PENDER
ALTERNATIVE ABSOLUTE RETURN FUND

MANAGER'S COMMENTARY – MARCH 2022

Dear Unitholders,

The Pender Alternative Absolute Return Fund finished March with a unit price of $10.01 and distributions of $0.05 per unit[1].

March 2022 was a volatile month for markets with a dramatic pivot from "risk off" to "risk on" in the middle of the month. Risk assets were not deterred by the start of the rate hike cycle in North America as markets continued to price in higher policy rates over the near term, with future 50bp rate hikes now the market's baseline expectation, rather than a tail event. The high yield market put up another negative month, with the ICE BofA High Yield Index returning -0.9%, driven by higher government bond yields. Spreads compressed in March, finishing the month at 343bp, down from 377bp at the start of the month. Yield to worst increased from 5.6% at the start of the month to finish at 6.0%.

Portfolio Update

While the overall positioning of the Fund did not change significantly in March, there was turnover in our long book. We exited several of the Fund's Current Income positions as the cost of capital and liquidity continued to move higher and the margin of safety provided by coupons below 6.5% was eroded, in our view. Some new positions were added at coupons of 8% or higher that we view as attractive. The Fund maintained a significant risk and duration hedge through the month, while shifting some of our risk hedge from credit to equities. We were surprised by the magnitude of the reversal of risk appetite in March. If high yield spreads had reached the vicinity of 500bp, that would have justified covering a portion of our risk hedges. However, high yield spreads peaked at 421bp, which in our view was not sufficient to pivot towards a more pro-risk stance. We have seen high yield spreads sell off to around 400bp on a wobbly quarter for earnings in the past, without the significant macro headwinds risk assets are currently facing.

One issuer that did reach levels consistent with a 500bp high yield market in March was CCO Holdings, LLC. (Nasdaq: CHTR). The company issued secured investment grade rated bonds with a significant new issue concession on March 10 which exacerbated an already weak market environment, causing their high yield bonds to sell off sharply. Near the market lows, we were able to purchase 10-year unsecured CHTR bonds at a price in the high 80s and a spread of about 400bp over the treasury curve at the time. As the bonds rallied sharply off the lows, we reduced the size of our position. The Fund added several high-quality bonds in our Relative Value strategy at dollar prices in the 80s, as higher interest rates combined with wider spreads created opportunities to buy bonds at lower dollar prices, which in our view reduced risk and improved optionality. These positions include Penske Automotive Group, Inc. (NYSE: PAG) and Thor Industries, Inc. (NYSE: THO).

In the Fund's Current Income strategy, we exited positions in Live Nation Entertainment, Inc. 4.875% 2024 (NYSE: LYV), Ichan Enterprises L.P. 6.375% 2025 (NYSE: IEP) and several other positions that had minimal potential for capital gains but could be impacted by another bout of broad market weakness. The Fund added a couple of attractive 1st lien secured bonds that had initially been issued as 5-year bonds in the early spring of 2020, including Transdigm Incorporated's 8% 2025 issue (NYSE: TDG) and Sea World Parks & Entertainment, Inc.'s 8.75% 2025 issue (NYSE: SEAS). While these bonds could be called away at any time, for every day they remain outstanding, we have been earning an attractive current yield.

The Fund's Event Driven positions grew in March as we added to our position in Exterran Energy Solutions, L.P. 8.125% 2025 bond (Nasdaq: EXTN) that we expect to be called in Q3 once Enerflex Ltd. (TSX: EFX) closes on their acquisition of the company. The Fund also added a position in Nielsen Finance LLC 5.875% 2030 (NYSE: NLSN) following the announcement of the company's acquisition by a consortium of private equity buyers. In both cases, the total expected return for holding the bonds into the merger looks better than the return available in the corresponding equity, while the bonds also benefit from significantly less downside in the event of a deal break, in our opinion.

[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.*

The Fund finished March with limited market exposure, with long positions of 114.5%. 40.4% of these positions are in our Current Income strategy, 60.6% in Relative Value and 13.5% in Event Driven positions. The Fund had a -47.2% short exposure that included -23.3% in government bonds, -13.0% in credit and -10.9% in equities. The Option Adjusted Duration was 1.4 years, which we believe effectively limits the portfolio's exposure to interest rates.

Excluding positions that trade at spreads of more than 500bp and positions that trade to call or put dates that are 2024 or sooner, the Fund's Option Adjusted Duration declined significantly to 0.4 years. We are maintaining a significant duration hedge despite materially higher government bond yields since the start of the year. The Fed's "dot plot" would argue that the 10-year yield sits right on top of their long run projection now. While the skew of future outcomes is not as asymmetric for rates as it was a few months ago, we expect that rates volatility will continue. Given where inflation and employment are, historically we would expect much higher rates than the 2.5% range where much of the curve is today. It is difficult to know where neutral lies, and the Fed itself argues that taking policy rates past neutral is appropriate given excessive demand driving the economy.

Market Outlook

Correlations shifted dramatically in March from earlier in 2022. Equities had their best month of the year, while government bonds had their worst. With war and sanctions impacting commodity exports from Russia, Belarus and Ukraine, the prospects for lower inflation over the near term have diminished. Inflation has also been driven by robust demand for goods, services and labor, with the US JOLTS job opening figures proving to be resilient in 2022 despite the Omicron COVID-19 variant impacting activity earlier in the year. The repricing of yield curves higher in March was appropriate in our view given the evolving fact pattern.

Fighting inflation through tighter monetary policy means intentionally slowing economic growth and reducing demand for goods and services to bring them in line with supply to stabilize prices. We are surprised that equity markets have been as resilient as they were in March. In our view, the higher and more persistent inflation becomes, the more difficult it will be to achieve stable prices without first causing a recession.

One narrative which has gained acceptance for explaining the recent strength in equity markets, despite weakness in fixed income and credit, is that equities are best prepared to deal with high inflation as companies can pass along rising costs to consumers. While there is truth to this logic, higher interest rates directly impact companies' cost of capital, resulting in lower earnings multiples. During the 1970s, the price to earnings multiple on the S&P 500 dropped from 15.2x to 7.4x. With the S&P 500 trading at earnings multiples not seen since the "dot.com" era around the turn of the century, we think risk assets have priced in a favorable outcome from the Fed's inflation fighting efforts.

We have witnessed the cost of capital for some high-quality high yield issuers move from 4% to 6% with remarkable speed. Even with this material repricing of risk, government bonds still trade at deeply negative real yields and credit spreads finished March below the average for the past 10 years. While positive momentum can certainly continue, we view the risks to most asset classes as skewed downward and are maintaining a cautious approach to risk, while seeking out event driven and short duration opportunities with significant margins of safety.

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