PENDER
ALTERNATIVE ABSOLUTE RETURN FUND

MANAGER'S COMMENTARY – APRIL 2022

Dear Unitholders,

The Pender Alternative Absolute Return Fund finished April with a unit price of $10.00 and distributions of $0.05 per unit[1].

April 2022 was a volatile month for markets as the rubber starts to meet the road with monetary policy normalization accelerating. The very sharp rebound for risk assets in late March did not hold. The ICE BofA US High Yield Index returned -3.64% in April, which was the worst monthly return since March 2020, and the second worst monthly return in the last 10 years. Yield to worst increased by 95bp in the month to finish at 7.0%. Option Adjusted Spread (OAS) widened by 54bp to finish at 397bp. With four consecutive negative months to start the year, losses have hit some historically significant levels in both high-yield and broad fixed income. The ICE BofA High Yield Index has returned -8.0% year to date, exceeding the losses that the market experienced in the late 2018 sell off and the 2013 taper tantrum.

Portfolio Update

With the yield to worst of the high-yield market approaching 7%, the Fund modestly increased both duration and long exposures towards the end of April. Duration management has been essential to protecting capital in 2022. If credit markets continue their downward trajectory in the weeks ahead, it will likely be driven more by spread widening than higher underlying government bond yields in our view. The Fund maintained significant risk hedges as both market technicals and absolute spread levels would argue that downside protection remains prudent.

The Fund added new positions in the energy sector in April as we expect industry fundamentals to remain very strong over the near term. Credit metrics should continue to improve, with companies maintaining much more capital discipline than in the shale boom era. Several of our holdings are focusing on generating free cash flow and reducing overall debt levels in 2022, with the potential to be at, or close to, net debt free in 2023 if current forward commodity prices hold. The Fund added Vermilion Energy Inc. 6.875% 2030 (TSX: VET) and W&T Offshore, Inc. 9.75% 2023 (NYSE: WTI). In both cases, we are earning a wider spread than the broad market and purchased our positions at discounts to par. Vermilion has significant exposure to European gas markets via their Corrib joint venture in Ireland, which is earning exceptional operating netbacks in 2022.

Late in April, we received an unexpected special mandatory redemption notice for our holding in Ritchie Brothers Inc. 4.95% 2029 (TSX: RBA). After an extended regulatory review, the company chose to abandon the acquisition of Euro Auctions which these bonds were meant to fund. The resulting spread at the redemption price of 100 was materially lower than our cost, driven by the significant increase in underlying government bond yields since issue in early December.

In the Fund's Current Income strategy, we sold out of our position in Greystar Real Estate Partners LLC 5.75% 2025 early in the month, only to add it back later in April as value improved. This bond was recently upgraded 1 notch by Moody's to Ba3 and put on "positive outlook". This is a secured issue that is supported by the largest US property manager of residential real estate and Greystar has reduced leverage from 4.0x in 2019 to 2.8x currently, based on Moody's estimates. With a 2025 final maturity and the bonds trading close to par, we believe this is an attractive income generator for the Fund and presents good value compared to similar BB rated 2025 secured bonds.

In the Fund's Event Driven strategy, our holding in Nielsen Finance LLC suffered, as The WindAcre Partnership LLC established a position which may be sufficient to block Elliott Investment Management L.P. and Brookfield Asset Management Inc.'s effort to take the company private. In our view, the bonds have priced in a low probability of a 101% change of control put being triggered, although optionality remains for a sweetened deal that would have the support of WindAcre, or a tender offer, which may trigger a change of control without gaining the support of the dissenting shareholder.

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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.*

The Fund finished April with long positions of 128.1%. 31.1% of these positions are in our Current Income strategy, 80.1% in Relative Value and 16.9% in Event Driven positions. The Fund had a -46.1% short exposure that included -23.5% in government bonds, -13.1% in credit and -9.5% in equities. The Option Adjusted Duration was 2.5 years.

Excluding positions that trade at spreads of more than 500bp and positions that trade to call dates that are 2024 and earlier, Option Adjusted Duration declined significantly to 1.7 years. As all-in yields in the high yield market increase, the sensitivity to government bond yields decrease. Historically, some of the tightest spread environments have occurred at or near the peak in government bond yields as seen in 2018 and 2007. While the pattern of facts this cycle is clearly different, we believe that all-in yields are an important consideration for our interest rate hedge position.

Market Outlook

Four months into 2022, the placid market environment of 2021 feels like a distant memory. The "buy the dip" mentality that saw dramatic reversals for asset prices in the first three months of the year was notably absent in April. Inflation continues to escalate in North America and Europe, while China's lockdowns are likely to frustrate global supply chains for months. Even though the evolving facts on the ground are causing investors to reassess risk premiums and the degree of central bank tightening required to rein in inflation, a lot has been priced in already, especially for interest rates. In our view, rates have likely moved about three quarters of the way to a level that would likely face significant resistance, especially for terms of five years or longer. It is possible that short term rates could move even higher, but we believe that policy rates above 3.5% are unsustainable over the medium and long term, potentially causing steep yield curve inversions.

A silver lining among much uncertainty is the continued strength of the labour market in North America, with the US job opening figures continuing to hold near record highs. The US Employment Cost Index hitting a new high in Q1 caused government bonds to sell off, but is arguably good economic news as lower wage earners tend to have a high propensity to spend, resulting in a strong economic multiplier.

The high-yield market yielded as little as 3.8% last summer, but has since increased substantially to 7.2% as of May 2, 2022. Although spreads are not historically cheap yet, all-in yields are approaching levels that we think are attractive, especially when they are combined with low dollar prices, which lowers risk. While the high yield market has a good chance of hitting yields of 8% or more as the year progresses, it will likely present an attractive buying opportunity over a reasonable time horizon. Corporate profits are near record levels, balance sheets have been repaired in the last two years. Credit quality of the high-yield market has improved relative to history, with more of the market comprised of the BB rating bucket, the highest quality on the high-yield spectrum. Generally speaking, ratings upgrades are expected to exceed downgrades this year, with several of our holdings having been upgraded in recent months, including Cedar Fair.

We acknowledge that although there is much uncertainty about how the global economy will face several challenges as 2022 progresses, it is important to take a long-term view. The yields available for quality businesses that convert a high percentage of free cash flow to debt, such as Macy's and Vermilion Energy, would have been hard to imagine at the start of 2022. Yields could certainly move higher over the near term, creating even better opportunities, but we think it is important to recognize how far we have come and that there may be compelling opportunities in the months ahead.

Justin Jacobsen, CFA
May 9, 2022

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