PENDER
CORPORATE BOND FUND

October 2023

Manager's Commentary
Geoff Castle

The Pender Corporate Bond Fund emerged from a volatile October with a modest 0.5%[1] drawdown. The month was characterized by sharply lower risk asset prices combined with higher risk-free rates across the curve.

Rate-sensitive positions such as Treasury Inflation-Protected Securities (TIPS) were weaker in October, while gainers included low priced securities exposed to catalysts. Our long-standing position in the re-organized equity of helicopter operator, PHI Group Inc, made a double-digit rally as investors anticipated a pending initial public offering.

From the General to the Specific…Thinking Through the Current Opportunity Set

After a volatile October, we are generally constructive on the bond market heading into the end of the year. There is a great deal of evidence that the economy is slowing down. We hear many local anecdotes. We see the bank layoffs and hear of the troubles brewing in condo markets. And we also observe some broader indicators. For instance, the Conference Board US Leading Index has declined in each of the past eighteen monthly readings.

So, the question we ask ourselves is whether the slowing economy is good for bonds. We believe the answer is a resounding "yes." If a rising economic tide in the context of COVID-constrained capacity led to high inflation, then a falling demand picture in an environment where productive capacity has essentially rebounded should do the opposite. And if higher inflation led to higher yields across the curve, then falling inflation should lead to lower yields.

The turn in inflation is no longer something about which we need to speculate. It has clearly happened. The Fed's preferred measure, Core Inflation, peaked at 6.6% in September 2022 and has declined in a steady fashion over the past twelve months to 4.1% at the end of September 2023. Given the continuing weak economic outlook, we would expect the decline in inflation to continue unabated for some time.

So, if inflation has been conquered, at least for now, and bond yields are set to decline, which bonds should we focus on? The two dimensions to consider are duration and credit exposure.

Duration, after being a negative factor for ages, seems to be worth looking at again. It is true that the term premium is not massive. But, with the prospect of a falling curve in front of us, we believe it is worth exposing ourselves to a degree of volatility to take advantage of the levered gains that could come from lower long-term rates. There are plenty of longer dated

[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.*

bonds down more than 40% over the past three years. Even a 1% decline in a 30-year bond's yield can offer the prospect of a one-year total return in excess of 15%.

While credit is not wholly attractive in a slowing economy, we do see bright spots. Cinemas, where the COVID recovery is still fairly nascent, is an area where enterprise values are still tiny, and credit is cheap. Likewise, oil which has suffered from capital starvation over the past five years. Healthcare and pharma, which lost margin dollars from the divergence of resources to COVID, also are still in rebound phase. And there are other random cheap pockets in credit markets because credit quality, ultimately, is situational. Businesses that can de-lever by selling hidden assets or businesses with implicit credit support from deep pocketed owners are a couple of classes of situation that have served us well over the years.

On the other hand, there are quite a few areas of expanding credit risks. Banking and real estate, as general categories, garner a pass from us for now.

All in all, we are very optimistic about our market and the prospect for a rebound. But we see perhaps, a different kind of rebound than previous episodes such as 2016 and 2020. Those were credit and commodity driven rebounds. In the current market, it is the risk-free rate itself which is the source of significant opportunity. And we view a rates-led, high-quality rally as the most likely near-term opportunity, with potential kickers to be provided by the above-noted pockets of cheap credit.

Portfolio Activity

In October we continued to find opportunity in discounted longer-tenor opportunities such as Occidental Petroleum Corporation's deeply discounted 4.1% notes of 2047 priced at roughly 64% of face value to yield 7.3%. Occidental's debt represents less than one quarter of the company's capitalization and operating earnings covered interest expenses more than eight times in the trailing 12 months. We view one year default probability as less than 0.1%. With Berkshire Hathaway an active purchaser of equity beneath these bonds, we view the credit quality of Occidental as extremely solid.

Also in October, we built out some higher quality lines in the portfolio including Waste Management Inc, where we added to the 2.6% 2026 notes yielding approximately 5.4%. A reliable, all-weather performer, Waste Management has a strong balance sheet and has low financial leverage. Recent operating earnings covering interest charges more than eight times.

Fund Positioning

The Pender Corporate Bond Fund yield to maturity at October 31 was 8.8% with current yield of 5.7% and average duration of maturity-based instruments 3.5 years. There is a 4.9% weight in distressed securities held for workout value whose notional yield is not included in the foregoing calculation. Cash represented 1.4% of the total portfolio at October 31.

Geoff Castle
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