Manager's Commentary

Justin Jacobsen, CFA

The Pender Alternative Absolute Return Fund finished May with a return of 0.1% bringing year to date return to 4.2%[1].

Despite historically expensive valuations at the start of the month, risk assets performed very well with US large cap equity indices hitting fresh all-time highs. Early in the month, BB spreads hit their lowest levels since 2007 before widening under the weight of heavy new issue volumes. While credit markets benefitted from falling government bond yields, with the 5-year US treasury yield finishing the month 20bp lower, BB spreads finished the month roughly unchanged.

Portfolio Update

Expensive markets which become even more expensive in an orderly, low volatility manner are one of the more difficult market environments for the Fund. As current valuations leave little room for error, we believe it is appropriate to be focused on protecting capital. We continue to expect that there will be better opportunities to take risk as the year progresses and will wait patiently before increasing market exposure. We have been active participants in new issue markets in Canada and the US and continue to find attractive opportunities to deploy capital selectively in what has been a robust capital market environment in 2024.

The Fund benefitted from several individual long positions where catalysts played out consistent with or even quicker than our initial investment thesis in May. In November 2023 through January 2024, we built a significant position in Videotron's Canadian dollar bonds due in 2030 and 2031, with the thesis that an upgrade to investment grade was likely, which we believe would significantly spread compression relative to peers like Rogers Communications. This played out as we had hoped in May with both S&P and Moody's upgrading the company's bonds to IG, resulting in even tighter spreads than we had expected at the time we put the position on, driven by generic market performance over the past six months.

Another example is Sensata Technologies 5% 2025 bond which we accumulated from late February through late April at prices of $99 and lower with the expectation that the company would likely look to refinance the issue prior to it becoming a current liability in October 2024, resulting in a call price of $101. The company came to market in May to term out this maturity resulting in a strong risk adjusted return for the fund as the bond rallied and converged to the $101 redemption level which will be paid out in July, several months earlier than we had expected.

The Fund added to two positions in May where we expect a combination of attractive carry and an early call to provide strong risk adjusted returns in the coming quarters with limited downside. One of these positions is a Commercial Mortgage-Backed Security (CMBS) attached to Park Hotels and Resorts Inc's (NYSE: PK) Hilton Hawaiian Village property located on Waikiki Beach in Honolulu. It is the largest hotel in Hawaii and the single most important asset for Park Hotels, contributing 31% of the company's Core Hotel Adjusted EBITDA in 2023, when no other property contributed more than 10%.

---

[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. Standard Performance Information for Pender's Alternative Absolute Return Fund may be found here: https://www.penderfund.com/pender-alternative-absolute-return-fund/*

In May the company called their 2025 bond just before it was about to become a current lability, leaving this mortgage as the next material maturity in their capital structure in November 2026. At $1.275 billion, it is the single largest maturity in their capital structure by over $500 million. We believe that there is a good chance that the company may look to refinance this mortgage prior to maturity, likely in mid to late 2025. This mortgage loan was originated in 2016 when the property was owned by Hilton Worldwide Holdings Inc. (NYSE: HLT). In 2017, the company spun off much of their owned hotel properties including the Hilton Hawaiian Village into Park Hotels in order to transition to an asset-light business model and focus on their hotel management business which generates high-margin royalty fee revenues which typically command higher multiples than owned hotel properties.

