position in the April 2022 term loan of Royal Caribbean Cruises Ltd. also gained on the issuer's completion of a $1B financing that makes repayment extremely probable. Finally, oil and gas weights were also strong, including our position in the 2023 secured notes of W&T Offshore, Inc. and Surge Energy Inc. convertible bonds.

There were lots of red lines in investors' portfolios in January, as nearly every stock and bond index declined in the face of the Fed's abrupt re-positioning as an inflation-fighting central bank. In the Fund's portfolio, we saw weakness in longer duration holdings, such as the Fairfax Financial Holdings Limited 3.95% notes of 2031 which declined over three points in the month. While we never enjoy taking markdowns, we do view price movements in high-quality bonds as merely shifting reported returns from the current period to a future period. We are comfortable with the idea that McDonald's, Fairfax, Pepsi and other high-grade holdings have rather limited risk of default, meaning that the primary impact of a sell-off here has the potential to raise our expected return on these positions between now and maturity.

Money Printer Go Hmmmm? Some Contrary Evidence on Inflation Emerges

For those of us who have been following the exploits of financial Twitter (FinTwit to its devotees), the year 2021 brought us no end of postings about the burgeoning inflation of the late-pandemic era. In some posts, a wild-eyed Jerome Powell stands astride an archaic printing press and furiously cranks out greenbacks to the delight of laser-eyed commentators with "takes" on our inevitable path towards Weimar-style inflation. Anything, one supposes, is possible, but the month of January saw a certain amount of evidence that doesn't fit neatly into a simple narrative in which both rates and inflation are straight lines that go up and to the right.

Take, for example, the curious case of hot-rolled steel. As pandemic-era commuters chose private automobiles over public trains and buses, the price of used cars and new cars pushed higher. As a result, a lot of the inputs into these vehicles' manufacture, such as hot rolled steel, climbed significantly in price. From a pandemic low of $470 per ton in the summer of 2020, hot-rolled steel shot to $1960 per ton in September 2021. However, since that date, we have seen a decline in steel prices of more than $500 per ton[2]. While inflation in steel prices in still positive on a year-over-year basis, on a sequential

[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] *Bloomberg, January 31, 2022*

basis, we have seen four months of significant decline. Part of the explanation for this may be found in relatively muted recent orders for consumer durables such as cars and appliances. But consumers are fickle beasts. When you raise the price of things they want to buy, they want to buy less. And it is, perhaps, this dynamic which is at work in the steel market.

Across the Pacific, it has been hard to ignore the ongoing financial implosion of many of the largest Chinese property developers. Take, for instance, the now flailing behemoth, China Evergrande Group. Five years ago, the company's equity was capitalized at over US$45B and the entity sported a further $100B of bond debt trading at par. Now the company's equity is virtually worthless, and its debt can be purchased below 20c on the dollar. Evergrande is hardly a one-off. Excess production of residential towers by a variety of developers has put one of the world's largest industries (by one count China's construction firms employ over 50 million people) into a period of financial distress and activity contraction that calls to mind the American experience of 2007-09. While bailouts and stimulus programs could possibly improve the situation, Chinese property development does appear to be entering the hangover phase after an extraordinarily long and wild party.

A couple of industries in contraction amongst many experiencing rapid growth does not necessarily spell an immediate end to inflationary pressures. However, the recent tightening actions of the Federal reserve – and, quite frankly, almost every other central bank save China's – should exert a cooling effect on inflation, given time. How much cooling and when it arrives are a matter of some conjecture. But there are enough governments, industries and individuals with significant financial leverage acquired at extremely low interest rates for whom even a relatively small number of rate hikes may have a significant effect.

Sometimes the pain of financial loss takes from investors the full use of their senses. Investors in high-grade bonds may still be recoiling from the shock of drawdowns in a place where they least expected. It is tempting in the circumstances to run wildly towards anything that is working. A fog of loss-induced anxiety may still prevent some from reading the writing on the wall. But we have seen that wall, with its letters coming ever more clearly into focus, and it says, "Don't fight the Fed." Thus, we continue to add high-grade credit as part of our evolving mix.

New Positions

In January, we took advantage of higher rates in high-quality bonds to significantly expand our position in the 2024 bonds of PepsiCo, Inc. This Canadian dollar "maple" issue trades somewhat wider compared to its Canadian benchmark than do US dollar Pepsi issues against the US treasury curve by virtue of its exotic "foreign issuer" status. However, we are entirely comfortable with Pepsi's credit profile, and while we won't get rich on an approximate 1.9% yield to maturity, the position helps bolster the Fund's strong liquidity position and credit quality.

Also in January, we purchased a position in the 9.5% convertible preferred shares of Targa Resources Corp. The position in Targa prefs represents, in our view, a unique yield opportunity within a highly defensive capital situation. The 9.5% prefs are deep in-the-money from the point of view of equity convertibility. However, due to a call feature on the prefs, the most likely outcome, in our view, is that the securities are called within the next two years at levels that create a simple IRR in excess of 8%. The company's midstream pipeline operations are performing well, with strong and consistent profitability, and we view one-year default probability for this issuer at less than 0.1%.

Finally, we acquired a position in the 9.5% first lien term loan of Canopy Growth Corp. Although Canopy has numerous internal credit strengths, including balance sheet working capital over three times first lien debt, our primary source of comfort is the entity's deep relationship with its 36% owner, global spirits marketer Constellation Brands. Through board level control, co-operative marketing activities and cross-capital structure investment links, we see Canopy effectively behaving as a subsidiary of the larger entity. Constellation sports a BBB investment-grade rating and has generated over $2B in free cash flow in the past 12 months.

Fund Positioning

The Pender Corporate Bond Fund yield to maturity at January 31 was 5.4% with current yield of 4.6% and average duration of maturity-based instruments of 3.5 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 5.1% of the total portfolio at January 31.

Geoff Castle
February 7, 2022

PENDER
PenderFund Capital Management Ltd.

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