Finbou Thales –Investor letter H1 2018

Dear investors,

In this investor letter, I will review the performance of Thales in H1, expand on my thinking around event trading and evaluate the outlook going into the rest of 2018. Moreover, I will discuss some changes to our organizational setup.

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PART I – PERFORMANCE ASSESSMENT

The year started immediately with a bang as the ECB signaled with its minutes for an earlier than expected end to quantitative easing, and we were quickly up over 4%. However, the gains were soon capitulated with the BoC Monetary Policy Report and subsequently with ECB Press Conference.

By May, our performance had largely stagnated. We had experienced a near 4% drawdown from the peak in January, which represented the largest drawdown[1] since the strategy has been offered to investors and longest period of stagnation since the strategy has been operational.

Towards the end of the half, two events – 5.18 BoC and 6.18 ECB - effectively ended up salvaging the performance for H1 2018.

H1 2017 Top 3 best and worst performing trades[2]

Event	P/L net of fees	Risk
ECB Press Conference 6.18	6.5 %	1.5 %
ECB Minutes 1.18	3.3 %	0.4 %
BOC Statement 5.18	3.2 %	2.5 %
ECB Press Conference 1.18	-1.1 %	1.5 %
FOMC Statement and Projections 3.18	-1.5 %	1.5 %
BOC Monetary Policy Report 1.18	-1.7 %	2.5%

As a result, we managed to return respectably above any benchmarks[3]. In risk-adjusted terms, the performance remained overall solid but failed to correspond to the past (Chart 1).

[1] Some accounts were hit by an even larger drawdown. Unfortunately, many accounts are subject to broker specific factors. Moreover, we didn't manage to decrease the amount of trades as fast as we wanted, therefore divergence ballooned on some accounts.
[2] The worst and best performing trades are not correct representation of our risk. Average risk on 2018 was 0.3%.
[3] There's a question whether there exists a proper benchmark for us. The strategy does not quite strictly fit into any classification for hedge funds.

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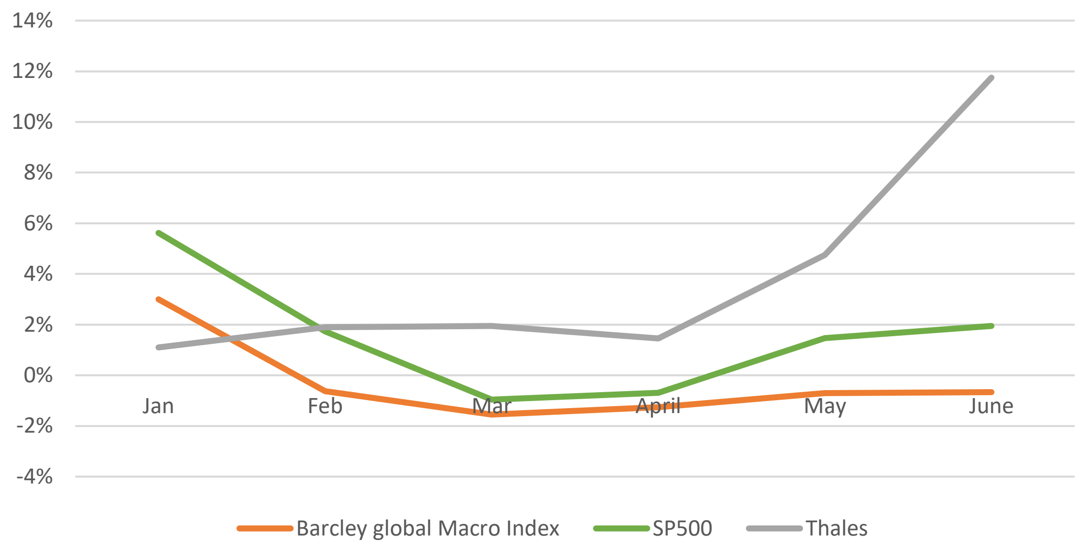
Volatility in equity markets and FX markets has risen this year, but around events, it has dried down or when there has been volatility, the events have been broadly priced correctly. This has been a function of most decisions coming in line with expectations. Now, in H2 2017 even as expected decisions triggered undue volatility, but this has not been the case anymore in H1 2018 to a certain extent.

