Finbou Thales - Investor Letter H2 2019

Dear investors,

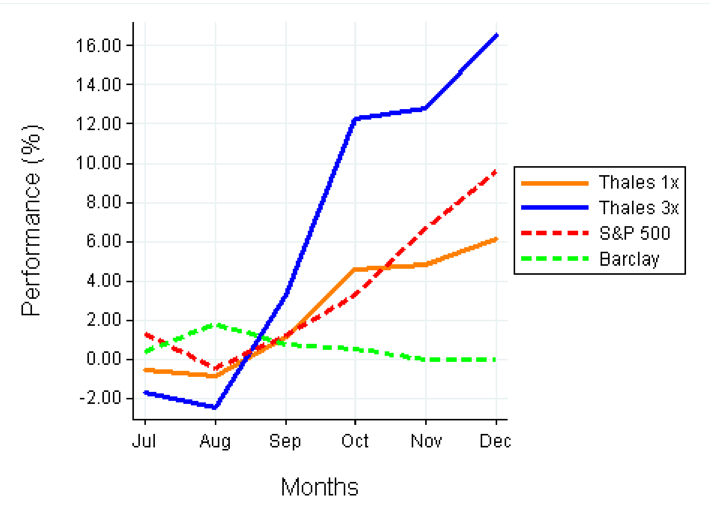
The strategy 1x (3x) ended H2 2019 up 5.1% (15.2%) net of fees. In this letter, I will provide an overview of H2 and discuss the prospects going into 2020.

Overview of H2

FX markets remain in deep hibernation. Overall, most major currencies ended the year close to where they started against the USD, as Fed rate cuts were counterbalanced by corresponding easing measures from national central banks. Moreover, the tentative trade truce between the US and China led to an expectation for pick up in the manufacturing sector, which also helped to suppress volatility. Finally, the Brexit saga reached an interim conclusion, as the conservatives gained a majority in parliament and reduced at least some of the near-term uncertainty over the Brexit process.[1]

Consequently, the factors mentioned above acted as positive catalysts for risky assets, with equities posting the best gains since 2013. Many global macro strategies continue to suffer from low volatility across most asset classes, and we are no different, with our 1x variant struggling to match historical gains.

Figure 1: Thales performance against the S&P 500 and the Barclay Macro Global Index



[1] The shape of the EU-UK trade deal will ultimately be the key driver for the valuation of pound and the government has set a strict deadline for the negotiations, which suggests at face value that uncertainty remains entrenched. However, the deadline is self-imposed, hence likely subject to adjustment to prevent cliff-edge scenario. Overall there is significantly more clarity about the path of Brexit compared to first half of 2019, which is a very favourable development for the strategy overall as it should lead to more focus around the central bank and UK economic data.

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The moderate performance pick up can be explained by the following factors:

1. While volatility remained particularly subdued, most of it was event-related. There were a few unexpected and volatile events that we capitalized very well (see *Table 1*).
2. With the recent conservative majority in the UK elections, the pound became a tradeable instrument again. The latest BOE decision was the first time we were profitable trading the pound for the past 18 months or so, not actually as if we tried to trade it much, but because we had broadly ignored the currency since it had been almost purely driven by Brexit negotiations related headlines.
3. During the first quarter of the year, we had observed a pattern where events got priced out faster; hence we started taking profits earlier. Regardless, against mounting contradicting evidence, we continued to take views expecting that we would get compensated ultimately by one or two big winners as it happened in the past. However, during the last half, we decreased the holding period for some positions from days to intraday[2] only, which had a marked positive impact on performance. In the spirit of John Maynard Keynes – it is not the generation of new ideas that are so hard but getting rid of the old ones.

Table 1; H2 2019 Top 3 best and worst-performing trades 1x[3]

Event	P/L net of fees	Risk
European Central Bank meeting 9.19	3 %	0.8 %
Bank of Canada meeting 10.19	2 %	1 %
Bank of England meeting 12.19	1.5 %	0.5 %
Sveriges Riksbank meeting 10.19	-0.6 %	1%
Sveriges Riksbank meeting 7.19	-0.7 %	0.8%
Bank of Canada meeting 9.19	-0.8 %	0.8%

Despite some recovery in performance, there is room for improvement in cutting our losses. One important pattern has been continued underperformance trading the Scandies. Since October, we have decreased the risk with them.

[2] From a few hours up to 12 hrs. Previously we had held some positions for much longer than that. Moreover, we don't exclude holding positions into the future, but it should happen much less frequently than in the past.
[3] The worst and best performing trades are not a correct representation of our average risk. Average risk per trade in 2019 was 0.2%. Average risk per monetary policy event was 0.3%, down from 0.6% in 2017, reflecting the low volatility environment.

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2020 prospects

The turn of the year is typically a busy time for investment professionals publishing their economic outlooks and forecasts. Philip Tetlock, a psychologist at the University of Pennsylvania, explored expert predictions for future economic and political events (and trends) in his landmark study *Expert Political Judgement: How good it is?* In over 80.000 predictions that he gathered, the overarching conclusion was that when it comes to predicting future, experts are not more accurate than monkeys throwing darts at a board with the answers.

