



Quarterly Letter April 2014

Written April 10th, 2014

THALASSA CAPITAL LLC

***“He who knows when he can fight and when he cannot, will be victorious.”
The Art of War, Sun Tzu***

As expected and discussed in our previous Quarterly Letter, the first three months of 2014 were volatile and eventful. Equity markets around the world struggled to find direction, new Fed Chairwoman Janet Yellen was possibly misunderstood by financial markets after her first press conference and Mr. Putin decided to take advantage of Ukrainian instability and annexed Crimea among global outcry.

If this was not enough, a polar vortex contributed to a significant deceleration of U.S. economic recovery and China, while dealing with its first ever corporate default, also had to admit to an economic deceleration.

The end of momentum especially in the equity markets stresses one more time what Sun Tzu eloquently stated centuries ago in its military writings. Knowing when to fight and when to be patient is key to a long and successful career as a general and as it turns out as an investor as well.

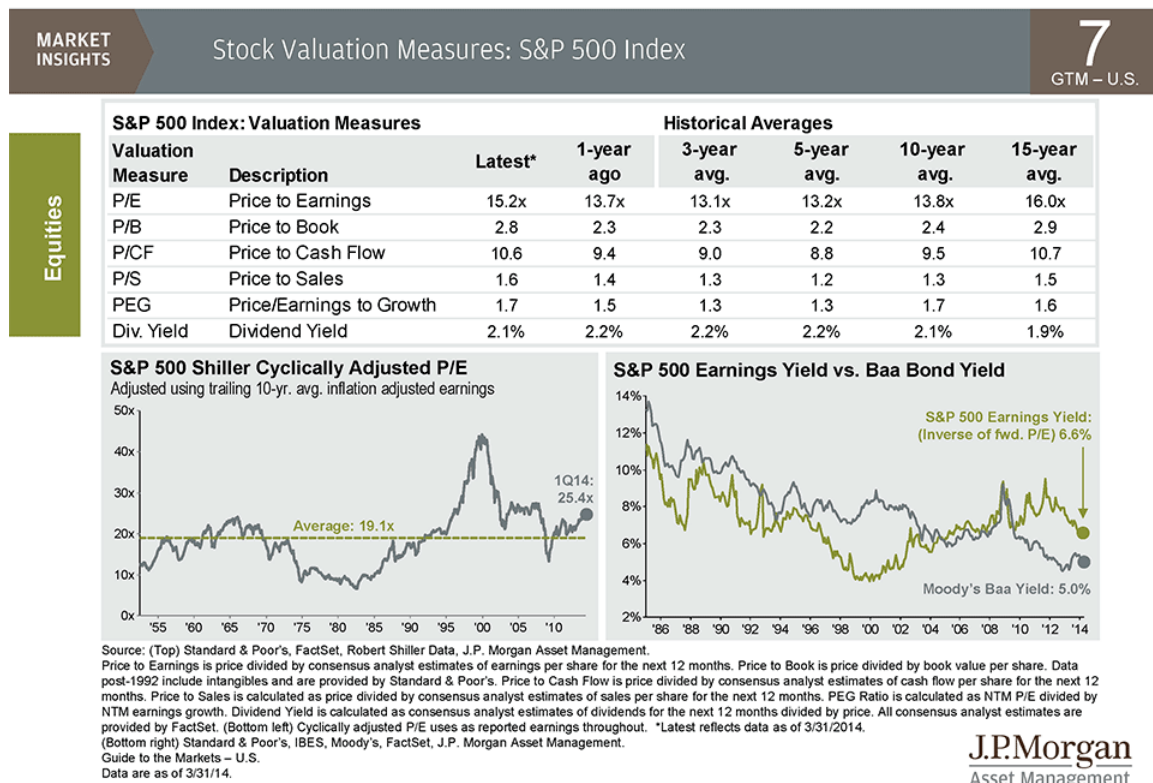
In this first part of the year, short term positioning was dictated by valuations in equities that were, if not outrageously expensive, at least much less attractive than in the past few years and forced us to find alpha (skill based) driven opportunities rather than pure beta (broad market) exposure. We also purchased some insurance in specific instances where we felt the reward was not worth the risk or we took profits altogether and moved to the sidelines.

