THE MANAGER'S MONTHLY COMMENTARY – DECEMBER 2022

Highlights

- Positive contributors in December were Chinese property developer Country Garden Holdings Company Limited, Emergent BioSolutions Inc., and Carriage Services, Inc., while detractors included National CineMedia LLC, and rising government bond yields that drove investment grade bond prices lower.
- In December, we initiated a position in Bandwidth Inc., a maker of software for web applications that interface with telephone networks and text messaging. We also initiated a position in the 2027 convertible notes of Winnipeg-based NFI Group Inc., currently yielding over 10%.
- The Fund starts 2023 with an average yield to maturity of approximately 8%, significantly higher than the start of last year.

The Pender Corporate Bond Fund returned 0.2% in December, a resilient performance within a volatile market context. For the full year, the Fund returned –5.7%[1], with a positive second half of 2022 recovering a portion of the drawdown from the first six months.

Relative strength in December came from some diverse pockets of the Fund. Our small position in the bonds of Chinese property developer Country Garden Holdings Company Limited continued to rise as significant state banking support appeared for the issuer. Our position in the debt of Emergent BioSolutions Inc. rebounded over 10% from an oversold position following what was, in our view, a non-critical earnings disappointment. Our position in the bonds of American funeral home operator Carriage Services, Inc. rose 6% following a refreshed banking agreement that removed liquidity concerns.

Offsetting weakness in December resulted largely from rising government bond yields that drove most investment grade bonds lower in price. Selective credit weakness also appeared, as was the case for National CineMedia LLC. First lien bonds of this motion picture theatre advertiser suffered due to the ongoing debt restructuring at major business partner, Cineworld PLC.

January 1, 2023 – So Where Are We Now?

"Sometimes," Paul Simon once declared, "when I'm falling, flying or tumbling in turmoil I say 'Whoa, so this is what she means.'" But we're not bouncing into Graceland; more just trying to navigate our way through one of the trickiest credit markets of a generation. The holidays offered a welcome period to read, think and reflect upon the situation we face as the calendar starts anew. Here are some thoughts for this moment:

Getting used to the new valuation math: At the end of 2022, the US two-year yield sat at 4.43%. Historically, that is an unremarkable level. Since June 1976, the average two-year Treasury yield has been approximately 5%. However, in the context of recent history, a two-year yield in excess of 4% should be compared perhaps to Mount Everest appearing suddenly on the Saskatchewan prairie. It is simply the highest yield in more than 15 years, a period during which, most of the time, short government paper paid less than 1%.

Treasury yields are important generally in finance because risk-free interest rates are situated in the denominator of asset valuation equations. And there, just to the right of the bracket that holds the risk-free rate, is an exponent, which makes the impact of higher underlying yields, well, exponential.

In short, higher rates mean asset valuations should be lower. What assets, you ask? Pretty much all of them. Bonds? Check. Houses? Check. Stocks? Check. Private companies? Check.

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

The business collateral that supports any credit investment is, on the margin, worth less in a higher rate environment than it is in a lower rate world. So, if we owned a bond last year in a hypothetical $3 billion company with debt of $1 billion, then, all other things being equal, that $3 billion company might be fairly valued at $2.5 billion now. And that clearly reduces the buffer of value below our credit position.

The "new math" for us creates an incentive to move higher up the capital structure, or into structures that have more buffer value below the debt. It also causes us to value companies with cash flows expected in the near term higher compared to those companies with cash flows that arrive in a distant future.

Getting used to higher all-in yields: While lower valuations are a tough pill to swallow, an offsetting benefit of the current environment is a higher all-in yield available across the credit markets. The Pender Corporate Bond Fund starts 2023 with an average yield to maturity of approximately 8%, significantly higher than the start of last year. Looking across investment grade and high yield markets, one must go back to 2009 to find a period with such a broad-based set of discounted corporate bonds.

In addition to the obviously higher running returns, a higher yield structure also offers a benefit in terms of being able to absorb any further rise in rates. A five-year bond that yields 1% suffers a -2.5% total return loss if its yield increases by 1%. But a five-year bond that yields 6% still provides a total return of 2.5% if its yield rises 1%.

"We recognize that Warren Buffett can handle 6% rates. But not everyone is Warren Buffett."

Thinking ahead: Which issuers can pay higher yields? The sudden rise in interest rates also raises concerns about general credit quality. Here is a simple example: A person borrows $1 million to buy a house at a 2% mortgage rate. The annual interest cost was initially $20,000. Now, with higher rates, the mortgagee must refinance at 6%, increasing their annual interest costs to $60,000. What happens if they cannot afford to pay an extra $40,000 in interest costs?

Now, take that problem and consider the following. Pretty much every stock and bond issue, every housing purchase, every business acquisition, virtually every significant asset purchase in the last fifteen years, was financed in the context of a much lower interest rate environment.

We recognize that Warren Buffett can handle 6% rates. But not everyone is Warren Buffett.

And this is why we expect the impact of the Fed's hiking to have a broad effect, reduce consumer demand and create debt service pressure across the economy in 2023. This is also why we expect risk-free yields to come down, at least temporarily, as a slowing economy quashes inflation and enhances demand for well-covered, liquid debt securities.

New Positions

In December, we initiated a position in Bandwidth Inc., a maker of software for web applications that interface with telephone networks and text messaging. A market darling at the height of the pandemic, Bandwidth's enterprise value has declined by more than 75% in the past two years and its valuation multiples now sit near record lows. We bought Bandwidth's 0.5% 2028 convertible notes in the low 60s, yielding approximately 10%. We like Bandwidth's growth and cash generation profile and we consider the company's status as an FCC-regulated telecom operator to form part of a meaningful moat around its business. Cash balance of $311 million is only slightly less than the recent market value of Bandwidth's debt of approximately $340 million.

Also in December, we added a position in the 2027 convertible notes of Winnipeg-based NFI Group Inc., currently yielding over 10%. NFI is North America's largest transit bus manufacturer, boasting an impressive order backlog of over $8 billion. Historically profitable, NFI has fallen on difficulties of late due to supply chain-related parts shortages. We believe 2023 may mark the beginning of an operational turnaround for NFI as supply chain issues ease. We believe that recent market concerns regarding the company's liquidity have been substantially relieved by commitments from the Government of Manitoba and Export Development Canada.

Fund Positioning

The Pender Corporate Bond Fund yield to maturity at December 31 was 7.9% with current yield of 5.6% and average duration of maturity-based instruments of 3.4 years. There is a 2.1% weight in distressed securities held for workout value whose notional yield is not included in the foregoing calculation. Cash represented 2.1% of the total portfolio at December 31.

Geoff Castle
January 6, 2023

Standard Performance Information for Pender's Fixed Income Funds may be found here: https://www.penderfund.com/fixed-income/
This commentary is subject to the Disclaimer found here: https://www.penderfund.com/disclaimer/

© Copyright PenderFund Capital Management Ltd. All rights reserved. January 2023.