CELERNUS

Fund Overview

The Celernus Absolute Growth Fund aims to provide long term growth of capital with below average volatility. The fund seeks to actively protect capital and manage risk. Equity selection combines a value-orientation with a robust quantitative framework. Net equity and currency exposure are dynamically managed to further mitigate risk.

Manager
Celernus Investment Partners Inc.

AUM
17.5 million

Minimum investment
$25,000

Advisory fee
0.85%

Performance fee
20%

High water mark:
Yes

Subscriptions
Weekly

Redemptions
Weekly

Prime Broker
National Bank Correspondent Network (NBCN)

Auditor
BDO Canada LLP

Administrator
Convexus Managed Services

Lawyer
WeirFoulds LLP

FundSERV code
C1P100A

Eligible accounts
RSP, RESP, TFSA, cash

Contact Information

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CELERNUS ABSOLUTE GROWTH FUND

Commentary – April 2013

The Space Between Perception and Reality

It is said that there is a difference between a market recovery and an economic recovery. We agree. However, we don’t view the two as mutually exclusive. This is not exactly an earth-shattering admission and we readily recognize that we’re not breaking any new ‘thought experiment’ ground with such a statement. However, it does serve to frame our thoughts and provide context as we continue to work through the current environment.

The U.S. balance sheet continues to deteriorate with March 2013 government debt sitting at a cool $16.77 trillion. That represents a 50 basis point increase from February, a seven percent increase from a year ago, a 50% increase from the market lows of 2009 and a 160% increase over the last 10 years (Bloomberg data.) Meanwhile, US Government revenues (which include all manner of personal and corporate taxes) have only grown by 17% since the 2009 market low and about 33% from the levels a decade ago. Now, when you consider obligations to Social Security, Medicare and other liabilities not accounted for in the national debt, the U.S. federal government has a $67.7 trillion shortfall. To put this in perspective, $67.7 trillion equates to $559,331 per U.S. household, 428% of GDP and 2,513% of annual federal revenues. So the U.S. owes a lot of money to its debtors and its capacity to pay has not kept pace with its insatiable desire to borrow. It would be putting it mildly to suggest that this is a structural problem.

The U.S. debt burden and revenue/expense relationship remains a key brick in the U.S. economic wall of worry. At some point, as the reasoning goes, this U.S. debt will become untenable. The more the debt burden outpaces government revenues, the closer the nation grinds to another liquidity crisis. With all of this in mind however, the world still has bigger problems. The numbers aren’t necessarily as big, but the implications are. For this discussion, we shift to Cyprus.

For the first time, bank deposits were put into play. Asset confiscation was added to the bailout toolbelt. Suddenly, average citizens were being forced to supply their government with a not-immaterial percentage of their savings to participate in the bailout funding. The game changed.

Prior to the events that unfolded in Cyprus, the European bailout model for credit-challenged sovereigns was characterized by the introduction of shiny new debt for the underlying country accompanied by copious spending cuts and unwelcome tax hikes. Investment losses, if any, would be experienced by stockholders and potentially bond holders as well. The Cyprus experience added an unexpected element to the mix. For the first time, bank deposits were put into play. Asset confiscation was added to the bailout toolbelt. Suddenly, average citizens were being forced to supply their government with a not-immaterial percentage of their savings to participate in the bailout funding. The game changed.

Many pundits suggest that bank deposit confiscation was a solution unique to the Cyprus situation. Well, many European citizens are not keen on taking the chance that it wasn't. As such, we believe that there is a material risk of euro-based assets fleeing to more politically stable and economically liquid climes. Like it or not, in a world of turbulence, the United States represents both. So while the U.S. economic climate remains structurally challenged from many perspectives, it remains more attractive than most.

While many continue to focus on the balance sheet and debt servicing issues of the U.S., they overlook the fact that US Corporate Profits and US nominal GDP continue to print new highs – having surmounted the pre-crisis highs of 2006/07 in 2010 and continued higher from their lows of 2008/09.

While many continue to focus on the balance sheet and debt servicing issues of the U.S., they overlook the fact that US Corporate Profits and US nominal GDP continue to print new highs – having surmounted the pre-crisis highs of 2006/07 in 2010 and continued higher from their lows of 2008/09. Given that longer-term equity market performance is driven by growth in earnings and cash flow, why then is the world surprised that the S&P 500 is trading at its highs of 2000 and 2007?

Furthermore, bond yields (go ahead and pick your spot on the yield curve) are very, very low. This ought to be constructive to market multiples because, holding everything else constant, a low and declining risk-free rate maps to a lower required rate of return which, in turn, maps to a higher 'theoretically fair' market multiple. With rising corporate profits and a historically low multiple (the trailing P/E currently sits at 15x) we don't believe it should be any surprise that the S&P 500 rallies through its all-time highs this year.

In the short-term, we recognize that there might be some headwinds.

The first and most imminent potential headwind is simply the seasonal pattern of equity market de-risking that has occurred over the last few years – commencing in early spring. This tendency has seen the rotation from higher volatility stocks into lower volatility, defensive ones and has typically culminated in a not immaterial selloff of the entire market. The de-risking trade, which also includes rolling up the capitalization curve from small-caps to large caps, has been in effect since mid-February. Given that the S&P 500 is bumping up against multi-decade highs, there is certainly scope for an equity market sell-off of the intensity that we have seen over the last few spring-time sessions. However, the context of such a sell-off, should it occur, would be in an environment of positive year-over-year tracking of the Conference Board Leading Indicator; ISM PMI above 50; Weekly Jobless Claims trending lower; ADP and Non-Farm Payrolls tracking positively and swap spreads at multi-decade lows. Should the equity market correct and our key economic 'tells' remain resilient,

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we believe that this would set the table for a resumption in the trend that would drive the S&P 500 convincingly through its key resistance (which we would define as about 1580 – drawn with a crayon.)

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There is another headwind. It is one that can't be assessed and predicted with econometrics or valuation techniques. The risk is that the elected officials of the many governments, from our perspective those of the US and Canada, might change the rules. It could be a change in legislation regarding the functioning of the capital markets, it could be an amendment of the tax code, it might be a new spending/borrowing initiative. Regardless of the motivation, be it pure or defiled, the actions of elected leaders are having an increasingly material impact on the capital markets. We just don't know what they might do and when they might do it.

Shifting to the equity portfolio, our strongest gainers on a percentage basis over the last quarter were Marathon Petroleum (MPC), Hertz Global (HTZ), WestJet Airlines (WJA) and Jacobs Engineering Group (JEC). Our weakest performers were Detour Gold (DGC), Kinross Gold (K), Apple (AAPL) and Home Capital Group (HCG).

The award for the highest volume of disseminated marketing literature over the last month goes to Agrium. Unambiguously so. The colour profile of the Celernus offices has morphed from beige to blue and white – all thanks to the Jana/Agrium battle. This might actually be a design improvement.

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The market continues to recover and the pieces appear to be in place for further upside. The Fed continues to buy bonds in an effort to make the US citizenry 'feel' wealthier so that they will consume more. Many have argued that the Fed's bond-buying spree ought to be reined in. At some point it will be and that event will likely weigh on the market. In the meantime, we will continue to seek out stocks with attractive fundamental dynamics that we believe are not hampered by overvaluation considerations.

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Not only are we in the throes of a market recovery, but we are likely in the latter stages of one. We do not believe that the story being told by equity market indices fully reflects the reality of the U.S. economic situation. The economy is not as healthy. However, the stock market story is in itself, its own reality. It is in the space between perception and reality where investment gains are found.

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