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CELERNUS ABSOLUTE GROWTH FUND

Commentary – July 2013

The Tipping Point

At Celernus Investment Partners, we prefer to make as few decisions as possible. We're not lazy. Far from it. In fact, we've spent copious amounts of time and energy testing and building frameworks to help us make fewer decisions. The reasoning, of course, is that more time to focus on fewer decisions will result in superior outcomes. The challenge is in identifying that which is truly important and then constructing an appropriate framework to manage the process

As it pertains to the management of the Celernus Absolute Growth Portfolio (CAGR), there are three key decisions that we make. (In fairness, the third decision contains a subset of smaller decisions.)

1. Are we currently bullish or bearish on equity markets? Thisis our highest-level assessment of the environment for equity investment. As with everything that we do, our process is highly empirical. We assess several measures of the North American employment situation, several more measures of economic activity and a single key measure of market risk pricing to come to a determination as to our bullish/bearish bias.

   The decision of whether we are bullish or bearish serves to inform the net long position of the fund. (i.e. If our equity market bias is bearish, our net long position will be comparatively low versus that of a bullish bias.)

2. Is the market extended vis-à-vis our equity market bias? Again, we approach this decision in a highly empirical fashion. Using fundamental data, we craft 'fair' market valuation levels for U.S. equity indices. From there, we assess the proximity of equity markets to these 'quantitatively fair' levels. When we quantitatively determine that equity indices appear to be discounting unrealistic earnings growth or multiple expansion, we take steps to reduce the net long position of the fund.

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
21.00 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

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This process assists in our quest to 'smooth the ride', so to speak and provide a steadier trajectory of net asset value appreciation. It also means that, from time to time, we will capture less of the upside of a market that lifts from 'very' extended to 'super' extended. Based on our empirical work, this is a worthwhile tradeoff.

3. What equities do we want to own? Our process of equity selection seeks out stocks that are poised to benefit from some measure of positive fundamental change. We identify such equities through our empirical models. We term our key measure a 'quantitative catalyst'. This measure represents an empirical assessment of the intensity with which income statement and cash flow line items are being considered. Stocks maintaining a high quantitative catalyst measure are typically in close proximity to some fundamental catalyst. If ahead of the catalyst (and it is well-received), then the stock is poised to profit from the full multiple expansion coincident with the event. If the quantitative catalyst occurs after a fundamental event, there is often an ensuing post-catalyst drift. Sometimes, what appears to be a positive quantitative catalyst is simply not well received by investors. Other times, a broader-based selloff weighs on stocks of all fundamental profiles. Over time, stocks with quantitative catalysts (as a group) have proven to outperform broad-based equity indices by leaps and bounds.

   We have also found that equities trading at bottom-quintile valuation levels tend to outperform those trading at higher levels - particularly when accompanied by the quantitative catalyst. As such, we join the ranks of many of the value investing community that seek opportunities for meaningful multiple expansion among low price-to-multiple names.

How do we view our three decisions now?

1. We remain in bull mode. Employment dynamics, economic activity and risk pricing data are all empirically consistent with a bull market. However, we recognize that the backstory, which often leads the data, is less than desirable. We recognize that the DNA of global financial markets is on unstable ground. Ben Bernanke's five years of multi-trillion dollar economic experimentation has resulted in a Fed balance sheet that now accounts for 25% of US GDP and 30% of 10-year US Treasury equivalents. Several weeks ago, Bernanke hinted at a late-fall commencement in the reduction of synthetic stimulus – citing the potential for future positive dynamics in employment and housing data. The market correction mechanism was swift and sure with material haircuts felt in treasury, equity and currency markets. Then came the 'kick save' as Bernanke and his top lieutenants began 'operation backtrack', claiming that the head of the Fed had been misunderstood. This proved supportive to the equity and currency complexes, as might be expected. It also implies that, perhaps the footing of an economic recovery is a whole lot less stable than the Fed is letting on.

Seth Klarman of Baupost Group said it well recently:

"If the economy is so fragile that the government cannot allow failure, then we are indeed close to collapse. For if you must rescue everything, then ultimately you will be able to rescue nothing."