Most of the new funds we put to work was directed at de-correlating trades such as commodities, which were coming out of a long period of underperformance and alternative strategies.

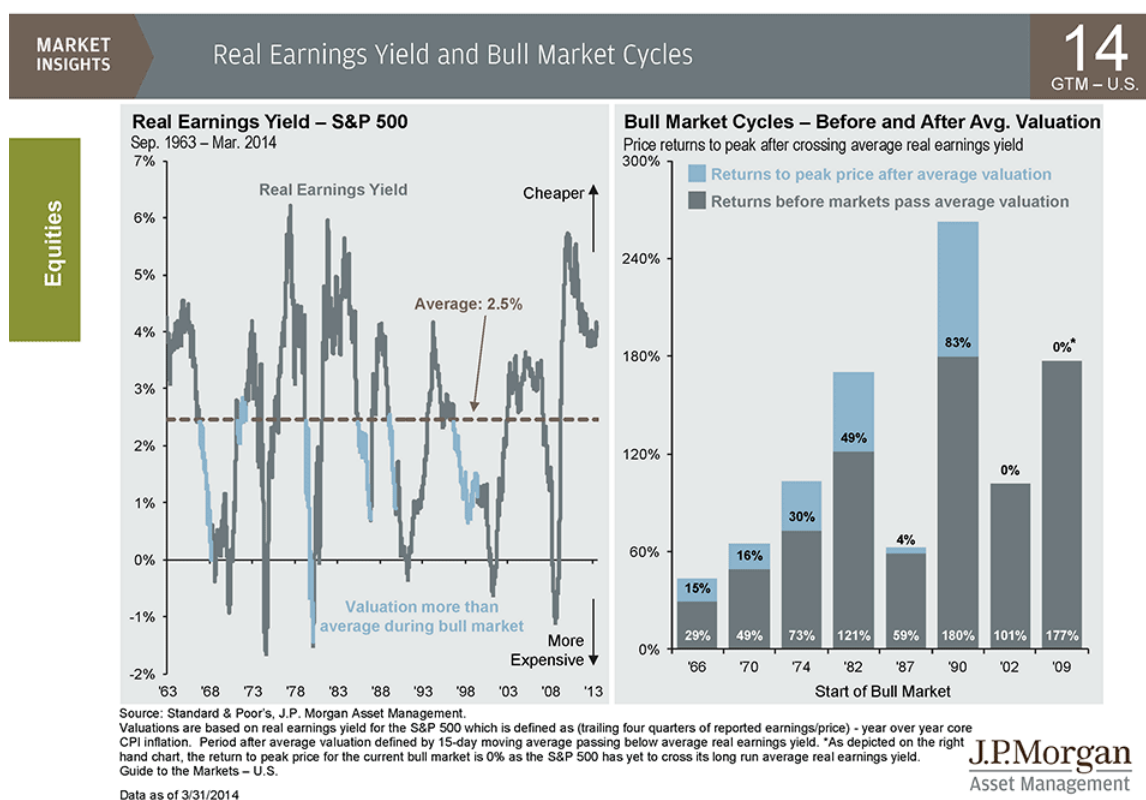
We were also active in the REIT market for the same reasons mentioned above; REITs underperformed last year as yields surged and seemed to provide good value and lower correlation to equities.

That was then, this is now.... Where are we now and how should we position or rebalance our risk exposures?

From a technical point of view, equities have had a run of over 40% since the last meaningful correction in June 2012 and historically the following median drawdown has been between 5% and 7% over the next three months and 10% to 12% over the next 12 months (source: Raymond James). We experienced a 6% correction in the first quarter so it is reasonable to expect a bigger pullback over the next eight months. This is not necessarily bad news as it provides the necessary volatility for risk adjusted rebalancing; in the long term equities are still far from “bubble” levels and while not cheap in absolute terms, they still are in relative terms to bonds.



