PENDER
ALTERNATIVE ABSOLUTE RETURN FUND

MANAGER'S COMMENTARY – JUNE 2022

Dear Unitholders,

The Pender Alternative Absolute Return Fund finished June with a unit price of $9.70 and distributions of $0.03 per unit[1].

June 2022 saw significant weakness in the high yield market as the strong bounce in late May faded ahead of US CPI which came in much hotter than expected. This erased optimism that inflation had already peaked and caused a material repricing of risk assets. The ICE BofA US High Yield Index returned -6.81% in June which was the worst monthly performance since March 2020 and the second worst month since 2008. Yield to worst increased by 175bp in the month to finish at 8.94%, Option Adjusted Spread (OAS) widened by 163bp to finish at 587bp. Despite equities and government bonds bouncing off their mid-month lows, the high yield market closed June at its lowest total return level for the year and at the widest spreads since July 2020.

Portfolio Update

Early in June, the Fund continued selling into strength as it had in late May as we viewed the market as fully valued. Following a significant repricing of the market mid-month, the Fund selectively added positions with a focus on high quality credits backed by publicly traded parent companies with relatively large market capitalizations. This included issues from companies like Charter Communications, Inc. (Nasdaq: CHTR), Live Nation Entertainment, Inc. (NYSE: LYV) and Hilton Worldwide Holdings LLC (NYSE: HLT). It is our view that high quality should be well positioned in the coming months regardless of whether the market bounces or sells off further. With the market yield approaching 9%, very few of the Fund's holdings trade at a premium to par. The Fund added to several shorter duration holdings trading multiple points below par. It is our base expectation that these short duration positions will be refinanced 12-18 months prior to maturity, which would result in a total return profile that, in some cases, is significantly higher than the yield to maturity.

The Fund added several short duration Investment Grade positions in June based on our expectation that we are unlikely to spend the cash generated from our short positions over the near term. These positions are all due within the next year and from high quality issuers including Apple Inc. (Nasdaq: AAPL), PepsiCo Inc. (NYSE: PEP) and Starbucks Corp. (Nasdaq: SBUX) which are unlikely to be the subject of any serious credit concerns in a recession. We believe these positions would be relatively easy to sell in the event that compelling opportunities arise further along the risk spectrum.

Energy had been a bright spot in markets this year until June as concerns about the impact of a potential global recession on demand, combined with an explosion at the Freeport LNG facility in Texas which also hit oil and natural gas markets. Despite the material repricing of the sector, well respected analysts at Goldman Sachs, Bank of America, RBC and JP Morgan highlighted that the physical market is still quite tight and vulnerable to supply side disruptions. While we remain positively biased toward the sector, the Fund materially reduced its exposure to Exterran Energy Solutions, L.P. 8.125% notes due 2025. While it is our base case that the company will be acquired by Enerflex Ltd. (TSX: EFX) in the coming months, which would result in the issue being called at a premium, in our view the potential for a deal break and the impact if it were to occur have both increased, decreasing the risk/reward and calling for the smaller position size within our risk management framework. If commodity weakness persists without any material change to the physical market, we anticipate carefully adding exposure with a bias towards high quality credits at a meaningful discount to par.

Two sectors where we remain cautious are retail and homebuilders. In our view, it is too early to take a meaningful position in either sector, but the cycle will likely set them both up for some compelling trades in the months ahead. We already see situations offering above market yields that we feel quite comfortable will be able to navigate an economic cycle.

In the Fund's Event Driven strategy, we established a position in Peninsula Pacific Entertainment, LLC 8.5% notes due 2027. We expect this position to be made whole at a premium to our cost base by the end of the year as the company is in the process of being acquired by Churchill Downs, Inc. (Nasdaq: CHDN), a best-in-class gaming credit company. The transaction was fully financed by Churchill Downs earlier this year. In response to market weakness in late June the Fund added a position in CDI Escrow Issuer, Inc. 5.75% notes due 2030 which would be redeemed at 100 in the unlikely event

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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.*

that the deal fails to close. At our cost base, such a redemption would result in a meaningful capital gain for the Fund. We expect both legs of this trade to work on an outright basis over time while the package provides a hedge in the event of a deal break, with attractive carry in the interim.

Portfolio metrics:

The Fund finished June with long positions of 109.6%. 30.6% of these positions are in our Current Income strategy, 72.6% in Relative Value and 6.4% in Event Driven positions. The Fund had a -41.7% short exposure that included -18.5% in government bonds, -13.3% in credit and -9.9% in equities. The Option Adjusted Duration was 1.9 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 to 0.7 years. The Fund shifted hedges away from government bonds and into risk assets early in the month while covering a portion of our credit shorts as value improved in the second half of June.

Market Outlook

The first half of 2022 was the second worst half in the history of the high yield market using ICE/BofA data going back to 1986. This was surpassed only by the second half of 2008 which saw the worst of the credit crisis following the collapse of Lehman Brothers. It is our belief that credit markets have strong mean reverting characteristics over time, and that from a starting point of nearly 9% yield to worst and spreads approaching 600bp that the forward returns for the high yield market look attractive on a two to three-year basis. The near-term outlook is a lot less certain with a recession in the coming quarters presenting as a real possibility as central banks grapple with the highest inflation over the past 40 years in North America.

There have been stunning moves in interest rates over the past several weeks, as a higher than expected US CPI report for May killed a popular market narrative that inflation had already peaked and was set to decline. Then, the market became convinced that a recession was likely in 2023 with rate cuts to follow. In our view, the 70bp move lower in Treasury yields from the highs was excessive and created an opportunity to re-set shorts. We have seen repeatedly that the market instinctively looks at the last cycle as a guide to the path forward, despite compelling evidence that a regime change has occurred. To us, it does not seem appropriate to price rate cuts in 2023. Even if there is a technical recession in the coming quarters, unemployment rates are likely to remain historically low and inflation will likely remain above target. Effectively, markets were pricing in an assumption that the Federal Reserve will ignore both aspects of its dual mandate and focus on asset prices. The FOMC minutes released in early July were a reality check that things are indeed different this time, and that tackling inflation is the highest priority.

In each of the past three recessions, high yield spreads have hit 1000bp or more and we believe there is a good case to be made that spreads will peak at lower levels this cycle. Outside of the Great Financial Crisis in 2008-09, the time periods spent above 1000bp have been relatively brief; just four trading days in 2020 and a few weeks in 2001 and 2002. 20 years ago, the high yield market was not as developed or efficient as it is today and was a fraction of its current size. There might not be high quality read throughs from that cycle, even though we believe the real economy will probably look closer to that event than either the 2008 or 2020 recessions. Also, the energy sector has usually been a major contributor to high yield market spreads and distress ratios since 2014 but now trades at a tighter spread than the broad market. ICE/BofA maintains a high yield index that excludes energy and mining and in 2020 this index never hit 1000bp and spent only a short period above 800bp. While it is impossible to know exactly how this cycle will play out, we believe there is a good chance that spreads will peak between 750 and 900bp if the North American economy enters a recession.

One aspect of prior cycles that we believe will hold up this time is that the best buying opportunities will likely be brief. It is exciting to us that there is a real possibility of opportunities to deploy capital at historically compelling levels in the months ahead. Although the Fund has mostly been focused on protecting capital since inception, with the high yield market moving from a yield to worst of less than 4% last summer to nearly 9% at the end of June, we believe that we are most of the way to an opportunity to pivot towards a focus on capital gains.

Justin Jacobsen
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