Finbou Thales - Investor Letter H1 2017

Dear investors,

In this very first investor letter, I will briefly discuss event trading theory, provide some explanations behind our recent trades, assess the performance in H1 2017 and the outlook for H2.

THEORY BEHIND THALES

Economic theory generally reflects that forex movements are driven by expectations of interest rate levels and interest rate differentials. In general changes in economic data such as trade balance, commodity prices, GDP, inflation, employment etc., also have an impact on the value of currency depending on how they influence the central bank's decision making. Ultimately the weighing of each input depends on the economic cycle and country concerned.

For instance, a high level of interest rates or expectation of even higher levels does not mean that a currency will automatically appreciate, as relative economic strength is also necessary. Take Russia, where rouble collapsed in 2014, as the Central Bank of Russia was hiking interest rates into a weak economy. On the other hand, the US dollar appreciated significantly in H2 2014, due to the expectation of rising interest rates. This instance was different as the US economy was comparatively strong, and dollar strength was compounded as other major central banks were heading to the opposite direction by easing policy.

The value of currency always reflects the expectations of how the interest rates and the economy will develop in the future. If the events that affect these expectations turn out to be different than what is expected, the currency tends to appreciate or depreciate. As an extreme example, after Brexit, the pound collapsed entirely due to the expectation that UK terms of trade and economic growth will be significantly weaker, and therefore the interest rates would have to adjust by going down. At the time of Brexit, the UK economy was the strongest in G10. The massive intraday move in the currency was amplified by the fact that market was expecting (pricing) very low probability that the UK would vote for Brexit, despite the polls being quite narrow.

The underlying idea behind Thales can be deduced from these principles regarding event trading. If the outcome of event deviates significantly from market expectations, the market is bound to move significantly. However, sometimes the market does not move enough after the event is in public knowledge. And sometimes the market overreacts. This means there are profit opportunities.

When we say that market prices something efficiently[1], it indicates that there are no profit opportunities as the price moves immediately to an efficient level. For the sake of simplicity, in this letter, I will focus mainly on instances where either

[1] Theory on market efficiency is based on the famous paper by Nobel Laureate Eugene Fama, available at http://efinance.org.cn/cn/fm/Efficient%20Capital%20Markets%20A%20Review%20of%20Theory%20and%20Empirical%20Work.pdf.

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- Market moves to an efficient level
- Market does not move to an efficient level[2]

Now whether the market is trading at an efficient level, is subject to debate. However, when trading events in the short-term, we don't care if the market is inefficient or efficient in the long term, we only care whether the market prices the specific event efficiently.

Markets are quite efficient at pricing simple information, say interest rate cut or hike or any other single economic data input. For instance, it will rarely occur that the market does not price the interest rate move correctly in forehand or immediately after the event. However, when there are multiple factors to be assessed, such as the central bank communication on future interest rates and outlook, determining whether the market is efficiently priced becomes more complex. This phenomenon is especially commonplace in the market after Federal Reserve[3] decisions. The interest rate decisions themselves bear little meaning as the market has priced them; therefore the focus always turns on the communication and what can be deciphered about the future direction of interest rates.

Historical price action can provide rather accurate scenarios, on what the market should do on a given expectation to a certain outcome. If the information is fully priced i.e. expected, the market does not move at all to the event. This is what happens with most events. On the other hand, if market prices the unexpected information efficiently, it immediately moves to an efficient level.

However, the historical parallels are never precise as the market conditions are bound to be different in terms of different market drivers, and again different weighting given to economic inputs depending on the cycle. This means that the same communication or measures are very unlikely to have a similar impact every time. The market might have priced the communication to a different degree in each case. Therefore, the historical parallels cannot be relied on – it's a tool - just like the theory on market efficiency.

I focus on circumstances when the market has not priced information correctly, that it should have in historical context, considering the changes in market dynamics. The more there is uncertainty to believe that the historical parallels aren't corresponding, the less there should be a risk. Therefore, the risk is always a function of the degree of uncertainty. If I am trading an event with full risk, it means I believe the uncertainty factor is low, and I have a high (subjective) probability of winning.

