PENDER
ALTERNATIVE ABSOLUTE RETURN FUND

MANAGER'S COMMENTARY – JULY 2022

Dear Unitholders,

The Pender Alternative Absolute Return Fund finished July with a unit price of $9.81 and distributions of $0.04 per unit[1].

July 2022 saw a strong rebound across most asset classes following a historically weak first half of 2022. The ICE BofA US High Yield Index returned 6.02%, the best monthly return since July 2009. Yield to worst declined by 129bp to finish the month at 7.73% while Option Adjusted Spread (OAS) declined by 111bp to finish at 483bp. While we were not surprised that the market bounced in July, the magnitude of the rally was larger than expected, driven both by a continued rally in government bonds, despite ongoing inflation pressures, as well as reduced risk premiums.

Portfolio Update

In response to valuations that were significantly less compelling than in late June, the Fund selectively reduced risk in the second half of July, with a focus on higher quality issues that were vulnerable to a repricing of risk premiums, government yield curves or a combination of the two. These sales included relatively short duration exposures as well as positions further out on the curve. The result is a significant reduction in the Fund's exposure to the market. While we would normally expect a calm market environment in August, the magnitude of the rally in July leaves the market somewhat vulnerable to a reassessment of fundamentals. We believe that the perception that Federal Reserve Chair Jerome Powell attempted to make a dovish pivot in his press conference following the July FOMC meeting might be reconsidered in the coming weeks.

Market volatility presented the Fund with opportunities to make compelling switches across issuers and industries. The Fund exited our small position in Sonic Automotive, Inc. bonds (NYSE: SAH), while adding to our position in AutoCanada Inc. (TSX: ACQ) and re-entering Parkland Corporation (TSX: PKI), which we had exited in January. While we remain cautious on retail and homebuilders, we selectively added to BB-rated Bath and Body Works, Inc. (NYSE: BBWI) and Mattamy Group Corporation (private). Both were purchased at a good discount to par as well as a premium to market yield.

In our opinion, some of the best value in the Fund is in our energy sector exposure. With some significant pressure in commodity markets early in July, the Fund topped up our holding in Vermilion Energy Inc. unsecured bonds (TSX: VET). In our view, credit markets either do not understand or appreciate the quality of their asset base and commitment to maintain a conservative capital structure. Vermilion's equity closed July at its 52-week high, while our bond holding trades below where it was issued in April. The Fund did not sell or reduce any energy holdings in our Relative Value strategy in July.

In the Fund's Event Driven strategy, we added several of American Campus Communities, Inc.'s (NYSE: ACC) unsecured bonds. ACC is the largest student housing REIT in the United States. The company is in the process of being acquired by Blackstone Inc. (NYSE: BX) with the transaction expected to close in early August. While there is no change of control provision for ACC's investment grade rated bonds, there are several covenants that are likely to prevent Blackstone from applying as much leverage as is typical in private equity sponsored residential real estate. In previous private equity buyouts of REITs, unsecured bonds have been taken out at the make-whole price. We believe that a make-whole call is probable for ACC's bonds, which would generate an attractive capital gain for the Fund.

The Fund exited our position in Nielsen Finance Co.'s bond (NYSE: NLSN) as a rebound in risk sentiment could increase the potential for a deal break. The Windacre Partnership has publicly expressed opposition to the transaction and has accumulated a sufficient position to block it. Windacre's view may prove to be the right long-term decision for Nielsen's

[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.*

shareholders, but the near-term consequence from rejecting the transaction would be negative. The stock closed July at 14.5% below the agreed upon transaction price of $28. Based on media reports, some of Windacre's limited partners have expressed displeasure with the Partnership's opposition to the Nielsen transaction. We believe that the pressure from LPs is likely to be higher in a weaker market environment, so with a strong bounce for risk assets the potential for a deal break increases. Unless Windacre publicly changes its view, we expect to remain on the sidelines.

Portfolio metrics:
The Fund finished July with long positions of 100.05%. 34.5% of these positions are in our Current Income strategy, 57.1% in Relative Value and 8.9% in Event Driven positions. The Fund had a -49.4% short exposure that included -16.7% in government bonds, -21.6% in credit and -11.1% in equities. The Option Adjusted Duration was 0.7 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 was flat at -0.5 years. With a significant portion of the long portfolio now in short duration or event-driven investment grade holdings, the Fund is positioned defensively.

Market Outlook
Given the historic magnitude of declines for most liquid assets in the first half of the year, it was not surprising that markets experienced a strong bounce in July. There were similar seasonal bounces in both July 2020 and 2018, after the market had finished June on a fairly weak note in those years. However, in our view both government bonds and risk assets are now probably close to the high end of their near-term trading ranges. Inflation may have peaked at the headline CPI number, but there is a lot of distance between current readings and the target rate of 2% in North America. The market may have prematurely declared victory. At the end of July, Fed Funds Futures had priced in 59bp of rate cuts for 2023 including the possibility of a cut as soon as March. We believe this reflects market conditioning from the past 10 years, where the Federal Reserve erred on the side of supporting asset prices. Investors and markets can be slow to adapt to regime change, with inflation now a dominant consideration for monetary policy, assumptions based on monetary policy from the past decade may no longer hold.

Jerome Powell's statement that rates are now at neutral has been compared to his assertion last year that inflation is transitory, in that it is possible but uncertain. Powell's optimistic inflation assessment from last year has not aged well. Many market commentators have suggested that the current environment with elevated inflation and a very tight labour market (the two aspects of their dual mandate) argue for a higher neutral interest rate. This was further supported by the quarterly Employment Cost Index (ECI) release on July 29, which showed inflation pressures for labour are not moderating at all. On a year-over-year basis, wages and salaries for private sector workers increased by 5.7%, with total compensation for private industry increasing at its highest quarterly rate this cycle. While the market shrugged off the release and yields dropped on the day, wage inflation is autocorrelated and is likely to be a serious concern for policy makers.

While some market stability is a welcome change, the improvement in valuations may have outpaced fundamentals. In each of the previous two instances where the high yield market generated a return of about 6% in a month, credit spreads were over 800bp at the outset - quite a bit wider than the 587bp that the market started July with. While sentiment and technicals have shifted quite dramatically, we believe that fundamentals haven't moved nearly as much and there will likely be opportunities to buy assets at better prices in the months ahead.

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