Manager's Commentary

David Barr, CFA and Sharon Wang

Fund Performance

Our Fund went up 6.5% in the quarter[1], beating the Canadian small cap index that was up 6.1% in the quarter. This is in line with our annual results with the Fund up 6.2%, while the Canadian small cap index was up 5.8%.

We are still in a macro/fund-flow driven environment and while this continues to favour large cap stocks over small, it does introduce significant volatility into the more liquid parts of the small cap market. In the quarter, we saw the Russell 2000 hit its 52-week low on October 27, and recover to its 52-week high only 42 days later – the quickest turnaround in history. This was driven by large investors seeking easy liquidity and exposure to an asset initially looking to take risk off the table and then looking to add on risk with a normalizing interest rate environment.

We did see a strong rally in small caps into year end. We found this very interesting given the past few tax loss selling seasons have been pretty hard on small cap stocks. This year we did not see nearly as much volatility through the tax loss selling season and the strong performance into year-end is indicative of a strengthening small cap market.

Early Innings or Game Over?

Over the past 5+ years, the common refrain you will have heard from this commentary is that small caps are trading at a discount to large caps, the inverse of what the long-term data shows us. We've all been waiting patiently for the reversal to occur so we can bask in the delight of the small cap performance which history has shown to be very attractive. But… maybe it's different this time. Markets change, and the market structure has changed with the growth and dominance of passive strategies and the rise of HFTs, new forces control the market.

Index Breadth Performance

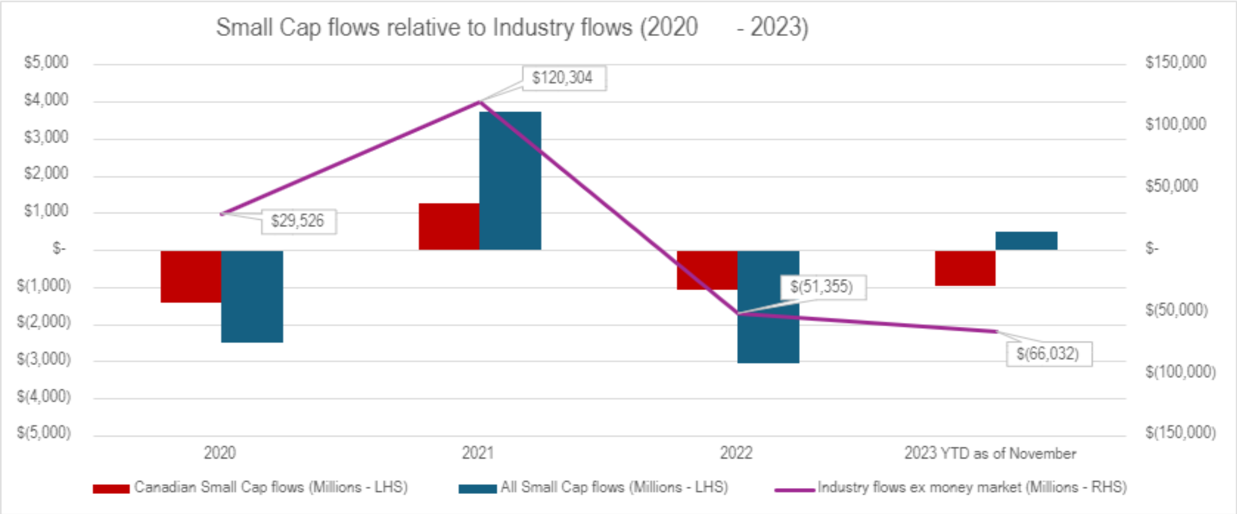
These market forces were in full effect for the first three quarters of the year as we saw seven stocks drive 85% of the gains in the S&P 500. This may have been the crescendo of a glorious run. In the fourth quarter we saw the breath of returns diversify as these seven companies only contributed 34% of the gains in the S&P 500 in the quarter. This trend appears to have continued into the new year.

Looking at macro fund flows, Canadian small cap has been a sector with negative flows for several years outside of 2021, 2020 and 2022 were substantive years for outflows in Canadian small cap funds, while the magnitude of outflows decreased in 2023 as we saw risk appetite increase into year end. Canadian small cap flows remained negative overall in 2023 but all other small cap flows were positive during the year. The Canadian market generally lags global

[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.*

and U.S. markets with respect to risk appetite and fund flows – we view this as a positive signal as we head into 2024.

Small Cap Flows Relative to Industry Flows (2020-2023)