Chart1; Thales performance vs. benchmarks



The market environment is always going to influence returns to some extent. However, lack of performance can also be attributed to my being wrong more often than before with my analysis which has translated to i. undercapitalization of opportunities ii. more losses. I'll discuss the former partially on part II, and the latter in part III.

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PART II – EXPANDING THINKING ON THE APPROACH

I would argue trading events comes down to the raw ability to interpret information better than other market participants. The beauty of event trading is that after the information is issued, everyone is operating with the same information. You are not naked in the dark expecting fortune to guide you to the light. While randomness is still an important factor to a certain extent, I believe there are a few segments in the marketplace where competition is so democratic. Everyone is looking to price the value of information better than others. Naturally, the pricing process is bound to trigger inefficiencies as the information must be interpreted within a number of seconds to minutes, and pricing often is complicated by interaction with multiple other market drivers as well.

When trading FX related events, the overall goal is to understand the implications changes in central bank communication or data have on the future direction of interest rates. However, as in Keynesian beauty contest[4], we are not predicting what implications data, or the central bank communication have on the future direction of interest rates, but how other participants interpret the impact. This is a crucial distinction. It is easy to draw arbitrary opinions, which make sense from an economic standpoint on where the market should pay attention. But with such a dogmatic approach, you get annihilated quite quickly.

Given the extent of interpretation having an impact on results, I feel like it's time to expand my thinking on the topic. I have selected a trade example from H1 as a tool for demonstration.

Trade example – Riksbank Monetary Policy Decision 26.4.18

As a background, the Swedish economy has enjoyed strong economic fundamentals for a long time, with rapid growth, but low inflation. It has meant that the central bank has kept interest rate low for a long time. Many participants have been consistently forecasting, a stronger SEK, on the basis that ultimately the strong growth and housing markets will feed through to higher inflation and result in higher interest rates. However, higher inflation never materialized, and the Riksbank has kept monetary policy ultraloose (Chart 2.1). Consequently, SEK has remained one of the weakest G10 currencies in the world, despite Sweden being one of the strongest developed economies growth wise (Chart 2.2).

On 4.18 the Riksbank communicated in line with market expectations that interest rate rises would be postponed. SEK had weakened already markedly[5] before the announcement as market expectations had generally converged for lower inflation in Sweden and overall later interest rate rises than what was priced in earlier towards the start of the year (Chart 2.3). This depreciation had been rapid by FX standards.

[4] https://en.wikipedia.org/wiki/Keynesian_beauty_contest
[5] Weaker house prices also contributed to weaker SEK in 2017.

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Chart2: Weekly EURSEK

The Riksbank stance regarding the currency weakening was unclear going into the report – they had previously communicated they expect Krona to strengthen. This time, they repeated this, but they also communicated "It is important that the krona exchange rate develops in a way compatible with inflation stabilizing close to the target."

The correct interpretation in context here was that in a market where SEK had rapidly depreciated, the line indicates bank may actually favor SEK depreciation, *as inflation had been unexpectedly weak*. This, in turn, implies interest rates do not need to raise, even if currency depreciates.

In terms of market reaction, Krone initially moved lower slightly and almost immediately pared some of the losses to the fully priced in the decision to postpone interest rates rises (Chart 3.2). Then it started gradually depreciating (3.3). Ultimately the SEK crashed, in relative terms, weakening gradually over 3% during the subsequent days, which can be considered a large move in short period of time considering current market condition (3.4). The risk-reward on the bet was astronomical for those that were smart enough.

I hadn't anticipated the language, nor thought it would have an impact (although I should have given my extensive knowledge of historical precedents). Hence I traded it with low risk and was actually shorting USDSEK as I perceived the move exxageration. I realized the correct angle only when it was too late. Later it was indeed clarified by Riksbank, that they didn't mean they want SEK to depreciate – perhaps indeed because SEK entered free fall. But that is beside the point. When central bank issues such communication, speculators need to price in ambiguity and it's their interpretation that counts.

