PENDER
VALUE FUND

THE MANAGER'S COMMENTARY – Q1 2023

The Pender Value Fund returned 4.3% in the first quarter of 2023, adding to a 5.0%[1] gain in the fourth quarter of 2022. By way of comparison, the S&P/TSX Composite Index posted a 4.6% gain and the Russell 2000 Index returned 2.5% in the quarter. The year started off with a reversal in some companies we believed to be oversold at year end as tax loss selling was aggressive, particularly in smaller companies. The momentum was short-lived however, as stress in the financial system became evident after a year of aggressive interest rate hikes.

The strain was apparent in the US regional banking industry, with the collapse of Silicon Valley Bank forcing monetary policy measures and the rapid expansion of the Fed's balance sheet to stave off immediate contagion. With the banking industry under pressure and economic growth slowing, we have pulled out our recession playbook to ensure the companies we own in the portfolio have the balance sheet and durability to withstand a tough environment.

Against this backdrop, investors turned to mega-cap technology companies to find a safe harbour. The S&P 500 Index gained 7.3% in the quarter, with over 80% of that contribution coming from the largest eight companies – most of them household names. The outperformance in large caps is nothing new and a theme we have written about before. At the end of the quarter, small caps were trading at a valuation of 14.5x forward P/E in the S&P 600 Index compared to 19.0x for the S&P 500 Index – a 4.5x discount. This is a far cry from the wide premium that small caps traded at for the decade prior to 2020. This valuation anomaly relative to history, and the correction we have seen in small caps through 2022, make it possible to target improved investment returns in the long term by allocating capital counter-cyclically. That is our intention.

With valuations in small caps attractive on an absolute and relative basis, this has created a fertile environment to find compelling businesses that are falling below the radars of average investors. Burford Capital Ltd. (NYSE: BUR) is an example of a misunderstood holding. Burford is the largest and leading expert in litigation finance and was a top contributor to the portfolio in the quarter. The company announced a favourable summary judgement in a large case it was representing, with the verdict entitling the company to receive between $3.7 billion and $7.6 billion in gross proceeds. Although a negotiated settlement may reduce that figure, we estimate the company will realize an increase in value of between $10-$20 per share compared to its approximate $8 share price at the beginning of the year. This was a major catalyst for the stock that helps validate its business model and removes a legacy overhang.

[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.

We continue to focus the opportunity set of the portfolio on small and mid-sized companies where we see a disconnect with the underlying fundamentals of the business. Our weight in Canadian equities grew to 53.3% at the end of the quarter, up from 36.3% in June 2022. As our Canadian exposure has grown, we have reduced our weighting in international companies from 16.1% at the end of June 2022 to 8.8% at the end of the quarter. We have been transitioning into Canadian companies as our international holdings approach fair value, or when we see compelling opportunities to capitalize on companies we know well. Approximately 48.7% of the companies in the portfolio were held in small and mid-sized businesses.

We see several catalysts to unlock this value as the companies we own continue to compound and demonstrate their superior fundamentals; as valuations normalize towards historical ranges and as M&A activity re-accelerates. On that final point, while we have seen M&A transactions slow from the torrid pace in 2021, we are seeing some encouraging signs. Strategic buyers are also taking note of the multiple compression, which is creating opportunities for disciplined acquirers to grow inorganically in a slower environment. Strategics that are well capitalized and have access to credit have an advantage in this market. We have heard from CEOs on various earnings calls that the expectations of buyers and sellers are becoming more aligned – particularly with sellers now willing to accept lower valuations as multiples have contracted.

Our process targets businesses with similar characteristics to these acquirers – attractive unit economics, sticky customer bases and high competitive moats – and these qualities are abundant across the portfolio of businesses we own, and we believe that unrealized value will be unlocked as they continue to deliver on their business plans.

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Standard Performance Information for Pender's Equity Funds may be found here: https://www.penderfund.com/equity
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