CELERNUS COMMENTARY – JUNE 2015

Celernus has passed a number of important milestones over the last year. As Founder and Managing Partner, I am very proud of the team that we have assembled and the accomplishments we have achieved together. Here are a few of the highlights from the past twelve months.

John Panneton, my long-time friend and mentor joined Celernus as our Chairman last fall. His fifty plus years of experience and wisdom have proven invaluable.

Kurt Hagerman became our fifth partner when he agreed to join as Senior Partner, Compliance and Operations. Kurt brings twenty years of experience with companies like Ernst & Young, Citco and State Street and he has already made a strong impact on our business.

In February, we launched our latest new fund – the **Celernus Equity Neutral Fund (CENF)**. The fund is off to a very good start. It is performing as planned, returning 3.98% over the first five months.

The **Celernus Absolute Growth Fund (CAGF)** reached its three year anniversary on April 30. It has grown to 33 million dollars and has performed consistently while managing risk.

The **Celernus Mortgage and Income Trust (CMIT)** reached its two year anniversary on April 30. The fund has grown to almost 20 million dollars and has exceeded our expectations.

Preparations are almost complete to launch our new **Real Estate Fund** this summer.

From an investment performance standpoint, Celernus had a very strong first half of 2015. Equity markets in both Canada and the United States were highly volatile in the first half of 2015. The S&P/TSX index (with dividends) in Canada was up +0.91% and the S&P500 index measuring the performance of the largest U.S. companies increased +1.23%. In this difficult environment, all three of our funds have posted commendable returns for the first six months of the year. CAGF, CENF, and CMIT increased 5.69%, 3.98%, and 4.47% respectively over the opening two quarters.

None of this would have been possible if not for the many clients who have placed their trust in us over the past three years. We thank you for your belief and trust in our abilities and we promise to continue to do our very best to ensure that your faith continues to be rewarded.

G.J. Martin

Gordon Martin
Managing Partner

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MARKET OBSERVATIONS

The past six months have been eventful for the global economy. Interest rates in North American remain near modern historic lows. The general consensus in the investment community is that the U.S. Federal Reserve will soon begin to raise its key lending rate ahead of potential future inflation. Inflation typically begins to rise as unemployment levels decrease and wage increases begin to apply pressure to company margins. Surprisingly to many, the decline in the unemployment rate south of the border has yet to translate to accelerating wage growth. Thus, the Fed has taken a cautious 'data dependent' approach to increasing its key rate. There is little doubt that the increase will come; however, the timing continues to be pushed out into the future. Furthermore, the pace of change is expected to be moderate.

In Canada, the steep decline in energy prices in late 2014 has caused economic growth to stall – moving a handful of domestic and foreign financial institutions to proclaim that Canada is now in the throes of a recession.

Outside of North America, investors are focused on the Greek funding situation as Prime Minister Alexis Tsipras seeks to broker a bailout for his ailing nation with the European Union and International Monetary Fund.

In Asia, growth in China continues to slow. Late in the quarter this slowdown began to manifest itself in the country's stock market with the Shanghai Composite sinking 17% in the final two weeks of June.

The second quarter of 2015 was a challenging one for North American equity markets. A 25% rebound in the price of crude oil proved insufficient to lift Canadian markets out of the red. South of the border, investors continued to grapple with slowing earnings growth in an environment of cyclically high valuation multiples.

Looking ahead, we feel that the risks remain unchanged. Year-over-year momentum in S&P 500 forward earnings expectations went negative in April and remains so at present. This last occurred in July of 2008 – a period when equity markets had already begun to slide into bear market territory. The previous incidence of similar negative earnings expectation momentum occurred during the bear market of the early 2000s. In the current environment, we believe we are simply seeing a mid-cycle correction in earnings expectations rather than the beginning of a bear market. During the early 2000s as well as 2008, the employment condition was deteriorating, economic activity was slowing and swap spreads were indicating heightened levels of counterparty risk – all hallmarks of a looming bear market. Currently, the employment condition is very constructive, economic activity is trending positively while swap spreads are at cycle lows. In our view, the current economic backdrop is consistent with a continued bull market.

However, we feel that upside to passive equity market indices over the next six months, if any, will be minimal. Earnings simply need to grow into their valuations. We do feel that the economic backdrop will remain supportive of stronger earnings. From a tactical perspective, we argue that strategies constructed to capture the positive impacts of equity return dispersion will be well-placed vis-à-vis the passive equity indices over the next half-year.

