THALASSA
CAPITAL LLC

Quarterly Letter December 2014

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THALASSA CAPITAL LLC

"The techniques I developed for studying turbulence, like weather, also apply to the stock market." Benoit Mandelbrot

Mandelbrot was a brilliant mathematicians that challenged the notion of efficient markets since its inception and spent considerable effort researching models that might capture financial markets' volatility in a more complete way than static theories.

Equating the stock market – or any financial market – to the weather and atmospheric turbulence seems not only mathematically brilliant but poetic as well. It is probable that almost every investor at some point in her/his investing life has felt lost in "stormy waters."

This past year has ushered in a return of some levels of volatility – or stormy waters - after a few years of great returns and historically low standard deviation. While the S&P 500 benchmark has closed 2014 in positive double digit territory, the move was not linear and sector performance differed wildly. This new dynamic seems reasonable as the synchronicity of global monetary policy is – albeit very slowly – coming to an end.

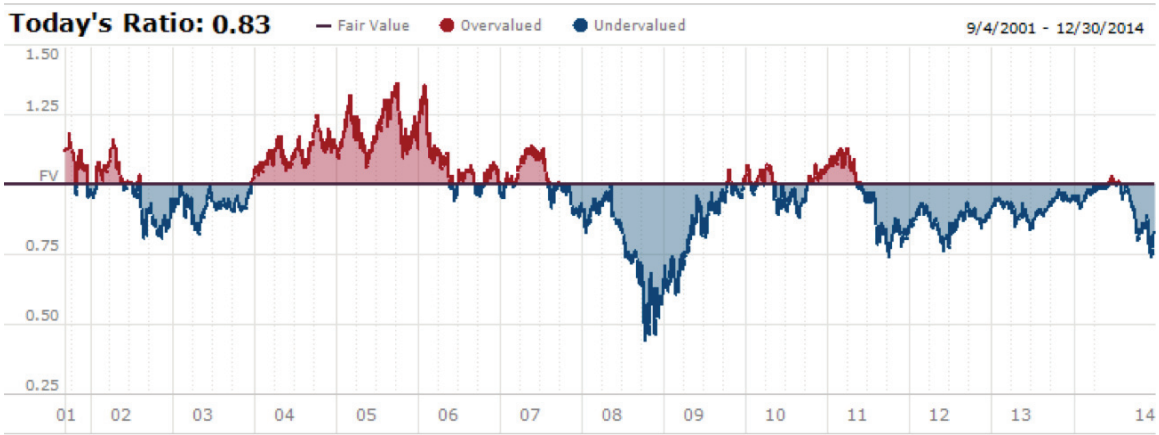
In recent writings, we mentioned the temporary end of beta and the resurgence of alpha. This theme may prove to be the trademark of 2015. Different geographical markets, different sectors, and different companies will react uniquely to different policies and diverse cycles.

Equities

Overall, we think equities, especially in the US, will still be the outperforming asset. The acceleration in economic growth that the US is experiencing along with an asymmetrical risk reward dynamic in credits, makes domestic stocks still attractive in spite of valuations that are historically pricey. Some consolidation is to be

expected in 2015, and probably February might be the time as the benefits of the most bullish period of the year comes to a close.

As mentioned earlier, it might be important to dig deeper than broad indexes and look at sectors individually. For example, as we indicated in previous writings, we see opportunities in Energy which is trading at a low P/E multiple of 13.4. See chart below for an historical perspective of over-under valuation for the Energy sector based on the Morningstar proprietary DCF (discounted cash flow) model:



Morningstar now also lists 37 energy companies carrying its best 5 star rating. The current bloodbath in energy names assumes a long term significantly lower price of oil. We think this is a misguided assumption, as we outlined in our previous letters, given clear issues with fast decline rates in shale production combined with natural decline rates in global production which reduces supply by 4%-5% per year absent new investments, and in light of the fact that increases in supply are all coming from unconventional resources which depend on high prices and really cheap financing – two elements that are quickly disappearing.

MLPs are also attractive as they suffered in sympathy with pure Energy and yet their long term correlation to oil is generally low. Other sectors trading at low multiples are Telecom at 13.6 and Financials at 14.7. This is in contrast with the P/E ratio for the S&P 500 at approximately 17, the Healthcare sector at 23 or Consumer Discretionary at 21.5.

