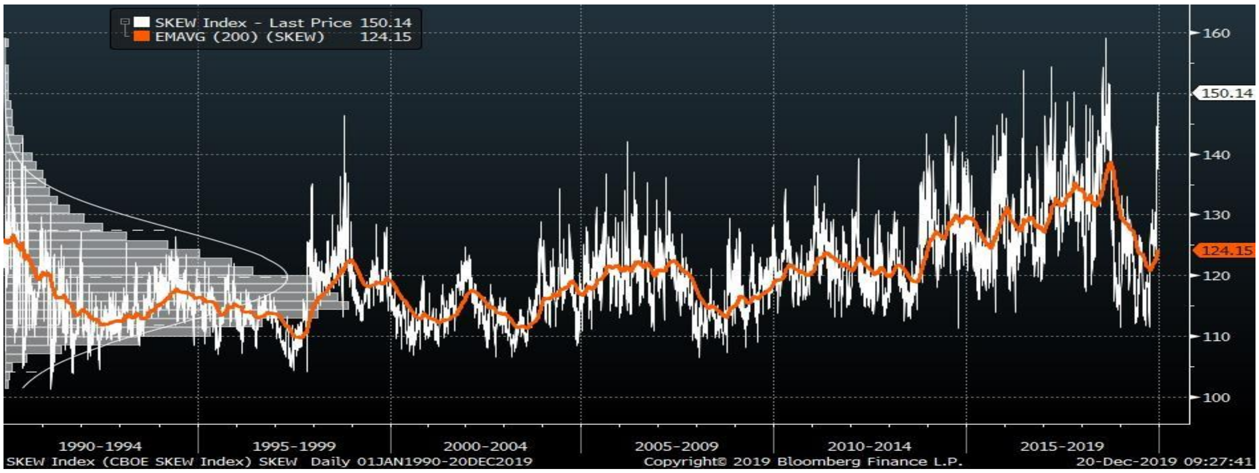
December 2019 Commentary

The Dipsea Capital Fund returned 1.15% to partners for the month of December and 8.13% for 2019. U.S. equity markets were very strong again in December, with the S&P 500 gaining 3.02%. The Dipsea Capital Fund posted its strongest monthly return since inception and 17th consecutive positive month. We are happy with this outcome as we consider the Fund's portfolio characteristics over the year as we describe later in this letter. We believe that not all returns are created equal and quality of returns is an important factor for investors to consider.

As the market rally intensified in December, the S&P 500's implied volatility exhibited increased skew. This was the result of increased demand for deep out-of-the-money options as investors sought "tail risk" protection. The CBOE's Skew Index reached 150 on December 19th, a level it has only reached on 18 occasions since 1990 (see graph below). This was one of the contributing factors for the portfolio this month as we were able to set up attractive long/short spreads to capture risk premia extremes in both the index and various single-name options. Another contributing factor was a short-term bearish directional tilt coming into the month.



Market Landscape

With two strong yet opposing indicators at work (upwards price momentum versus exuberant investor sentiment), we anticipate a period of variable, choppy price action without prominent price appreciation in the coming month.

Tailwinds supporting higher stock prices include:

1. Continued robust economic activity on the consumer level. For example, holiday sales rose 3.4% from 2018, despite the season being six days shorter (Barron's).
2. The Federal Reserve, albeit unofficially, is in quantitative easing mode by continuing its purchases of Treasury securities.
3. Consistent upward market price momentum supporting literally all asset classes.
4. Fourth quarter 2019 earnings are expected to be slightly positive for the first time in four quarters due to earnings surprises.

Headwinds to higher stock prices include:

1. The U.S. stock market's cyclically adjusted P/E ratio (CAPE ratio) is at 31.1x, 83% above its historical mean of 17. The market is not cheap by any metric.
2. Numerous sentiment readings are indicating historical exuberance based on investor behavior with some at extremes not seen since 2000.

<u>Thoughts on the Year</u>

Reflecting upon our results in 2019, several items stand out for us:

1) The Fund's net exposure (long exposure – short exposure) averaged -1%.
2) The correlation of the Fund's daily gross returns to the S&P 500 at 0.15 indicates there is basically no relationship between the two.
3) Common factor risk in the portfolio across 32 factors such as tech sector exposure, equity volatility, momentum, and valuation were de minimis, each remaining in the range of 0.0 – 0.5%.
4) We had our best year since inception despite the stock market's very subdued level of volatility – the CBOE's VIX index averaged 15 for the year.

We believe these items characterize Dipsea's returns as being alpha and point to the efficacy of our models and strategy as we are achieving increased returns without resorting to raising gross exposure (using leverage) or increased correlation to the market.

In these heady times for markets, capital preservation remains the primary priority for Dipsea Capital.

We remain appreciative of the opportunity to be a trusted steward of your capital.

Sincerely,

Chris Antonio
Chief Investment Officer and Founder