

Manager's Commentary

Justin Jacobsen, CFA

The Pender Alternative Absolute Return Fund finished July with a return of 0.21% bringing year to date return to 4.39%¹.

Market dynamics appeared to shift in mid-July as the first half of the month was a continuation of the exceptionally benign market environment of the previous two months, while the second half of the month saw a significant increase in volatility. A very strong technical dynamic persisted in credit markets with both BB and B rated indices reaching their lowest spread levels on July 23, since the Global Financial Crisis.

Portfolio and Market Update

The past three months have been a challenging period for the Fund as very tight spreads combined with low volatility have made it difficult to find attractive trading opportunities. One of the few areas where we have been able to put capital to work is in new issues in the Canadian dollar high yield market. Some higher quality Canadian issues have come to market at meaningfully wider spreads than are available in similar quality issues in the larger US high yield market.

Shortly after both B and BB spreads likely bottomed for the year in late July, spreads widened significantly. As of the time of writing, high yield spreads had not widened enough to be attractive by historic standards as risk premiums for higher quality high yield are still well inside long run averages. In contrast, CCC spreads widened to their highest level since early November 2023, and above the 10-year average. While too early to make any definitive statements, the move wider in spreads for the lowest rating bucket in high yield since March could prove to be a leading indicator of a broader market shift.

ICE BofA CCC & Lower US High Yield Index – Gov't OAS bp



Source: Bloomberg/ICE BofA

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/>

We have seen plenty of examples of excessive risk tolerance in markets in recent months. In July, our position in the Austin Fairmont CMBS issue was redeemed, we purchased our holding at about 3 ½ points below par in December 2022, realizing a holding period return of about 9% annualized. A year ago, it seemed unlikely that the private equity owners of the property would be able to roll over the full \$300 million mortgage and it was reported that the property had been put on the market for sale. Not only were the sponsors able to roll the \$300 million that was coming due, but the CMBS market allowed them to take out an additional \$130 million of equity when the mortgage was refinanced in June. We did not participate in the refinancing due to our belief that leverage is excessive at 9.6x last 12-month EBITDA and more than 14x 2023 EBITDA. While this is undoubtedly a high-quality property, we generally assume that even high-quality hotels will sell for about 10x EBITDA in a forced sale. The largest US hotel REIT, Host Hotels & Resorts Inc. (Nasdaq: HST) recently traded at about 9x forward EBITDA, and it is unclear to us how many institutional buyers there are of high-end hotels now. We suspect that market depth is not great and is highly correlated with credit market conditions.

Perhaps the most dominant equity market theme of the past year and a half has been AI. In June, a couple interesting pieces were published by Goldman Sachs and Sequoia which questioned if the massive amounts of capital being deployed to AI would be matched with sufficient revenues and profitability to justify the spend. These questions proved to be highly influential in how the market perceived the Q2 earnings season from big technology firms, resulting in a significant narrative shift.

In the world of financial information, no firm is better resourced and capable of innovation than Bloomberg. Earlier this year we tried some of their AI capabilities and found that they added no value at all to our process. In investment management we are bombarded with information, with the vast majority of it being noise. It takes a lot of judgement and experience to separate the information that matters, and from what we've seen, AI is a long way from having this capability. Where there's a specific deliverable outcome like an image, video or code there clearly is value in AI. Thinking through ambiguous information is a lot harder.

The recent change in market tone has increased our confidence that better opportunities to buy risk assets are coming later in the year. We will continue to be positioned defensively until valuations improve.

Portfolio metrics

The Fund finished July with long positions (excluding cash) of 137.3%. 62.4% of these positions are in our Current Income strategy, 70.7% in Relative Value and 4.2% in Event Driven positions. The Fund had a -53.1% short exposure that included -5.0% in government bonds, -31.9% in credit and -16.2% in equities. The Option Adjusted Duration was 0.83 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 0.62 years.

The fund's current yield was 4.1% while yield to maturity was 5.7%.

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