*Finbou Thales - Investor Letter H2 2017*

Dear investors,

In this second investor letter, I will review the performance of Thales in H2, the evolution of the strategy in 2017, and evaluate the outlook going into 2018. Those unfamiliar with the theory and technicalities of the strategy should get acquainted with the H1 investor letter.

**PERFORMANCE IN 2017 AND THE EVOLUTION OF THALES**

During H2, the underlying strategy returned over 20% with a drawdown of 2.5% before fees. The return before fees for the whole year is over 40% with 3%[1] drawdown. Past 5 months the strategy has returned near 20% with below 1% drawdown. I use the before fees metric here solely because there are some discrepancies between MAMs mainly due to issues encountered in H1.

As demonstrated in the previous letter, the strategy does not need volatility – only volatility around events. Ironically most of the events turned out as expected in H2, but there was still sufficient volatility to make profits as markets struggled to price them correctly. On balance, the volatility around events has not been nearly at the levels of 2014, 2015 or 2016. Regardless our risk-adjusted performance has never been better. This reflects improvements in two important areas of the strategy.

*Increased number of tradable scenarios and events*

I have significantly increased the number of events and scenarios we can trade compared to previous years. This has dispersed risk and lead to smoother performance. There were in total around 100 tradeable[2] events in 2017, compared to around 40 in both 2015 and 60 in 2016. This is mainly because I keep constantly researching new events as well.

If the returns are sustained, I expect at a stage; we will also move to trade other markets such as commodities, which would further disperse risk, smoothen returns and ultimately increase capacity. I have already monitored the oil inventories data and similar underlying principles that I use for trading data events apply.

*Risk management*

Since Q4 2016, I have used a risk categorisation approach to trade events. I divide events into five risk classes (RC). Following is a non-exhaustive list of qualities I use for defining the RC for a given event.

- *Risk class 1-2;* Not necessarily pre-determined, but based on overshoots or undershoots in data, patterns, market condition and past high probability of winning or asymmetric risk profile.

[1] Corrected from previous investor letter which indicated a 3.5% DD.
[2] Regarding tradability, I followed probably over 200 events (including news data pieces), so there has been trade with around 50%. There are of course many more events in G10, which are not worth following because the market does not care about them.



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- *Risk class 3-5:* Only strictly pre-determined signals, with strict evidence of mispricing in terms of fundamental impact, parallel, market condition, past high probability of winning with equivalent signals and asymmetric risk profile.

I acknowledge, there's a discretionary element involved in comparing events to the past signals (confirmation bias). However, higher RC signals have several elements that are designed to mitigate such biases. The downside is that given the discretionary element being minimal, they occur less frequently.

*Categories*

1. Risk class1 (0.3%); Risk varies from 0.1% to up to 0.3%; Leverage limit 1:2. Approx. 55% of events. Approx. return 6% in 2017.
2. Risk class2 (0.8%):  Risk varies from 0.3% to up to 0.8%; Leverage limit 1:2-4. Approx. 30% of events. Approx. return 8% in 2017.
3. Risk class3 (1.5%): Risk varies from 0.8% to 1.5%. Leverage limit 1:4-6. Approx. 15% of events. Approx. return 15% in 2017.
4. Risk class4 (2.5%): Risk varies from 1.5% to 2.5%. Leverage limit 1:6-8. Approx. 7% of events. Approx. return 6% in 2017.
5. Risk class5 (4%): Risk varies from 2.5% to 4%. Leverage limit 1:6-10. Approx. 3% of events. Approx. return 8% in 2017.

One of the key elements of the strategy is that you never know if there's going to be a trade. The RC is, therefore, always contingent on the market move and shifts dynamically during the trade. I may per se determine a signal Risk Class 5 in terms of fundamental impact, but if the market prices it correctly and moves over a certain area, the RC and therefore risk, shift dynamically. After a certain threshold, the event may not be tradeable at all. This makes sense, as sometimes the market does get the pricing right.

For instance, if there was a pre-determined fundamental signal with a major impact on markets, I might determine that the entry area for full risk is at below 0.6% move. If the market moved over that threshold, the Risk Class would be dynamically lower, e.g. RC4 with 0.8% move and after a certain move, say 1.2%, the trade would translate into a no-trade.  I could still enter if there was a retrace to the "inefficient area", depending on the asymmetric risk profile of the trade.

*Results and outlook*

On balance, these changes have led to less volatility, but much smoother performance. I am happy sacrificing high absolute returns in order to make the best risk-adjusted returns possible. For instance, in 2017, the max loss per event was 1.4%., while in 2016, the max loss was 6.7%.[3] The max profit per trade was 5% in 2017 (but we had several winners in the 2.5%-4% range), compared to 9% in 2016.

While in H1, I still claimed that the changes hadn't had any impact on returns, I have to backtrack on that claim, since I certainly do not expect similar returns as in 2015 anymore. For those who chase higher absolute returns, we offer higher-risk options.

3 As of August 2016, I reduced the max risk per event from 8% to 4%. Max leverage was also reduced from 1:15 to 1:10 in H2 2017.



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As you can decipher from the risk categorisation approach, abrupt drawdowns are relatively unlikely – but of course not impossible. Such instances are mainly related to Risk Class 4-5 signals. Regardless, I want to retain flexibility with them. One of the key elements of the strategy is that I take the market as given and never know when an opportunity presents itself. Therefore, it's prudent not to impose yourself too many artificial restrictions and remain patient like a leopard waiting for its prey.

