PENDER
ALTERNATIVE ABSOLUTE RETURN FUND

MANAGER'S COMMENTARY – MARCH 2023

Dear Unitholders,

The Pender Alternative Absolute Return Fund finished March with a return of -0.1%, bringing year-to-date returns to 2.3%[1].

While negative months are always disappointing, the macro set up in March was particularly challenging for the Fund, with interest rates and equities posting a positive month while credit spreads widened and credit ETFs finished the month at significant premiums to net asset value. The ICE BofA US High Yield Index returned 1.1%, but spreads widened 36bp to finish at a 458bp option-adjusted spread (OAS). The excess return of the high yield market vs. government bonds finished the month at -1.4%. As a reminder, most of the duration in the Fund's long positions are hedged out with short positions in government bonds and credit instruments that include ETFs and individual bonds. We use equity index hedges to protect capital during significant spread-widening events. We believe that many of our portfolio holdings now appear to be particularly cheap relative to broad markets, given the divergence between asset classes that we saw in March.

Market Update

Interest rate volatility in March was historic, as rates moved quickly from pricing in 'higher for longer' to pricing in a dramatic reversal of policy rates, with cuts signaled as soon as next quarter. This move was exacerbated by positioning with several hedge fund pods reportedly hitting loss limits, covering shorts and shutting down due to the extreme volatility in short-term interest rates. Equity markets focused on lower discount rates rather than a rapid widening of credit spreads. Large-cap technology caught a bid in an echo of the 2020 playbook. In mid-March, the Nasdaq 100 put up its best week since November 2022, hitting new year-to-date highs late in the month and re-entering a bull market. When credit and equity markets diverge, history has shown that credit markets are more likely to be the leading indicator.

We believe that the facts have changed dramatically since 2020 and therefore established a short position in Invesco Nasdaq 100 ETF (Nasdaq:QQQ) late in the month. The market reflexively going back to what worked in the past is common following a regime change. While momentum and technicals can carry the market further and longer than is justified by fundamentals, ultimately, cash flows and cost-of-capital drive asset prices over the long run.

Markets have been eager to price in a pivot from the Federal Reserve for much of the past year. In summer 2022, cuts were priced in for early 2023, which was inconsistent with the Fed's messaging about its expected path for interest rates. Several central banks followed through with interest rate hikes in March, notably the European Central Bank, which hiked 50bp despite the collapse of Credit Suisse. The Fed released an updated dot plot in March that showed a further 25bp of policy tightening between now and the end of the year while the market is pricing in a net easing of policy rates over the next nine months. For the market path for interest rates to prove accurate, we believe that economic and financial conditions would need to deteriorate materially. The market was spoiled during the quantitative easing and zero interest rate policy era and it takes time to break free of that muscle memory. Our base case is that the regional banking failures in March are unlikely to have a systemic market impact.

[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.*

Credit Suisse's rescue by UBS and the wipe out of its AT1 capital notes had a significant impact on credit markets. We own modest positions in two Canadian bank Limited Recourse Capital Notes (LRCN), both of which sold off following the event. The Credit Suisse bonds had a covenant package that differed in material ways from our Canadian bank holdings. The Office of the Superintendent of Financial Institutions felt compelled to issue a statement reaffirming capital securities' ranking in the capital structure as senior to common equity. In the event of acute capital need, these securities would be converted into equity (based on a 10-day volume-weighted average price), subject to a $5 per share floor. For one of our holdings, there would be an additional 1.25x multiplier, which effectively drops the floor to $4 per share. In both cases, a top four Canadian bank would need to see its share price decline by over 90% from current levels before any losses would be incurred for its LRCNs. In the Global Financial Crisis, the vast majority of large Canadian banks proactively raised common equity capital in order to shore up capital ratios. We expect these banks to use a similar playbook in the future if necessary.

Our most recent trades in LRCNs were sales in early February as our holdings rallied on general market strength. Our total fund exposure is less than 4%, which is less than half of what it was last fall. We did not find value to be compelling enough to add to our holdings in March, but will continue to monitor these positions closely.

The weakness in US regional banks caused market participants to focus on their significant role in financing commercial real estate. There was generalized weakness in the Commercial Mortgage-Backed Security (CMBS) market in March, which caused our position backed by the Fairmont Hotel in Austin, Texas to be marked down, although we did not see any bonds for sale in the tranche that we own at lower levels. We were able to add a position in a second CMBS structure late in the month, buying the D tranche of a trophy hotel asset in a leisure-focused market that is generating cash flows above pre-COVID levels. Our exposure to commercial real estate is focused on hotels and multi-residential, where we believe fundamentals are solid and valuations attractive relative to broad credit markets.