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2 We may also consider that market moves to an inefficient level, but it is unlikely to correct the inefficiency soon etc. From trading perspective, the outcome in such instances is analogous to market pricing the event efficiently.

3 Typically, the Fed will ensure by its communication that market pricing is at least 80% before they move interest rates. Essentially the Fed does not want to shake the financial markets by raising interest rates unless the market has priced it in.

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ASSESSING H1 TRADES

Overview

In this section, I will assess some of the trades in H1. Rather than cherry-picking the winning trades, I will particularly focus on occasions where I was wrong because being wrong in the right way is much more difficult than being right. We have received most questions regarding these instances, and while I don't think it is necessary for me to open my trading in a similar fashion during future investor letters, I will probably continue to assess some of the trades during each half. The examples cover the following areas;

1) Why I initiate positions two ways, i.e. buy currency initially and then sell after
2) Why I sometimes buy a currency when the data is weak
3) Full risk trade

I wouldn't be explaining my approach if I thought it didn't provide value. I think it is important for investors to have a sort of grasp of the logic of my trades. However, accurate descriptions are not feasible here, considering the nature of the investor letter. I have largely ignored explanations on market expectations, historical parallels, and how the market condition influenced the event. Furthermore, I have not described my method of entries or risk management in detail.

Few words on risk

Before I begin gauging some of the events, I feel following issues regarding our risk setting should be clarified, since it has caused some confusion among our investors.

First, the maximum risk per trade is 4% per event. This does not imply I have a pre-set drawdown limit of 4%. I may be wrong three times in a row and therefore occur a 12% drawdown. However, in the past for the 30-month history of the track record, I have had 10 trades with the maximum risk setting, which implies they do not occur frequently (about once every quarter). There's a logical explanation behind this – I only take a major risk if I consider there's a high probability of winning big and such events do not occur frequently.

Second, I have been wrong only once out of 10 trades with maximum risk. This occurred in July 2016, when we experienced a major drawdown. Of note is that I was trading with 8% max risk back then, which has been tuned down to 4% since August 2016. This, of course, in isolation also implies smaller profit expectancy, that was in the past. However, our returns have not been impaired significantly from these adjustments, while the risk-adjusted returns have improved.

Third, the typical risk per event varies between 0.3-1.5%. Thus, the profits and loss expectancy for any given event typically varies from 0.3-1.5% in losses and 0.6%-6% in profits. The top end of the profit expectancy is based on past trades, which still reflects an extremely favourable risk profile.

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Lastly, I use proportional entries to events. If you see 10 trades on a day when there's Non-farm payrolls (NFP), you should look at the risk as a whole, not the risk of individual trades. For instance, if I lost 1.2% on NFP, with 10 trades, this should interpret as one single trade. The leverage for the day may look especially high in your daily statements. However, we have very rarely more than 1:5 leverage on simultaneously. Hopefully, the table below illustrates this more clearly.

H1 2017 Top 5 best and worst-performing trades[4]

EVENT	**P/L before fees**	**Risk**
Bank of Canada Monetary Policy Report 1.17	5,0 %	1,3 %
Reserve Bank of New Zealand Monetary Policy Report 2.17	3,0 %	4,0 %
Riksbank Statement 4.17	2,3 %	1,3 %
Reserve Bank of New Zealand Monetary Policy Report 5.17	1,8 %	3,0 %
BoE Gov. Carney Speech at ECB Forum 6.17	1,8 %	0,8 %
US Non-Farm Payrolls 6.17	-1,1 %	1,3 %
President Trump Inaugural Address 1.17	-1,1 %	1,3 %
Bank of England Monetary Policy Committee Minutes 6.16	-1,2 %	3,0 %
European Central Bank Press Conference 6.17	-1,3 %	1,3 %
US Non-Farm Payrolls 2.17	-1,3 %	1,3 %

[4] The worst and best performing trades are not correct representation of our risk, as the risk is naturally higher than for the average trade.

