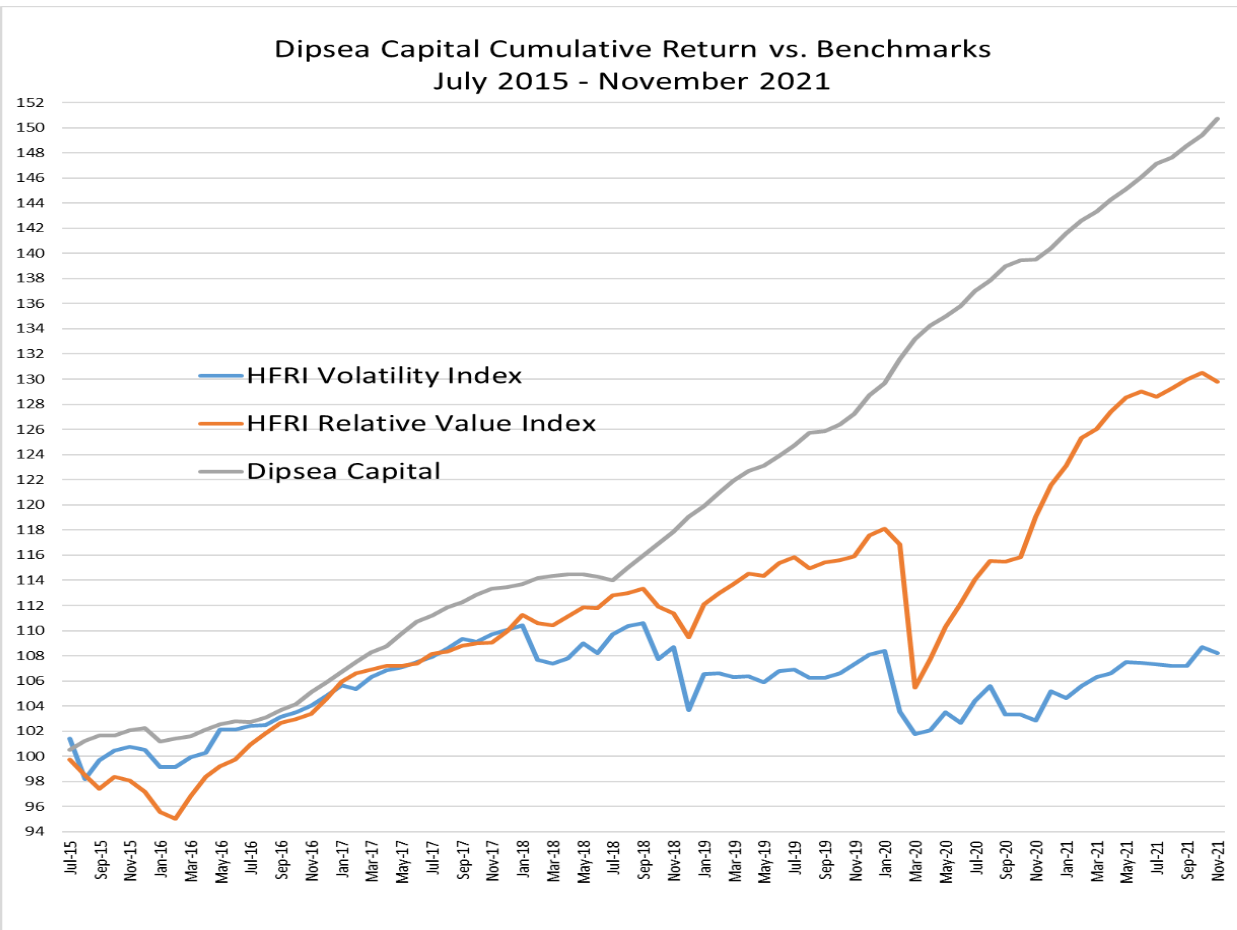
Absolute Returns for all Market Environments - Dipsea Capital December 2021 Commentary

"Investors need to respect that they're riding a huge liquidity wave [in the equity market] thanks to the Fed, and that wave will eventually break as monetary stimulus winds down. So investors should keep an eye on the risk of an abrupt shift from a *relative valuation market mindset to an absolute valuation one*." Mohamed El-Erian, Goldman Sachs Top of Mind Global Macro Research interview, December 2021



The Dipsea Capital Fund returned 0.47% in December and 7.83% for 2021. The S&P 500 bounced back with a gain of 4.48% to close the year +28.71% and the S&P's 10-year Treasury Index lost -3.74% for 2021. Our absolute return strategy performed consistently throughout the year while averaging zero market exposure (0.5% net exposure measured on a daily basis) – we review below several statistics describing our fund's performance.

The CBOE's volatility index (VIX) started December at 31 and from there declined to the 20s and high teens the final week of the month. December offered both directional and volatility selling opportunities – we shifted from the former to the latter as our signals confirmed a declining implied volatility pattern ahead. Skew was on the decline until the 20th, but picked up significantly after that, with the CBOE's Skew index hitting 156 and it continues to remain elevated into January. This provided attractive single-name set up opportunities, which we increased exposure to, running a higher gross exposure through month end.

We were consistently profitable throughout the month, with our strongest day during the first week. The Fund's gross daily returns were in the range of +0.11% to -0.04%. Index trading accounted for 69% of December's return, with the remainder coming from single-names. Dipsea's net market exposure averaged -0.7%.

<u>Market Landscape</u>

As we typically do at quarter ends, we take a pause to note and evaluate the macro dynamics impacting equity markets.

