PENDER FIXED INCOME

MANAGER'S COMMENTARY – MARCH 2023

The Pender Corporate Bond Fund returned -0.5%[1] in March. Although the period was a strong one for the high-grade part of the portfolio, a few idiosyncratic events in particular lines and widening spreads in lower-tier credit holdings led to a net negative result for the month.

Decliners included our position in convertible bonds of Esperion, which fell to $0.40 of face value in the wake of news of a disputed $300 million milestone payment between the company and its marketing partner, Daiichi Sankyo Co Ltd. We believe that, regardless of the outcome of the current dispute, Esperion is worth far more than the market value of its debt, and that Esperion's 4% notes represent a significant value opportunity. Other significant decliners included secured 2027 notes of Lumen Technologies, Inc., which declined over 10 points after an S&P ratings downgrade.

Positive movers included most of the Fund's investment grade holdings as the benchmark 5-year US Treasury yield declined 0.6% in March. Some stronger individual credit lines included Coeur Mining, Inc.'s 5.125% notes, which rallied over 10% on positive quarterly results and a flight-to-safety trade that benefitted gold miners.

Banks in the Tank – Thinking Through the Risks of Liquidity and Leverage

It was a turbulent month. In addition to the collapse and rescue sale of Credit Suisse, we also witnessed both the second and third-largest banking failures, as measured by asset value, in United States' history. Confidence quickly plummeted, requiring the Federal Reserve to hastily patch together the Bank Term Funding Program (BTFP). With the Fed deposit backstop in place, investors rejoiced. So, true to form, March came in like a lion and went out like a lamb.

However, the recent banking crisis offers certain lessons about liquidity and leverage. Before we start opining on the issues related to other entities' balance sheets, we thought it would be helpful to first consider the potential for issues to develop within our own house and how we address them.

Liquidity of Banks and Credit-Oriented Mutual Funds: The businesses of running this Fund and running a bank, while different in a number of important respects, are not entirely dissimilar. This Fund's unitholders, like a bank's depositors, have the ability to make withdrawals on demand. And like a bank, we essentially lend our assets long-term.

A key difference between this Fund and a bank on the asset side is that we lend by investing in tradeable debt, such as bonds or similar securities issued by large companies, whereas banks lend directly to smaller borrowers based on custom terms. But in both the Fund's and the bank's situations, credit underwriting must be calibrated with an eye to potential liquidation. Long-time followers of these commentaries will recall our policy is to stress-test the Fund's asset base against a theoretical 50% one-day liquidity requirement[2]. The events of March 2023 should highlight to holders why this policy is a useful risk control.

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[1] *All Pender performance data points are for Class F of the Fund. Other classes are available. Fees and performance may differ in those other classes.*

[2] Read our Commentary from July 2022 (https://www.penderfund.com/commentaries/fixed-income-july-2022/)

The Risks of Leverage: Recent stresses in the banking sector have also highlighted the danger of leverage. Simplified, the balance sheets of many banks consists of ten parts of assets financed by nine parts of debt and one part of equity. In such circumstances, the liabilities always stay at par, while the fair value of the earning assets can move up and down. Now, there are many mechanisms such as cautious underwriting standards, tight loan terms, etc., which make most bank assets relatively stable in value over time. But the fundamental exposure that exists in a bank financed in this manner is that the fair value of the earning assets can decline to the point where equity is wiped out. In that circumstance, a bank "run" is an entirely logical action on the part of its depositors.

Our Fund, operating without leverage, is an inherently more stable structure. Drawdowns, should they occur, are not magnified by nine or more turns of liabilities. In fact, twice in the lifetime of the Fund, once in 2015/16 and again in 2020, the Fund delivered a drawdown of greater than 10% on a total return basis. But our unlevered structure allowed us to bend in those circumstances, rather than break, and the benefit of the flexibility is that we can take advantage of excellent credit pricing available at moments of stress. In fact, in the three years *following* that 2020 drawdown, this Fund has delivered an annualized return of over 8% per year, notwithstanding the fact that this period included a dramatic rise in risk-free bond yields.

March Activity

In March, we added to our weighting in the preferred shares of Canadian Utilities Limited (TSX:CU), picking up weight in some of the perpetual preferred shares at yields in excess of 6%. We like the stable operating profile of this issuer, which operates principally as a regulated utility in the electricity grid distribution and gas pipeline segments. In price terms, the Canadian Utilities perpetuals are trading near the lower end of their historic range as investors are currently more focused on inflation risks than business risks. We believe that high quality preferred shares of this type will be more sought after if inflation slows further.

Also in March, we added to our position in Great Lakes Dredge and Dock Corporation (GLDD) 5.5% 2029 bonds. GLDD has seen unusually erratic cash flows in the past couple of years as dredging contracts issued by the US Army Corps of Engineers, the principal public dredging buyer in the United States, have been delayed. However, with a rebound in bidding activity and low prices on GLDD debt, we believe the bonds currently yielding over 10% represent strong risk-reward.

Fund Positioning

The Pender Corporate Bond Fund yield to maturity at March 31 was 7.9% with current yield of 5.6% and average duration of maturity-based instruments of 3.31 years. There is a 3.7% weight in distressed securities held for workout value whose notional yield is not included in the foregoing calculation. Cash represented 2.8% of the total portfolio at March 31.

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PenderFund Capital Management Ltd.

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