THALASSA
CAPITAL LLC

Quarterly Letter December 2015

Written December 31, 2015

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"Successful Investing is anticipating the anticipations of others." **John Maynard Keynes**

The task of writing the investors' year-end letter is always inspiring and yet challenging. This year especially, this undertaking carries many challenges as the past twelve months have defied most of the investment expectations and left a cloudy outlook for the next twelve.

As the quote by economist extraordinaire John Keynes illustrates, the game of investing is largely a strategic mission based on anticipation of other people's expectations of future developments. The trick is that expectations are based on multiple shifting variables and the mood of the investing crowd is highly reflexive in its actual shaping of current and future fundamentals.

In other words, while classical macro-economic theory views the supply and demand curves as given and stable, the reality of the matter is much more complex and elusive.

One clear example of such dynamic was at work last year in one of our core exposures: midstream energy infrastructures Master Limited Partnerships. While these utilities are generally less volatile than stocks and dedicated energy companies, 2015 produced unprecedented price volatility and a much higher than normal correlation to the price of oil.

Midstream companies were punished more than service oil companies even though their business model makes them clearly more sheltered from the large swings of crude oil. Unfortunately, reflexivity came into play and increased pressure on the sector via a vicious cycle of negative expectations. Such dynamic affected access to capital markets with the result of indeed potentially altering fundamentals. MLPs have actually had a good 2015 from a business perspective but financial markets painfully raised the cost of capital required for continued expansion and therefore put pressure on the sanctity of consistent and significant distribution growth.

We have hardly ever seen a sector so despised and yet running a solid and quasi-monopolistic business model. A catalyst is needed to break the vicious cycle mentioned above but valuations and sentiment measures seem to indicate better times ahead.

While energy infrastructures companies were the negative outlier, not much else worked in 2015. As of this writing, the total return of S&P 500 index is barely positive on the year and so is the MSCI EFA index (international equities ex-US). Emerging markets are ending another "annus horribilis" down 15% along with commodities which have generally recorded double digit losses. Bonds were flat, which is actually better than what was expected at the beginning of 2015 but currency funds saw their worst year since 2011.

REITs fluctuated wildly following the whims of expectations for changes in monetary policy; the sector also showed much dispersion between subsectors. Apartment complexes did generally well although they were and still remain one of the most expensive segments while health care names – which do have the best long term fundamentals and usually lower sensitivity to higher interest rates – performed the worst.

And then there were Hedge Funds… Our thesis at the end of 2014 was that beta would disappoint (a correct assumption) and that alpha, or skilled active based returns, would be a better bet. Such line of thinking worked magically for about three quarters of the year but then starting in Q3 most active managers found themselves in real trouble as crowded trades became impossible to unwind and oil started to affect not only energy names but most of the investing spectrum. Ultimately, hedge funds, as of this writing, did not do much better than the passive indexes. However, it must be noted that a team of superior managers may find temporary contingencies to be unfavorable but if there is a track record of significant outperformance and a logical reason for such outperformance, the long run eventually corrects the short term deviations.

If 2015 turned out circuitous and disappointing, 2016 does not seem to start with much more clarity. Many of the cross-currents that affected returns in the past twelve months are still present: a Federal Reserve intent in normalizing rates and yet facing a global economy which is growing at rates below historical averages, a geopolitical and largely self-defeating game played in the oil market and valuations in most asset classes at or above averages.

Today more than ever, a long term approach is needed. Energy and energy infrastructures are highly cyclical and require patience but the supply and demand projections seem extremely favorable in due time. Equities, especially in the US, are not cheap but also do not show any of the signs seen at major tops; on a relative basis, when compared to bonds they actually seem well priced. Emerging markets equities are beginning to look attractive although they may still be held hostage to the Fed normalization policy; on a selective basis, 2016 should provide opportunities in this area.

REITs are at an interesting juncture. The lackluster performance of 2015 makes them a value proposition. Their average discount to Net Asset Value, while reduced since the lows of September, is still historically significant. Furthermore, REITs have been active in taking advantage of a hot physical market to divest non-core assets at attractive prices. Yields are attractive and some sub-segments such as timber and health care continue to draw attention.

The one caveat is the sector's sensitivity, at least on a short term basis, to interest rates. On a longer term basis, the sector's correlation to interest rates is highly dependent on the macro-economic contingency: if rates rise along strong economic growth and/or inflation, REIT usually do well; however, if rates rise in sync with subpar growth, the sector will underperform. Nevertheless, we think the sector deserves a core long term allocation in almost any portfolio.

As always, we would like to thank you for the renewed confidence in our work,

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