DIPSEA

CAPITAL, LLC

April 2020 Commentary

We wish our new and long-time partners robust health and safety as we continue to face the challenges thrust upon us by Covid-19.

The Dipsea Capital Fund returned 0.81% to partners for April, 4.32% year-to-date, and 9.43% for the last twelve months. U.S. equity markets staged a major bounce back in April without any fundamental reason to do so. The S&P 500 had its strongest monthly rally in 33 years, gaining +12.82% and taking it to -9.29% for the year. In stark contrast to this performance, although the severity of Covid-19's human toll ameliorated, the ravages to the economy deepened as business basically ground to a halt, oil collapsed (with prices even briefly going negative), and millions became unemployed.

Dipsea Capital posted its 21st consecutive positive month in April. Overall, it was an uneventful month and our gain was in line with our non-directional positioning. We remained defensive throughout the month, maintaining modest gross exposure and net exposure averaged 2.0%.

The CBOE's volatility index (VIX) declined steadily in April and ended the month at 34, a decline of 40%, as complacency took hold particularly on the back of continued Fed monetary policy actions. Our weekly model signaled a more attractive market environment the third week of April, when we increased gross exposure. Our return was generated fairly consistently throughout the month and was relatively balanced between indexes and single-names (1.2x ratio), with both oriented towards profiting primarily from declining volatility.

Market Landscape

Last week I enjoyed listening to Warren Buffett's recent annual speech to Berkshire Hathaway shareholders and I identify with his cautionary comments regarding the economy and markets:

1) Covid-19 is not a transitory issue and he expects it to have an enduring effect on the economy and 2) he has stayed on the sidelines for now, expecting further fallout in the markets.

As we wrote about last month, the economy is facing tremendous uncertainties and we expect continued elevated volatility in markets. Tactical, short duration trading presents unique advantages in this environment and we believe will continue to be a highly effective investment strategy.

Tailwinds supporting higher stock prices include:

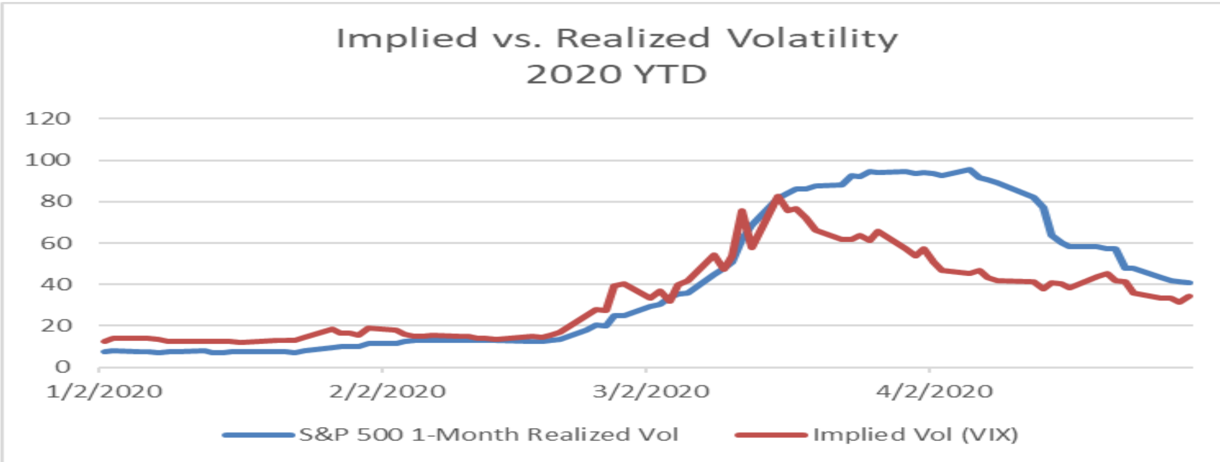
1. All three major central banks have expanded and recommitted to their asset purchases.
2. Crude oil appears to be stabilizing, which among other supportive factors helps dissipate fears about the banking sector's exposure to the oil industry.
3. It's an election year in the U.S. and both political parties agree on implementing massive government stimulus to counteract the GDP downturn.
4. There are continued signs of Covid-19's effects abating in various countries.

Headwinds to higher stock prices include:

1. 20 million Americans filed for unemployment benefits in April and consumer spending accounts for 70% of U.S. GDP.
2. International trade faces challenges as nations scramble to protect their citizens and economies with tariffs and China's handling of the Covid-19 breakout is scrutinized.
3. Share buybacks and dividends are being curtailed even by stalwarts. Royal Dutch Shell cut its dividend for the first time since World War II.
4. The U.S. stock market's cyclically adjusted P/E ratio (CAPE ratio) remains elevated at 27x, 59% above its historical mean of 17.
5. From a seasonality perspective, May is historically a difficult month for the market.

Portfolio Thoughts

One of the significant features of this market dislocation has been the relationship between implied volatility and realized volatility. The difference between the two is the volatility risk premium, which is typically positive as implied, forward looking volatility trades at a premium to the actual volatility of the equities market. However, during periods of extreme stress, this relationship can reverse as traders anticipate lower market volatility ahead. This is what happened starting March 13th and continuing through April. As can be seen in the graph below, realized volatility remained very elevated before falling off in mid-April, while implied volatility steadily declined.



Source: S&P Dow Jones Indices, CBOE

The continued elevated negative risk premium was a sign of caution to us early this month. Implied volatility by this metric was cheap, but the higher realized volatility makes positions much larger than usual on a risk basis. As the negative risk premium began to collapse later in the month, we took advantage of the normalizing trend to increase our exposure to net collecting volatility-oriented positions.

The most comparable period in my experience is 2008, when the volatility risk premium also went negative, presenting unique challenges which we were able to navigate successfully in our predecessor vehicle. We are happy to make these returns available to investors on request.

We remain focused on generating returns that by virtue of their consistency, can provide a reliable source of diversification. We appreciate your support during this challenging period for everyone.

Sincerely,

Christopher Antonio

Chief Investment Officer and Founder