CELERNUS COMMENTARY – DECEMBER 2015

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Upon reflection, 2015 was most definitely a tale told in two parts. The first half of the year showed promise. As I wrote to you in July, the major US and Canadian indexes were slightly in positive ground and all the Celernus funds had performed very strongly. Conversely, in the second half of the year volatility in global markets increased and returns turned negative. Given the difficult environment we are generally satisfied with the investment performance of the Celernus funds over the entirety of 2015. The Celernus Mortgage and Income Trust (CMIT) had another terrific year posting a gain of 7.63 percent. The Celernus Equity Neutral Fund (CENF) was launched in February 2015 and posted a positive return of 3.49 percent for its first eleven months. The Celernus Absolute Growth Fund (CAGF) suffered the effects of the difficult global equity environment in the second half of 2015 and finished the year with a modest loss of 2.37 percent. While we are not content with a losing year in CAGF, the results for the Celernus fund family in 2015 were generally strong.

As a result of the large number of potential mortgages that we review for CMIT, opportunities to make equity investments in real estate projects began crossing my desk a few years ago. The attractive return profile of some of these projects combined with the ability to diversify portfolios with investments in another asset class provided the genesis for our latest fund. In September, we launched the Celernus Realty Income Properties LP.

On a final note, we continued to receive a significant number of referrals from you, our clients, in the second half of the year. Thank you for your trust and support. Best wishes to everyone for health and happiness in 2016.

G.F. Martin

Gordon Martin
Managing Partner

MARKET OBSERVATIONS

2015 was a challenging one for allocators of capital. The S&P/TSX Composite Index fell 11.08% on a pure price basis and 8.30% on a total return basis. South of the border, the Russell 1000 Index closed 91 basis points to the positive, thanks to a dividend yield of approximately 2.00%.

The commodity complex told the story of a global economy whose manufacturing base suffered materially in the wake of declining demand for the primary inputs of production. Crude oil shed 30% while natural gas was off 19%. Copper sold off 24.5% while aluminum and nickel dropped by 18.6% and 40.5%, respectively.

The weakening profile of crude oil, combined with unfavourable interest rate differentials drove the Canadian dollar south versus the U.S. greenback to the tune of 16%. Interestingly, this accounts for most, if not all, of the broad-based positive performance of U.S. or global equity funds that are denominated in Canadian dollars but operate in the absence of a currency hedge.

2015 saw great bouts of volatility from Asian equity markets – particularly the Shanghai Composite – that, while closing slightly positive for the year, experienced a peak-to trough selloff of 43%. To put this into perspective, it took the S&P

MARKET OBSERVATIONS CONT'D

500 almost a year and a half to sell off the same amount during the most recent bear market. Looking even further back, during the bear market that followed the tech bubble of the early 2000s, it took more than two years to sell off that amount. During this period, the VIX index spiked from the low teens to over 50, before again regaining mid-teen levels.

In 2015 the Federal Reserve finally did it. Many would argue (and I am one of them) that they did it much too late. But they did it. On December 16, the Federal Reserve raised the target range for the Federal Funds rate to ¼ to ½ percent. Increasing expectations for this rate hike saw the yield of U.S. 2-year notes rise from 66 basis points to 98 basis points. Similarly, the yield of the 10-year Treasury bond rose 63 basis points to 2.27%.

Canadian monetary policy was another matter entirely. Over the course of 2015, declining oil prices and an overall weakening economic environment moved the Bank of Canada to drop their Overnight Rate Target from 1.00% to 0.50%. This drove yields on the 2-year note 53 basis points lower. The yield on the 10-year note actually saw an increase of 14 basis points.

As has historically been the case, the strengthening U.S. dollar was accompanied by weakness in the price of gold which sold off 10.5%.

