PENDER
CORPORATE BOND FUND

September 2023

Manager's Commentary

Geoff Castle

The Pender Corporate Bond Fund returned –0.5%[1] in September, a month in which markets faced a considerable headwind from rapidly rising benchmark yields across the curve, driven by a hawkish Federal Reserve.

The Fund had several pockets of strength in September. Energy-related securities did particularly well, and the Fund saw meaningful mark-ups in McDermott International Ltd. and PHI Group Inc capital structures. The announced acquisition of Intercept Pharmaceuticals Inc during September created a boost as Intercept bonds rallied approximately 17 points towards a change-of-control premium. Positive regulatory changes for marijuana companies in the United States also drove Trulieve Cannabis Corp bonds up as much as 20%.

Offsetting this strength was a widespread weakness caused by higher risk-free rates. Indeed, most of the bonds within the Fund fell in price as the five-year benchmark bonds in both Canada and the United States saw yields increase by approximately 0.5% in September. Specialty pharmaceutical maker Emergent BioSolutions Inc came under specific pressure from a ratings downgrade. We continue to like Emergent's prospects for rebounding earnings and added to the position on weakness.

Lower Prices and Better Fundamentals…Why We Are Starting to Like Long Bonds

Recently we have become more constructive on longer duration issues. Where previously we had been somewhat reluctant to extend duration beyond five years due to historically low bond yields and negative term premiums, we now believe that many longer-dated issues offer a vastly improved risk-reward equation. There's nothing like the 10-year US Treasury yield going from 0.5%, as it was in the summer of 2020, to more than 4.5% in late September 2023 to change the valuation math across a host of longer-dated maturities.

In fact, an enormous price reset has taken place in the bond market. Some examples include:

- The 1.25% US Treasury May 2050 bond, issued just over three years ago, has lost more than half its value to trade at 47% of face value;
- Canadian dollar perpetual preferred shares from several high-quality issuers have dropped from trading at a premium above $25 par value in the summer of 2021 to less than $17, a decline of roughly a third; and
- Broad investment grade bond index-tracking portfolios have lost roughly one quarter of their value in the past three years.

[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.*

While a price reset, in and of itself, is a good thing for bond valuation, another important factor to consider is the path of inflation and changes in economic drivers:

- Recall that headline CPI in the United States hit 9.1% in June 2022 and has since fallen to 3.7% recently;
- Note that the stickier measures of inflation (e.g., U.S. Personal Consumption or 'core' inflation) have declined from recent peak values of 5.4% in early 2022 to 4.2% in July 2023;
- Economic growth appears set to decline, with the Conference Board US Leading Index having declined in each of the past 17 months;
- U.S. money supply, as measured by M2, has declined by 3.7% in the past year; and
- Many other hallmarks of a pending economic slowdown, including tighter bank lending standards and an inverted yield curve are suggestive of a prospective reduction in consumption and demand.

So, while higher yields are already here, *higher yields in the context of prospectively lower inflation* may be the opportunity that the market is presenting right now.

"We believe, on balance, the overall value in high-grade fixed income is as attractive as it has been in more than a decade, and the building blocks of a rally in the longer-dated part of the bond market are falling into place."

Admittedly, there are some data points that do not fit with the overall narrative of declining inflation, including a supply-driven oil shortage. However, we believe, on balance, the overall value in high grade fixed income is as attractive as it has been in more than a decade, and the building blocks of a rally in the longer-dated part of the bond market are falling into place.

New Positions

In September, we added significantly to weighting in perpetual preferred shares of **Canadian Utilities Ltd**. The $17-priced Canadian Utilities preferred "J" sports a running yield of approximately 7%. On a tax-equivalent basis, this dividend income approximates to a bond yield of 9.1% to a Canadian investor. Not only is the current income stream attractive, but the risk-reward appears to be exceptional for securities of an issuer with de minimis credit risk. (We estimate one year default probability for A- rated Canadian Utilities at less than 0.01%.) In the case where the preferred share yield falls by 1%, we model a one-year total return of +23%. In the event that yields were to rise by 1%, the expected one-year total return is a comparatively modest -5% loss. We like this positive risk-reward payoff in the CU perpetuals.

Also in September, we added a position in the 2052 0.125% **United States Treasury Inflation Protected Securities** (or TIPS), priced at approximately 55% of its index-adjusted face value. At $55 this bond yields approximately 2.3% more than the breakeven 30-year inflation forecast inferred from the difference between TIPS and straight treasuries. We like this deeply discounted long-term inflation protection. While we expect a short to mediumterm reduction in inflation, in the long run American inflation seems likely to re-emerge due to a host of factors that include burgeoning Social Security obligations, challenging geopolitical security issues and populist politics.

In a more purely credit-oriented move, we also added to our position in the takeback term loan of **McDermott International Ltd.**, priced in the mid-50s to yield approximately 28% to a 2027 maturity. McDermott, which has faced many challenges since its 2020 reorganization, is finally seeing a vastly improved end market for its construction and engineering services. Notwithstanding the improved trading conditions, the enterprise value of McDermott at current market pricing is still a small fraction of its pre-petition levels. Although we have been surprised by the length and difficulty of the company's turnaround, we believe momentum is finally building behind this beaten-down cap structure.

Fund Positioning

The Pender Corporate Bond Fund yield to maturity at September 30 was 8.5% with current yield of 5.5% and average duration of maturity-based instruments of 3.4 years. There is a 5.0% weight in distressed securities held for workout value whose notional yield is not included in the foregoing calculation. Cash represented 3.0% of the total portfolio at September 30.

Geoff Castle
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