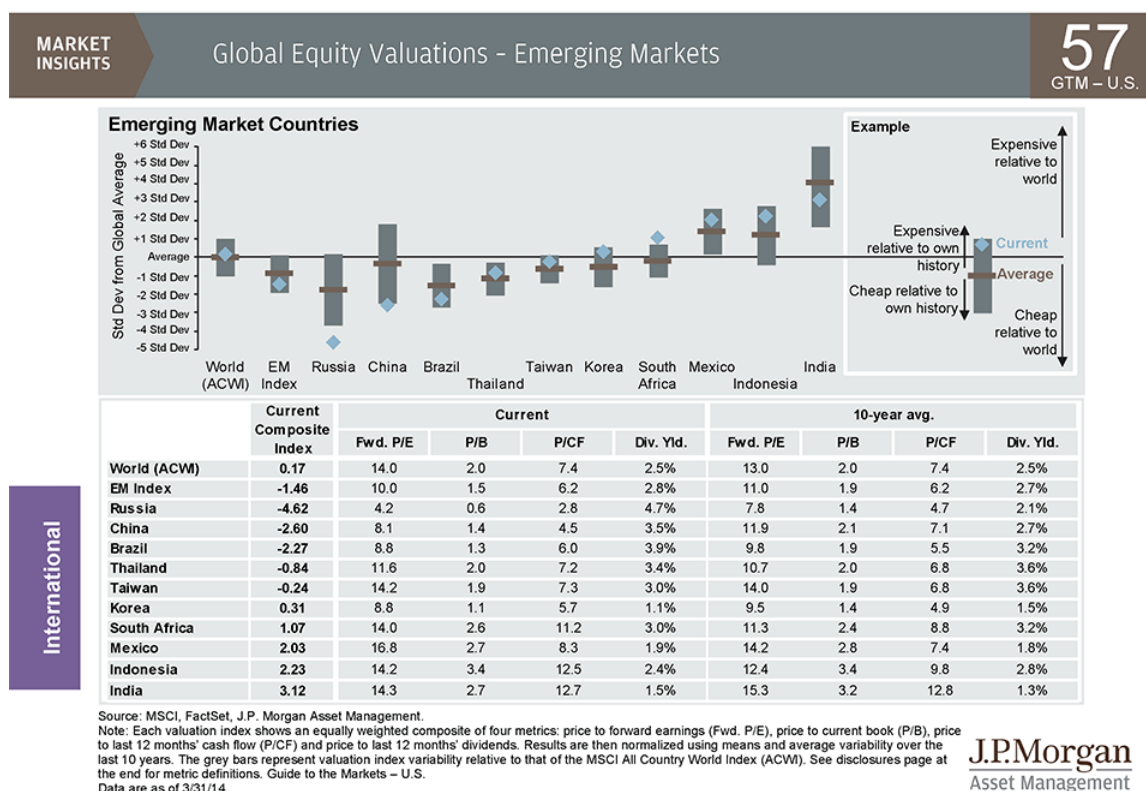
As the above chart shows, most valuation metrics are on par with historical averages with the CAPE ratio being the only one waving a red flag. The following chart makes the case for more long term appreciation in equities; real earnings yield is still way above average and historically markets have continued to appreciate in some significant fashion (albeit with widely varying degrees) even after reaching average valuation on this metric.



The investment implications of all this seems to be short term patience and long term boldness as Sun Tzu might have phrased it.

The situation is somewhat different in Emerging Markets where equity wise valuations are historically much more attractive yet macro conditions may be less intriguing. EM have suffered more than other markets from the negative combination of slowing global economies and rising yields in the US. Some of these markets are at historical low valuations and may provide value while others seem expensive. The conundrum is that the cheap ones are so for good reasons (Russia for example) and so are the expensive ones (Mexico). Investors are paying up for good

macro conditions and creating liquidity vacuums for the unstable economies. Equities and bonds from Emerging Markets should certainly be on the radar screen and opportunistic positioning should be considered.



As far as Europe, we continue to like equities as they are relatively cheap to US and future actions from the European Central Bank may end up being much more equity friendly than the Fed's future decisions.

The Fixed Income markets should continue to undergo the process of interest rate normalization even though, as we indicated at the end of last year, we continue to expect lower volatility than in 2013 at least for the next six months. We continue to believe that bonds should be underweighted and any exposure should be highly diversified by sectors and instruments and possibly include hedging.



Markets will remain challenging as the Fed normalizes monetary policy and most assets reach full valuation; successful portfolios will master the ability to be tactical within long term strategic consistency and discipline.

Sincerely,

Youri Bujko and Davide Accomazzo