CELERNUS

CELERNUS ABSOLUTE GROWTH FUND

Commentary – July 2012

What, Me Worry?

Real people worry about actual loss. This is how real people approach risk. The Dean of Value Investing, Ben Graham, called this loss a 'permanent loss of capital.' Classical finance would postulate that risk ought to be defined as relative price volatility or, beta, in industry parlance. This fails to capture what actually worries real people.

Minor fear is a major pain

It is the downside risk that we fear and there is psychological evidence to support this. Last month we discussed a particular investment game. This month we will discuss another. In this game (documented by Bechera et al. 2004), each player was given $20. Each round of the game required a decision: whether or not to invest $1. If the decision was to invest, then $1 was handed over to the experimenter. The experimenter then tossed a coin. If the outcome was heads, the player would lose their invested dollar. If the outcome was tails, the player would receive $2.50. This process was repeated twenty times with the player making the decision as to whether or not to invest $1.

This game was played with three different groups. The first group was a 'normal' group that had not experienced any damage to their neural circuitry. The second group consisted of patients that had experienced damage to their neural circuitry resulting in a 'loss of fear'. The third group consisted of patients that had experienced other lesions to the brain, but that were not associated with fear.

In this investment game, the players with damage to their fear circuitry placed a bet in 83.7% of the rounds. The 'normal' players invested 62.7%. The group with non-fear related brain damage bet 60.7% of the time. Following iterations in which a player lost their $1 investment, the group with the loss of fear still invested in 85.2% of rounds. Following a loss of $1, the normal group invested only 46.9% of the time in the next round. The pain of losing even a mere $1 was so significant that 'normal' players were willing to sit out the next round more than half the time. This tells us what we intuitively know, that loss causes pain.

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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
2.4 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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People worry about loss even more than they enjoy gains – a property known as loss aversion. Consider the toss of a fair coin in which you pay $100 every time that you lose. How much money would you need to win to make the bet attractive? A survey of over 500 professional investors indicated that the average required return to make a $100 bet was $200. Clearly professional investors dislike losses as much as the non-professional ones (although we would suggest that their assessment of required return for the given risk was inadequate!)

At Celernus, we are keenly focused on risk as defined by a permanent loss of capital. We worry about actual long-term loss. Our family money is invested alongside that of our clients so, naturally we worry about actual loss. However, we define the 'safety' of a particular situation, by the flow of company fundamentals, valuation and the risk / reward profile as defined by price structure. We are first and foremost investors.

We hearken back to the words of Ben Graham in Security Analysis in which he defined investment as a process which:

"… upon thorough analysis, promises safety of principal and a satisfactory return."

He added the following additional criterion:

"An investment operation is one that can be justified on both qualitative and quantitative grounds."

We heartily agree and have built our investment process accordingly.

Sea of sinking sovereigns (scrupulously surveyed)

In our efforts to understand risk and identify attractive investments, one thing has become unambiguously clear: we are all exposed to the sovereign risk story. As Greece, Italy, Spain and Portugal work through their debt-induced indigestion, the accompanying news flow is having material effects on the dynamics of valuation multiples. The higher the perceived risk of a sovereign credit (yes, they are now considered credits), the lower the appetite of investors to hold equities. Similarly, the lower the perceived risk, the more apt investors are to exposing their capital to equities. This dynamic created many attractive valuation opportunities in the summer of 2011 and appears to be doing so again in the summer of 2012.

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News flow is not the only exposure of equities to the sovereign story. Policies by central banks to deal with the debt contagion are having very real effects on the operation of economic engines the world over – the economic engines that drive the revenue and margin dynamics of the companies in which we invest.

Sovereign debt now represents not only interest rate risk, but not-immaterial credit risk. As such, the automatic assumption that new sovereign debt will be reintegrated into private markets is no longer a guarantee. With heightened fears of sovereign defaults, private players are less inclined to purchase sovereign paper, repo it at their central bank and lend it to companies to drive economic expansion.

Yields are not naught… at least not quite

The multitudes of quantitative easing have also resulted in what has been termed 'zero-bound' interest rates. In other words, interest rates that are low and seemingly stuck there. Historically, central banks have relied upon the model in which lower yields stimulate aggregate demand for money, supporting asset purchases further and further out the risk spectrum to make up for the lower base yields. Recently, the series of quantitative easings have been successful in keeping asset markets in 'adequate' shape. However, with policy rates near zero, quantitative easing capacity bumping up against limits and lenders unable / unwilling to find sufficient outlets for what credit they can create, this begs the question as to the effectiveness of the central bank model in a 'zero-bound' interest rate regime.

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And another thing – the U.S. yield curve is flat. Not perfectly flat, mind you, but flatter than we'd like. More importantly, flatter than we'd like while at low levels. Therein lies the problem: an insufficiently steep yield curve with near-zero nominal yields. The machine that is capitalism does not operate particularly well when Fed Funds rates and 30-year Treasuries co-exist at similar (low) levels over extended periods of time. Even though short-term yields are at historic lows, the inability to extend out the curve to earn an adequate profitability spread has the resulting effect of decreasing leverage.

