PENDER
ALTERNATIVE ABSOLUTE RETURN FUND

MANAGER'S COMMENTARY – OCTOBER 2022

Dear Unitholders,

The Pender Alternative Absolute Return Fund finished October with a return of 1.3% bringing year to date performance to 4.8%[1].

October witnessed a significant bounce in most asset classes, as dip buyers emerged following significant repricing from mid-August to mid-October. The high yield market put up its first positive month since July, with the ICE BofA US High Yield Index returning 2.8%. Spreads tightened significantly during October finishing at 463bp OAS, lower by 80bp on the month. Year to date, the market has returned -12.2%. High yield spreads reversed almost all the 100bp of spread widening that occurred in the second half of September, bringing market spreads close to where they were before both the August and September US CPI reports came in hotter than expected.

Portfolio Update

The large macro moves in recent weeks have created some pockets of dislocation within credit markets. A theme the Fund focused on this month was the dislocation between Investment Grade and High Yield credits. At one point in October, BB spreads were 100bp lower than their peak for the year, while BBB spreads were only 3bp below their peak. The Fund reduced high yield exposure in favour of investment grade, purchasing bonds issued by Host Hotels & Resorts, L.P. (Nasdaq: HST), Toronto-Dominion Bank (TSX: TD) and The Bank of Nova Scotia (TSX: BNS), among others. In one case, we bought investment grade bonds trading at about the same yield and spread as high yield bonds rated B+ in the same sector. While rating agencies often get things wrong, in this case neither entity is misrated in our view.

We believe that a large driver of the divergence between investment grade and high yield is internal technicals. The investment grade market has seen significant issuance into a weakening macro backdrop, which has driven spreads wider. In contrast, the high yield market has seen the lowest volume of issuance since 2008, which has created a supportive internal market technical as the cash from coupons, calls and maturities must go somewhere. Compounding this is the strong influence that ETF flows can have on the market on a short-term basis. Fund flows can create opportunities to both buy and sell at better prices than are supported by fundamentals, and one of our primary value-add levers in this Fund is to be an opportunistic provider of liquidity in credit markets.

We sold out of several positions in large capitalization, high quality, high yield issuers that we viewed as fully valued, recycling capital into parts of the credit market which we were of the view had lagged the macro move higher. One credit that lagged the supportive macro environment was the bonds of Tamarack Valley Energy Ltd. (TSX: TVE). In September, the company announced the acquisition of Deltastream Energy Corporation, which was funded with a combination of debt and equity. The company issued a $100 million add-on to its 7.25% 2027 Sustainability Linked Notes that had been issued earlier this year, pricing at a six-point discount to par to yield 8.85%. At the same time, the company issued equity at $3.75/share. In the seven weeks since the transaction was announced, TVE's equity has performed quite well, closing October at $5.25/share up 40% from the issue price. At the same time, the bond has lagged badly. We have been able to grow our position at a discount to the already discounted issue price, buying TVE's bonds at a yield of over 9% to maturity. Despite there being a great deal of volatility in the 2014-2021 period, we believe that the setup for energy credit is quite supportive, and in some select Canadian issuers there is as large a margin of safety as we can find in markets today.

As expected, October was a busy month for our Event Driven strategy with our positions in Nielsen Finance LLC along with Exterran Energy Solutions, L.P. paying out as both mergers closed. Once Elon Musk agreed to move forward with his purchase of Twitter, Inc. (private), we became comfortable adding to our holdings in Twitter, Inc. 5% 2030 bonds, which we partially hedged with an equity short. We believe the bonds provided optionality. Although a Change of Control put at $101 was our base case, we had seen consent solicitations at a premium to $101 in several instances, as well as the potential for a make whole call. Ultimately, the company offered to purchase our bonds at $101 with a settlement date in late November; we will receive a decent premium to our cost base in addition to accrued interest

[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.*

over our holding period. We will be selling into this event and would need to see significant improvement in the company's cash flows to consider participating in the LBO financing if the underwriters ultimately do bring a transaction to market. Our position in Peninsula Pacific Entertainment LLC paid out on November 1. We topped up our position in both Shaw Communications Inc. Class B shares (TSX: SJR.B) as well as our position in Rogers Communications Inc. (TSX: RCI.B) Special Mandatory Redemption bonds, tilting our exposures slightly more towards the transaction completing than where our exposure had been at the end of September.

The Fund covered a small portion of our duration hedge in October at a 4.25% yield on the 10-year US Treasury bond. We subsequently added duration hedges closer to and through a 4% yield on the 10-year when treasuries rallied later in the month. With high yield spreads in the mid-400s at the end of October, we viewed the market as fully valued and layered on risk hedges into strength, closing the month with our largest short book since inception.

Portfolio metrics:
The Fund finished October with long positions of 137.8%. 18.2% of these positions are in our Current Income strategy, 93.1% in Relative Value and 25.5% in Event Driven positions. The Fund had a -69.6% short exposure that included -24.2% in government bonds, -31.6% in credit and -13.8% in equities. The Option Adjusted Duration was 2.3 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 1.8 years. The duration figure includes several Event Driven positions where bonds we expect to be redeemed in the next five months are assigned durations of five years or longer.

The Fund's current yield was 6.8% while yield to maturity was 7.9%

Market Outlook
To be an effective investor, at least over the short term, understanding psychology can sometimes be even more important than understanding fundamentals. Anchoring, recency bias and availability bias are some of the reasons why markets do not always react efficiently to incoming developments. After a decade of easy monetary policy, where central bankers encouraged risk-taking by frequently stepping into backstop markets — most notably in early 2019 and 2020 — market participants have been conditioned to expect short cycles and to buy the dip. The highest sustained inflation in forty years has resulted in a regime change where markets will no longer be coddled at the first sight of real pain.

Despite this change, the impulse to buy the dip remains strong. The dramatic intraday turnaround on October 13 after the release of yet another US CPI report that came in hotter than expected was a perfect example. There are autocorrelated aspects to markets where price moves drive sentiment, which provides the fuel for moves to continue. We believe that momentum-chasing strategies played a key role in bidding up the high yield market in late October. There was $7.1 billion of inflows into high yield funds in the two weeks leading up to the November 2 FOMC decision, a historically elevated level of inflows. Despite arguably attractive all-in yields, with high yield spreads in the mid-400s and a high risk of recession over the near term, we believe that the near-term skew is for wider spreads and lower prices for risk assets.

As we head into the final two months of the year, our focus is on protecting capital. Market cycles take time to play out, as participants slowly accept the new market reality and price assets appropriately for the new regime. In the dot-com bust, which in some ways is one of the best analogues to the current market environment, the peak-to-trough on the S&P 500 took over two and a half years to play out. We are only ten months removed from a market peak and the dip-buying impulse is still too strong to form a meaningful bottom in our view. While we are always looking for new information and counterarguments to our views, we will patiently wait for opportunities to take on more market exposure at compelling valuations in the months ahead.

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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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