It is hardly the experts' fault; it is just that the world is quite complex and unpredictable. One may deeply consider the second order effects and still be wrong on the n^{th} order.[4] So instead of making predictions about the future outlook (especially about the state of volatility), we engage in a brief thought exercise under the condition that current, extremely low volatility conditions prevail, or the situation turns even worse.

After all, there's an old, worn out, adage that when you assume things can't get worse, they will. We went through history, and while the current low volatility period is exceptional, the long duration is not entirely unprecedented. In the late 1970s, there was another entrenched low volatility period, with the important similarity being that major central banks had a policy on hold.[5] Therefore, a key question going into 2020 and beyond is if the a priori benign global outlook is set to continue - with central banks on hold - how may the strategy continue to perform under such circumstances.

Fortunately for us, market movements are not caused by actual interest rate decisions, but language changes that shape the expectations regarding the future interest rates paths. Some decisions are indeed more market-moving than others, especially the ones on quantitative easing, but equally surprising decisions that move expectations of future interest rates decisions can be very market moving as well. For example, the decisions by the Federal reserve during H1 2019 packed a larger punch for markets, than the actual rate cut decisions during H2, as in the former period the "surprise factor" was not priced in, while in the latter period the market had come to expect the rate moves fully.

As such, we like to think that it is not as big of a deal, if all central banks are on hold or, in other words, it will simply be more of the same in terms of volatility implications. Ultimately, as long as expectations fluctuate, we should have some opportunities. And, historically on an annual basis, each year there have been at least a few larger opportunities. We doubt 2020 will be any different in that regard. The one thing we are confident is on the persistence of our edge, and we haven't seen any evidence that it has diminished, rather the contrary.

[4] The concept of second order thinking was popularized by Howard Marks in his acclaimed book 'The Most Important Thing Illuminated: Uncommon Sense for the Thoughtful Investor' (Columbia Business School Publishing), 2013.
[5] At the time of previous letter, we studied only a 30-year period, because we thought the parallels to older than that would be rather inaccurate given monetary policy principles were quite different and inflation – not lack of – was the problem of the times.

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Discussion on our edge

There's a deeply ingrained academic paradigm that markets are priced efficiently around events. Most of the price deviations from the "true" value that is derived from the new sources of information are considered noise or a random walk. As a result, there is little research on strictly post-event price formation. Most of the historical research has focused on market anomalies[6] and well-documented post-earnings announcement drift phenomena[7] in equity markets. Hence, because the public is not aware of these inefficiencies, post-event trading is a fertile ground for superstitions and anomalies, as anything else that is poorly understood.

Compared to the theory on efficient pricing, we see the post-event price formation more like a process where a number of market participants compete, and those most capable of interpreting the value of information is going to profit at the expense of others. It is a zero-sum-game engaged by professionals in its nature. The lack of public understanding also means that it has not led to a proliferation of investment strategies around it.

The most sophisticated approach employed by the competition is probably one chosen by systematic traders, who use machine learning models to assess the importance of language changes or data and then aim to predict the subsequent market reactions based on relative historical importance. For example, one could use a model to scour thousands of events for certain language changes and assess their market impact – if similar changes occur now, in principle, we should expect similar market reactions as in the past.

However, we would argue, of those events, only a few offer predictive value, because they do not share enough similarities in terms of expectations and market context. The potential impact of language change always depends on the *context* and current *expectations.* And knowing what the market expects is notoriously difficult. Typically, simple parameters such as interest rate expectations are reflected in the forward pricing curve or employment change in the economist's polled expectations. But when it comes to more complex parameters, such as the details of a quantitative easing program or nuances regarding forward guidance, the consensus' expectations are much more difficult to obtain.

We'd argue the competition is approaching trading events from the wrong angle and lacks the tools to evaluate events appropriately, therefore there is alpha for us to make. Few funds, including us, have researched events price action case-by-case in a systematized way and built a scenario-based strategy around future events, because it is very unconventional, labour some and counterintuitive. Being unconventional is hot but failing in an unconventional way is generally not so this creates a prisoner's dilemma where nobody really goes for the unconventional apart from some very niche players like ourselves.

[6] https://en.wikipedia.org/wiki/Market_anomaly#List_of_Anomalies_Documented_in_Academic_Journals

[7] https://en.wikipedia.org/wiki/Post-earnings-announcement_drift

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Conclusion

Equity-based strategies insist on assessing their performance based on their long-term performance, which can be several years depending on the definition. This is another way to insure against sudden redemptions, during times of underperformance. We are different in that regard, as we believe on an annual basis, we will have enough opportunities to provide solid risk-adjusted performance.

In that regard 2019 was no different, although the situation looked particularly difficult in September. Overall our 1x strategy overperformed peers in H2 and 3x strategy kept up quite well with SP500 throughout 2019. The performance comes with lower risk than our benchmarks and in a market that continues to be, arguably, the most challenging for FX traders in decades.

We feel we are in a good spot offering different risk products depending on investor's risk appetite, even if these low volatility conditions persist. We remain confident about the persistence of our edge due to its unconventionality and the fact that post-event price formation remains poorly understood. To quote the Berkshire legend Charlie Munger, just as animals flourish in a niche, it is possible for people who specialize in a narrow area to thrive.

Sincerely,

Aatu Kokkila

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