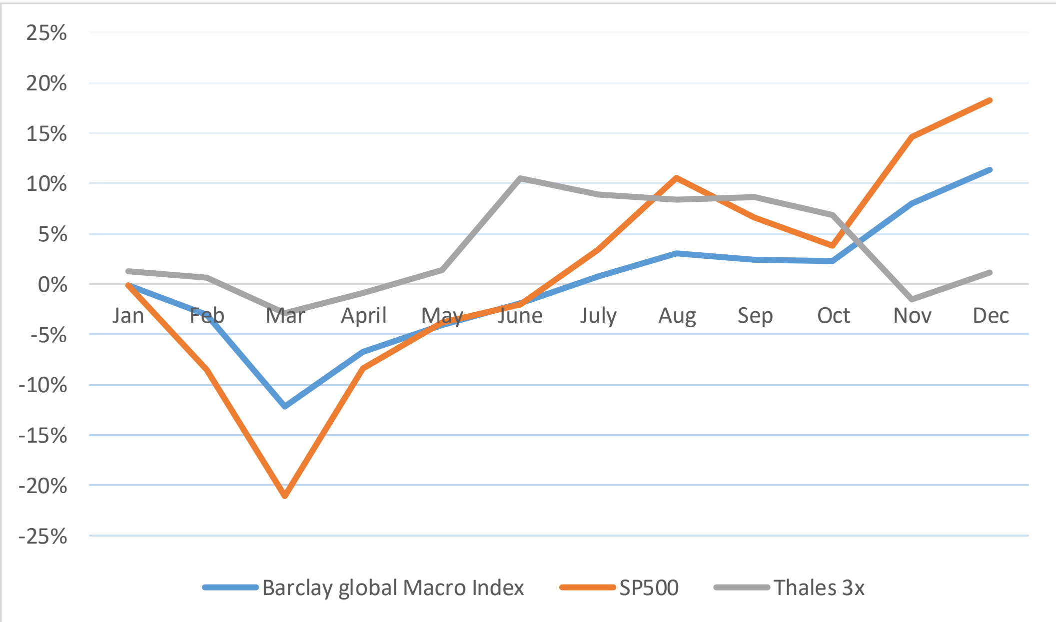
Finbou Asset Management

Finbou Thales - Investor Letter H2 2020

Dear investors,

The strategy ended the year roughly flat net of fees for both the 1x and 3x variant. This represents a meaningful underperformance compared to our benchmarks, Barclay Global Macro, which is up 10.81%, and the SP500, up 20,30%. In this letter, we will gauge the reasons for underperformance and outline the outlook. Performance for the year was quite volatile. Overall since the launch in 2017, our performance remains significantly above benchmarks in both risk-adjusted and absolute return terms for Thales 3x.

