PENDER
ALTERNATIVE ABSOLUTE RETURN FUND

MANAGER'S COMMENTARY – MAY 2022

Dear Unitholders,

The Pender Alternative Absolute Return Fund finished May with a unit price of $9.86 and distributions of $0.06 per unit[1].

May 2022 brought a wild swing to markets with rates, credit and equities all selling off before rebounding sharply late in the month. The ICE BofA US High Yield Index returned 0.25%, which was the first positive return in 2022. Yield to worst increased by 8bp in the month to finish at 7.1%. Option Adjusted Spread (OAS) widened by 25bp to finish at 422bp. At the market low on May 19, the high yield market had lost nearly 11% year-to-date before rebounding to finish the month down only 7.8% for the year.

Portfolio Update

The Fund reduced risk in May as it became evident to us that certain cyclical portions of the market were coming under increased scrutiny. While our high quality and short duration positions held up well for the first four months of the year, once the market yield broke decisively through 7%, there were fewer places to hide, causing us to re-evaluate what the appropriate long and net exposures are for the Fund to protect capital. The market rally in late May was primarily driven by ETFs in our view as the largest, most liquid issues saw dramatic price moves, while some smaller illiquid issues that do not meet the thresholds for ETF inclusion barely budged. We viewed this as an opportunity to de-risk at prices that would have been unthinkable a week earlier as the iShares iBoxx High Yield Corporate Bond ETF (NYSE: HYG) rallied 4.9% over the week ending May 27, closing at its highest premium to net asset value in nearly two years.

We expect to modestly increase our long and net exposure if opportunities arise in the weeks ahead. New issues were scarce in May as volatility and increasing yields kept issuers on hold, but we expect supply to increase if valuations hold close to late May levels. Based on recent transactions in leveraged loan and structured product markets, it appears that investors have been able to extract higher liquidity and risk premiums in exchange for providing capital.

The Fund reduced or eliminated exposures to credits and sectors that we expect could face significant pressure in a market-wide sell-off. The Fund sold its position in McLaren Finance PLC ahead of what we expected to be a challenging Q1 report given a tight liquidity position, supply chain issues and product delays. While our initial thesis that the company was in play appears to have been incorrect, the quarter did indeed prove to be challenging, which resulted in the bonds moving significantly lower than our sale price. Our sale of McLaren greatly reduced the Fund's exposure to CCC rated credits, which usually perform poorly in a market sell-off. Our only remaining CCC exposure is in a publicly traded company where we have employed a position-specific hedge that we believe is effectively a net short on a risk-adjusted basis.

Sector Update

While decreasing gross and net exposure overall, the Fund modestly increased exposure to energy in May as the recent new issue from Vermilion Energy Inc. (TSX: VET) traded lower despite a strengthening backdrop for energy, especially Vermilion's European assets. The tightness in the energy market poses a risk to the broad economy in the coming months but has the potential to benefit many of our positions in energy credits, which are already generating significant free cash flow and paying down debt. We continue to hold Exterran Energy Solutions L.P. 8.125% 2025 (NYSE: EXTN) bonds and expect the issue to be called at a premium to our cost when Enerflex Ltd. (TSX: EFX) closes its acquisition of the company, which is expected next quarter.

Lodging and leisure is another sector where the Fund has a positive bias. After a difficult couple of years, there is significant pent-up demand for travel and entertainment. In May, the Fund added a position in Live Nation Entertainment, Inc. 6.5% 2027 (NYSE: LYV) secured notes at quite attractive prices, in our view, before reducing the

[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.*

position on strength later in the month. One of our core holdings, XHR LP, a subsidiary of Xenia Hotels & Resorts, Inc. REIT, was upgraded in May by S&P who noted that April was the first month, since March 2020, in which the company had generated positive comparable operating income relative to 2019 levels.

Developments in the retail sector generated a lot of attention in May as both Target Corporation (NYSE: TGT) and Walmart Inc. (NYSE: WMT) reported results which raised concerns about profit margins and the health of the US consumer. The Fund's largest retail exposure is Macy's, Inc. (NYSE: M), which reported positive results for its first quarter and raised guidance for the year. The Fund's retail holdings are rated BB at the issue level and, we believe, are well supported in weak operating environments. Retail is a sector that we will be very careful about position sizing over the near term. Ultimately, the negativity could present an opportunity off a market bottom as it did in prior cycles. We expect that the sector will continue to be high beta over the near term and are therefore cautious about taking on too much exposure at this point in the cycle.

Portfolio Metrics

The Fund finished May with long positions of 93.9%. 22.5% of these positions are in our Current Income strategy, 61.4% in Relative Value and 10.0% in Event Driven positions. The Fund had a -47.5% short exposure that included -17.5% in government bonds, -18.8% in credit and -11.2% in equities. The Option Adjusted Duration was 1.3 years.

Excluding positions that trade to spreads of more than 500bp and positions that trade to call dates that are 2024 and earlier, Option Adjusted Duration declined to 0.5 years. The Fund shifted hedges away from government bonds and into risk assets in May as we believe that spread widening is a larger concern than higher interest rates over the near term.

Market Outlook

With the start of 2022 bringing what felt were continuous losses for four and a half months, it was reasonable to expect that risk markets were due for a bounce. We were surprised by the magnitude of the rally, given that there was not much substantive news driving the market higher other than Raphael Bostic, President of the Atlanta Fed suggesting that the Federal Reserve might consider a pause in policy tightening in September. Given the uncertainty about the path of inflation, it strikes us as optimistic that the Fed would be able to pause at only a 2% Fed Funds rate. A view that was echoed in early June by Fed Vice Chair Lael Brainard stating that it was very hard to see the case for a September pause.

Despite the high yield market registering its first positive monthly return since December, the underlying fundamentals of the market deteriorated. Using Bank of America data, the distress ratio, or percentage of issues trading at spreads of greater than 1000bp, more than doubled in May from 2.5% to 5.2%. The previous two months where the distress ratio doubled were March 2020 and July 2007, both of which signaled the end of those respective credit cycles. It is unclear if we are at the end of the cycle or not, but fundamentals are shifting quickly. With high-yield spreads trading in the low 400s, which is below the 10-year average of 453bp, the range of potential outcomes argues for a defensive posture.

It is important to avoid anchoring and recency bias when investing. Although credit markets have sold off significantly in 2022, it was from a historically expensive starting point. While credit markets traded at tighter spreads in 2007 than they have since, all-in yields had never been lower than they were over the past 18 months. The combination of tight spreads and low government yields provided a uniquely poor setup for absolute returns. Inflation remains a significant issue and a headwind for markets, the consumer and the economy. To tackle inflation, policymakers will need to lower aggregate demand, weakening the economy. While a relatively soft landing remains a possibility, they have been difficult to engineer in the past. Our focus is on preserving liquidity and protecting capital to deploy into what we expect could be higher risk premiums in the coming months.

Justin Jacobsen
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PenderFund Capital Management Ltd.

Standard Performance Information for the Fund will be available when it reaches its one year anniversary. https://www.penderfund.com/pender-alternative-absolute-return-fund/