DIPSEA

CAPITAL, LLC

The Rise of the Retail Investor – Dipsea Capital January 2021 Commentary

The Dipsea Capital Fund returned 0.83% to partners in January and 9.17% for the last twelve months. The equity rally we have experienced for the last couple of months reversed the last week of January with a sharp selloff and the S&P 500 lost -1.01% for the month.

Retail investors came to the forefront in January again as they indiscriminately ran up names like GameStop and AMC Theatres in contrarian bets, with their spectacular rallies being reinforced by ensuing short squeezes. We nearly saw the failure of a well-regarded, $12.5 billion hedge fund - Melvin Capital - as it experienced a loss of 53% during January. Had it not been bailed out, we may have seen even greater market volatility. Short squeezes are nothing new, having been chronicled as far back as 1901 over control of the Northern Pacific Railway. Certainly, the breathtaking rise and then fall of GameStop was a reminder of the dangers of being wrong on a trade and remaining stubborn. As John Maynard Keynes said, "the market can remain irrational longer than you can remain solvent."

The CBOE's VIX index declined in January after hitting a peak of 29 to start the new year but then experienced a large spike on January 27th, from 24 to 37. Throughout the month, many single name options exhibited high upside skew, one of various technical indicators signaling elevated market frothiness. This environment provided strong opportunities for directional plays, both long and short. We profited on long Tesla Call spreads the first week of January as its upside skew was very pronounced (12 bps contributor on Jan 8th). As the market's bullish sentiment grew throughout the month our models' signals became more bearish; this helped us capitalize when the S&P 500 sold off 60 points intraday on the 25th and we realized profits on bear index Put spreads (8 bps contributor). It was a strong last week of the month as our signals also led us to put on long exposure in Nokia (14 bps contributor on the 27th), which we did by buying stock, the best risk-reward security in our view given the extremely high pricing of its options. Skew remains high at the start of February.

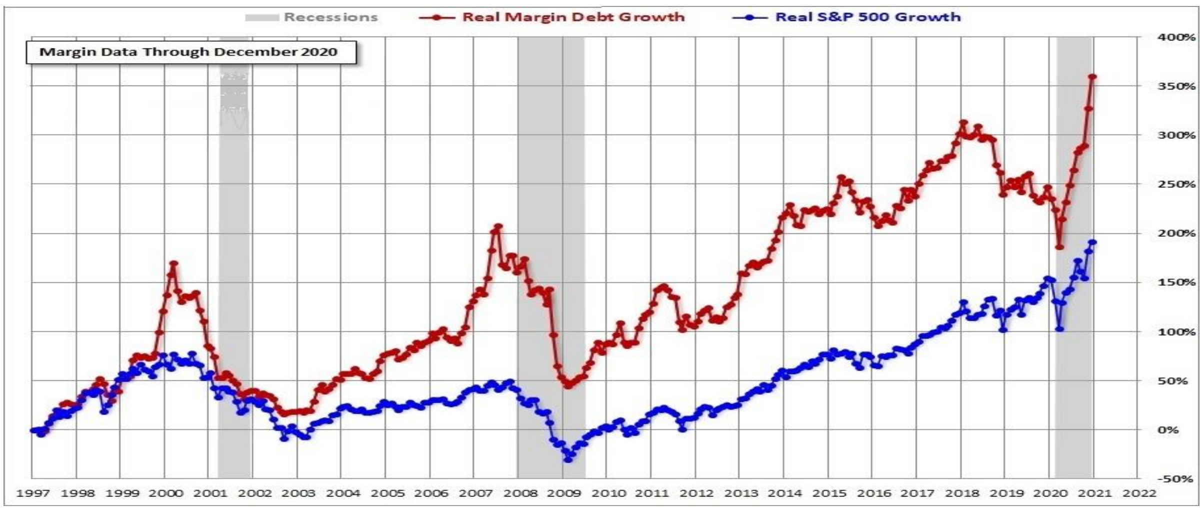
Index trading accounted for 54% of January's return, with the remainder coming from single-names. Our portfolio hedges were profitable for the month. Dipsea's net market exposure averaged +0.8%.

Market and Strategy Thoughts

It has been interesting to note the rising trading volumes in U.S. equity options. The Options Clearing Corporation (OCC) reported a record daily average volume across U.S. exchanges of 33 million contracts for December, which rose to 44 million in January, up 80% from last January. This has been due primarily to an increase in retail investors, which is an opportunity for Dipsea as more "price-insensitive" or otherwise inexperienced investors enter the asset class.

On another topic, one metric we keep an eye on to gauge market sentiment is the market's level of margin debt. Lately it has spiked to record levels as this graph illustrates:

FINRA Margin Debt / S&P 500
Real Growth, 1997 – 2020



Source: FINRA

There is a stark contrast in the trend of margin debt during the 2020 recession and prior ones (up, rather than down). Prior peaks in margin debt were an early indicator of market corrections.

We expect the market's dynamics to provide ample opportunity for Dipsea's strategy, regardless of market direction. We remain vigilant in our portfolio construction yet poised to profit on risk premia extremes with our tactical approach in the short-dated options space. We continue to incorporate updates to our models from our ongoing research. Recently we have begun taking advantage of the benefits of machine learning, which has allowed us to more efficiently and accurately map non-linear, yet consistent, relationships that have proved worth exploring.

Thank you for your continued trust and support.

Sincerely,

Christopher Antonio

Chief Investment Officer and Founder