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



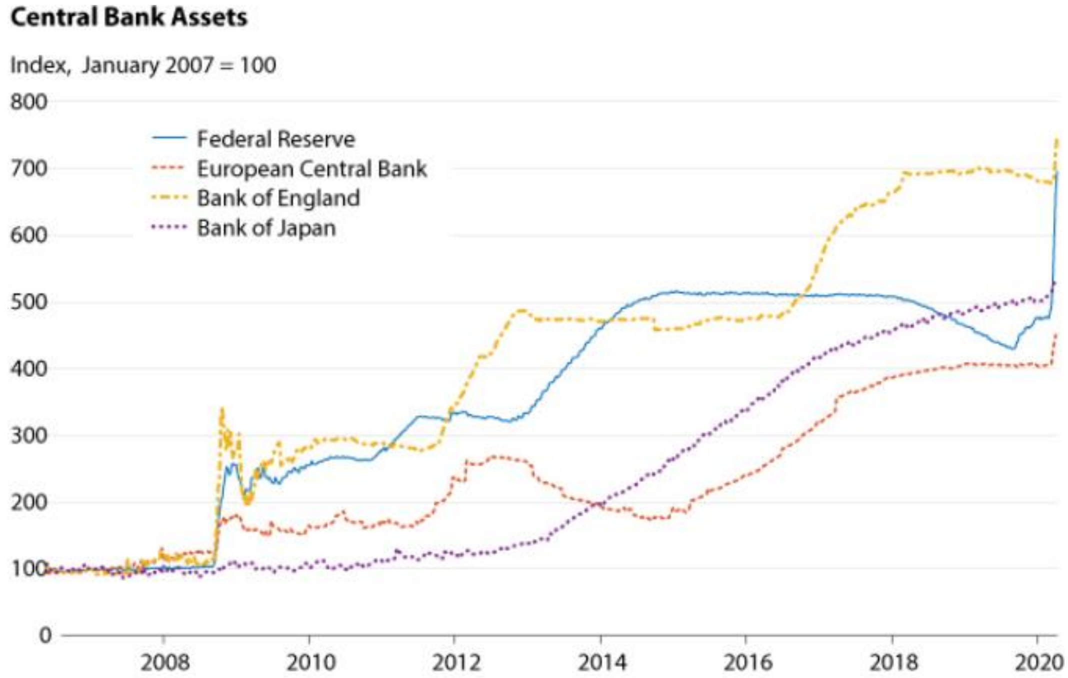
Stimulus triggered boom

While the real economy has continued to weaken, the second half of the year was characterized by a boom in the stock markets, cryptocurrencies, and precious metals. The second wave of coronavirus has proven to be worse than expected. Still, the market has chosen to look through the developments given the record amount of stimulus and the positive news regarding a vaccine in November.

Perhaps the most important driver behind the rally is the unprecedented money creation that central banks have engaged in since the crisis began (Fig 2). On top of that, interest rates are pinned at rock bottom levels for the foreseeable future. Although inflation expectations remain subdued, this is likely to generate inflation over time unless there are abrupt stimulus changes. In particular, the Fed has increased its balance sheet with larger volumes than ever before, causing the dollar to depreciate and alternative assets to rally.

Finbou AG, Freiestrasse 34, 8800 Thalwil, Switzerland, +41 79 418 37 03, g.carolo@finbou.com.
Company number: CHE-162.519.027, LEI: 8945005TPI7VHWYOOH55 Regulated by "PolyReg Allg. Selbstregulierungs-Verein".

Figure2; Central bank balance sheet expansion



Source; Bloomberg

Performance across jurisdictions has been very variable. European stocks have grossly underperformed alongside with value stocks. On average, both have produced similar returns to our strategy, with significantly higher volatility in performance.

Assessing the second half

Despite heavily overperforming markets and competition in the first half, the second half was the weakest half since launch. What gives? Although volatility had increased, most events came in line with expectations, triggering choppier market reactions. Positive performance is inevitably linked to events causing either mean reverting or momentum type of responses. If events cause choppiness instead, we tend to perform weaker.

Another reason was our risk-taking, which could have been better and where we have recently worked on improvements. Since we have covered how deviations affect performance in previous letters[1], we will discuss our approach to risk-taking more on this letter and outline the improvements.

[1] See Investor Letter for H1 2017 page 1, available at https://www.finbou.com/investorletters

Finbou AG, Freiestrasse 34, 8800 Thalwil, Switzerland, +41 79 418 37 03, g.carolo@finbou.com.
Company number: CHE-162.519.027, LEI: 8945005TPI7VHWYOOH55 Regulated by “PolyReg Allg. Selbstregulierungs-Verein”.

Risk classes

We usually would refrain from such technical explanations, but one has an obligation to reveal what is going on behind the curtain during times of poor performance. The current risk classes are illustrated below for Thales 1x (note the 3x variant is multiplied three times).

We have conducted improvements and adjustments throughout the strategy's lifeline to the risk classes, but the overarching principles have stayed the same. The risk limits are contingent on the past probability of winning with equivalent risk class events. For example, the historical probability of winning with risk class 1 events stands at 33%[2] and for risk class 4 events roughly at 90%.

Table 1; Risk classes for Thales 1x

Classification	Risk Variation	Leverage	Frequency
Risk class #1 (0.3%)	**0.05% – 0.3%**	**1:2**	**60/100**
Risk class #2 (0.8%)	**0.3% – 0.8%**	**1:4**	**30/100**
Risk class #3 (1.5%)	**0.8% – 1.5%**	**1:6**	**10/100**
Risk class #4 (2.5%)	**1.5% – 2.5%**	**1:8**	**4/100**

Trade example

The risk management methodology is best illustrated by way of a trade example. In *figure 3*, you can find a five-minute timeframe of the Federal Reserve decision in December. The first blue arrows constitute a single trade idea (EURUSD long) and three positions with a stop loss of 7 pips and 0.5 leverage of account size per position. The cash at risk is, therefore;

Cash at risk on a single trade idea = leverage x positions x stop loss

Which, in this case, is roughly 0.1%. These trades get stopped out as EURUSD moves down. Afterwards, we re-enter new trades gradually 20 minutes later, and these positions become profitable without hitting the stop loss.

If the first trades are not profitable, we might enter a number of trades until the risk limit is breached, assuming we believe the trade idea is still intact. In this trade, the maximum risk was 0.8% (risk class 2). Therefore we had plenty of leeway for a re-entry, despite the first positions did not work out.

[2] The reason we trade risk-class 1 events, is asymmetric skew. While we tend to lose more often, our winners compensate for the losers.

