Top 10 Equity Holdings

F	Ford Motor Company
AAPL	Apple Inc.
ARUN	Aruba Networks Inc.
MTZ	Mastec Inc.
HUM	Humana Inc.
CMI	Cummins Inc.
WAB	Wabtec
OI	Owens Illinois Inc.
EQIX	Equinix Inc.
PRU	Prudential Financial 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
12.7 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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CELERNUS ABSOLUTE GROWTH FUND

Commentary – January 2013

It's not what you say but how you say it.

The behaviorists call it 'narrow framing' or 'frame dependence'. It means that we simply don't see through the way in which information is presented to us.

Consider the following example: You are a physician preparing for the arrival of an unusual disease from offshore that is expected to be particularly troublesome. It is anticipated that the disease will claim 600 lives. Two alternative strategies have been proposed to combat the outbreak. The scientific estimates of the outcomes of the two programs are as follows. If Program A is adopted, 200 people will be saved. If Program B is chosen, there is a 1/3 probability that 600 people will be saved and a 2/3 probability that none of them will be saved. In the 1970s, when researchers Kahneman and Tversky asked this question, they found that 72% of the respondents favoured Program A.

Now, consider the same problem but with the following estimated outcomes. If Program C is adopted, 400 people will die. If Program D is selected, there is a 1/3 probability that nobody will die and a 2/3 probability that 600 will die.

If you read this closely, it should become apparent that Programs A and C are identical, while Programs B and D are also identical. However, Kahneman and Tversky found that only 22% of subjects favoured Program C. The way in which the question was presented created a reversal of preference.

The presence of 'frame dependence' is highly prevalent in the world of finance and investment analysis. We have cognitive limits. Our brains can only deal with so much information (and there is a lot of information available in the investment world.) As such we often seek out concepts or catchphrases that seem plausible and are simple to remember.

Consider the following marketing phrases borrowed (loosely) from the marketing material of two investment management operators:

> "An approach of investing in companies that pay dividends and grow them outperforms all other investment strategies time and time again."

Or how about:

> "We purchase only the highest quality companies with the best balance sheets at attractive valuations."

Having heard similar sound bites over and over again in the media, in popular literature and from 'experts', these ideas take on lives of their own. They seem plausible and are simple to remember. They become part of our lexicon. They become part of our assumed understanding. They become axioms.

In the investment world, there is typically an element of truth to these axioms. A particularly successful investor might have successfully espoused and applied a certain strategy. Perhaps a research paper generated particular results that were widely published. In our experience, popular investment axioms, inappropriately understood and applied, result in substandard investment returns.

Consider the first axiom regarding dividend paying and dividend growing stocks. Remember that dividends represent a cash (or sometimes stock) payment from a company to an investor. Contrary to popular belief, dividends do not represent free money. When the stock of a company goes ex-dividend, the price of the stock decreases by the amount of the dividend. It is a transfer of capital and the stock price reflects it.

We recognize that the aging of the baby boomer generation has introduced a particularly prescient need for cash flow – difficult in light of historically low bond yields. As such, the dividend growth axiom certainly seems plausible. So we tested it. Our investment universe is a combination of the Russell 3000 and the S&P/TSX Composite indices. When we tested the returns of the top quintile dividend growers (three-year dividend growth) over the last ten years, we found that the mean return of 13.94%* appeared quite average vis-à-vis the 14.15% return of our universe. Not overly interesting. This doesn't mean that an investor cannot generate attractive performance through investment in dividend growing stocks. It simply suggests that this particular application of the strategy really hasn't added any value over the last decade.

Now, consider the second strategy: The purchase of the highest quality companies with the best balance sheets at attractive valuations. This strategy is a mutual fund staple – so ubiquitous that it too has become axiomatic. So we tested it. In this case, we chose the S&P 500 Index as the universe of choice under the notion that the stocks contained therein represented an appropriate subset of successful companies. We defined high quality simply as the top tertile of Return on Equity. A strong balance sheet was defined as the top tertile of Debt/Equity (where a higher score represents a lower debt/equity level.) Attractive valuation was defined as the cheapest tertile of the universe on a P/E basis. Over the last ten years this strategy, applied this way, generated a mean return of 13.26%* against the S&P 500's mean return of 13.33%. Little difference again.