CELERNUS ABSOLUTE GROWTH FUND (CAGF – CIP100) AND CELERNUS EQUITY NEUTRAL FUND (CENF – CIP300)

CAGF COMPOUND RETURNS (%) (SERIES A)

1 month	3 months	6 months	1 year	3 years	5 years	10 years	Inception
-1.83	1.03	-7.56	-2.37	7.65	–	–	6.12

CENF COMPOUND RETURNS (%) (SERIES A)

1 month	3 months	6 months	1 year	3 years	5 years	10 years	Inception
0.17	-3.01	-0.47	–	–	–	–	3.49

In 2015, the Celernus Absolute Growth Fund (CAGF) was down 2.37% net of fees and expenses. The month of August proved particularly challenging for the fund as many of our Health Care and Pharmaceutical holdings sold off significantly more than the broader-based market and failed to re-appreciate over the ensuing two months.

We are disappointed with a negative annual return. However, we are encouraged that, given the difficult economic climate, the weakness in the fund was relatively muted.

In 2016 we will continue to manage the security selection process of the fund according to our quantitative alpha factor model. We would remind that we are managing the fund to provide equity market returns – or better – at lower levels of volatility – across the market cycle. To do this, we are willing to maintain net long exposure to equities in an equity bull market, but materially reduce such exposure during equity bear markets.

In 2015 we launched the Celernus Equity Neutral Fund (CENF). The purpose of the fund is to provide a strategy that is long a basket of equities and equivalently short a basket of different equities, with the intention of generating positive returns from the return spread between the two baskets. Put differently, the fund is profitable when positive returns in the long basket are greater than those in the short basket <or> when losses are greater in the short basket than those in the long basket. The fund is intended to provide consistently positive returns across the market cycle at volatility levels that are markedly lower than those of the broad-based indices.

Since its inception in February 2015, the Celernus Equity Neutral Fund returned 3.49% – this during a period in which the S&P/TSX Composite Index returned -11.30% and the Russell 1000 gained 0.62%. Furthermore, monthly returns were negatively correlated to the returns of both equity indices.

We contend that, from a portfolio perspective, the Celernus Equity Neutral Fund is an attractive diversification tool with positive expected returns that are uncorrelated with those of the broader-based equity indices.

CELERNUS Investment Partners Inc.

CELERNUS MORTGAGE AND INCOME TRUST FUND (CMIT – CIP200)

CMIT COMPOUND RETURNS (%) (SERIES A)

1 month	3 months	6 months	1 year	3 years	5 years	10 years	Inception
0.62	1.48	3.01	7.63	–	–	–	6.99

CMIT had another very positive year in 2015. The return of 7.63% for the year was in excess of our expectations and projections. The fund grew to over 23 million dollar during the course of the year. As the fund grew, we were able to invest the money in mortgages at attractive rates of return without having to relax our high standards for risk management. As a result, over the life of the fund, CMIT has still never experienced a loss of principal on any mortgage.

For 2016, we expect the broader private mortgage market to experience slight downward pressure on rates. Over the past few months, the amount of capital flowing to the alternative mortgage market has increased and the result has been some downward pressure on rates. CMIT has largely been able to resist these pressures by continuing to be highly selective. The relatively small size of the fund and our ability to move nimbly often provides us the opportunity to exact a slightly premium rate.

In their fourth quarter report, CMHC describes the national housing market as generally balanced. The expectation is that MLS resales will moderate slightly in 2016 and 2017. Positives for the housing market over the coming year include stable employment trends, an expected rebound in gross domestic product and an increase in the pace of new household formations. A slight negative is the potential for an increase in interest rates for conventional mortgages. We remain concerned about the impact of low energy and commodity prices on the Prairie Provinces and Newfoundland. We have zero exposure to any of these markets and expect to maintain this stance throughout 2016.

We are generally optimistic about the prospects for real estate in 2016. However, we are continuing to keep our time horizon short by limiting the term on our mortgages to one year. Additionally, we are continuing to maintain stringent requirements for loan to value in order to provide additional protection in the event of softening prices.

CELERNUS REALTY INCOME PROPERTIES LP (CRIP – CIP400)

In the fourth quarter, we made our first two purchases for the new fund. The first is a two unit food service location on Kingston Rd. The anchor tenant is Tim Hortons and we have a twenty year lease with escalations every five years. The location has unused land with the potential for additional future development. Attractive features included a preexisting drive thru and left turn access into the property off Kingston Rd through a cutout in the centre boulevard. The property is the only one which is accessible to south bound traffic and provides the opportunity to add value through the acquisition of adjacent properties in future.

