CELERNUS Investment Partners Inc.

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
27.50 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

GORDON MARTIN, MBA
Managing Partner, Portfolio Manager
gmartin@celernus.com

Celernus Investment Partners Inc.
10 Four Seasons Place
Suite 1027
Toronto, Ontario
M9B 6H7

416.649.5827
fax 1.855.870.7464
www.celernus.com

CELERNUS ABSOLUTE GROWTH FUND

Quarterly Report – Q1 2014

“The only way to make sense out of change is to plunge into it, move with it, and join the dance.”

Alan Watts

I have three children under the age of 9, all with personalities that dwarf the size of their little bodies. My daughter is the middle child and is the performer of the group. Though she is a gymnast by training, she is an entertainer by vocation (self-declared, of course.) As such, she often channels her energies into what one might loosely identify as a dance routine.

Several weeks ago we combined our talents. With daddy warbling ‘Maniac’ in broken falsetto, my little girl began to bust moves. Cell phone rolling, she broke into an ungainly series of gyrations that awkwardly transitioned from ‘Running Man’, to ‘Stanky Legg’ (my personal favourite) to that thing that Elaine Benes did on Seinfeld that was once described as ‘a full body dry heave set to music.’

This went on for about a minute.

I stopped singing 'Maniac' and turned the camera off. My daughter came around to watch our creation on the screen of my phone. She was so proud.

Fast forward to the following week. Daddy had the brilliant idea of uploading the music video to YouTube. That way my little girl could really be a star! The video was uploaded and a link emailed to my wife with instructions to show it to my daughter when she got home from school.

Several hours later I received this email:

"Ummmmm... I'm sorry to say, this didn't go over well! She burst into tears within the first few seconds... She didn't want it on YouTube."

Fail.

My daughter who, several days ago, couldn't find an audience sufficiently populous for her performing aspirations, was now weeping at the prospect of anyone she didn't know watching her perform the ‘Stanky Legg’ on YouTube.

The world had changed very quickly.

It is changing everywhere.

We characterize 2013 as a year in which the rising tide lifted all ships. Opportunities for alpha were reduced from previous years as the entire market enjoyed the wind at its back. There was respectable earnings growth in 2013 with forward earnings estimates gaining approximately 7% over the calendar year. The more impactful driver of stock market performance however, was multiple expansion. The price/earnings (12 month forward) multiple of the S&P 500 rallied a handy 23% from 12.52x to 15.42x. In doing so, it crossed the 10-year median level of 14.12x. In simple terms, one could say that the market moved from below-average valuation to above-average valuation. Equities are now expensive. They weren't in 2013. The world has changed.

> Equities are now expensive. They weren't in 2013. The world has changed.

Now, juxtapose this against our analysis of the economic 'deltas.' The 'deltas', as we like to call them, represent measures of change in key economic variables that have historically mapped to equity market outperformance.

The US employment situation.
Many investors focus on the U.S. Unemployment Rate. At 6.7%, this level was last seen in late 2008 as recessionary influences drove unemployment to double digit levels. However, before 2008, one must look as far back as 1993 when the labour market was recovering from the slate of job losses that impacted the economy from 1989 to 1992. We would note that the last two bull markets in equities terminated with an unemployment rate between 4.0-5.0%. At present, the U.S. labour market is not even close. In fact, the U.S. labour situation could be considered challenged.

However, for the purposes of equity markets, the U.S. labour situation offers valuable insight. Weekly Jobless Claims are trending lower. During periods of economic recovery, this reading of labour market health tends to find a steady state below 350,000 per week. Weekly Claims appear to have reached steady state levels. Non-Farm Payrolls as well as ADP Employment Change are both tracking positively above zero and consistently above 100,000. Based on historical precedent, these levels are consistent with rising equity prices. From the perspective of equity markets, the U.S. employment situation appears constructive.

Economic Activity.
Of the economic activity indicators that we follow, the Conference Board Leading Indicator is perhaps the most comprehensive. Along with employment and stock market data, the indicator also measures activity in manufacturing, housing, credit as well as consumer expectations. Of particular interest to us is the YoY% measure. Over the last two market cycles, equity bear markets were accompanied by weak momentum in the Conference Board Leading Indicator. More specifically, when the YoY% change dipped below zero, economic challenges were imminent.
At present, the indicator is above zero and rising. So, levels of economic activity appear consistent with upside in equity market prices as well.

