PENDER
ALTERNATIVE ABSOLUTE RETURN FUND

MANAGER'S COMMENTARY – SEPTEMBER 2022

Dear Unitholders,

The Pender Alternative Absolute Return Fund finished September with a return of 0.5%, bringing year-to-date performance to 3.4%[1].

September proved to be another challenging month for markets and the strong summer rally feels like a distant memory now. The ICE BofA High Yield Index returned -4.0% bringing year-to-date performance to -14.6%. The high-yield market posted three consecutive negative quarters for the first time since Q2 2015 to Q4 2015. Yield to worst increased by 113bp to finish at 9.58% and Option Adjusted Spread (OAS) increased by 40bp to 543bp. While September saw yields hit new highs for the year, the highest since early April 2020, spreads are still about 60bp inside of the year-to-date highs of just under 600bp reached in early July. September was the third worst month for the high-yield market since 2008, surpassed only by June 2022 and March 2020.

Portfolio Update

Early September presented the Fund with some good relative value trading opportunities as a strong technical bounce between Labour Day and the release of US August CPI data allowed the Fund to de-risk, selling some positions that we viewed as fully valued, as well as some smaller positions in weaker credits that likely would not be well supported in an extended market downturn. With a large intramonth drawdown (from September 12 through 29 the ICE BofA High Yield Index returned -5.65% while Govt OAS increased by 100bp) the Fund added to long exposures with a focus on credits backed by high quality, larger capitalization enterprises like Hilton Worldwide Holdings Inc., Live Nation Entertainment, Inc., Restaurant Brands International Inc. and SS&C Technologies, Inc. The combination of wider spreads and the highest government bond yields in over a decade provided some attractive all-in yields.

The Fund opportunistically used a strong market tone early in the month to exit small positions in Corus Entertainment Inc. 6% 2030 notes (TSX: CJR.B) and Empire Communities Corp. 7.375% 2025 (private). The Fund sold out of several capital securities issued by Canadian financial institutions as we are concerned that risk premiums for Canadian banks could continue to move higher due to the potential for Canada's real estate market to have its most significant drawdown in over 30 years. If there were a significant spread-widening event for large, well-capitalized Canadian banks, we expect to be buyers on weakness.

While there could be further market weakness in the weeks and months ahead, the all-in yields available in some higher-quality high-yield issuers look attractive to us. The Fund added a position in Live Nation Entertainment, Inc. 4.75% 2027 (NYSE: LYV) at a yield to maturity of 8.0%. If this bond is refinanced a year prior to maturity, when it will be callable at par, the yield would increase to 8.7% over a 4-year term.

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[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.*

It was an active month in the Fund's Event Driven strategy where we added a long position in Shaw Communications Inc. equity (TSX: SJR.B) and paired it with a long position in Rogers Communications Inc. 3.75% 2029 bonds, that has a Special Mandatory Redemption (SMR) feature which requires the bond to be bought back at a price of $101 if Rogers' all-cash bid for Shaw does not close. It is unusual and attractive to find two long positions that hedge each other, and in our view, the Rogers bonds reflect a higher probability of the transaction going through than Shaw's equity. Our best estimate is that the bonds imply a roughly 85% probability of the transaction completing while Shaw equity implies a roughly 65% probability. Because of this mismatch, the package of these two securities should allow us to break-even in the event of a deal break, while profiting if the deal closes successfully, which is our base case. Both outcomes are subject to fast-changing market conditions, but one of these securities will spike higher than our purchase price depending on the outcome of the proposed merger. Using month-end marks, the SMR feature in the Rogers bonds would offset a decline in Shaw equity down to $19.26 per share. Rogers would pay Shaw a breakup fee of $1.5 billion, which is worth just over $3 per share in Shaw if the transaction fails to close.