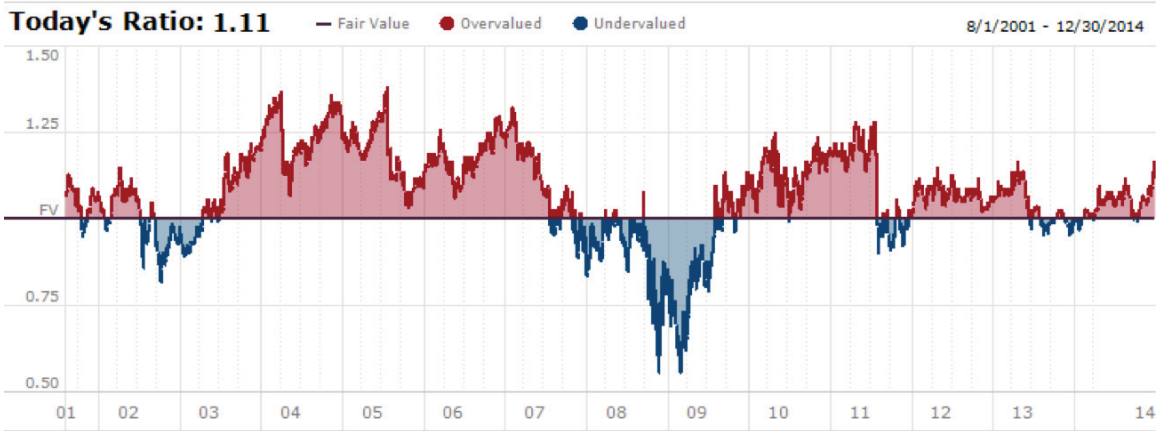
One additional element that makes equities attractive from a relative perspective in what is still potentially a low yielding world, is the Equity Real Earnings Yield (the inverse of the P/E ratio). At just over 6% for domestic equities and over 8% for Emerging Market equities, the earning yield compares favorably with a real yield of

just above zero for the 10 year US Treasury and the approximately 3% for the 5 year EM Sovereign paper.

From a technical perspective, we report some findings from a JP Morgan study on previous periods when monetary policy tightening was initiated. The study isolates three periods similar to today when policy was normalized following an easing cycle associated with a recession: 1984, 1994 and 2004. In all cases, the S&P 500 traded in a tight six to nine month range in the time around the first rate increase. In those three instances, the new monetary policy regime did not end the bull market but marked the beginning of a broad and volatile period.

REITs

We like REITs very much long term in terms of income, total return and de-correlation qualities but we see current high valuations and some headwinds coming from a change in the interest rate environment. The chart below shows an 11% overvaluation over fair price as calculated by the Morningstar proprietary DCF model. This contingency makes us cautious and forces us to look at specific opportunities as they occur rather than making a "blanket" sector bet. In this light, we still favor health care related REITs based on long term demographic trends and current relative valuations.



Commodities

In the basic materials space, with the exception of energy, we continue to have an underweight relative to our long term allocation model. Global oversupply and slow global demand (especially from China) seem to be factors still lingering in this space for the foreseeable future.

Credit Markets and US Dollar

While 2014 was a surprisingly positive market for most types of credits (especially munis which we liked at the beginning of the year), we think a renewed underweight in this asset class is a reasonable decision. Economic growth is expected to accelerate in the US and most likely globally as well. This should keep the Federal Reserve on schedule to start normalizing monetary policy which will weaken most fixed income investments. High yield is still expensive and very vulnerable as an asset class to dislocations in the energy sector, a combination of elements that should warrant significant underweight.

We note that TIPS have recently become more attractive after a long period of negative valuations and could be used again in an effort to diversify inflation risk exposure.

On the currency front, for once we join the consensus, as we expect strong outperformance of the US Dollar. A combination of Fed decoupling from other central banks' action and better expected relative economic performance in the US should continue to provide good sailing for the greenback.

Conclusions

As we wind down this eventful 2014, we reiterate our main themes for 2015: alpha over beta, energy overweight, equities as relative outperformers and a strong US Dollar.

While nobody knows for sure what the future holds, the game of investing is about positioning as strategically as possible in the information curve and then play the probabilities with discipline… and don't forget an umbrella in case of "weather turbulence!"

We look forward to managing your wealth in 2015 and we feel honored to have gained your trust once more.

Youri Bujko

Davide Accomazzo