



ALTERNATIVE ABSOLUTE RETURN FUND

MANAGER'S COMMENTARY – JANUARY 2023

Dear Unitholders,

The Pender Alternative Absolute Return Fund finished January with a return of 1.5%¹.

A new year brought a clean slate and increased risk-taking appetite. January 2023 was the strongest start to the year for credit since 2019 and the second strongest year since 2009. Credit spreads compressed significantly, with the Option Adjusted Spread (OAS) on the ICE BofA US High Yield Index declining from 481bp to 430bp, finishing the month below the 10-year average, at one point breaching August's low. The ICE BofA US High Yield Index returned 3.9%. As we argued [last month](#), it has proven challenging for the market to break through that trading range. While the high yield market peaked in the middle of the month both from a spread and absolute return perspective, equities kept on grinding higher, undeterred by a steeply inverted yield curve and disappointing guidance from bellwether companies.

Portfolio Update

As the Fund's more liquid holdings rallied sharply in January, we sold into strength, recycling capital into bonds that had lagged the move higher. Several of these holdings also rallied sharply after our purchase, which caused us to take additional sales. As the month progressed, it became difficult to recycle capital, and this caused our cash balances to increase. We found value in Canadian dollar bonds in January, adding or establishing positions on bonds issued by SECURE Energy Services Inc. (TSX: SES), Superior Plus LP (TSX: SPB) and Keyera Corp. (TSX: KEY). With cash piling up, we purchased a six-month US Treasury Bill at a yield of 4.83%, which is now the Fund's largest long position. With spreads trading very close to resistance, the Fund is positioned quite defensively with approximately 15% of our long exposures being bonds that have either been called or have a final maturity within the next six months.

The Fund was active in the new issue market during the month, participating in bonds issued by Transocean Ltd. (NYSE: RIG), W&T Offshore, Inc. (NYSE: WTI) and the Bank of Montreal (TSX: BMO), all of which came with attractive concessions to secondary market levels. In response to a strong bid for risk, the Fund reduced exposure to the automotive sector in January. In our view, spreads are priced for a very benign environment over the near term, with risks skewed to the downside. We see value in the energy sector, which is discounting weaker commodity prices than what are priced into forward curves for oil over the next several months. The path forward for oil is subject to much debate, but in our view, there is good support from a valuation perspective, which is not the case for several other market sectors.

The Fund added to our loan exposures with a focus on front-end maturities that we expect to be refinanced in the next year or so. We are actively looking for opportunities to earn defensive carry, but are focused on credits with a very solid floor based on our view of valuations and risks over the coming months.

The Fund de-grossed several event-driven positions in response to valuations. Our exposure to both Shaw Communications Inc. Class B shares (TSX: SJR.B) and Rogers Communications Inc. "Special Mandatory Redemption" or SMR bonds decreased in January as we sold into strength following an

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

appeals court ruling against the competition bureau, which had opposed the transaction. In response to what we view as mispriced optionality in the Rogers bonds we own, we have adjusted the ratio of Rogers bonds relative to Shaw equity in this package to benefit from a deal break, even though we view that as an unlikely outcome.

Over the last two weeks of January, the Fund was positioned very defensively, our most defensive posture since August 2022. We have shifted a portion of our hedges away from government bonds and into risk assets, both equity and credit. It is entirely possible that we will have been early in reducing risk, but the Fund is not a momentum-chasing strategy. We believe that patience will be rewarded and there will likely be better opportunities to deploy capital in the months ahead. An expensive market that becomes even more expensive is one of the more awkward macro backdrops for this strategy, which could be the case for the next couple of months. Both the option value and yield available in cash look attractive to us in the meantime.

Portfolio metrics:

The Fund finished January with long positions of 110.1%. 21.9% of these positions are in our Current Income strategy, 76.2% in Relative Value and 12.0% in Event Driven positions. The Fund had a -60.6% short exposure that included -14.2% in government bonds, -35.2% in credit and -11.2% in equities. The Option Adjusted Duration was 1.5 years.

Excluding positions that trade at spreads of more than 500bp and positions that trade to call or maturity dates that are 2025 and earlier, Option Adjusted Duration declined to 0.9 years. The duration figure includes Event Driven positions where we believe duration does not accurately reflect the option value embedded in the security.

The Fund's current yield was 4.8% while yield to maturity was 5.7%.

Market Outlook

Mean reversion trades are alive and well in early 2023. With a disorderly close to 2022, combined with a fresh start that a new year brings, we were not surprised to see a strong bid for risk assets to start the year. Price movements can shift sentiment, creating either virtuous or vicious feedback loops. While the market may continue to feed on its own momentum for some time, it looks to us like there is a lot of optimism baked into securities prices, with cyclical stocks like Hyatt Hotels Corporation Class A (NYSE: H) and Caterpillar Inc. (NYSE: CAT) both hitting all-time highs in January.

We believe that the current market cycle has a lot of parallels with the unwinding of the tech bubble that played out from 2000 to 2002. Over that period there were some incredibly sharp market rallies, especially in the most overvalued segments of the market. After a long period of speculative excess, it takes time for valuations to revert to levels that are supported by fundamentals and appropriate risk premiums. So far in 2023, we have seen massive rallies in the equities of companies that are either on the verge of bankruptcy or currently insolvent, like Bed Bath & Beyond Inc. (Nasdaq: BBBY) and Carvana Co. Class A (NYSE: CVNA). These price moves should be seen as a warning sign that the risk-taking impulse has become excessive. Despite this, we have seen indications that some market participants who were positioned defensively have decided to pivot and take on a more pro-risk posture. This is evident in very strong performance from baskets of heavily shorted securities, consistent with a short covering rally. Even in our own short book, the cost to borrow high yield ETFs has declined to the lowest level since the Fund launched in 2021, which is a stark contrast with late September 2022, when the availability of incremental borrow on these securities dropped to zero.

There can be times when fundamental developments combined with attractive valuations warrant a shift to a more pro-risk posture. There are some positive fundamental developments when it comes to

inflation in North America: energy prices have declined and stabilized and goods inflation has come down significantly. The primary issue for policymakers is that the labor market is still very tight, and services inflation has been relatively steady at elevated levels for the past several months. The Employment Cost Index (ECI) is one of the Federal Reserve's favourite inflation measures as it is generally viewed to be more complete and higher quality data than the monthly wage data that accompanies non-farm payroll releases. The ECI for Q4 2022 was released on January 31, and while the quarter-over-quarter figure was slightly less than consensus at 1%, year-over-year compensation increases for civilian workers are still running above 5%, which is still very close to the high this cycle and, prior to last year, there was a level of wage inflation unseen in decades.

In North America, capital markets and the economy have handled rate hikes remarkably well to date. This could be because while front-end interest rates are elevated, there is a very steep curve inversion, so that the real yield on the 10-year Treasury or Canada Government Bond is still negative relative to CPI. There is a possibility that inflation could prove to be sticky around 4%, which, in our view, is not priced into the market, and would be negative for both government bonds and risk assets generally. Forecasting inflation is incredibly difficult, but the market appears to have a high degree of confidence that it will return to 2% in an orderly manner. When a market is priced for perfection, it's a very difficult standard to live up to.

Justin Jacobsen, CFA
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Standard Performance Information for the Fund may be found here: <https://www.penderfund.com/pender-alternative-absolute-return-fund/>

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