

PENDER

BOND UNIVERSE FUND

THE MANAGER'S COMMENTARY - OCTOBER-DECEMBER 2022

For the three months ended December 31, 2022, the Pender Bond Universe Fund generated a 0.8%¹ return, outperforming its benchmark by approximately 70bp. For the full year of 2022, the Fund returned -6.4%¹, realizing a respectable 5.3% of relative outperformance compared to its benchmark. The Fund's positive return over the last six months of the year was aided somewhat by its exposure to higher yield credit through its Pender Corporate Bond Fund holdings.

2022 in general was a very poor year for long duration bonds, with the iShares 20 Plus Year Treasury Bond ETF (NASDAQ: TLT) down over 30% for the year. While we were not completely immune to the difficulty, our short duration and high-quality positioning enabled robust outperformance of indices.

In the latter part of the year, several of our longer dated positions performed well with the Fairfax Financial Holdings Ltd. 3.95% of 2031 notes up 1.8%, the BCE Inc. 3% of 2031s up 1.7% and the Loblaw Companies Limited 2.284% of 2030s up 1% in the fourth quarter. In terms of the Fairfax 2031s specifically, we added to our position later in 2022. Positive performance here was the result of a combination of rate retrenchment towards year-end and spread compression. Fairfax continued to see strong underwriting performance as pricing and demand remained solid for their North American operations.

The Road to Recovery

As we well know...it's all about inflation. At the end of November Jerome Powell gave a progress report, and in it, he discussed how Personal Consumption Expenditure (PCE) inflation (their preferred measure) ran at 6% through October – a surprise to the downside. This measure for November came in at 5.5%. Even though we are a long way from the Fed's ultimate target and two months of movement in the right direction does not necessarily indicate a trend, we will take this as good news.

Another reason for optimism is an anticipated decline in the housing component of the PCE. In November, Powell spoke to housing services inflation and how it has continued to rise, standing at 7.1% over the previous year, but notably it tends to lag other prices because of the slow rate that rental leases turn over, making the market rate on new leases a better indicator of where overall housing inflation will move over the next year. One-year inflation of new leases rose significantly during the pandemic, but this has fallen quite sharply since the middle of 2022. This is in contrast to the PCE measure for housing, which continues to rise due to the lag discussed previously. Powell felt that this will likely continue into 2023, but if new lease inflation keeps falling, he expects housing services inflation to start falling sometime next year². Given that housing makes up a non-trivial portion of PCE, this has the potential to bode well for inflation in the coming year and will hopefully contribute to the eventual easing of the significant increase in rates we have seen to this point.

As we look forward to 2023, we are seeing some additional promising signals relating to what may be in store for Investment Grade...

¹ Class F of the Fund. Other classes are available. Fees and performance may differ in those other classes.

² "Inflation and the Labor Market", Jerome Powell, Nov 30, 2022

An Investing Set-Up for Investment Grade Bonds

First – we have seen signs of a fundamental change materializing in relation to Private Mortgage Insurance (PMI), which could signal fading inflation. Developed Markets Manufacturing PMI, which looks at the purchasing behaviour of corporate executives, has moved in almost lock-step with US 10-Year Government Bond Yields over the past decade. More recently, however, PMI has fallen drastically versus only a small drop so far in the 10-year yield, implying that there may be further declines to come in yields³.

Second - there is currently an overly negative sentiment backdrop, which may provide a contrarian signal for the future. Examples here include fund flows, current dollar prices and the US Treasuries Sentiment Index itself. Specifically, in December, year-to-date fund flows for US Investment Grade mutual funds and ETFs were the lowest they have been going back to 2009, and US Investment Grade dollar prices were trading at the low end of their historic range at just under \$90, a level not materially different from US High Yield dollar prices of ~\$86⁴ and finally, the US Treasuries Sentiment Index recently pulled back from an extreme bearish level on bonds, potentially signalling a change in sentiment as we move forward³.

Third - there is currently a lopsided market participant positioning on UST futures. At the end of December, the short interest on five-year treasuries was just shy of three standard deviations below the mean, revealing significant bearishness and therefore the potential for mean reversion in the future.

In the event that we do see inflation ease consistently and with it, the Fed's actions on rate hikes, the impact that even a 100bp decline in yields would have on bond prices is significant and worth considering as we move forward into 2023. For instance, even a relatively shorter dated four-year bond with a 5% coupon and a 5.75% YTM currently would see an 8.6% one-year total return for a 100bp decline in yields... not bad.

As we say goodbye to 2022, various signals, including those discussed above, are combining to make us positive on the prospects for Investment Grade.

Duration Strategy

The level of the term premium signals the degree of compensation offered for taking on the increased duration risk inherent in longer dated bonds. It's a key factor that informs the duration positioning of The Bond Universe Fund. We may extend duration as the term premium cycles higher, and reduce overall duration when it falls. With the term premium dipping below 0 in the latter part of 2022, duration of the Fund remains relatively tight.

Fund Positioning

The duration of the Fund was 3.5 years at the end of Dec 2022 and yield to maturity was 5.3%. The Bond Universe Fund held a 24.4% weight in Pender Corporate Bond Fund units at the end of December giving it 18% in overall exposure to non-investment grade securities.

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³ Topdown Charts, December 2022

⁴ CreditSights, December 2022