The collapse of 2008 was driven by too much leverage. The collapse of Lehman was a function of too much leverage. The woes of Greece, Cyprus and shortly other larger European entities were (and are) driven by too much leverage. There is chatter that outsized interest rate and derivatives exposures in some large, intertwined international financial entities are poised to cause damage. The reason? Too much leverage. In October of 2007, the month that marked the cycle top of the rally in the S&P 500, U.S. national debt was about $9.1 trillion. That was considered a very high number. Since then, under Bernanke's watchful eye, U.S. debt has ballooned to at least U.S. $16.8 trillion. That represents 85% growth over a period where GDP grew 14%. This, friends, is leverage. Remember also that all of this paper money – backed only by a promise – has value because it is scarce. When this scarcity is reduced, particularly at a rate as alarming as that of the U.S., this questions the credibility of the entire trust-based monetary system.

So, while we continue to glean insight from our empirical models, we recognize that there are some strong, less-than-desirable undercurrents that will eventually tilt our longer-term model into negative territory.

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2. We view the current valuation situation of the S&P 500 as ‘quite’ extended. One of our mid-trend models measures a 6.0% - ish lift to what we would ascribe as fair value. Over the last seven years, the S&P 500 has only been able to hold a level this tight for a maximum of about two weeks. We would also note that, based on another one of our models (this one an arbitrage pricing theory (APT) model), the YoY% change of the S&P 500 is currently about 17% versus a fair level closer to 12%. In historical terms, this is an extended spread.

   So, based on fundamental/statistical analysis, the S&P 500 appears extended in the context of our current bullish bias. Could this extension continue? Absolutely. Continued artificial stimulus from Bernanke’s camp could easily keep a fire lit under the equity complex. Nevertheless, it remains our intention to expose less capital to empirically overextended situations. We are perfectly comfortable not fully participating in upside from these levels for the simple reason that we identify meaningful downside risk on the basis of both timing and valuation at present. We can’t control the outcome. We can, however, control our discipline to process.

3. In terms of security selection, many of the situations in which we have been and continue to be engaged, relate to big ticket consumer items – particularly homes and automobiles. We are active in select names of stocks that build homes, finance them and furnish them. We also continue to tap the stocks of companies that build and sell automobiles and automobile components. Apart from these two sub sectors, we are seeing the breath of life re-entering our managed health care and human resources & employment positions. We also maintain meaningful exposure to the insurance, capital goods and retailing segments of the market.

Previously, we referenced the entire monetary system as one that is trust-based. As we look forward, one of the things about which we continuously muse is if and/or when the U.S. will materially lose the trust that it has garnered over many decades. The United States lays claim to an inspired constitution intended to guide its rule of law. Created to ‘form a more perfect union, establish justice, insure domestic tranquility, provide for the common defense, promote the general welfare, and secure the blessings of liberty’ , adherence to the tenets of the U.S. constitution made it possible for those with similar philosophies to develop mutually beneficial relationships of trust. In simple terms, the U.S. has, for the most part, been historically viewed as ‘trustable’. Is it still?

As with any issue, where you stand is a function of where you sit.

Can an entity that collects much more private information about its citizenry than is realized or understood be viewed as worthy of continued trust? Maybe. Can an entity that continues to assume more debt than any of its thinking citizenry would view as prudent, be trusted to pay back those obligations? Perhaps. Can an entity that claims inflation is under control even as a quick visit to the supermarket or service station proves otherwise be trusted? Not impossible.

Our question is: Where is the tipping point? At what point will trust erode and confidence disappear? At what point will investors require U.S. bond yields sufficient to account for the risk that they might not get their capital back? At what point will the U.S. interpretation of the rule of law be sufficiently in question that investors seek an alternative home for their assets? Perhaps never. Perhaps soon. We don’t know. This is what keeps us up at night – looking for the tipping point.

On balance, we are optimists. We see the positive economic deltas and recognize that they will likely be constructive towards higher equity market prices. However, the more important underlying story is that that there remains some unpleasant medicine that needs to be had. Debt burdens must be reduced, not added upon, in order to place the U.S. economy on footing that will drive meaningful growth. We have to go through it in orderto get through it. We have yet to go through it.

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