*Capacity*

We have solved most of the discrepancies which were covered in the very first investor letter, and investor returns have converged with the underlying account. We cannot, however, fully converge the returns as there will always be broker-specific issues we have little influence on. In order to completely solve the divergence, we would have to pool the assets on a single broker, which is out of scope in the very near term. Updating our IT infrastructure is also due, which we will work on Q1.

To ensure capacity for the future, I will further work on reducing the overall trading volumes (which have already decreased during the past 2 months). For now, with some RC1 trades, I have allowed myself to enter in and out of the market until I am satisfied with the entry level of positions or we lose the pre-defined max risk (0.1%-0.3%). This has sometimes translated to over 20+ positions on a given event (with maximum 2-3 on simultaneously), as I constantly jump in and out of the market in order to optimise the entry and ensure losses stay small.

This kind of trading has generated some value in the past, but perhaps not so much with higher AUMs and especially when trading illiquid currencies. I won't fully omit such trades, as there's a time and place for multi-entry event trading with higher RC trades, such as during press conferences to mitigate risk. However, in terms of RC1 signals, the net return is probably very low so that I might discard part of them altogether.

## ASSESSING H2 TRADES

The BoE, BoC and ECB decisions provided sufficient volatility to generate solid performance during the second half. While the ECB and BoE decisions still turned out broadly as expected, the market struggled to price them correctly. The rest of the G10 central bank decisions were relatively anticlimactic, but there were smaller inefficiencies that could be exploited. However, I struggled to get the Riksbank and Norges bank right.

The Bank of Canada has been by far the most interesting central bank event for the year. Initially, the unexpected erosion in spare capacity forced the BoC to raise interest rates, but then the faster than expected slowdown and relatively predictable appreciation of CAD forced them to backtrack from rate rises that were already priced in the market. We managed to profit from these opportunities both ways, while the CAD is currently trading broadly flat for H2.



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*H2 2017 Top 5 best and worst performing trades*[4]

| **EVENT** | **P/L before fees** | **Risk** |
|---|---|---|
| Bank of Canada Monetary Policy Report 7.17 | 4,5 % | 0.6 % |
| Bank of England Quarterly Inflation Report 11.17 | 3,5 % | 1,0 % |
| ECB Press Conference 10.17 | 3 % | 1,5 % |
| Bank of Canada Monetary Policy Report 10.17 | 2.8 % | 2 % |
| Norges Bank Monetary Policy Report 9.17 | 1,5 % | 0,6 % |
| US Non-Farm Payrolls 11.17 | -0.5 % | 0.8 % |
| Bank of England Quarterly Inflation Report 8.17 | -0.6 % | 0.8 % |
| ECB Gov. Draghi Speech at Jackson Hole 8.17 | -0.6 % | 0.8 % |
| Norges Bank Monetary Policy Report 12.17 | -0.8 % | 1.5 % |
| Riksbank Monetary Policy Report 7.17 | -1,4 % | 1,5 % |

## OUTLOOK AND THEMES GOING INTO 2018

As always, it is difficult to predict whether the year 2018 will be interesting monetary policy-wise or not, since its typically the unexpected that makes monetary policy interesting and exposes opportunities. However, we can make an educated guess, that if global growth stays stable as in 2017, there will be certain themes which are near guaranteed to produce opportunities going into 2018.

- Fed hiking cycle according to dots or pricing (Q1-Q4)?
- BOC hiking cycle to continue at a slower pace (Q1-Q4)?
- BoE after the transitional deal is agreed or not agreed (Q2-Q4)?
- Both Scandinavian banks still moving in conjunction with ECB or going separate ways (Q2-Q4)?
- ECB deciding on whether to finish QE or not (Q3-Q4)?
- BOJ finally scaling back APP (Q3-Q4)?

[4] The worst and best performing trades are not correct representation of our risk, as the risk is significantly higher than on average. Average risk on 2017 was 0.6%, while median is around 0.3%.



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- Antipodeans (RBNZ/RBA) finally putting feet off the breaks and beginning to raise interest rates (Q3-Q4)?

As you can probably deduce the start of the year could be slow as these themes are not expected to materialise during the first quarter. I can also freely admit I haven't been good in anticipating the signals in the past, so probably this is of little predictive value. Regardless of what happens with monetary policy, we have in the past managed to make a quite steady profit by trading economic data pieces. This is something I am looking forward to improving further going into 2018.

There's every reason to remain optimistic that high risk-adjusted returns will be achievable in 2018. There have been very little changes in the way the market prices events or data in H2 and the very same rules I use for pricing events apply. This is also why I think a yearly investor letter should be enough for now.

I'm not advocating total radio silence. Were we do encounter an abrupt drawdown, say 5%, rest assured I would communicate and keep you on top of it. However, if we sail relatively smoothly as in 2017, I see little need for constant communication. All the information about the basics of the strategy is laid down on Finbou website and these two investor letters.

I will continue to have my full net worth invested with the strategy. I guess I don't need to repeat this with the following investor letters – this won't change unless I stop believing in the strategy and then we would be certain to close the shop anyway. However, I am quite young and intend to do this for a long time. There are few things in life where you can experience a sort of intellectual satisfaction as seeing your analysis work and being right in the market place.

Sincerely,

Aatu Kokkila
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