DIPSEA
CAPITAL, LLC

February 2020 Commentary

"Never think that lack of variability is stability. Don't confuse lack of volatility with stability, ever."
- Nassim Nicholas Taleb

The Dipsea Capital Fund returned 1.46% to partners for February, 2.21% year-to-date, and 8.74% for the last twelve months. Much like in January, U.S. equity markets started the month with strong gains, but this trend abruptly broke down in the last ten days. The S&P 500 suffered a loss the last week of February on par with some of its worst weekly losses ever. It ended the month down -8.23%. Dipsea Capital posted its 19th consecutive positive month. The majority of our return was generated during the second half of the month as the market transitioned from a low to a high volatility regime. Our net market exposure averaged 0.0% for the month.

The CBOE's VIX index, which tracks the US equity market's volatility, erupted with a 250% intra-month breakout, from a low of 14 on Friday Feb 14th to 49 on Feb 28th. Dipsea's weekly models began signaling caution on January 31st and our daily signals corroborated the regime change on February 21st. This led us to reduce gross exposure to 24% and net to -1.4% over the next two days. As market volatility spiked the following week to extreme levels, our models signaled opportunities for increased exposure with a continued bearish tilt, limited to very brief time windows. Liquidity in the options markets has remained high.

These portfolio shifts positioned Dipsea for profitable days the last week of February, primarily on Put spreads in the broad indexes and tail protection positions. We are pleased with this result as oftentimes periods of market transition prove to be the most challenging.

Source: Barchart

As a reminder to our investors, our strategy combines the use of systematic signals with discretionary management. This is applied through our formal investment protocol in a manner which allows me to ignore signals to add risk to the portfolio but prohibits me from adding risk without a signal to do so. We believe this produces an ideal combination of the strengths of both our models and professional market trading experience.

Market Landscape

In February, the market changed from choppy, sideways market action to downside momentum due to increasing bearish sentiment based on the coronavirus threat. Historically, what causes the market the greatest duress is uncertainty. Our expectation is that when greater clarity about the virus's impact is gained, even if accompanied by worse news, market volatility will decline. Until then, we anticipate continued market swings.

Tailwinds supporting higher stock prices include:

1. Dramatic Federal Reserve rate cut: The Fed provided a surprise 50 bps rate cut the first week of March and there is widespread expectation of a further cut at its next meeting March 17th.
2. The possibility of a fiscal stimulus package in the US.
3. The potential for a more moderate, business friendly candidate being nominated by the Democratic Party.

Headwinds to higher stock prices include:

1. The probability of a worldwide recession has increased with the outbreak of the coronavirus.
2. The flatness of the US yield curve, which has declined to levels implying negative real rates, is signaling lower growth ahead.
3. Despite the February selloff, the U.S. stock market's cyclically adjusted P/E ratio (CAPE ratio) remains elevated at 29.6x, 74% above its historical mean of 17.

Portfolio Thoughts

In our January letter we highlighted Dipsea Capital's highly consistent positive performance during down market days. February was consistent with these results, despite the highly volatile market action:

	S&P 500 down days	Dipsea Capital # of up days on down S&P 500 days	Cumulative return of S&P 500 down days	Cumulative return of Dipsea performance on down S&P 500 days
February, 2020	10	7 (70%)	-13.5%	+1.8%
January, 2020	9	6 (67%)	-5.9%	+0.5%
2019	102	75 (74%)	-44.4%	+3.4%

February's market action reminded us of another intense February – 2018's - which due to the dynamics of certain ETF products, a 115% increase in the VIX index, and the demise of a number of volatility trading hedge funds, was dubbed "Volmageddon". Dipsea Capital also produced a gain in February 2018, but this year's February was a greater challenge, as the shift in market volatility and drop in the market were much more violent.

As market volatility has persisted to start the month of March, we are pleased to note that month-to-date performance is positive. Please accept our continued appreciation for the opportunity to be a trusted steward of your capital.

Sincerely,

Christopher Antonio

Chief Investment Officer and Founder