We also purchased a 42.5% interest in a retail building on Bloor Street just east of Ossington Rd. in Toronto. The building is currently vacant; however, our partners have strong retail connections and have received expressions of interest from multiple quality anchor tenants. We are extremely optimistic about the return potential for this property over the coming twelve to eighteen months.

We have a number of additional prospects in the pipeline and will make additional investments to diversify the portfolio as funds are raised.

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OUTLOOK FOR 2016

As the calendar rolls into 2016, it is our belief that the first half of the year will be characterized by superior, though modest growth in the U.S. economy vs. inferior growth in many other developed markets. The U.S. economy is expected to experience real GDP growth at a year-over-year pace of 2.5% in 2016. This compares with developed market expectations of 1.8% growth in Canada as well as Germany, 2.3% growth in the United Kingdom, 1.1% in Japan and 6.5% in China (clearly not inferior to the U.S.)

The U.S. dollar index rallied approximately 9.3% over the course of 2015 and even more against economies that are levered to the commodities complex. We expect (and this is by no means a contrarian call) that this broad-based strengthening will, over time, provide a headwind for U.S. manufacturing-based exporting sectors. With that said, the service sector represents 80% of the U.S. economy. A brief look at the ISM manufacturing and non-manufacturing indices clearly illustrates a divergence between a strong service sector and a weakening manufacturing sector. As such, we believe that sectors that are levered to U.S.-based service industries are better-positioned to outperform versus manufacturing counterparts. A strong U.S. dollar will likely play to this theme as well.

Over the next 12 months, stocks in the Russell 1000 are estimated to collectively grow their earnings per share by 14%. This is higher than the 9.7% 12-month growth that was expected when measured in Q1 2015. These expected growth levels are consistent with those that were experienced in the late innings of the previous market cycle. They are, however, unambiguously lower than the 20-30% growth estimates extant in the mid-to-late 1990s. At present, valuation levels of 15.5x forward earnings and 17.7x trailing earnings are much lower than the 20-30x levels reached in the late 1990s. However, during the 1990s, an argument could be made for higher valuations. That argument was based on higher EPS growth expectations (however unrealistic those expectations may or may not have been.) That argument cannot be made now. At present, current valuation levels remain higher than those of the previous cycle, but with expected growth that is consistent with previous-cycle expectations. In other words, the U.S. market continues to appear expensive vis-à-vis its expectations for EPS growth. Furthermore, the U.S. Treasury is beginning to exit the business of asset inflation.

With a market now absent its marginal buyer of fixed income assets, the catalyst that once helped drive all asset prices higher is now in the rear-view mirror. While the economic deltas that we follow remain consistent with a bull market in equities, we are not convinced that realized EPS growth over the next 12 months will be sufficient to overcome the declining valuation multiples that we expect will be driven by higher volatility and broad-based de-risking activity.

We contend that there will remain profitable opportunities in equity markets. While we would tread with caution in the arena of internationally-leveraged energy and materials exposure, at least in early 2016, we would suggest that there may emerge pockets of opportunity where the benefits of idiosyncratic growth might be captured in rising stock prices.

As we have highlighted in previous writings, we feel that there remains opportunity to profit from the equity return dispersion that we feel will be present at current lofty valuation levels. We believe that equity-oriented strategies that are active on the short-side may have superior opportunities to generate positive returns in 2016 – providing desirable return flow that is uncorrelated with typical asset class returns. The Celernus Equity Neutral Fund is one such fund.

We feel that we are in the late innings of the market cycle and that, in the absence of a resurgence of earnings growth, expected equity market returns that are delivered by passive indices will be muted. Thus, we would argue that actively-managed strategies, across the asset spectrum, provide the best opportunity for superior, relative returns.

At Celernus Investment Partners we take our fiduciary responsibilities very seriously. As such, we have built and manage a family of unique, complementary funds. Where typical portfolios tend to be constructed with long exposure to publicly traded securities, things are different at Celernus. Using our suite of funds, we provide actively-managed long and short exposure to public and private securities. This allows us to target portfolio returns that are market-level or better at volatility levels that are significantly below market, over a market cycle.

We look forward to a profitable 2016!

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