A Year for the History Books – Dipsea Capital December 2020 Commentary

The Dipsea Capital Fund returned 0.62% to partners for the month and 9.08% for 2020. The equity rally continued in December with the S&P 500 gaining 3.84% and finishing the year with a total return of 18.40%.

The markets presented challenging circumstances to navigate in 2020. No one could have predicted that a global pandemic was imminent and would cause the loss of life and economic havoc we experienced last year. The economy fell into recession, unemployment claims spiked, and balance sheets became severely overextended. Despite this, after the initial market crash, both the S&P 500 and Nasdaq, which started the year at all-time highs, experienced major rallies taking them to new highs through the end of the year.

As we mentioned in last month's letter, the current market rally may have the effect of clouding investors' memories, but 2020 was a year of extreme market action that certainly tested trading managers' mettle. During the February through April period we experienced a major stock market crash that included a one day drop in the Dow Jones Industrial Average of 13%, saw the Treasury market seize up, T-bills trade at a negative yield, and WTI oil futures settle at negative prices.

Regardless of this volatility, Dipsea's absolute return strategy is not dependent on market valuation or performance and has proved itself effective without taking any significant market exposure. We review several metrics regarding our performance this year in the section below. The year presented its challenges but also opportunities. We profited from both directional, long volatility trades, particularly during the extreme volatility of February and March, and positive carry volatility oriented trades.

The CBOE's VIX index remained in the low to mid-twenties throughout December. As our signals indicated a continued low volatility environment, we positioned the portfolio for high probability volatility oriented trades. Skew became more pronounced in the second half of December which provided for higher returns for equal risk opportunities. It has remained elevated to start the new year, providing an attractive opportunity set. Index trading accounted for 55% of December's return, with the remainder coming from single-names. Dipsea's net market exposure for the month averaged 0.2%.

Market Landscape

Our outlook remains the same in that we expect that the combination of high market valuations and tepid economic growth, high uncertainty regarding fiscal and monetary policy outcomes, and Covid-19's lingering impact to maintain market volatility at historically elevated levels.

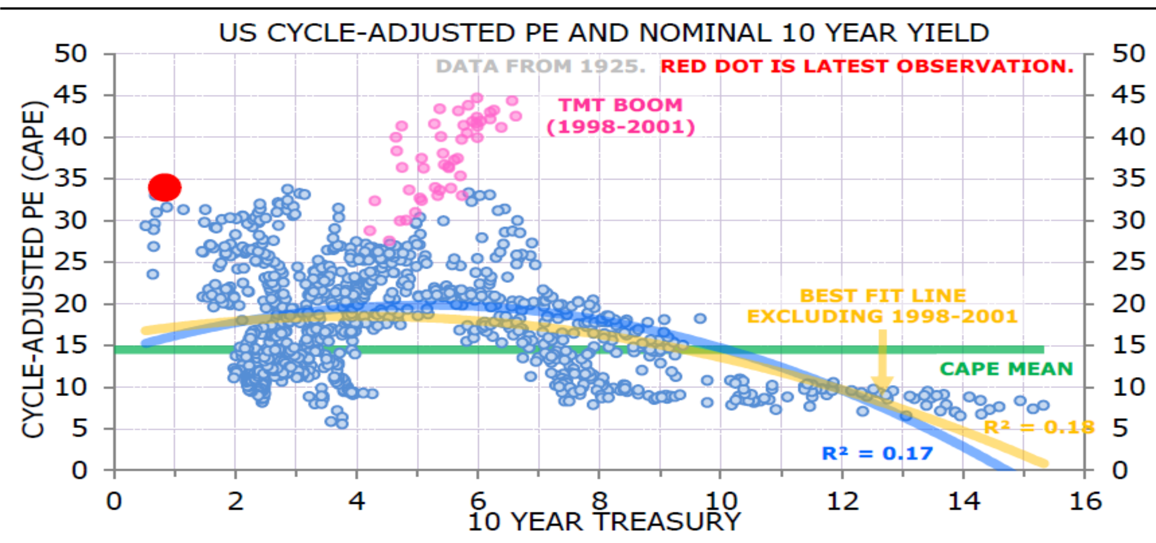
Tailwinds supporting higher near term stock prices include:

1. The Fed and other major central banks remain committed to an unprecedented level of monetary expansion with the goal of stimulating their economies.
2. Effective Covid-19 vaccines are now available and being distributed.
3. A $900 billion Covid-19 relief package has just been passed by Congress.

Headwinds to higher near term stock prices include:

1. The U.S. stock market's cyclically adjusted P/E ratio (CAPE ratio) has risen to 34x, 33% above its 20 year mean of 25.6.
2. Continued economic lockdown from the "second wave" of Covid-19 infections.
3. The economy's rebound is dissipating and the consensus U.S. GDP growth forecast for 2021 is a tepid 3.8%.
4. The ROBO ("retail-only, buy-only") put/call ratio indicates continued aggressive call buying by this segment, a contrarian indicator.

The following graph showing historical market valuations compared to 10 year Treasury bond yields caught our eye.



Using a cyclically adjusted PE ratio, the market is trading at the highest valuation ever for the current level of very low interest rates. The implication is that both stocks and bonds may be facing a protracted period of minimal returns as they normalize to historic means.

Portfolio Thoughts

We are pleased with this year's result as the combination of our models' signals and discretionary investing experience enabled an attractive return while also navigating the extreme market volatility without experiencing a negative month.

We wanted to share the following data points for 2020, which speak to the absolute return nature of Dipsea's track record and strategy:

- The Fund's net exposure (long exposure – short exposure) averaged -0.1%.
- The correlation of the Fund's daily gross returns to the S&P 500 at 0.06 indicates there was no relationship between the two.
- 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%.
- The annualized standard deviation of gross daily returns in 2020 was 2.0%.
- The Fund's worst intramonth drawdown was -0.66%.
- 70% of trading days had a positive return.

Dipsea's strategy is designed for consistency by benefiting from 1) effective models to anticipate volatility regimes such as the major spike in volatility in February, 2) high probability ranking models that signal attractive securities and trade timing, and 3) short duration securities, typically expiring in 1 to 5 days, which offer greater price extremes and serve to increase our trading objectivity.

We are excited by the opportunity set for Dipsea's strategy in 2021 and wish our readers a healthy and prosperous New Year.

Sincerely,

Christopher Antonio

Chief Investment Officer and Founder