Manager's Commentary

David Barr, CFA and Sharon Wang

The Pender Small Cap Opportunities Fund returned -1.1% in the second quarter, bringing year-to-date returns in 2023 to 1.8%[1]. The gains were concentrated in June as the Fund returned 2.8% in the month as small caps more broadly caught investor attention. June was the first month of outperformance for small caps relative to large caps since February, with the S&P 600 gaining 8.2% in June compared to the S&P 500 gaining 6.6% in local currency terms.

Narrow equity leadership in 2023

The rally this year in equities has been narrow and concentrated in a handful of mega-cap tech companies. The top seven contributors to the S&P 500 this year have driven 75% of the gains. These same seven companies that drove the market's returns ended June trading at an average forward earnings multiple of 43x, a valuation nearly 50% higher than that at the start of the year.

	NTM P/E Dec 31, 2022	NTM P/E June 30, 2023	Weight June 30, 2023
Apple Inc. (NasdaqGS: AAPL)	21.0x	30.8x	7.7%
Microsoft Corporation (NasdaqGS: MSFT)	24.3x	32.3x	6.8%
NVIDIA Corporation (NasdaqGS: NVDA)	37.5x	47.2x	2.8%
Alphabet Inc. (NasdaqGS: GOOGL & GOOG)	17.9x	21.4x	3.6%
Amazon.com, Inc. (NasdaqGS: AMZN)	60.2x	75.8x	3.1%
Meta Platforms, Inc. (NasdaqGS: META)	16.4x	22.4x	1.7%
Tesla, Inc. (NasdaqGS: TSLA)	23.7x	71.2x	1.9%
Average	**28.7x**	**43.0x**	

Source: Capital IQ, as at 30 June 2023.

The valuation expansion in these companies has continued to push the disconnect between small and large caps to historically wide levels. The S&P 600 finished the quarter trading at 15.2x forward earnings, compared to the S&P 500 at 20.1x – a nearly 5x discount. It is rare to see such a spread and we have not seen a gap this wide since the early 2000s as the S&P peaked at the height of the tech bubble.

There is hope on the horizon. In the aftermath of the 'dotcom' bust, small caps went on a multi-year run of outperformance. In the six years from 2000 to 2005, small caps outperformed in each year at an average rate of nearly 12% per year.

	2000	2001	2002	2003	2004	2005
S&P 500	-9.1%	-11.9%	-22.1%	28.7%	10.9%	4.9%
S&P 600	11.8%	6.5%	-14.6%	38.8%	22.6%	7.7%
Small Cap Outperformance	**20.9%**	**18.4%**	**7.5%**	**10.1%**	**11.7%**	**2.8%**

Source: YCharts.

[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.*

Most investors are under allocated to small caps. After the last decade of outperformance from large caps and the view that small caps are riskier than large caps, some investors have lost interest. While momentum can carry trends to extremes, at some point they break, and new leadership takes hold. What has happened in the past does not necessarily reflect the future and the next 10 years will surely look different than the last. Time will tell if the last month is the start of a new trend and if the 1999-like setup in small caps comes to fruition. But with the valuation discount in small caps, we believe it's worth paying attention.

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Portfolio Updates

This valuation expansion and continued interest in technology was spurred in part by the rapid pace of innovation in artificial intelligence (AI). Of course, these advances have been occurring for years, but the spotlight has intensified with the mainstream adoption of ChatGPT and Open AI. We have some exposure to this theme within the portfolio. For example, PAR Technologies (NYSE: PAR) provides a unified commerce platform for restaurants and collects data from all touch points of restaurant operations and customer transactions. Copperleaf Technologies (TSX: CPLF) is another example. It provides decision analytics software that is AI-powered with analytics based on the vast quantities of domain-specific proprietary data that the company has collected from its global utility customers and partners. Both Copperleaf and PAR Technologies focus on integrating AI on top of existing proprietary data, which we believe offers them a unique advantage.

We have continued to execute our investment process and have been paying particularly close attention to the balance sheets of our portfolio holdings. This has always been a focus, but it has become more important in an environment of higher interest rates where a company's ability to raise capital is more challenging, particularly in a tougher macro environment. We are now focused on reviewing our holdings to re-assess their ability to service existing debt, in addition to their maturity profile and the risks of refinancing their debt, and this has led to us trimming some names accordingly.

Sylogist Inc. (TSX: SYZ) was a top contributor in the quarter. We were active with the company over the last few months and have successfully negotiated a nomination agreement that allows us to appoint a director to its board. We are pleased with this result and believe the company is well positioned and reaching an inflection point in its growth. The company's last quarterly results are a positive indication, with organic growth accelerating to 17% (adjusted for currency).

We also made some portfolio adjustments in the quarter and sold our position in Magnet Forensics (TSX: MAGT). The company had been a strong contributor to the portfolio as it was acquired, and the deal closed in the quarter.

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