Interestingly, when this strategy was applied to our preferred investment universe of the Russell 3000 and S&P/TSX Composite Index, the measured mean return rose to 20.57% per annum. This is somewhat more interesting and suggests that perhaps there might be some value to this strategy if better understood . Perhaps the alternate universe picked up the some of the small cap anomaly effect. Perhaps the larger universe allowed the test to capture the impact of more companies that were growing cash flows and earnings.

> A focus on attractive valuation and positive fundamental improvement are first key steps in the generation of attractive equity market returns.

At Celernus Investment Partners, we do a lot of work to understand what drives investment returns. Our research continues to suggest that a focus on attractive valuation and positive fundamental improvement are first key steps in the generation of attractive equity market returns.

Moving to the macroeconomic picture, we continue to worry that the marginal economic improvements being reported on a weekly and monthly basis will be insufficient in the long run to stem the debt burden under which so many countries now find themselves. We believe that Japan is one of the worst, if not the worst, positioned countries in the world in terms of its debt burden. At last measurement, its sovereign debt as a percentage of revenue was an astounding 1800%. The next highest country on a debt/revenue basis was Greece at a mere 400%. Interestingly, the US is next in line after Greece. So, Japan owes a lot of money to other countries.

The cost of carrying this debt, at last measurement, was almost 25% of Japan's tax revenue. Now, here's the kicker: Japanese debt is almost free. 10-year JGBs trade at 80 basis points.

Yet, the cost of carrying this near-free debt is a quarter of government revenue. So what happens when interest rates rise? Kyle Bass of Hayman Capital Partners (who has performed and published extensive research on the issue) terms the result the 'Keynesian end-point.' This is the point at which interest debt alone exceeds revenue. Hayman expects that an increase in interest rates to about 3.55% - a level consistent with 10-year levels in China, Thailand and Malaysia – would serve to consume 100% of government tax revenue.

It has been argued that particularly robust GDP growth could mitigate the effects of Japan's debt situation. Kyle Bass suggests that GDP growth of 4.8% would be necessary to do this. Japan's GDP growth is expected to have risen no more than 1.9% in 2012.

It would appear that Japan cannot grow out of its woes. There does not appear to be any plausible revenue growth rate sufficient to offset the cost of capital increases that would accompany rising interest rates.

A final argument in Japan's favour suggests that the country is self-funding and will continue to be so. The retort is that the country's demographics are not working in its favour. By 2050, potentially 1/3 of the country's population will be past retirement age. This will serve to reduce the labour force, limiting productive capacity and organic demand growth. Social security expenditures, which are already material, will continue to increase even as tax revenues decline. A nation that was once characterized by 'saving', will be forced into retirement-supporting expenditure. Private capital that was once available to purchase Japanese government bonds will no longer be available. As Japan increasingly turns to sovereign investors to fund its activities, we expect that these sovereign investors will, at some point, begin to require higher yields. Yields consistent with other international bonds of similar credit quality. We expect that the future effect of a debt-unwinding in Japan will be material weakness in all of its financial markets including a devaluing of its currency.

It would appear that Japan cannot grow out of its woes. There does not appear to be any plausible revenue growth rate sufficient to offset the cost of capital increases that would accompany rising interest rates.

It appears that what we are witnessing in Japan and many other areas of the world is pure economic entropy. Wikipedia defines this as the "...dissipation and degradation of natural materials and available energy with respect to economic activity." In statistical mechanics, it is suggested that the higher the entropy of a system, the higher the disorder. In a series of economic systems all operating under various levels of entropy (disorder) we would postulate that a very possible end result is increased sovereign conflict. In other words, more and potentially bigger wars. They might be trade conflicts. They might be military. They might be sovereign (external) or they might be civil (internal.) We believe that the risk of increased geopolitical conflict is very real and managing those risks in our portfolios is something upon which we continually focus.

