

MANAGER'S COMMENTARY – FEBRUARY 2023

Dear Unitholders,

The Pender Alternative Absolute Return Fund finished February with a return of 0.9% bringing year-to-date returns to 2.4%¹.

The euphoric mean reversion theme of January gave way to sober second thoughts in February, as sticky inflation and robust employment data caused markets to significantly re-price terminal rates higher, resulting in losses in most asset classes. The high yield market was no different, with the ICE BofA US High Yield Index (USD) returning -1.3% and at one point experiencing a 4% intramonth drawdown. The negative return for the month was entirely driven by rising interest rates, as credit spreads tightened by 8bp to finish at 422bp, below the 10-year average of 446bp.

Portfolio Update

The Fund's positioning was very defensive to start the month, running a net exposure to the market of about 40% excluding cash and very short-term bonds. When the market reacted positively to Federal Reserve Chair Jerome Powell's remarks at his press conference on February 1, the sharp rally across markets showed signs of capitulation from market participants who had been waiting on weakness to buy. We continued to sell into market strength, held back only by the potential for the market to continue to rally and not wanting to produce a negative return if it had done so. As the market sold off, the Fund added to select positions on weakness with a focus on high-quality secured debt issued by publicly traded companies. There were only select pockets of opportunity, as many issuers we follow were trading at spreads that we viewed as fully-valued, even at the market low late in the month.

We added to holdings where we believe that we are likely to earn better than an 8% holding period return in higher quality high yield, while also adding to our long exposures in six-month treasury bills with excess cash. In our view, cash is a legitimate alternative to traditional allocations and compares favourably with a lot of opportunities across asset classes that offer relatively small risk premiums compared to recent trading ranges. While we don't want to dismiss the effect of improving all-in yields for credit, there still needs to be an appropriate risk and liquidity premium to justify moving out the risk spectrum.

Among our portfolio holdings, we have seen issuers recognize the value and yield of cash. In the fall of 2022, we built a position in Valvoline Inc. 4.25% 2030 bonds, which the company had stated would be redeemed at par with the proceeds of the sale of their global products business to Saudi Aramco. We believed that the transaction had a high probability of closing and had expected the issue to receive a redemption notice in the first quarter of 2023. When the company reported fourth quarter results in February, it suggested that a deal close was imminent, but that it would use the full 12-month reinvestment period with the proceeds from the asset sale before redeeming its bonds. With short-term treasuries yielding over 5%, the company can earn close to 100bp higher than the coupon on its bond over the next year. Unfortunately for us, our position in Valvoline was profitable, but it did not meet our return expectations. We took sales in February and exited the position entirely in early March following a bounce after the asset sale closed. The spread above cash was insufficient to justify holding in our view.

¹ [This Pender performance data point is for Class F of the Fund. Other classes are available. Fees and performance may differ in those other classes.](#)

While the Fund finished February with more market exposure compared to the end of January, we remain positioned defensively as spreads are tighter than the historic average, with near-term risks for asset prices skewed to the downside in our view.

Portfolio metrics:

The Fund finished February with long positions of 132.1%. 30.5% of these positions are in our Current Income strategy, 90.7% in Relative Value and 10.9% in Event Driven positions. The Fund had a -54.6% short exposure that included -16.8% in government bonds, -27.1% in credit and -10.7% in equities. The Option Adjusted Duration was 2.19 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 1.71 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 5.68% while yield to maturity was 7.50%

Market Outlook

The dominant market theme in February was the repricing of terminal rates higher. At the end of January, the Fed Funds futures curve had priced in a peak rate of 4.9% in June 2023. A month later, the terminal rate had shifted higher to 5.4%, with the peak now occurring in September. Even more importantly, the implied rates further out the curve shifted up more than the terminal rates had, as the rapid rate cutting that the market had priced in starting in the second half of 2023 became increasingly priced out of the market. Pricing for the year end Fed Funds rate moved from 4.5% to 5.3%. Since last summer, the market had priced in the end of the hiking cycle with rate cuts just around the corner, despite messaging from the Federal Reserve indicating no cuts until at least 2024. February might have been the final nail in the coffin for the notion that we are on the precipice of a quick Fed pivot without any real market or economic pain.

We are concerned about the outlook for risk assets generally. In addition to competing with a real cost of capital for the first time in years, S&P 500 earnings growth turned negative in the fourth quarter of 2022 on a year-on-year basis. From what we can tell, based on equity multiples and credit spreads, very little attention is being paid to the decline in earnings and its implications for asset prices. With a dividend yield currently below most of the quantitative easing and zero interest rate policy era, we struggle to find a compelling bull case for the S&P 500 from here. While value looks better to us in credit, as higher rates are transmitted to asset prices directly, the reality is that any significant weakness in equity markets will have an impact on credit spreads. Much of this is due to the outsized impact that ETFs have on the market, especially when these funds trade at large premiums or discounts to NAV.

Over the near term, we will take what the market gives us. If spreads continue to tighten as they did in February, we expect to reduce market exposure. Conversely, if high-quality credit spreads widen, we expect to scale into long positions on weakness. Our overall market exposure is low, and we believe that patience and a focus on protecting capital will be rewarded with better opportunities in the months ahead.

Justin Jacobsen, CFA

March 9, 2023



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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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