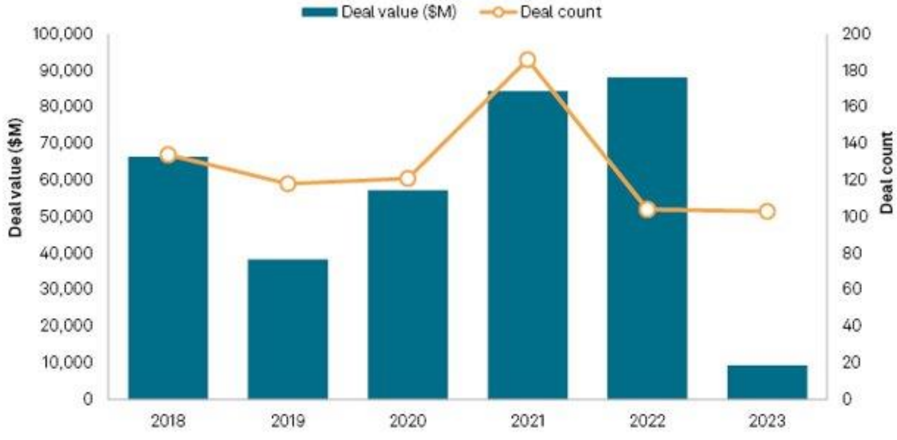


Canadian Small Cap Flows = Canadian Small/Mid Cap Category + Canadian Focused Small/Mid Cap Category, All Small Cap Flows = Canadian Small/Mid Cap Category + Canadian Focused Small/Mid Cap Category + US Small/Mid Cap Flows + Global Small Mid Cap Flows for all CIFSC categories.

Source: The Investment Funds Institute of Canada (IFIC), Morningstar, as of November 2023.

Another key driver of returns both for the stock market, in particular small cap market, and something we've benefited from in our history is corporate M&A. The chart below shows M&A of technology companies declined about 80% from the previous year. The acquisition of companies we did see enter into transactions tended to be opportunistic "go private" transactions led by management teams due to the depressed valuations of the companies. Two factors played into this lack of decreased M&A last year: 1) larger strategic companies were focused on improving their own operations, increasing their own free cash flow and were not looking externally for growth, and 2) rapidly rising interest rates and sudden valuation adjustments of public companies created an environment where not a lot of buyers and sellers agreed on price. Share prices were depressed below where shareholders and boards valued the company. Moving into 2024, we have a stabilizing interest rate environment and strategics have got their house in order which we believe will lead to increased M&A by both private equity firms and strategic buyers.

M&A by large tech strategies has cratered.



Source: S&P Global Market Intelligence, as of January 2, 2024.
Analysis includes whole company and majority stake acquisitions announced between Jan 1, 2019 and Dec 31, 2023, where buyer and investor is a software and service company that is headquartered in the US and Canada or Europe, and its market cap is more than $10bn as of Jan 2, 2024.

2023 saw the slowest app IPO market in Canadian history. Canadian IPO's raised approximately $200 million last year, a decline of over 80% from the previous year and over 95% from 2021. The previous lowest year on record was 2016 where $600 million was raised in IPO's. We see this as a proxy for risk appetite and this data point is very representative of how out of favour small cap stocks and risk were in 2023. With valuations improving and private companies coming to grips with lack of funding and declining valuations we would expect to see more activity this year and in the years to come in the IPO market.

"The Canadian market generally lags global and U.S. markets with respect to risk appetite and fund flows. We view this as a positive signal as we head into 2024."

Inflection Point Investing

We would like to highlight one of our portfolio holdings Thinkific Labs Inc. (TSX: THNC). Thinkific is a provider of cloud-based software solutions that enable entrepreneurs and established businesses to build, market and sell online courses directly to their customers and audience under their own brand and while retaining full ownership and control of their content and business. This is a company that IPO'd in 2021 to great fanfare and a very lofty valuation. We previously followed the company as a private company and knew that the management team was a cash flow driven and very disciplined group. The underlying unit economics of the business had proven to be attractive and the management team had successfully bootstrapped the company with very little outside capital from founding to a pre-IPO round of investment. As part of the go-public process they invested heavily in people to scale up the business to justify raising a significant amount of capital at the valuation they did. Moving into 2022, the outside world began to see the company as a money losing enterprise that was going to blow through all the cash on its balance sheet and go bankrupt. Knowing the management team and their discipline gave us the confidence to step in and build a position in the company. They were a leader and starting to right size the organization for the reality of a post COVID growth slowdown. Management discipline and execution came to fruition in Q3 of 2023 where they returned to profitability. We talk about Thinkific because several of the companies in our portfolio are currently unprofitable and our thesis is management will turn these companies profitable sooner rather than later. When this happens, the rewards are appealing. See the stock chart below. Upon news of Thinkific becoming profitable the stock moved up 42% as investors no longer saw it as a distressed asset. We continue to hold the company and believe fundamentals will continue to improve and management will move the company towards the "rule of 40" - where a combination of revenue growth and operating margin is 40% or higher.

Source: Capital IQ, PenderFund, as of January 2024.

Portfolio Positioning

"Please, sir, may I have some more quality please?" We have written in the past on strategies we implement when we have a market downturn. When writing, we had in mind what to do in case of a dramatic market correction. We have seen a protracted downturn in the small cap market resulting in very attractive both absolute and relative valuations. As we discussed, the first thing you want to do is buy blue-chip, high-quality companies. While we can't buy blue chips in the small cap world, we took this opportunity to increase the quality of the portfolio and the position sizing of these companies.

Comparing the portfolio at year end 2023 to the previous year end, our top ten has increased to represent 48.3% percent of the portfolio from 38.0% percent of the portfolio. We also took the opportunity to decrease the number of positions in the portfolio. At the beginning of the year we had 61 companies in the portfolio, and today we have 48.

We are very excited about how the portfolio is positioned today and the potential returns it can drive for the next three to five years.

Happy New Year everybody and risk on!

David Barr, CFA and Sharon Wang
January 17, 2024