

Manager's Commentary

Justin Jacobsen, CFA

The Pender Alternative Absolute Return Fund finished August with a return of 1.2%, bringing year-to-date returns to 5.2%¹.

Following two months of decreasing risk premiums and volatility, both picked up in August. At the end of July, the S&P 500 index had not had a one-day loss of more than 1% since May 23, while there were three days where the index lost more than 1% in August. Despite the increase in volatility as well as government bond yields, risk assets finished the month relatively unchanged, perhaps helped by limited engagement late in the month. We expect capital market activity to pick up significantly in September, which could reprice credit markets that benefitted from a strong technical partially driven by a lack of new issuance in the second half of August.

Portfolio Update

With a defensive posture at the start of the month, the Fund benefited from volatility in credit markets in August. While credit spreads remain somewhat tight by historic standards, we believed that all-in yields were compelling enough to increase both duration and market exposure in the first three weeks of the month. Our focus was on high quality credits that had moved significantly in price and were approaching yield levels that we believed were attractive with relatively limited downside. We covered several short positions in individual bonds, while maintaining all of our macro hedges. In some cases, we were able to sell bonds into strength late in the month as much as two points higher than where we had recently purchased them, despite no company-specific news. Much like the market itself, the Fund finished August close to where it started, with a bias to protecting capital.

The Fund's exposure to Event Driven positions was significantly reduced in August. One position was called, while several others were sold down as the event had played out. Our position in PDC Energy Inc 2026 bonds was defeased by Chevron Corporation (NYSE: CVX), effectively turning it into a nine-month US T-Bill, but with less liquidity than our T-Bill holdings. We believe that the option value of liquidity is greater than the limited spread pickup over cash and exited our position. Our thesis had been that the company did not want to report separate financials for the acquired assets, which turned out to be accurate, we had expected the bond to be called rather than defeased. Since we had sold most of our position when the market had mostly priced in a call, we generated both income and a capital gain in aggregate on this position. The experience was a good reminder that having a real cost of capital for the first time in many years changes the calculus for corporate finance departments in ways that the market has not fully appreciated.

Portfolio Metrics

The Fund finished August with long positions of 132.2%. 34.3% of these positions are in our Current Income strategy, 96.2% in Relative Value and 1.7% in Event Driven positions. The Fund had a -62.1% short exposure that included -13.3% in government bonds, -31.8% in credit and -17.0% in equities. The Option Adjusted Duration was 1.70 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 1.17 years. The duration figure

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.

includes an Event Driven position where we believe duration does not accurately reflect the option value embedded in the security.

The Fund's current yield was 4.64% while yield to maturity was 6.57%.

“In our view, there is a negative skew to asset prices over the near term and we are positioned accordingly.”

Market Outlook

While risk assets were able to shake off the highest government bond yields this cycle in August, we believe that it is prudent to be cautious as we are most likely late in an economic cycle. The late August rally was reminiscent of 2021, when the market had taken an optimistic view that inflation would prove to be transitory. The S&P 500 closed August at almost the exact same level as it did two years ago, 4,508 in 2023 compared to 4,523 in 2021. In some ways, risk markets could be even further ahead of themselves now than they were two years ago. While inflation turned out not to be transitory, to support asset prices now we believe that both a soft landing and lower rates are required. It seems unlikely to us that both will be achieved, with the possibility that neither a soft landing nor lower rates is also a realistic scenario.

We do not believe that valuations in large-cap public equities, private markets and real estate have appropriately adjusted to a higher interest rate regime. While credit spreads are not cheap by any means, the impact of much higher base rates than the post-GFC era is reflected in prices. Over the medium to long term, there is a good prospect for high quality credit to outperform other asset classes, mostly driven by the significant carry advantage. In August we were able to buy what we believe are high quality, high yield bonds with maturities six to eight years out at around 8% yields and significant discounts to par. According to CBRE, the generic cap rate for regional malls in Canada is 6.2% as of Q2 2023. We would not underwrite a mortgage on a regional mall at a 6.2% rate, and we believe that cap rates should be higher than mortgage rates on commercial real estate in order to compensate for being lower in the capital structure.

In the short-term, divergences between other asset classes and credit markets can and have persisted for much of this year, but we believe that ultimately risk premiums will revert to where they should be. We expect this repricing to be choppy and present opportunities for us to provide liquidity to motivated sellers at some point in the coming quarters.

There are several warning signs present in markets today. One is risk assets responding positively to both good and bad economic news, which suggests a relatively high level of complacency about macroeconomic risks. Secondly, we have seen some high profile “perma bears” turn bullish which can be a sign of capitulation, which happens close to market peaks. On July 31, Mike Wilson of Morgan Stanley, who had largely been staunchly bearish for the past two years, turned tactically bullish, comparing the current market run to 2019. As of the time of writing, July 31 was the highest close of the year for the S&P 500. Time will tell if Wilson capitulated at the local high.

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