June 2020 Commentary

The Dipsea Capital Fund marked its fifth anniversary at the end of June. We are grateful to all our partners, and in particular the Day 1 investors, the vast majority of whom remain with us. We believe fund performance has delivered on our goal of generating consistent, uncorrelated returns. Over the full range of market environments that we have navigated, the fund has compounded at 6.31% with a Sharpe ratio of 3.28 and negative correlation to the S&P 500 of -0.13. The fund's twelve month trailing return is 9.63%. We remain committed to continuous improvement of our investment models and processes with the goal of increasing returns while maintaining a high quality return defined by its consistency.

The Dipsea Capital Fund returned 0.59% to partners for June, 5.51% year-to-date, and 9.63% for the last twelve months. U.S. equity markets continued to rally in June and the S&P 500, range-bound for much of the month, ended with a gain of +1.99%, reducing its year-to-date loss to -3.08%. This capped a spectacular quarterly gain of 20.54% for the index. Gold reached $1,800/ounce, up from $1,523 to start the year (+18%) as investors have sought it as a safe haven from what a rapidly expanding monetary base may portend. We are agnostic as to the price of gold but several gold miners are among the universe of stocks our models track and some of them have become increasingly interesting as their volatility has picked up.

Dipsea Capital posted its 23rd consecutive positive month in June. The CBOE's volatility index (VIX) briefly rose in the first half of June but quickly tapered after that to end the month basically unchanged at 30. Our model signaled a shift to rising volatility on June 8th, which was followed by the VIX rising to a high of 42 on June 11th. We increased gross exposure over this time period as we found upside skew trades, in particular, compelling. We discuss a trade in Amazon below. A challenge during the month was that most of the market moves took place overnight, rather than during the day, making it more difficult than usual to be active during the day. Net exposure averaged -0.4%. Both indexes and single-names were profitable, with indexes accounting for 64% of the gain.

Market Landscape

The second quarter was extraordinary in that we witnessed a tremendous market rally, particularly in the riskiest of assets, in the face of tremendous uncertainty. We believe that the current profound unknowns regarding the economy and geopolitics make confident forecasts of the market's intermediate direction impossible. Fortunately, this is not a disadvantage to Dipsea given our strategy's short duration and flexibility to adjust to new scenarios as they present themselves. We expect a protracted, volatile trading environment over the remainder of the summer.

Tailwinds supporting higher stock prices include:

1. The Fed and other major central banks continue to commit to an unprecedented level of monetary expansion with the goal of stimulating their economies.
2. Further fiscal stimulus is likely as the U.S. Congress's relief bills have not been penalized by the market and it is an election year.
3. The number of unemployed in the U.S. declined by 4.8 million in June, reducing the unemployment rate to 11%.
4. There are bullish contrarian indicators, such as institutional investment funds being underexposed to equities and record level small-trader short interest in index futures.
5. Relief from Covid-19 may be here sooner rather than later as there are a large number of vaccine candidates in progress (over 100).

Headwinds to higher stock prices include:

1. The U.S. stock market's cyclically adjusted P/E ratio (CAPE ratio) remains elevated at 29x, 13% above its 20 year mean of 25.8.
2. As U.S. states have begun to reopen for business, there has been a disproportionate increase in Covid-19 cases, threatening increased economic activity.
3. Federal stimulus checks to individuals may be phased out as the number of unemployed has gone down.
4. Political risks such as a contested national election and the potential for higher taxes and regulation with a change of administration are real.
5. Bearish contrarian indicators include very low Put-Call ratio averages and exuberant retail activity, such as observed by the popularity of the Robinhood Financial platform.

<u>Portfolio Thoughts</u>

Last month we noted the increased upside skew available in the market and the opportunity set this presents. This was a significant factor in our trading during June, as highlighted by the following trade in Amazon.

Amazon's options became highly dislocated the second week of June, exhibiting pronounced upside skew in its Calls. Dipsea's model signaled an opportunity to capture this risk premia extreme as Amazon's chart began to break out of a consolidation pattern. We established a bull Call ratio spread with four days to expiration, sized at 1%, with the long leg 10% away from the last sale ($2,800 strike) at an implied volatility of 45% and the short leg at three times the size 30% away ($3,300 strike) at double the implied vol (90%). This trade construct allowed us to achieve substantial long gamma (upside convexity) at no cost. Momentum did not carry through to the expiry date in this case (Amazon closed at $2,545), but the trade was highly profitable with a 17% net return in four days on the net proceeds of the spread.

The opportunity set remains attractive. At the end of June, the CBOE's skew index was at its highest level for 2020 (146), indicating elevated prices for out-of-the-money options and VIX three month futures are signaling modestly higher levels of market volatility ahead.

As we have mentioned before, at Dipsea we focus on achieving attractive and consistent risk-adjusted returns. To this end, risk management is of primary importance and we were pleased to share a memo last month from Ken Grant of General Risk Advisors. His firm produces daily risk metrics for Dipsea and in it he noted his thoughts on Dipsea's risk management in general and throughout the extraordinary market volatility this year. If this would be of interest, please let us know so we can share his memo with you as well.

Thank you for your support and we want to take this opportunity to wish everyone a healthy and rewarding second half of the year.

Sincerely,

Christopher Antonio

Chief Investment Officer and Founder