PENDER
ALTERNATIVE ABSOLUTE RETURN FUND

MANAGER'S COMMENTARY – APRIL 2023

Dear Unitholders,

The Pender Alternative Absolute Return Fund finished April with a return of 0.8%, bringing year-to-date returns to 3.2%[1].

The theme of disconnects between markets that we observed in March continued in April. The CBOE Volatility Index ended April at its lowest level since early November 2021. Virtually all asset classes put up positive absolute returns in April, with the ICE BofA US High Yield Index generating a return of 1.0%, while spreads tightened by a modest 5bp to finish the month at 453bp OAS, roughly in line with the 10-year average. On a two-month basis, high yield excess returns relative to government bonds are -0.9% despite a significant carry advantage. The last time that the VIX was around 15 in late 2021, the trailing two-month excess return for the high yield market was +0.9% despite much lower absolute yields. At a macro level, large-cap equities would argue that risks are receding while credit and small-cap equities would argue that risk is increasing.

Portfolio Update

Several of our shorter duration holdings experienced solid gains in April. We took sales in secured bonds issued by Greystar Real Estate Partners LLC (private) and Life Time Group Holdings Inc (NYSE: LTH) on strength, in both cases selling most of our position. While there were pockets of value in the market, the Fund was a net seller of risk in April as we believe that markets are trading close to the high end of the near-term trading range. The Fund finished April with our most defensive positioning since mid-August 2022.

Banks and commercial real estate continue to be highly topical sectors for credit markets. We saw pockets of opportunity in both sectors in April as some investors appeared to be highly motivated to reduce exposure. In banks, our focus was on AT1 securities issued by the two largest Canadian banks trading at prices of 75% of par or lower. In our view, the Limited Recourse Capital Notes (LRCN) market in Canada is not particularly efficient. The market trades at high yield spreads but there is relatively little differentiation between the top five banks despite the Royal Bank of Canada (TSX: RY) having a market capitalization that is more than three times greater than CIBC (TSX: CM). Additionally, in our opinion, the market does not appropriately price the value of lower dollar price bonds. We believe a low price can both reduce risk in a downside scenario and improve convexity if spreads were to tighten. We established new positions, both long and short, in Canadian Bank LRCNs in April.

Understandably, there is significant focus on office REITs and the potential for a very difficult cycle in the coming years as a perfect storm of higher cap rates, lower occupancy and tighter credit conditions should lead to losses and distressed sales. Brookfield defaulted on loans backed by several office properties in April, a trend that will likely continue in cases where mortgage balances exceed property values. We established a position in an unsecured bond backed by a westcoast-focused US office REIT. The indenture for this bond contains a covenant that requires that the unencumbered asset base must be at least 150% of the unsecured debt balance. While carrying values are likely well above market value, at our purchase price we would only need the unencumbered asset portfolio to be worth about 29% of carrying value in order to break even. There certainly would be some significant transaction expenses if it became necessary to liquidate the portfolio, but we expect there to be some excess equity value from the REIT's portfolio of encumbered assets. Our purchase price was sufficiently low that we believe the skew of outcomes is positive, even though the sector will likely be under pressure for years to come. While we are not seeing broad-based opportunities in commercial real estate yet, we will continue to do our work and assess how much stress is priced into individual securities.

[1] *This Pender performance data point is for Class F of the Fund. Other classes are available. Fees and performance may differ in those other classes.*

Despite a significant rally in longer-dated North American bond yields over the past two months, there does not appear to be a significant fallout from several banking failures in the real economy or credit markets yet. At the same time, inflation appears to be sticky at levels that policymakers are not likely to accept. The Employment Cost Index, arguably the Fed's favourite measure of wage inflation, came in hotter than expected in the first quarter. That same day, the University of Michigan's survey of long run inflation expectations also came in higher than expected. The market appeared to ignore both data points and long-dated US treasuries rallied, which we viewed as an opportunity to shorten duration. At a high level, from what we can tell the market has priced in the best of both worlds, no persistent inflation and no significant economic pain. The reality could end up being quite different, with a weak economic outlook and persistent inflation. Because of this, we are focused on protecting capital at the present time but will always actively reassess in response to incoming data and changes in asset prices.

<u>Portfolio metrics</u>:
The Fund finished April with long positions of 101.4% (excluding cash positions). 22.6% of these positions are in our Current Income strategy, 75.3% in Relative Value and 3.5% in Event Driven positions. The Fund had a -57.2% short exposure that included -15.8% in government bonds, -29.3% in credit and -12.2% in equities. The Option Adjusted Duration was 0.93 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 0.29 years. The duration figure 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 4.09% while yield to maturity was 5.71%

Market Outlook
As we outlined above, the VIX hit its lowest level in almost 18 months at the same time that the rates market appears to be ignoring data points that argue for sticky and persistent inflation. While markets might ignore incoming data, The Federal Reserve will not, and we believe is highly likely to hike by 25bp on May 3 and hold rates steady for some time, with cuts only likely following material economic weakness. Market pricing appears to be divorced from reality on multiple fronts to us, and as a result, we are firmly focused on protecting capital. We expect there to be better buying opportunities later this year and would not be surprised if we saw significantly better entry points for risk assets later this quarter.

Justin Jacobsen, CFA
May 3, 2023

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Standard Performance Information for the Fund may be found here: https://www.penderfund.com/pender-alternative-absolute-return-fund/
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