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Gauging the events

1. Example of initiating positions two ways - 6.17 Bank of England Monetary Policy Committee (BoE MPC) meeting - 1.2% loss with 3% risk limit.

The BoE MPC signalled, against market expectations, that its tolerance of high inflation is eroding and voted 5-3 to hike interest rates. This implied in isolation that the BoE could raise interest rates much sooner than the end of 2019, priced in by the markets. I had prepared "scenarios within scenarios" for this outcome, as I saw multiple possibilities for trades here.

1. The market should interpret this as decisively bullish since the market was pricing interest rate hikes only into 2019. This was a significant deviation from market expectations, which do not occur often. GBP should rise 1.5%-2% with this interpretation, with the initial move being 1% and the market should quite swiftly start continuing a move up.

2. Alternatively, there was a risk that the market could interpret this having no impact, given BoE credibility for signalling higher interest rates was rather low. The ongoing Brexit negotiations, weaker economic outlook and number of dovish decision-makers in the BoE should ensure that interest rates will remain low despite high inflation. If this interpretation was correct, GBP should initially rise 1%, but then start going down slowly and hit break-even by the end of the day.

I had a maximum risk for the scenario of 3% if GBP would go up less than 0.4%. However, the market moved around 0.8%; therefore, the risk was lowered initially to 1.5%. I still thought this kind of scenario could prompt move worth of 1.5-2% (with the leverage at our disposal, I would have been looking for 3-5% gains, with 1.5% risk); therefore the risk-reward was sufficient to initiate a position.

However, as the market did not move as I expected, the positions were exit for a 1% loss.[5] As I exit the positions, I was assuming the market interpretation would turn towards interpretation 2. The risk limit was 1.5% for this scenario as well, so I still had a 0.5% risk left to trade the event (as I had taken a 1% loss). For a while, we were profitable, but the price turned into range, and we exited the trade with a 1.2% loss.

2. Example of fading data - 6.17 US Non-Farm Payrolls - 1.1% loss with 1.3% risk limit.

The NFP came out at 130k M/M with wages at around 0.2% M/M against expectations of 180k, and 0.2% wages.

This trade was based on rather high conviction idea, that even if NFP comes weaker than expected, the market response should remain muted as Fed was bound to hike interest rates regardless of NFP unless

[5] Note I don't hold stops until the full risk is hit. If the price does not behave as I expect, it's a strong signal to get out. I want to isolate those events, where market behaves as I expect per my research and the plan.

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the number was accompanied with weaker wages. However, the risk was lower as I was aware that US data had been lately particularly weak so that the market might sell the dollar anyway.

I thought EURUSD would initial move up around 0.3%-0.5% and then within minutes trade back to break even, to reflect that the data is meaningless. I initiated positions at these levels (1/3 of the position at 0.3%, and 2/3 at 0.5%), assuming that market wouldn't go higher. However, the market promptly continued higher by around 0.7%, and I exit full position at this level for a total of 1.1% loss.

Now we have lost quite a lot with NFPs lately, and some of my theses considering the event may be revisited. Any case, it's the only event for this year which I trade consistently each month, where we are in a total net loss.

3. Example of full risk trade - 2.17 Reserve Bank of New Zealand (RBNZ) Monetary Policy Report 3% return with a 4% risk limit.

Against expectations of signalling a tightening bias[6], the RBNZ maintained a soft easing bias. This signal was extremely unexpected, as, at the very least, the central bank should have signalled a neutral bias. The trade was based on the idea; if the market did not move to the decision by RBNZ to maintain their forward guidance and signal the possibility of rate cuts, we would have a full risk trade here. Thus, I took full risk entries according to this thesis.

In the press conference, the Central Bank Gov. Wheeler contradicted the statement partly and suggested RBNZ had moved to neutral guidance. When central banker's answers to unscripted questions contradict their initial statements, price action can get violent; therefore, it is prudent to take profit to contradicting language. I promptly exited the positions for 0.3% profit (3% profit total, given we had 10x leverage).