We have long been proponents of sovereigns taking their proverbial medicine; of reducing their debt burdens; of following economic and societal expediency rather than political expediency. We have seen some progress but it remains insufficient. However, what we have not done is offer the U.S. sufficient credit for the recapitalization of its banking system. Before the crisis of 2008, the U.S. banking system was capitalized to the tune of about $1trillion. Following the crisis, an additional $800 billion was injected to shore up the system. In our view, this will be key to the functioning of the U.S. economy going forward. While this recapitalization is a good thing, continuing to pile on debt is not. Debt problems have never been solved by the issuance of more debt. If the U.S. is not careful, it will find itself with a debt-servicing burden (currently around 7% of revenues) closer to that of Japan. If that occurs, there will likely be no plausible revenue growth rate that will be sufficient to offset the increase in debt servicing costs that will arise from investor requirements for higher compensating bond yields. Just like Japan.

Economic entropy was not constrained to sovereigns over the last quarter. It was succinctly felt in several micro situations. One particular situation that impacted the Celernus Absolute Growth portfolio came at the hands of the management of Freeport McMoran. This company was the go-to entity for low cost, copper exposure with key operating and development assets in North America, South America, Indonesia and to a lesser extent, Africa. In early December, management announced a surprising change in strategic direction from predominantly copper to a combination of copper and oil & gas. (We consider this an entry into the asset management business as well (tongue in cheek) because the company created a portfolio of one stock that we want to own and two that we don't!) They did this through the purchase of McMoran Exploration Co (MMR) and Plains Exploration & Production (PXP.) Freeport has a long history with McMoran. This history, combined with unambiguously non-arms length executive relationships resulted in a 74% premium paid for shares of McMoran – a company that had significant liquidity and solvency risk. We estimate that the transaction multiple was 26.4x EV/EBITDA for shares of MMR. This was significantly above other similar transactions that have occurred over the last two years. However, the 3.8x EV / EBITDA (2013) for PXP was significantly below recent transaction multiples. As such, the combined deal, while dilutive to EPS and NAV estimates, did occur at about a 4.8x forward multiple of EBITDA which was below other similar transactions. So while the optics of the transaction leave a lot to be desired and the expected dilution has had its effect on the share price, we would argue that there is actually scope to hold the stock at the new, albeit lower, levels. This is a prime example of how one man's capital entropy can be another man's capital windfall!

In the 1956 Issac Asimov science fiction short story 'The Last Question', people repeatedly ask a series of super-computers named 'Multivac' how the net amount of entropy of the universe might be materially decreased. Multivac's answer was always some iteration of "Insufficient data for meaningful answer." In the last scene, humanity is gone, the universe is dead and space and time no longer exist. However, Multivac's descendent, "AC" continues to mull over the question. And then he discovered the answer. With nobody to report it to, AC elected to demonstrate the reversal of entropy, creating the universe anew. The story concludes with a pronouncement from AC:

AC said "Let there be light!" And there was light.

Our battle against portfolio entropy is driven by a process that seeks situations in which fundamental improvement drives the revaluation of attractively-valued stocks.

We reiterate AC's pronouncement. Our battle against *portfolio* entropy is driven by a process that seeks situations in which fundamental improvement drives the revaluation of attractively-valued stocks. In the last quarter, this process identified attractive situations in Canadian stocks such as Home Capital Group (HCG-T) and WestJet (WJA-T). Stateside, this process identified attractive situations in such names as Ashland (ASH-US), Cummins (CMI-US), Wabtec (WAB-US), Owens-Illinois (OI-US) and Ford (F-US).

Rather than embark on a love affair with any particular name, we approach portfolio management in a more pragmatic fashion. We seek attractive situations rather than the best companies (although sometimes the best companies are attractively valued.) Stocks of the best companies become expensive because they are the best. Expensive stocks tend to underperform. Underperforming stocks do not, an attractive investment proposition, make.

We continuously do copious amounts of statistical homework to help us understand what drives equity market performance. This is our way of avoiding 'frame dependence'. It is also how we seek to avoid economic entropy inside the portfolios that we manage.

So we embark upon a new year with anticipation. We expect that there will continue to be politically-driven volatility. We anticipate that sovereign debt burdens will continue to be pressured. We expect that the world will become a less peaceful place as societal acrimony drives change. As it pertains to our portfolios, we believe that all of this will drive the volatility that will continue to create attractive investment situations. This is what excites us about 2013!

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