Tailwinds supporting continued strength in the broad market:

1. 2021 was a record year for S&P 500 earnings and revenue growth: FactSet estimates earnings growth at 45% and revenue growth at 16%, with an estimated Q4 year-on-year earnings growth of 21%.

2. Interest rates have been steady despite the hawkish shift by the Federal Reserve in December and remain moderate - the 10-year has until recently hovered around 1.5% and the 30-year around 2%.

3. Short-term market sentiment at the end of December was negative. This is typically a bullish signal.

Headwinds to higher stock prices:

1. The U.S. stock market's cyclically adjusted P/E ratio (CAPE ratio) is 40x, 55% above its 20 year mean of 25.8.

2. The U.S. economy slowed in Q3 to a real annualized growth rate of 2.0%, down from 6.7% in Q2.

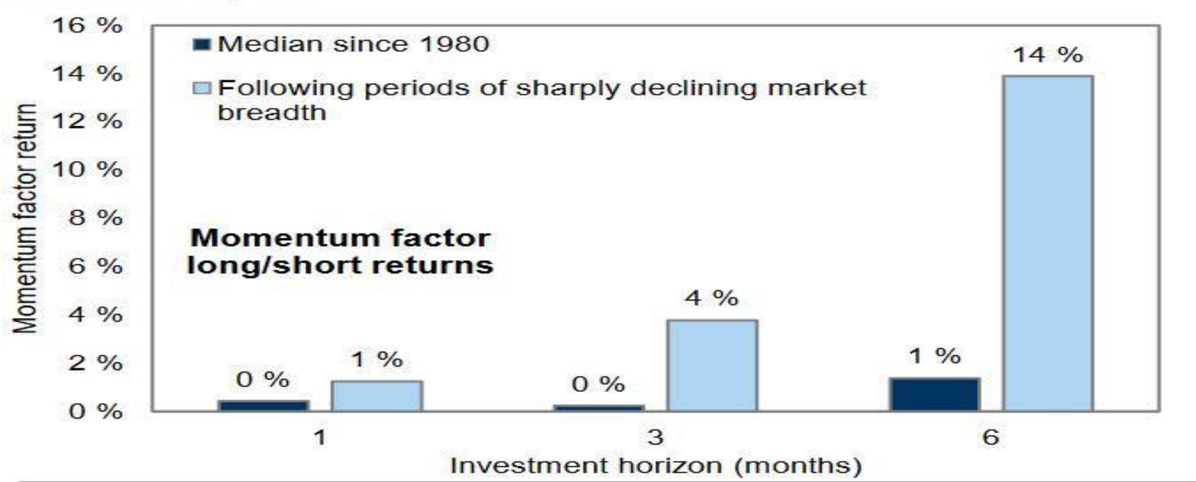
3. The Federal Reserve reacted to the persistently high inflation rate, significantly shifting its stance on December 15th by announcing an accelerated phaseout of its open market bond purchases, projected to end by March, and anticipating three rate hikes for 2022.

4. Additional fiscal stimulus is on hold for now as the Build Back Better bill was halted by Congress.

5. Covid-19's newest variant may spur further shutdowns in various parts of the U.S., with their consequent economic impact.

The following chart indicating the effectiveness of momentum strategies following declines in market breadth caught our attention. The narrowing stock market breadth in 2021 has been a persistent concern (as we have also highlighted in this letter). Goldman's long / short momentum factor has returned roughly +1% in the typical six-month period since 1980. However, following six-month declines in market breadth greater than 4.5%, the factor has returned a very significant +14% on average. This is an example of a market pattern that would benefit Dipsea as it would expand the opportunity set and potential magnitude of returns of our single-name equity momentum plays.

Exhibit 7: Momentum generates strong returns following narrowing breadth
as of December 9, 2021



Source: Goldman Sachs Global Investment Research

Strategy Thoughts and Year End Summary

We are pleased with our performance in 2021. Adhering to our goal of generating consistent returns, we extended our run of consecutive positive months to 41 and maintained completely market uncorrelated performance. We have also continued to grow the firm, as assets under management grew by 69% for 2021. We were also honored to receive the *top Volatility Fund at the HFM 2021 European Quant Performance Awards* in November.

As investors evaluate their portfolios for 2022, we would like to highlight the following data points from the Dipsea Capital Fund track record. We analyzed the last three years, which included a major market upheaval as well as substantial growth in our assets under management. For the period 2019-21:

- Annualized return of 8.35% with Sharpe ratio of 7.6.
- Zero negative months vs. 10 negative months for the S&P 500 (28%).
- The Fund's daily net exposure (long exposure – short exposure) averaged 0.1%.
- Daily gross returns correlation of 0.04 to the S&P 500 indicates no relationship between the two.
- 77% of trading days had a positive return.
- Skewness of 1.2 indicates a highly positively skewed distribution of daily returns.
- The annualized standard deviation of gross daily returns was 1.4%.
- The Fund's maximum intramonth drawdown was -0.66%.

We believe the above statistics demonstrate the absolute return nature of Dipsea's track record and strategy, as we successfully navigated this particularly challenging market period with its multiple bouts of shifting market volatility.

Dipsea's strategy is designed for consistency through all market environments by benefiting from 1) effective models to anticipate volatility regimes such as the major spike in volatility at the end of January and, later in the year, in November into early December, 2) high probability ranking models that signal attractive securities and trade timing, and 3) the qualities of our short duration securities, typically expiring in 1 to 5 days, which offer greater liquidity for effective risk management.

We are excited by the opportunity set for Dipsea's strategy in 2022 and wish our readers a healthy and prosperous New Year.

Sincerely,

Christopher Antonio

Chief Investment Officer and Founder