CELERNUS ABSOLUTE GROWTH FUND (CAGF – CIP100)

Compound Returns (%) (SERIES A)

1 month	3 months	6 months	1 year	3 years	5 years	10 years	Inception
3.11	2.10	5.69	9.37	10.73	–	–	9.92

The Celernus Absolute Growth Fund (CAGF) posted Q2 growth of 2.10%, bettering the HFRI Equity Hedge Index by 194 basis points for the quarter. Year-to-date returns of 5.69% have bettered the HFRI Index by 332 basis points.

Top-performing names were found in the technology-related space with Tableau Software (DATA) and Arista Networks (ANET) pacing gains. Also constructive to the fund's performance was a positive development in a private equity position that allowed us to effect a revaluation at higher levels.

The Celernus Absolute Growth Fund currently maintains a relatively high degree of tracking error vis-à-vis the Russell 1000 Index. At present, the largest factor contributions to the active risk of the fund are represented by higher-than average exposure to U.S. stocks with high momentum, lower-than average exposure to U.S. large cap stocks, lower-than-average exposure to energy stocks and higher-than-average exposure to US stocks with high earnings variability. Security selection for CAGF is ultimately discretionary but is informed by a highly quantitative process. The active risk factors listed above are incidental to our process and our models. They are not stationary and will change frequently over the course of a year. However, they serve as a tool to understand some of the larger, well understood risks that are being assumed in the fund, even if they do not represent those proprietary factors to which we seek to maximize our exposure.

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CELERNUS MORTGAGE AND INCOME TRUST FUND (CMIT – CIP200)

Compound Returns (%) (SERIES A)

1 month	3 months	6 months	1 year	3 years	5 years	10 years	Inception
0.61	2.21	4.47	8.07	–	–	–	7.07

CMIT turned two years old this past May. When it was launched in 2013, the objective was to provide our clients an alternative to low bond and GIC interest rates that would also protect capital in the event interest rates start to rise. Since that time, (CMIT) has delivered exactly the investment performance profile that we intended – consistent monthly returns with extremely low volatility. CMIT currently holds approximately 50 mortgage investments and our focus continues to be on safety of capital. The average loan-to-value (LTV) is 65% and the median LTV is 70%. The portfolio is diversified geographically between Ontario and Quebec and the maximum LTV on any loan is set at 80%. Since inception of the fund, it has invested in almost 100 mortgages and never experienced a capital loss. Over that time, five mortgages have been in default and CMIT has never experienced a loss of principal on any mortgage. CMIT continues to be positioned to protect capital in the event that interest rates begin to rise. Each mortgage investment is for a term of between three months and one year and the dollar weighted average time to maturity for the portfolio is less than six months. The short term nature of the investments allows us to be nimble in adjusting to changes in both interest rates and property market valuations.

Looking ahead to the remainder of 2015 and into 2016, the latest CMHC market report views the Ontario and Quebec markets as having a risk level that is slightly elevated compared to the national level but which is still at a moderate level. They note that a large portion of this risk is a result of condominium units under construction being at near record levels in Toronto and Quebec. We agree with this assessment and this has been a concern of ours for the past two years. As a rule we only invest in mortgages secured by condo units when the LTV is extremely low and these mortgages are a very small percentage of the portfolio. Generally, we expect to continue to be able to find mortgage investments over the coming months that meet our stringent criteria for safety and return.

CELERNUS EQUITY NEUTRAL FUND (CENF – CIP300)

The Celernus Equity Neutral Fund (CENF) returned -0.17% for Q2, bettering the HFRI Equity Market Neutral Index by 66 basis points. Since inception in mid-February of 2015, the fund has posted growth of 3.98% which is 311 basis points better than that of the index over the same time period.

While the long side of the portfolio performed well, the outsized moves occurred in the short side with Micron Technology leading the charge lower on a late-June earnings miss.

The Celernus Equity Neutral Fund seeks to hedge every dollar long with a dollar short. We do not seek to neutralize exposures to beta or other commonly understood factor risks. We do, however, seek to avoid overconcentration to any one particular factor risk. We also seek to manage our gross leverage in an appropriate and conservative fashion.

As noted in the earlier equity market commentary, we do feel that returns from passive exposure to equity indices will be muted over the next few months. As such, we believe that exposure to strategies that are dependent on active risk and return dispersion (CENF) rather than market directionality are endowed with the tools to provide attractive returns vis-à-vis the passive indices.

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