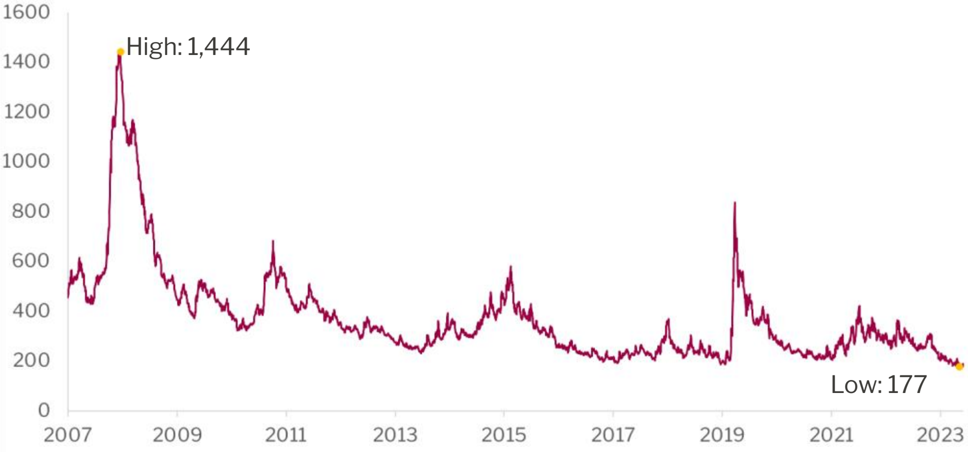
The scale of the CMBS mortgage made sense under the ownership of Hilton but likely does not make sense for Park Hotels which is a significantly smaller enterprise than their former parent. We own tranches D, E and F in this structure which are the three most junior tranches. We believe the whole structure is well covered by the asset base, with trailing leverage of about 6.5x last twelve-month Hotel Adjusted EBITDA per company reports. Host Hotels & Resorts Inc. (Nasdaq: HST) announced the purchase of another trophy asset on Oahu, the Turtle Bay Resort at a multiple of 16.3x EBITDA on May 29. The Turtle Bay Resort is a luxury property, and having been recently renovated should command a higher multiple than the Hilton Hawaiian Village (HHV). We believe that the read-through multiple for HHV is about 12-13x based on the Turtle Bay transaction, which implies a significant equity cushion. Even at a distressed sale multiple of about 10x, we believe that our position is well covered after accounting for value leakage due to transaction fees and expenses.

The yield at our most recent purchase was 7.7% to maturity in 2026 but would increase to about 10% if the bond is refinanced in late 2025 as we expect. Compared to Park Hotels 2029 high yield bond which closed May at a yield of about 6.5% we believe that the risk adjusted opportunity in the HHV mortgage bond is compelling.

Market Update

Spreads hit new lows for the year in early May in both broad high yield and the BB index. The high yield market hit a spread of 303bp on May 6 which was just 2bp above the post Global Financial Crisis low reached in late 2021, while BBs made a new 16 year low in spread and were only a few basis points away from the 2007 low of 171bp.

ICE BofA BB US High Yield Index – Gov't OAS bp



Source: Bloomberg/ICE BofA

© Copyright PenderFund Capital Management Ltd. All rights reserved. June 2024.

We've clearly reached levels where it is difficult for spreads to move materially tighter. In each of the past five instances when high yield spreads bottomed below 340bp, spreads have widened to 500bp or higher within six months. We believe this is due to market complacency and autocorrelation which causes spreads to reach historically compressed levels. The lack of negative developments creates a grinding environment of new lows in spreads until something inevitably changes. This change in market narrative causes a repricing of risk which creates a negative feedback loop, resulting in material spread widening events. We believe there is a good chance of this occurring at some point in 2024, as the recent extended period of low volatility has created a ripe environment for a regime shift.

ICE BofA US High Yield Index

Bottom date	Spread	Next 500bp date	Days to 500bp	Peak spread (6m)	Peak widening (bp)
June 1, 2007	241	November 9, 2007	161	592	351
June 23, 2014	335	October 15, 2014	114	571	236
October 3, 2018	316	December 20, 2018	78	544	228
January 20, 2020	338	February 28, 2020	39	1,087	749
December 28, 2021	301	June 16, 2022	170	587	286
Average	306		112	676	370

Recent Low	Spread
May 6, 2024	303

Source: Bloomberg/*ICE BofA*

Portfolio metrics

The Fund finished May with long positions (excluding cash) of 153.5%. 78.6% of these positions are in our Current Income strategy, 71.2% in Relative Value and 3.7% in Event Driven positions. The Fund had a -52.6% short exposure that included -5.2% in government bonds, -31.9% in credit and -15.5% in equities. The Option Adjusted Duration was 0.84 years.

Excluding positions that trade at spreads of more than 500bp and positions that trade to call or maturity dates that are 2026 and earlier, Option Adjusted Duration declined to 0.37 years.

The fund's current yield was 3.9% while yield to maturity was 6.3%.

Justin Jacobsen, CFA
June 10, 2024

© Copyright PenderFund Capital Management Ltd. All rights reserved. June 2024.