Two of the Fund's largest positions are bonds backed by Xenia Hotels & Resorts Inc. (NYSE:XHR) and Greystar Real Estate Partners LLC (private). We accumulated a position in Greystar's 5.75% 2025 bond in March at about a four-point discount to par on average. We expect that the company will look to refinance the bonds, which are currently callable at par at least one year prior to maturity. If that were to occur, the IRR at our purchase price will be 8% or higher, depending on the exact timing of a call notice. Fundamentally, Greystar's business is performing well; the company reported its best quarterly EBITDA figure since inception in Q4 2022. The company's leverage declined in 2022 and its bond is on a positive outlook at both major rating agencies.

We are careful about security selection in real estate and related industries based on the potential for an extended and significant drawdown in the coming years. We estimate what asset value might look like in a distressed sale scenario and look for a good margin of safety in that event, in case our estimates are not sufficiently conservative. There are CMBS deals that were underwritten in recent years that could face significant losses, even on trophy assets. One issue that we recently reviewed was a $3 billion single-asset, single-borrower mortgage backed by the new One Vanderbilt office building in New York. While this is unquestionably a fantastic asset in a great location, in our view it looks like the transaction was underwritten at a 4% cap rate and with a 60% loan to value at origination in 2021. At a 7% cap rate, which might not even qualify as a distressed sale if underlying government bond yields are 4% in the future, the most junior tranches in that transaction could incur losses.

The Fund added back a position in Valvoline Inc. 4.25% 2030 (NYSE:VVV) that we had sold out of in February. This bond is expected to be called in Q1 2024 with the proceeds from the already-completed asset sale to Saudi Aramco. This was a function of an improved price relative to where we had sold, allowing us to generate an attractive IRR for what is a low-risk, short-duration position. We exited our position in Rogers' special mandatory redemption bonds as well as Shaw equity in March, following a significant rally in rates. We believed that there was downside in Rogers' bonds either from higher interest rates or wider credit spreads. It was always our base case that the transaction would close given the high degree of regulatory capture in the media and telecommunications industry in Canada. Rogers' standalone capital structure looks a lot like high yield cable credits that we own where credit spreads are significantly higher.

The Fund added to both long positions and macro hedges in March, as pockets of opportunity emerged that allowed us to initiate new positions and scale existing ones. We view a significant interest rate hedge as appropriate given that the path forward for inflation remains uncertain and is likely to be choppy. We added to duration hedges at yields of 3.4% and lower on US Treasuries. With most of our floating rate loans resetting at quarter end at spreads of 325 to 350bp, we are now earning current yields of about 8% on most of our loan book for some very high-quality issuers.

<u>Portfolio metrics</u>:
The Fund finished March with long positions of 126.2%. 25.0% of these positions are in our Current Income strategy, 91.1% in Relative Value and 10.1% in Event Driven positions. The Fund had a -63.3% short exposure that included -19.4% in government bonds, -30.5% in credit and -13.4% in equities. The Option-Adjusted Duration was 1.82years.

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 0.62 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 5.46%, while yield to maturity was 6.93%

Market Outlook
Risk assets are back to pricing in a pivot from global central banks without any acute economic pain. We believe that the immediate fallout from the failures of several regional banks is manageable and won't significantly alter the path of central bank policy rates. However, in our view, there is mounting evidence that we are late in the economic and market cycle and are therefore positioned conservatively overall.

Risk assets could be repriced lower by higher rates, lower earnings or higher risk premiums. The market dynamic of "bad news is good" because it will bring about lower rates is unsustainable. We have seen this in several periods over the past decade or so and it usually argues that the risk-taking impulse is stronger than it should be. Eventually, economic weakness should flow into both earnings and risk premiums.

In the first two months of the year, corporate defaults hit their highest year-to-date total since 2009. While defaults are often a lagging indicator and distress ratios are a leading indicator, what is unique about today's market is that defaults are elevated at a time when risk premiums are not. Below the surface of credit markets, we are noticing that market sponsorship is becoming increasingly narrow. This echoes what we saw in May last year, when the market put up a positive month while the distress ratio doubled.

The divergence between small-cap and large-cap equities as well as between credit spreads and equities in March is consistent with a market that is vulnerable to repricing lower. We believe that while the short-term path for asset prices is uncertain, over the next two to three quarters, we will likely see better opportunities to take on market exposure.

Justin Jacobsen, CFA
April 10, 2023

PENDER
PenderFund Capital Management Ltd.

Standard Performance Information for the Fund may be found here: https://www.penderfund.com/pender-alternative-absolute-return-fund/
This commentary is subject to the Disclaimer found here: https://www.penderfund.com/disclaimer/