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
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

Contact Information

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CELERNUS ABSOLUTE GROWTH FUND

Commentary – June 2012

Who's Beautiful?

You are now going to play a game against others around you. Pick a number between 0 and 100. The winner of the game will be the person who guesses the number closest to two-thirds of the average number picked. What is your guess?

The Market Game

It's called 'The Beauty Contest' and claims its roots in Chapter 12 of J.M. Keynes' *General Theory of Employment, Interest and Money*. Keynes described a fictional newspaper beauty contest where contestants were asked to select a set of six faces from photographs of women that might be considered the '*most beautiful*.' Those that selected the most popular photographs would then receive a prize.

So, which number did you select?

There is an actual solution to the game which can be found through a process the mathematicians and scientists call 'iterated dominance.' The highest possible outcome is 67. This assumes that all respondents select 100, in which case the resulting answer would be 100*(2/3). That's a pretty unlikely outcome. Assuming everyone understands this, then the next logical response would be about 45 (67*(2/3)). Eventually, the process leads to a *rational* answer of zero. This level represents the Nash equilibrium (think Russell Crowe in 'A Beautiful Mind') and is a 'best response' to all other strategies in the equilibrium.

Over the course of many years and iterations of this game, winners might have selected a number anywhere between about 9 and 30 – depending on their sophistication and level of thinking.

Now, here's the rub. Most of the participants in the *Beauty Contest* for which we have data, were professional allocators of capital. Their responses varied widely in the game. The result was that the most rational response (zero – the Nash equilibrium) was never the optimal one. Zero never won the game! The players of these games make up a subset of the community that is now valuing and allocating capital in the global financial markets. How do you structure an investment process when opinions regarding valuation vary so dramatically and where the most rational analysis might not be the optimal one?

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Well, the average value investor might suggest that the answer to overcoming this difficulty is to focus on the absolute value of a given security (or market) and not worry about shorter-term price fluctuations. Simply purchase a security below its absolute value and wait for the market to re-rate it.

The above-average value investor, recognizing that there is no true *'absolute'* value, might seek to determine what a security *isn't* worth, and then purchase it with a sufficient margin of safety such that, if they are incorrect in their analysis, the ensuing loss is manageable.

Now, an investor with an understanding of the key style and performance characteristics of individual stocks (*'non-random quantitative biases'* in industry parlance) might seek to use this information to assess how attractive a particular security might be at a given time, as well as the nature of the marginal purchaser of that security.

How We Play

At Celernus, our process lives dynamically between the latter two examples. We are more quantitatively-oriented than a pure value manager. We are more value-oriented than a pure quantitative manager. We continuously search for investment situations in stocks that generate (or will generate) positive free cash flow, that have realistic opportunities to increase revenues and margins and transact at valuations that allow for future multiple expansion. At the same time, we seek to understand and assess the reward of a correct analysis relative to the cost of an incorrect one. Some say that's not possible.
We reject what some say. We maintain a disciplined process. Similar to a butcher that slices the same cut of meat the same way every time, we seek to apply our framework in similar fashion. Hence our descriptor: "Discretionary investing, systematically applied."

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And We're Off

Month One

The first month in the life of the *Celernus Absolute Growth Fund* was spent playing defense. While the S&P 500 declined by 6.27% and the Dow Jones Industrial Average backed up a similar 6.21%, the fund closed essentially flat (-0.21%) for the month. (We don't explicitly benchmark our activities to a particular index.
We do, however, maintain an affinity for the U.S. mid-cap spectrum. We are also very aware of what the currently depreciating equity indices are up to.) Towards the end of May we began to gently increase our equity weighting into lower volatility situations in which we could clearly define risk. We have identified many more situations that we believe will benefit handsomely from overall equity market upside. We'll continue to allocate capital, according to our framework, as we are able to define and manage the risks of each position.