However, my interpretation, in the end, was false. The market was already pricing a significant amount of interest hikes – even signalling neutral policy was decisively dovish. NZD moved down over 2% in the following day after this event, which was something I had been anticipating for the bear scenario. In hindsight, it would have been best to hold here at least partially.

6 I.e. that rate hikes would be likely in the future.

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PERFORMANCE IN H1 AND THE WAY FORWARD

Thales was launched to investors on 6.1.2017. Although the risk-adjusted performance on the underlying strategy has been very solid in H1, there have been significant discrepancies with the MAM performances. During H1, the underlying strategy returned over 20% with a drawdown of 3.5%, while the MAMs have struggled at the return of around 10%, even before fees. There were a number of reasons behind the discrepancies.

First, it should be noted that part of the MAMs were launched at the end of January, which was our strongest month. This has caused the LMAX and Varianse MAMs to miss around 7% in performance by itself.

Second, we have missed a few profitable trades on Varianse, due to an issue with our trade copier infrastructure. This led to around 3% weaker performance compared to the underlying account (9% for the 3-risk variant). We have taken the appropriate measures to minimize the risk of missing trades, and such issues shouldn't exist in H2 to a similar degree.

Third, a major part of the discrepancies, seem to stem from the fact that I take several trades during an event, per my risk management rules. The Swissquote MAM has in particular suffered from this. Although this method of trading would be very effective, if the assets are pooled, with the current structure, it can lead to excessive slippage which compounds the discrepancies. As of 7.7, I have revisited this method of entries and found it is possible to reduce the number of entries, possibly significantly with some events. This should, by itself, help converge the performance.

I'm confident that our solutions regarding the discrepancies will work and the performance will converge going into H2.

Outlook

During H1, we went through a period of low volatility. The great thing about trading events is that you don't need markets to be volatile – you just need volatility around events – i.e. that the unexpected happens. Unfortunately, most of the major events turned as expected in H1; therefore, there were fewer profit opportunities. For instance, the ECB was deciding whether to adjust its forward guidance. It did this in a very cautious and telegraphed manner – as expected. The BoE was generally expected to signal that rate hikes are far away – as expected. The FED generally engaged in rate hikes in a gradual and as expected fashion.

However, this all changed during the last week of June, as collectively several G10 central banks started signalling a tightening bias, or that is at least how the market interpreted it. Now, this should be a recipe for volatility in the future. If the market expectations for policy tightening aren't met, there are likely to be violent moves in going into H2. On the other hand, the opposite could happen if there are clear signals for tightening cycles. Now, more volatility does not automatically mean there are more trades – again; the events could be priced efficiently. However, the performance of the strategy has tended to be the best during times of high volatility; therefore, I am optimistic about H2.

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At the time of writing (13.7) we had a bit of a rough start for H2, as we were down initially 2%. We understandably received some feedback from these losses. I want to emphasise that these losses were nothing out of the ordinary. In fact, the current low drawdown of 3.5%, for the past year, likely underestimates the riskiness of the strategy. Swings between 2-5% should be considered normal when we are trying to achieve above-market returns in the longer term.

Now, most funds would like investors to commit for the long term. We are no different in that sense. I think there are reasons to believe that there will continue to be alpha available in trading events. Events have always tended to move markets in quite similar fashion (of course to different signals), but the pricing has never been efficient. As long as these inefficiencies occur from time to time, there will be trades for a strategy like Thales.

Furthermore, I believe that the public and the much more sophisticated traders than us tend to operate under the misperception that the price behaves either randomly or efficiently during the immediate release time. The broader market remains fixated on traditional investment approaches or copying what's hot. I don't expect any swift paradigm changes in this sense.

As ending words, I would like to emphasise that I am fully committed to the strategy. I have currently my entire net worth at risk (apart from daily living expenses) and will continue to have in the future. Like any entrepreneur, I believe going all-in on a venture you have full faith in is the only way to achieve something extraordinary in the long term.

Sincerely,

Aatu Kokkila
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