When the financial system can no longer find applications for the credit that it creates, this decreases leverage. When the financial system can no longer extend maturities to earn adequate investment returns, this decreases leverage also. We would expect decreasing leverage to weigh on the progression of the revenues and earnings of the companies in which we invest.

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When financial systems find themselves hampered by uber-high debt / GDP ratios and a loss of confidence in their ability to service this debt (read: European sovereigns), the only real solutions are to
1) Destroy the debt (default), or
2) Print sufficient money to reflate it away. Both alternatives are nasty-tasting medicines but likely to improve the health of the respective patients. Both alternatives are also toxic to equity and bond markets. However, any solution to solve this debt problem that involves the injection of additional debt, is a non-solution in our eyes. It simply delays the inevitable – the inevitable being default or the printing of money.

We approach the sovereign story as structural in nature, recognizing the risks associated with it – those risks being related to both economic growth and valuation multiple dynamics. We also recognize that, inside of this structural dynamic, there have been and will continue to be, attractive opportunities in the equity markets. We believe that our multi-framework process of identifying positive fundamental flow, attractive valuation and constructive structural price profile is one that will benefit in an investment regime that is characterized less by broad-based growth and more about tactical risk management.

United we stand, divided we follow the Supreme Court's decision

Shifting from the health of sovereign nations to the health of the Celernus Absolute Growth portfolio, we continued to take a conservative stance through the month of June. While price action was quite constructive for the S&P 500 on a month over month basis, we note that the index was rallying from 'deep in the hole.' As such, we acted conservatively, allowing the index to build structure which, in turn, allowed us to define and manage risk. We had the luxury of doing this as we were very conservatively situated through the month of May as broad-based equity markets sold off in material fashion.

Let us be clear, our methodology is not index-centric. We do, however, understand the statistical characteristics of equities that outperform in up and down markets. The characteristics of stocks that outperform in up markets are different from those that outperform in down markets. The ability to manage risk at the index level helps us to more effectively manage risk at the individual security level. This framework helps us minimize the 'actual loss' that was referenced earlier – the kind of loss that real people worry about.

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In the fund we maintain a position in UnitedHealth Group (UNH-N). This stock was exposed to June's Supreme Court decision to uphold the Patient Protection Affordable Care Act (PPACA.) When we entered into the position back in May, as we do with all positions, we identified positive fundamental flow, attractive valuation and a constructive price structure from which we could manage risk. We believed that valuation levels more than offset the risk of potential margin compression in the commercial pricing cycle. Furthermore, UnitedHealth's business model was attractively poised to generate outsized gains from its Optum unit as well as the PBM business that was recently brought in-house. UNH has the most experience in managing complex populations and that positioned it well for upcoming contract opportunities vis-à-vis its peers. We viewed scope for increased penetration in Medicare and PPACA Medicaid expansion through 2014. The balance sheet was strong, asset volatility and credit risk low, management best-in-class and the stock paid out a 1.5% dividend yield.

If fundamental flow remains positive and valuation attractive, we will seek to re-enter at a point when risk can again be clearly defined and managed. That is if and only if, the potential reward is sufficient to justify said risk and the probability of realizing the reward is meaningfully positive.

The fundamental story was positive, the company was executing well, valuation was attractive and price risk could be clearly identified and managed. Enter the Supreme Court and its decision to uphold the PPACA. The decision was unambiguously positive for the hospital group as the prospect of a higher percentage of clients that paid their bills sent the share prices in the group higher. Implications for the HMOs were more ambiguous – including UNH. There was the prospect of more clients – particularly for UNH that already had operations in what was expected to be the most affected States. However, the impact on margins of these new clients was and remains a question mark. How would the inability of UNH to decline already sick clients affect its margin profile? We believe that UNH will navigate the opportunity to its advantage.

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We are constructive on the story of UNH and the fundamental flow remains positive. However, this is not a love story. There is no Notebook. If risk levels on the stock are tripped, we will exit the position. If fundamental flow remains positive and valuation attractive, we will seek to re-enter at a point when risk can again be clearly defined and managed. That is if and only if, the potential reward is sufficient to justify said risk and the probability of realizing the reward is meaningfully positive.

The delicate balance of asymmetry and bitter pills

This is how we at Celernus approach and manage the risk of a permanent loss of capital. Real people fear actual loss. However, in order to avoid the big losses, you have to sometimes accept small ones. This is difficult for real people to do. This is even difficult for professionals to do. It is a bitter short-term pill that is necessary for the long-term preservation of capital. It is a pill that the European sovereigns have yet to swallow. We expect that their costs (as well as society's) will be higher in the end as a result. It is a pill that needs to be taken with discipline. It is a pill that we at Celernus do not fear taking because it creates the asymmetric risk/return profile that we seek in every investment situation. When it comes to investing, we believe that asymmetry is a great reason to take your medicine!

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