While our process of capital allocation is bottom-up, we recognize that broad-based, short-term fluctuations in valuation multiples tend to be driven by higher-level news flow. In fact, recent (and very interesting) research has documented that 2/3 of a stock's return over the first year of being held is determined by the movement in its P/E ratio. The longer that a stock is held, the higher the proportion of its price return that is determined by growth in operating earnings, not valuation. So much for long-term value investing! Such was the situation in the summer of 2011. During this period, many stocks that we viewed as fundamentally attractive declined precipitously in valuation terms. This was driven by worries over the solvency of some European sovereigns. Furthermore, those attractive fundamentals and low valuations fit very neatly inside our tactical risk framework. There were some wonderful opportunities in September 2011. Oh, how we lamented that the fund was not live!! But here we find ourselves in mid-2012 with a strikingly similar, albeit slightly altered situation.

Europe Drives Sentiment

Spain and Greece continue to generate headlines as they work through the indigestion that inevitably follows a decade-long binge of debt-assumption and unbalanced budgets. Debt destruction and asset deflation continue to make the lives of many Greek and Spanish citizens pretty miserable. While we feel for those whose lives are in turmoil, we do not neglect our fiduciary responsibility to our investors. In other words, we continuously monitor our models for attractive situations that might emerge as a result of European unrest. We recognize, going forward that companies whose revenues are particularly exposed to risky European sovereigns could be at risk of revenue and earnings misses over the coming months. The US dollar has rallied appreciably versus the Euro over the last year – to the tune of 14%. We believe that smaller multinationals with more than 30% revenue exposure to this geographic region are at risk. We are applying this theme to reduce risk in our equity selection.

Politics and Markets

The 'Fiscal Cliff', which refers to the series of policies set to either expire or take effect over the next six to eight months, remains a key focus. Going forward, we monitor:

1) The expiration of the 2001/2003 tax cuts;
2) The imposition of the 'sequester' spending cuts;
3) Reversal of payroll cuts;
4) Reversal of selected emergency unemployment benefits;
5) Potential reaching of the debt limit.

The political debate will continue, but we remain wary of stocks with outsized exposure to U.S. government spending – particularly of the more discretionary variety.

In our view, the more interesting investment situations of 2011 were driven by the U.S. consumer. Growing sales and expanding margins drove healthy earnings and cash flow profiles. The S&P 500 Retailing and S&P 500 Consumer Durables & Apparel industry groups both currently lead the 12 month total return horse race at 15% and 11%, respectively. We believe that there will continue to be pockets of outperformance from these two sectors. However, Consumer Discretionary margins now sit at 32-year highs. Furthermore, discretionary stocks are showing up as expensive using traditional valuation metrics. We believe that the uber-high margins of today may foreshadow a particularly difficult season for the earnings growth of tomorrow. Proceed with caution.

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In spite of the aforementioned thematic risks, we remain constructive on equity markets over the medium term. Key economic indicators, including OECD U.S. Leading Economic Indicator, ISM (manufacturing and non-manufacturing), ECRI as well as consensus GDP estimates remain consistent with continued top-line growth in the 6-8% range. Furthermore, the models that we apply to understand risk suggest that we are in the throes of a mid-cycle correction.

Numbers Tell The Story

While we are empirical skeptics, we are also societal optimists. Hope is not an investment thesis, but the looking forward to a better day is imperative – particularly in an environment of continued geopolitical tension, socioeconomic unrest and even construction in your neighbour's backyard that is loud, messy and going to take all summer! One market participant has continuously stated that *"we have to go through it to get through it."* Act two of the debt destruction/asset deflation playbook is clearly developing on sovereign soil. It's something we need to go through to get through. You don't get better until you take your medicine. However, it is typically the journey through difficult days that breeds innovation from the best and brightest – innovation that begets new knowledge, productivity, employment and prosperity. That is what we have to look forward to on the other side of this financial crisis. This is what we hope for. While our prose is anecdotal, our analysis and methodology are empirical.
We appreciate a well-told market anecdote. However, we believe that the best anecdotes are the ones that end in double digit revenue and margin growth, combined with significant multiple expansion – identified through the lens of our tactical risk framework. That's a story with a happy ending!

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