The Fund topped up positions in bonds issued by Switch, Inc., Valvoline Inc. and Peninsula Pacific Entertainment LLC in September and added a position in Citrix Systems, Inc. 3.3% 2030, which was called shortly after our purchase and should pay out in early October. We expect that half of our Event Driven positions to be turned into cash in October as we have received call notices for our holdings in Citrix and Exterran Corporation, our position in Nielsen Finance Co. 5.875% 2030 has been tendered, while Churchill Downs Incorporated expects to close its purchase of Peninsula Pacific Entertainment early in the fourth quarter, which we believe will lead to a make-whole call notice in October.

The Fund used the increased short selling capacity to opportunistically sell short ETFs, US Treasuries, and individual high-yield bonds in September. This increased capacity helped the Fund to protect capital during a volatile period.

With some stunning moves in government bond markets late in September resulting in higher yields, the Fund was comfortable taking on more duration than we have historically. The 10-year US Treasury bond briefly surpassed a 4% yield in an overnight session for the first time since 2010. While central bankers have made it clear that they have no set path forward, rates have moved sufficiently high where risks for government bonds are much more balanced than they have been in a long time. The 2-year Treasury traded at a yield of as high as 4.35% which seems like a decent holding for those looking to protect capital over the near term. The era of "TINA" or There Is No Alternative to risk assets appears to have ended for now.

Portfolio metrics:

The Fund finished September with long positions of 141.0%. 30.0% of these positions are in our Current Income strategy, 69.7% in Relative Value and 23.7% in Event Driven positions. The Fund had a -53.1% short exposure that included -14.5% in government bonds, -28.5% in credit and -10.1% in equities. The Option Adjusted Duration was 3.6 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 2.5 years. The duration figure includes several Event Driven positions where bonds we expect to be redeemed in the next six months are assigned durations of five years or longer.

The Fund's current yield was 7.5% while yield to maturity was 8.8%

Market Outlook

It has been a brutal nine months for markets. There has been nowhere to hide, with virtually all assets except energy equities impacted by a significant regime change from over a decade of zero interest rate policies, quantitative easing, and other nonconventional market interventions. While it feels like correlations have been close to one for much of this year, going forward we believe that there will be room for differentiation between asset classes.

High-yield returns look attractive on a medium-term basis to us, with the short run being much less certain. At the end of September, high-yield market metrics look very similar to where they stood at the end of 2007. While that turned out to be an awful point to buy just about any risk asset over the short term, on a 3-year basis the ICE BofA High Yield index returned 10% annualized, which was about 12% annualized ahead of the S&P 500. The Russell 2000 performed better than the S&P over this period but was still well behind the high-yield market. We believe that a similar setup exists today, where the bar to generate returns in high quality credit over the next two to three years is much lower than it is for equities. With this in mind, and with borrowing in the largest credit ETFs becoming challenging, we may shift some of the Fund's macro hedges away from credit and into equities in the weeks ahead. We have already made a small shift in the final days in September, covering a portion of our credit shorts while topping up equity index ETF short positions.

While value has improved a great deal this year in credit markets, we may never see the all-in yields of 2021 again. After a decade of easy monetary policy prior to the start of the COVID-19 pandemic, the high-yield market had spent only a few days below a 5% yield to worst in 2013 and 2014, and in both cases sold off sharply after reaching those levels.

Central bankers took liquidity to another level this cycle, with yields and risk premiums so depressed that the high-yield market spent a full calendar year below a 5% yield, averaging a yield to worst of only 4.15% for all of 2021. In hindsight, it should be painfully obvious that policies were too loose for too long. In our opinion, last year, the threat of inflation was not being taken as seriously as it should have been and there were many signs of excessive risk-taking behaviour that could have been moderated by tightening policy sooner.

The ability of capital providers to access healthy risk premiums is a market development that should be welcomed. We are optimistic about our ability to add value through credit selection and active trading now that the market is providing more opportunities. We expect to dynamically increase or reduce our exposure to the market in response to valuations in the weeks ahead.

Justin Jacobsen, CFA
October 13, 2022

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PenderFund Capital Management Ltd.

Standard Performance Information for the Fund may be found here: https://www.penderfund.com/pender-alternative-absolute-return-fund/

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