Finbou AG, Freiestrasse 34, 8800 Thalwil, Switzerland, +41 79 418 37 03, g.carolo@finbou.com.
Company number: CHE-162.519.027, LEI: 8945005TPI7VHWYOOH55 Regulated by “PolyReg Allg. Selbstregulierungs-Verein”.

We enter multiple positions because else we would receive weaker execution and risk getting slippage. This methodology ensures that our positions do not move markets, and we get the best possible execution. It also allows us to adjust if we get executed at inferior entry levels.

Figure 3; 5-min EURUSD chart of FED decision 16.12.2020

Improvements

This risk management methodology's upside is that our stop losses are seldom breached, which allows the deployment of higher leverage. When we are right, we are right big, and the procedure gives us leeway to re-position if initial positions do not work. In the *Fig 3* example, if we refrained from positioning the second time, we would not have made money and lost -0,1% (1x). Alternatively, if we used a simple hard stop loss of up to 35 pip with our maximum risk, we would have lost up to -0,8%. Instead, we made 2% with that trade.

If we need to re-position, the downside is that we may enter at worse levels than before and incur higher transaction costs. In circumstances where we have to re-enter multiple times as there is risk left, the adverse effects tend to compound.

In the past, we have tried several solutions to work on this problem, such as bluntly decreasing the overall number of trades to an arbitrary limit. Although simple and elegant solutions to complex problems are often the best modus operandi, we found this led to subpar results as we also missed opportunities.

To improve, we recently posed the question of the right number of trades per event and conducted a study on the subject. To answer the question, we revisited the evidence from the past two years (2019-2020) and concluded that we should not take more than a maximum of four trades per event, which can mean 10-40 positions in total. You can find the results of the study below.

Table 2; Optimal amount of trades per event (gross returns Thales 1x)

Year	1 Trade	2 Trades	3 Trades	4 Trades	5 Trades	x Trades
2020	**0,8 %**	**4,1 %**	**5,2 %**	**5,6 %**	**4,8 %**	**2,5 %**
2019	**4,3 %**	**7,7 %**	**9,1 %**	**11,2 %**	**10,3 %**	**7,8 %**

The performance for 2019-2020 would have improved considerably had the position taking rules been in place. Furthermore, this simulation ignores transaction costs, which would be inevitably lower with fewer trades and improved performance. Therefore, we are confident that we are closer to the sweet spot regarding the right number of trades with these improvements.

Conclusion

Putting the year to perspective, according to studies[3], at some point in their careers, virtually all top-performing money managers underperform their benchmark and their peers over a period of three years or less. While we certainly do not expect such an underperformance – our edge is very different – it's an unfortunate statistical reality that there tend to be weaker years for almost all managers.

Our expectations and trust in our edge have never wavered, and we are nearly certain that this year was just an aberration. Although we have stuck to this narrative quite a while, with central banks being the only game in town, we might soon be in an environment of significant over-performance, as in 2017. Regardless of the risk management improvements, we can deliver at least adequate returns under all market conditions and less risk than comparable investments.

We appreciate our investors for stomaching a weak year like this, especially as specific asset classes have been performing very well in the short-term. Despite the near-term difficulties, we are optimistic 2021 will be a much better year than 2020.

Sincerely,

Aatu Kokkila
Investment manager
Finbou AG

[3] See http://www.bairdfinancialadvisor.com/steelzellergroup/mediahandler/media/27752/TS_-_Web_the_truth_about_top-performing_money_managers.pdf

Finbou AG, Freiestrasse 34, 8800 Thalwil, Switzerland, +41 79 418 37 03, g.carolo@finbou.com.
Company number: CHE-162.519.027, LEI: 8945005TPI7VHWYOOH55 Regulated by "PolyReg Allg. Selbstregulierungs-Verein".

DISCLAIMER

This letter is for informational purposes only. This letter's content is not intended as an offer to sell, or as a solicitation of an offer to buy, any investment strategies offered by Finbou AG. This letter does not provide investment or other advice, and nothing on the letter is to be deemed to be a recommendation to invest in any strategy offered by Finbou AG.

Trade examples and statements are likewise included for informational purposes only and are provided as a general overview of investment strategy by Finbou AG. There is no guarantee that the examples or any information discussed here are entirely representative of the investment strategy. While we have compiled this letter in good faith, we do not warrant that the information is accurate, correct, reliable or up to date.

Performance data represents past performance, and past performance does not guarantee future results. Current performance may be lower or higher than the performance data presented.

Finbou AG, Freiestrasse 34, 8800 Thalwil, Switzerland, +41 79 418 37 03, g.carolo@finbou.com.
Company number: CHE-162.519.027, LEI: 8945005TPI7VHWYOOH55 Regulated by “PolyReg Allg. Selbstregulierungs-Verein”.