Credit Risk.
When assessing risk, we are particularly attuned to U.S. 5-year swap spreads. This measure represents the difference between the yield of 5-year interest rate swaps and 5-year U.S. Treasuries. The spread between the two yields represents the relative credit worthiness of the counterparty as well as the characteristics of market supply. Rising swap spreads represent an increasing assessment of counterparty credit risk in the markets. Over the last two market cycles, equity bear markets have been preceded by swap spreads that expanded beyond 60 basis points. At present, swap spreads are not reflecting meaningful credit risk at all.

In terms of the economic deltas, everything that we monitor and measure remains congruent with strength in equity markets. However, with high valuation reducing the likelihood of further material multiple expansion, we anticipate a dialectic discourse between challenged valuations and constructive fundamentals. In time, we believe that positive fundamentals will push equity markets to new highs. We concede that, in the shorter term, the trading waters could prove choppy with a lot of movement but little progress. The world has changed.

> With high valuation reducing the likelihood of further material multiple expansion, we anticipate a dialectic discourse between challenged valuations and constructive fundamentals.

The largest contributors to the Q1 2014 performance of the Celernus Absolute Growth Fund were a combination of old friends and new acquaintances. Helmerich & Payne, Delta Airlines and Magna

International all returned better than 20% and are all well-acquainted with the Celernus Absolute Growth models. New additions to the models that were key contributors to the portfolio's performance were Domtar Corp. and Royal Caribbean (there may not be time to take a vacation but at least we can own a boat!)

On the downside, names that detracted from the fund's performance over the first quarter of 2014 were Mohawk Industries, United Stationers Inc. and KBR Inc.

Another of the key flows in early 2014 was the relative weakness of the Canadian dollar versus other major currencies. As foreign allocators were coming to the realization that Canada's poor productivity, lack of competitiveness and indebted consumers might offer less than attractive future returns, Bank of Canada Governor Stephen Poloz was fueling the fire by striking a more dovish tone than that offered by U.S. Federal Reserve Board Chair Janet Yellen. In the Celernus Absolute Growth Fund we hedge the majority of our foreign currency exposure, so our participation in the weakening loonie versus the U.S. greenback was present but minimal.

With newly christened Fed Chair Janet Yellen now having broken in her new chair (and almost broken the equity markets in the process), we turn our attention to interest rates and the Fed. On average, the stock market has declined 8% in the first year of a new chairperson. This is an argument that has been raised by several sources as fodder for imminent downside to equity markets. Janet Yellen is the 15th Chairperson of the Federal Reserve. Statistically, we require at least 15 more Fed Presidents and likely a couple hundred more years of data before we can even think of making comments of a statistical nature. We reject this idea.

There is also chatter that the Fed will move the front end of the curve earlier than people think. This view seems more prevalent in bond-land than equity-land. Yellen has told us that, assuming the economic data remains more or less as expected, the front end of the yield curve will move 14 to 17 months from now. The Fed has created $3 trillion dollars to purchase U.S. securities. We do not believe that they are in any way incented to risk being too hasty, letting the market move to its organic state in anything other than an orderly fashion.

It is typically the 2nd and 3rd interest rate hike that causes the fear sufficient to drive worries of an economic slowdown and the multiple contraction that typically accompanies such fears.

More importantly, however, we're not convinced that raising the front end of the yield curve is necessarily bad for the equity market. There is, of course, scope for a knee-jerk reaction following the first move higher in the Fed Funds rate. However, it is typically the 2nd and 3rd interest rate hike that causes the fear sufficient to drive worries of an economic slowdown and the multiple contraction that typically accompanies such fears. If the Fed elects to increase its key lending rate by 25 basis points in mechanical fashion at each meeting following the initial hike, then yes, there might be something to worry about for equity investors. If the Fed elects to pursue its monetary policy on a data-dependent basis, as they have already said they would, then there is scope for equity market earnings growth to outstrip multiple contraction, resulting in higher stock prices.

Earnings growth and multiple expansion will continue their discourse – sometimes drifting in unison but often submitting to one another in the sinusoidal choreography of elevation and depression that is the equity markets.

While the progression from 2013 to 2014 brought with it some key changes, we suppose that some things just don't change. Our little daughters will continue to dance. Their well-intended fathers will continue to make bad choices that make their daughters cry. Seinfeld references will never ever get old. Earnings growth and multiple expansion will continue their discourse – sometimes drifting in unison but often submitting to one another in the sinusoidal choreography of elevation and depression that is the equity markets. When not waxing poetic, we believe, quite simply, that there is scope for higher equity market prices by year end, driven less by multiple expansion and more by earnings growth.

CHRIS GRANT, CFA
Senior Partner, Portfolio Manager
cgrant@celernus.com