PENDER
ALTERNATIVE ABSOLUTE RETURN FUND

MANAGER'S COMMENTARY – AUGUST 2022

Dear Unitholders,

The Fund has marked one year since its inception, and we are happy to now report the performance of the Fund. The Pender Alternative Absolute Return Fund finished August with a return of 1.5% bringing year to date performance to 2.9%[1].

Credit markets experienced a sharp reversal in August with a very strong tone in the first half of the month, buoyed by the perception of a dovish pivot by the Federal reserve and a strong summer technical. Market tone shifted significantly in the second half of the month, with a large options expiration on August 19, and Jerome Powell's address to the Kansas City Fed's annual Jackson Hole Economic Symposium which definitively pushed back against the Fed pivot and reiterated their resolve to tackle the highest inflation in decades. The ICE BofA High Yield Index returned -2.4% while spreads finished the month 20bp higher at 503bp. Yield to worst now stands at 8.45%, up significantly from 7.7% at the end of July.

Portfolio Update

The Fund took advantage of the strong tone in early August by reducing long exposures, continuing a theme from the second half of July. We were frankly surprised by the degree to which the market rallied, but gladly took sales at prices that would have been difficult to imagine in June. Late in August, the Fund selectively purchased high-quality high-yield bonds as valuations improved, while maintaining significant risk asset and duration hedges.

The Fund's thesis in American Campus Communities, Inc. (private) played out as we had hoped, with our holdings being called at the required make-whole price following the company's acquisition by Blackstone Inc. (NYSE: BX) on August 9. This resulted in a capital gain from our purchase prices, as market pricing had indicated some significant doubt about the eventual outcome.

With a lot of excess cash but with what we judged to be a poor near-term risk-reward profile for most markets, the Fund sought out attractive carry instruments for our Current Income and Event Driven strategies in August, adding to or initiating several positions that we believe should hold up well if risk premiums increase in the coming months.

The Fund added to our position in SeaWorld Parks & Entertainment Inc. 8.75% 2025 (NYSE: SEAS), which is a first lien secured bond that was issued in April 2020 during the depths of the COVID-19 lockdowns. Since that time, SeaWorld has enjoyed a very strong rebound at its parks, with revenue and cash flow exceeding 2019 levels. We believe that with a lot of asset value supporting this short duration position, we are taking relatively limited mark to market risk.

In the Fund's Event Driven strategy, we re-entered Nielsen Finance LLC 5.875% 2030 (NYSE: NLSN) bonds as the Windacre Partnership LLC agreed to terms with the purchasers, dramatically reducing the risk profile of the transaction. Our thesis was to hold NLSN bonds in to a 101 Change of Control Put, but we

[1] *All Pender performance data points are for Class F of the Fund. Other classes are available. Fees and performance may differ in those other classes.*

expect to realize a slightly better outcome as the company announced a tender offer with total consideration of 101.125 plus accrued interest. The Fund initiated positions in Switch, Ltd. 3.75% 2028 (NYSE: SWCH), which we expect to put at 101 once the acquisition by DigitalBridge Group, Inc. (NYSE: DBRG) closes later this year, and Valvoline Inc. 4.25% 2030 (NYSE: VVV), which the company has stated it expects to redeem at par once its asset sale to Saudi Aramco closes later this year or early in 2023. In both cases, we expect to earn decent carry in addition to capital gains, capturing an attractive IRR compared to arbitrage situations with similar risk profiles. Finally, the Fund added a position in Twitter, Inc. 5.0% 2030 (NYSE: TWTR), which in our view is pricing in a low probability of Elon Musk's bid for the company closing, which would likely require a make-whole call at a significant premium to par. In our view, the upside is roughly double the downside in this situation. While there are a lot of unknowable aspects as to how the legal wrangling will play out, the risk-reward profile is favourable in our view.

