Manager's Commentary

Geoff Castle

The Pender Corporate Bond Fund gained 1.2%[1] in June, which marked a notable period that saw several issuer-specific catalysts drive returns for the Fund within the context of a rising risk-free rate environment.

June started well, with longtime holding Paratek Pharmaceuticals, Inc. agreeing to be acquired by a group that included Denmark's Novo Holdings A/S, leading to a gain of more than 10% in that position. Another longtime healthcare position, OPKO Health Inc, also rallied significantly on the FDA's approval of the company's NGENLA growth hormone therapy. Later in June, our holding in the bonds of funeral home operator Carriage Services Inc. rallied over 5% on a takeover bid from a trade buyer. Our longstanding position in Fannie Mae preferred shares also bounced off its recent lows as the result of a favourable court ruling.

Offsetting the issuer-specific strength was a prevailing headwind of higher benchmark bond yields that impacted the investment grade portion of the Fund. And while most credit positions fared well in June, an adverse arbitration ruling against McDermott International, Ltd. resulted in a significantly lower mark for that position. We consider the McDermott capital structure to offer great value at current levels.

A Quick Note on Strategy

From a strategic perspective, the Fund continued with a defensive bias that is expressed by our historically large weight in investment grade securities. The portfolio is also fairly heavily weighted in high yield bonds of issuers that fit within our lowest default probability band.

We see elements in the environment that warrant caution on credit. These include an inverted yield curve, a persistently negative trend in the Conference Board US Leading Ten Economic Indicators, a rapidly decelerating US Personal Consumption Expenditure Price Index and tightening credit standards from surveyed lenders. Given that these factors have historically led to recessions, we have tempered our expectations for issuer earnings and have taken a careful stance in considering both existing portfolio companies and prospective investments.

Our caution on credit, however, is offset by a growing optimism regarding other areas of the fixed income universe that do well when policy rates come down. We like higher rated investment grade securities that are now offering yields that are close to 13-year highs. We also have become increasingly constructive on a group of yield curve-affiliated positions that we believe have been punished by rising North American policy rates.

[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.*

Looking to past cycles, we note that an end to tightening in North America has resulted in strong returns in precious metals and higher-grade emerging markets (EM) debt. Given that there are extraordinary yield premiums available in the debt of some gold and silver miners and large discounts for higher quality EM credit issuers, we consider these ideas to be likely beneficiaries in the event we see an end to rising policy rates.

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Bottom-Up Opportunities

Against a general strategic backdrop of defensiveness, we continue to scour the credit markets for line-item opportunities. Individual names get beaten up, sectors go in and out of favour, and refinancing challenges all regularly create opportunities that do not fit neatly into the broad narrative of a market cycle. In fact, we have often succeeded in spite of our strategic positioning as opposed to because of it.

On a bottom-up basis, we see interesting opportunities in several market niches. The Canadian preferred share market is one attractive corner at the moment. Take, for example, the Fairfax Financial Holdings Limited five-year rate-reset preferred series M. Sporting a current dividend yield of 6.25%, the shares are scheduled to reset 21 months from now at a yield of over 9.5%, assuming Canada's five-year benchmark yield remains at its current level of 3.68%. That would amount to a tax-equivalent yield of 12.4% from Fairfax M's, more than double this issuer's five-year bond yield.

Another line that seems far too cheap is the 0.5% putable convertible notes of Liberty TripAdvisor Holdings, Inc. As a condition of their issuance, these notes are putable at par in March 2025. While the issuer appears to be comfortably capable of honouring this obligation, the market has been reluctant to price in the upside from this near-term catalyst. The Liberty TripAdvisor convertible notes still offer a far-too-wide yield-to-put of over 14.5%.

A third example of current credit value is our continuing position in the first lien secured bonds of medical imaging manufacturer Varex Imaging Corporation The amortizing secured notes of this consistently profitable issuer are indicated at approximately 8% yield to 2027. This line represents the topmost $243 million of a $1.4 billion cap structure where EBITDA coverage of first lien interest was over 6x in the trailing twelve months to date.

To sum up our positioning, we are generally cautious, but selectively optimistic heading into the latter half of 2023. We believe investment grade credit offers interesting value here, as do a number of individual lines in the high yield spectrum where prices have become detached from strong fundamentals.

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Portfolio Activity

In June we added weight in the deeply discounted 2025 convertible notes of Esperion Therapeutics Inc. Esperion's bonds have suffered in the wake of a dispute between the company and its partner Daiichi Sankyo. At the heart of the matter is whether the effectiveness of Esperion's cholesterol-reducing drug, NEXLETOL, as demonstrated in recent clinical studies, is sufficient to trigger $300 million in milestone payments from the Japanese company. We believe Esperion will eventually prevail in its efforts to secure the milestone. Moreover, the prescription growth that has already been observed following the data release is also supportive of the proposition that the Esperion's value is far greater than the face value of its $265 million in debt. With bonds around 50c of face value, we like the risk/reward here.

Fund Positioning

The Pender Corporate Bond Fund yield to maturity at June 30 was 8.1% with current yield of 5.4% and average duration of maturity-based instruments of 3.2 years. There is a 2.3% weight in distressed securities held for workout value whose notional yield is not included in the foregoing calculation. Cash represented 4.2% of the total portfolio at June 30.

Geoff Castle
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Standard Performance Information for Pender's Fixed Income Funds may be found here: https://www.penderfund.com/fixed-income/
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