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Chart3; One-minute SEK chart during the event

Conclusion

The beauty of this kind of trading lies in its risk-reward. After the first couple of minutes, one can implement a bet, even if he is wrong, with extremely tight stops and time profitability. If the market doesn't start responding the right way, the worst case is you are flat or lose a little.

Even if I didn't trade it correctly, I believe it makes a terrific example on importance skill in interpretation during trading. Hence, performance will also vary due to my skill in recognizing opportunities. It also solidifies the case how the context regarding recent market developments matters and makes nearly every central bank event a case-by-case affair. This makes it particularly difficult for algorithms to price language related trades based on big data.

Now, one could argue, it is easy to explain the event in hindsight, but that is beside the point. I have been successful in identifying such opportunities in the past; I simply selected to show an example where I got outplayed. Goes without saying this kind of opportunities do not occur often. Missing this one contributed to weaker performance in the quarter.

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PART III – OUTLOOK

Trying to anticipate the drivers based on the past is an exercise in the realm of prediction, where despite the name of our company perhaps indicating so, I don't really excel. The start of the year wasn't exactly slow - as I predicted in the previous investor letter - although things did indeed quiet down a bit later, until June.

So, this time I'd rather not make predictions. At the time of writing, the start of the second half has been sluggish, but historically central banks tend to become more active toward the end of the year. Hence it doesn't seem unreasonable to assume we will see more action during the second half.

Adjustment going into H2 and performance expectation

I have recalibrated the risk lower for some events as result of H1 performance. For example, the probabilities of winning for risk class 3[6] events have declined, and certain lower risk trades have not worked as well as before. I'll adjust the risk higher if we start getting evidence the trades work well again.

I have continued working on changing my entry methodology for several months, and I am near finished with the process (it takes a lot of work as in conjunction I am preparing the trades and constantly looking to improve on other areas as well). Do not be surprised if in the future, some months volumes are a fraction of what they used to be. This will be a positive development in a sense discrepancy should disappear and capacity increase significantly. Mind you if I only traded the higher risk events, I would trade awfully rarely - only a few times a quarter - yet the discrepancies would be non-existent and returns still solid.

I am not going to adjust the risk for highest risk events (RC4-RC5)[7] since they worked well and should continue to do so. While this might sound both heretical and monumentally arrogant to the efficient market aficionados, I firmly believe - with rigorous analysis conditional on the ex-post market reaction - it is possible to identify instances which exhibit near free lunch type of characteristics. I am confident, we will continue to have bouts of stronger performance if we remain patient.

I am expecting that the strategy should be able to produce somewhere around 15-40 % yearly returns (1x risk) depending on market conditions and my ability to capitalize on opportunities while maintaining moderate drawdown below 5%.

[6] *See* H2 2017 investor letter for explanation on risk classes https://www.finbou.com/investor-letters

[7] While on balance, this should imply the strategy is riskier, it's more a question about probabilities of winning. The past probabilities of winning are very high at 90% and due to utilisation of methods such as time stops, the probability of above 60% drawdown stands at only 5% with full risk at 3%.

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Concluding remarks

I have moved to manage the strategy from a different regulatory structure, to accommodate higher assets under management. As a result, I will no longer be employed by Prediction GmbH (Finbou) as of the end of July 2018. The partnership between Thales and Finbou will be there on forward similar to the one with Stoletov and Fermi. Goes without saying that the strategy remains exactly the same as before, apart from the adjustments outlined in the previous page.

Now, the assets under management of the strategy have risen considerably. But judging from execution during July and August, the impact looks minimal (or even positive) given the changes to the entry methodology. Were there any AUM related discrepancies we would inform you immediately.

Thanks to all our investors who have rightly taken a long-term view on the strategy and stayed onboard through the recent bumps and wiggles. I am looking forward to producing a performance worth your trust in H2.

Sincerely,
Aatu Kokkila

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