The end of August marked one year since the Pender Alternative Absolute Return Fund launched. It has certainly been a challenging year for markets, but also an excellent opportunity to demonstrate the potential for alternative strategies to protect and grow capital in volatile periods. Early on, it became evident to us that the base liquid alternative legislation, where a fund can sell short up to 50% of its Net Asset Value, was insufficient for the Fund to effectively hedge both duration and spread risk. The Fund has applied for and received exemptive relief to short up to 100% of our Net Asset Value[2], which we expect will be more than sufficient for the Fund to protect capital and capture idiosyncratic market opportunities going forward.

While short selling has been helpful in the Fund's first year, it is not lost on us that in order to generate the kind of returns we would like over a market cycle, long exposures will contribute most of the performance. When the Fund launched in 2021, the yield to worst on the ICE BofA US High Yield Index was only 3.9%. Yields have more than doubled since then. While there are good prospects for better buying opportunities in the coming weeks, we are likely most of the way to a compelling opportunity to buy credit - the recent peak in market yields was just under 9% on June 30. Depending on how the facts on the ground evolve, a 10% to 11% high-yield market could be a compelling opportunity for the Fund to increase long exposures and cover risk hedges.

We are happy to announce that Rachael Zhang, CFA has joined the Pender Alternative Absolute Return Fund team as an analyst, which will significantly increase our capacity to evaluate new opportunities for the Fund. Rachel joined from Canalyst, where she had spent the last three years building value-add models for buy-side institutional clients. Rachel holds a MSc in Finance from Simon Fraser University, where she served as a Fixed Income Portfolio Manager for the well-regarded Student Investment Advisory Service Fund.

Portfolio Metrics:
The Fund ended August with long positions of 102.7%. 25.9% of these positions are in our Current Income strategy, 55.7% in Relative Value and 14.2% in Event Driven positions. The Fund had a -46.9% short exposure that included -15.9% in government bonds, -14.8% in credit and -9.5% in equities. The Option Adjusted Duration was 1.3 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 0.6 years. The duration figure includes more

[2] More information is available in the Fund's Simplified Prospectus dated August 29, 2022, available on SEDAR at www.sedar.com.

Commented [JF1]: Reference or support for this number?

Commented [MM2R1]: @Justin Jacobsen @Rachel Zhang Please can you provide support for this per Janine's request?

Commented [JJ3R1]: Added

Event Driven positions than have historically been a part of the Fund, the largest of these being Nielsen Finance LLC 5.875 2030 (NYSE: NLSN), which has a duration of five years but is currently subject to a tender offer that should pay out in the next few weeks. There are several other Event Driven positions where we believe duration overstates exposure to interest rates. The Fund 's current yield was 5.7% while yield to maturity was 6.3%.

Market Outlook:

While risk markets were due for a bounce in July after a brutal first half of the year, the extent of the rally exceeded historic precedent. Usually, high-yield market spreads have been significantly wider than 600bp in order for the market to put up a +6% month as it did in July. Technicals and optimism about inflation peaking took the market up a further +1.7% in the first half of August, taking high-yield spreads to below the 10-year average. The market level of spreads arguably overstated how expensive the higher-quality corners of the market were, with some bonds trading close to the tightest spreads of the past 6 months, which included some historically expensive conditions. Given that there is still a lot of distance between current inflation readings and central banks' 2% target levels, this seemed like an excellent opportunity to reduce exposure to the market. The sell-off in late August following Federal Reserve Chair Jerome Powell's eight-minute speech at Jackson Hole has been welcomed by at least one Fed regional governor.

The rapid and at times disorderly re-rating of risk at the end of August created pockets of market opportunity where it has been possible to purchase high-quality, high-yield bonds at levels that are close to their June lows. While the near-term path forward likely will lead to better and more broad-based opportunities to buy assets at favourable prices, we believe that forward returns are already looking much better than they did just two or three weeks ago. We expect to dynamically increase exposure to the market as valuations improve.

Justin Jacobsen, CFA
September 9, 2022

© Copyright PenderFund Capital Management Ltd. All rights reserved. September 2022.