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
4.66 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 – August 2012

A Vacation from my Problems…
You Bet I Will!

Bob Wiley was a good natured man. Unfortunately, he suffered from multiple phobias. He felt particularly good about an initial session with the uber-egoed psychiatrist Leo Marvin.

Dr. Marvin was scheduled to leave for his vacation home at Lake Winnipesaukee, so he left Bob with a copy of his new book, 'Baby Steps', and marching orders to help Bob get through the next month. Bob could not cope. He followed Dr. Marvin to his vacation home. He was well received by Marvin's family but, not so much by Marvin. Nevertheless, the doctor gave Bob a prescription. It was a prescription to take a vacation… from his problems. This resonated with Bob.

Bob: "This is… incredible. This is ASTOUNDING. For the first time since Menningers I feel free! I knew coming up here was the right thing to do!"

Dr. Marvin: "It feels right because you're here and because you're leaving."

Then chaos ensued.

'A vacation is what you take when you can no longer take what you've been taking.' – Earl Wilson

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We believe that global equity markets have followed Dr. Marvin's prescription for Bob almost better than Bob did. With all of the economic and sociopolitical unrest prevailing across the world, the S&P 500 has taken a vacation from its problems, 'melting up' from its early June bottom of 1266 to current levels not seen since late May.

Typically, a healthy upside move in the equity markets is characterized by an increase in investor appetite to assume risk. This tends to be identified by outperformance in smaller capitalization, lower quality equities with higher leverage to the economic cycle. The summer melt-up in the S&P 500 has been different.

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Economically leveraged equities have lagged in performance vis-à-vis their more defensive counterparts. Large capitalization stocks have unambiguously outperformed their small cap siblings while lower valued stocks have decidedly underperformed the growthier names. Furthermore, higher quality equities, as characterized by profitability and financial volatility have continued to maintain leadership over their lower profitability, higher volatility counterparts. The stock market may be taking a vacation from its problems, but it has not completely forgotten that there are problems.

"The best way to keep one's word is not to give it" – Napolean Bonaparte

The ECB's Mario Draghi assisted financial markets with an impeccably-timed announcement stating the ECB's intention to do 'whatever it takes' to support the euro – inside the mandate of the ECB. According to the Maastricht Treaty, the mandate of the ECB is to maintain price stability and support Europe's common market and economic and monetary union. On the surface, this appears to provide Draghi with plenty of latitude to effect euro-supportive undertakings. Furthermore, Draghi recently extended the ECB's mandate to reducing risk premia on national debt if the premia were to lead to the breaking down of the euro. Equity markets, sitting near 200-day moving averages and tepidly testing structure, received this news with open arms. Italian/Spanish bond yields that were ballooning to untenable levels, were tempered. The question continues to be, as it was a year ago when the ECB announced a bond purchase operation (which turned out to be a mere $40 billion effort), is there enough firepower to back the rhetoric? We expect that this effort will likely be superior to the previous one, however, we remain unconvinced that the current policy will accomplish anything more than postponing a day of reckoning.

Baby steps onto the elevator… Baby steps *into* the elevator…

The earnings parade continues to track constructively with an earnings beat rate of approximately 68%. That is slightly off year-ago levels but still quite good. The key difference is found on the revenue line which is tracking at a beat rate of a mere 35%. This suggests two things to us:

1. Generally, management has greater insight into earnings than sales (this shouldn't be news to anybody);

2. Expectations for sales growth will decline. Surprises tend to begat estimate revisions. Estimate revisions tend to begat at least short-term price action.

Furthermore, negative EPS preannouncements outnumbered positive preannouncements by a ratio of 5 to 1. That is the weakest showing since 2001 and characterizes our current environment.

In the intermediate term, we do remain constructive on equities, believing that there remain positive tailwinds that will assist the earnings flow in late 2012 / early 2013. The ratio of broad-based new orders to inventories has remained mostly positive through the bull phase of the current market cycle. This lack of inventory overhang will allow businesses the luxury of not having to discount excessive amounts of inventory before rolling out new product lines. On the margin front, a lukewarm commodity price environment has widened the spread between producer and retail margins. We also note that companies have been quick to manage expenses with the flow of unit labour costs beginning to decrease. There are fundamental reasons to maintain a bullish view.

Losing my religion: 'The cult of equity is dying'

However, this month we have received a litany of prose suggesting that the demand for equity securities is waning. The monthly missive from PIMCO's Bill Gross stated quite succinctly that 'the cult of equity is dying.' He proceeded to discuss the fading of the annualized 6.6% historical stock market real return since 1912. He also discussed the declining risk appetite of investors. 'Boomers can't take risk. Gen X and Y believe in Facebook but not its stock. Gen Z has no money.' The destination of the article suggested a high probability that policy makers will seek to reflate their respective economies – trying to drive corporate profit growth by 5-10% and the U.S. economy by 6-7%. In theory, this could potentially reflate the global economy's liabilities away, but at a material cost to long term bond and questionable cost to equity investors.

We have indicated, several times, our preference for a policy of debt destruction rather than debt augmentation. We prefer to rid economies of the offending agent rather than continuing to medicate in the hopes that it will go away on its own.

With the expectation that policy makers will likely seek to apply reflationary policy, we tend to agree with Gross – at least from a 30,000 foot vantage point. The difference is that his work considers equity markets as an entire asset class. So does ours, but only inasmuch as the flows in question affect our value-oriented investment philosophy and strategy. We believe that there will always be demand for attractively valued securities with scope for growth. What Gross's rhetoric suggests to us is that the interpretation of 'attractively valued' and 'scope for growth' might require consideration and amendment. 'Attractively valued' might begin to require a higher discount rate than has historically been applied to a sub-industry. It might mean that a price/earnings multiple trading one standard deviation below its long-term mean is no longer an appropriate interpretation of cheap. 'Mid-cycle' valuation and 'peak earnings' assessments might need to be altered.

> 'No man needs a vacation so much as the man who has just had one'
> – Elbert Hubbard

A dynamic, value-oriented strategy that is keenly focused on the management of risk does not require a 'cult of equity' to drive high valuations higher. It merely requires the presence of periodic rationality that allows attractive valuation situations to be realized.

We are keenly aware that, following every vacation, is the requisite return to work. A permanent vacation from the world's problems will not occur. Even when we go on vacation, our debt doesn't.*
We will look to Mr. Draghi to make good on his promises in a meaningful fashion. We will also look to the U.S. earnings machine to drive positive activity while maintaining constructive margins. We will continue to seek investment situations with attractive valuations, positive fundamental flow and constructive structural risk profiles.

Chris Grant

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* Dr. Marvin: "You think he's gone? He's not gone. That's the whole point! He's never gone!
[Marvin opens the door; there's Bob]
Bob: Is this some radical new therapy?
Dr. Marvin: YOU SEE?