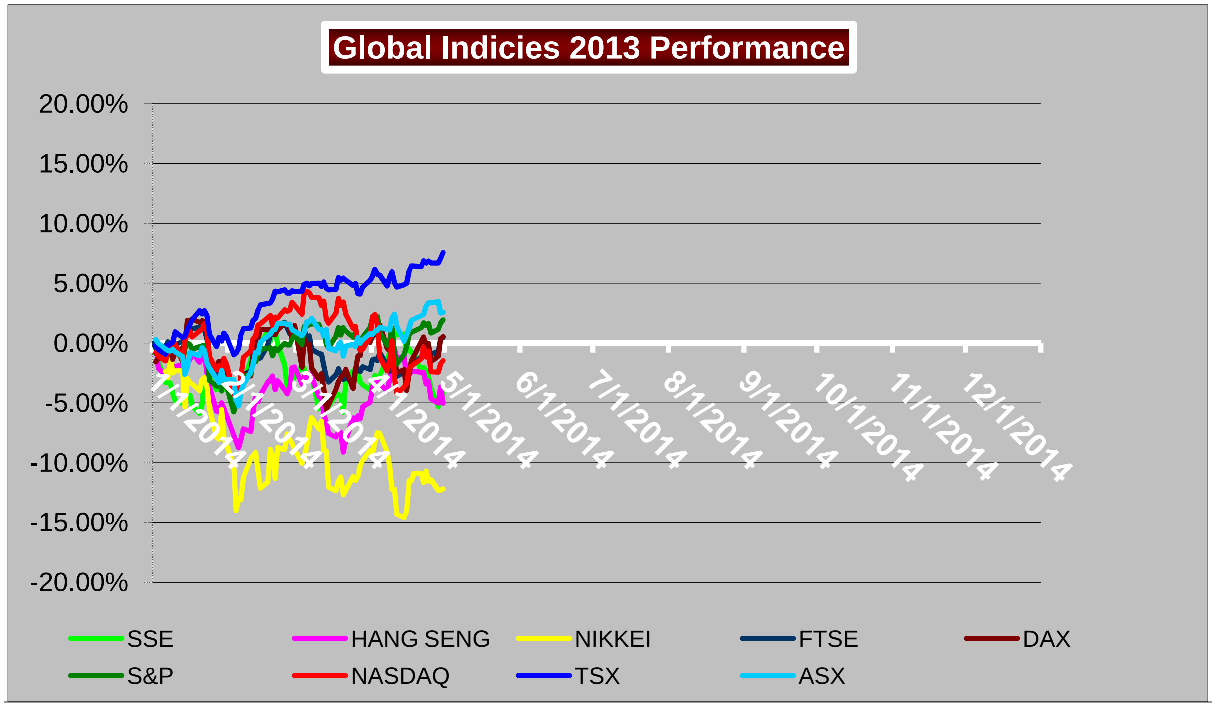
GDB Capital Inc.

GDB May 2014 Newsletter

Monthly Market Summary:

2014 April Market Activity		
SSE COMPOSITE	***2,026.36***	-6.95 (-0.34%)
HANG SENG	***22,133.97***	-17.09 (-0.08%)
NIKKEI 225	***14,304.11***	-523.72 (-3.53%)
FTSE 100	***6,780.00***	+181.60 (2.75%)
DAX	***9,603.23***	+47.32 (0.50%)
DOW	***16,580.84***	+123.18 (+0.75%)
S&P 500	***1,883.95***	+11.61 (+0.62%)
NASDAQ COMPOSITE	***4,114.56***	-84.43 (-2.01%)
ASX 200	***5,489.10***	+94.30 (+1.75%)
TSX COMPOSITE	***14,651.90***	+316.60 (+2.21%)



Investment Themes:

Of the 20 trading days in May at the time when this Newsletter was written, the S&P has been up a total of 13 days. Both the S&P and Dow have now hit record highs. After five years of gains in the stock market, the US and Asian volatility indexes are at record lows showing there is general complacency towards risk. CBOE VIX closed at 11.35 on May 23, its lowest level since March 2013, and close to its all time lowest close of 9.31 on December 22, 1993. Lack of volatility in Asia is also at record low levels with VHSI at 14.49, Australia VIX at 11.31, Nikkei Volatility at 21.40, and the V-Kospi at 11.11. Volatility across other asset classes exhibit much of the similar pattern, implied volatility is currently at one year low for oil and gold. The volatility for rates and foreign exchange for G7 countries is also low.

The record low volatility across asset classes signals complacency and investor's unwillingness to pay for portfolio protection. Both calls and puts for equity and other asset classes are not fetching high premiums. In the environment of ultra low interest rates and global central bank QE, investors are more comfortable assuming more and more risk knowing if markets take a major reversal to the downside; the central banks will intervene and act as backstops. Looking back at the "great moderation" in 2005 to early 2007 when there was a lot of confidence and liquidity in markets and the pricing of volatility was very low, there was a widespread belief that volatility would not rise again.

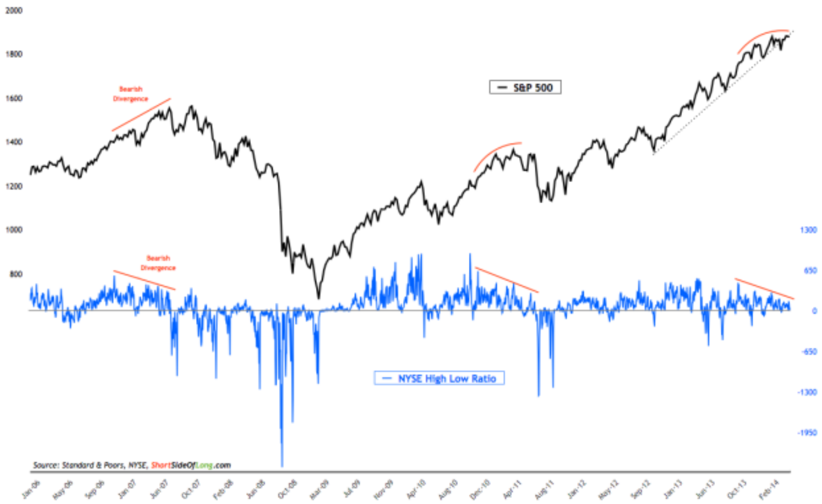
It is also in 2007, the collapse of Lehman Brother and global financial crisis rocketed the CBOE VIX to record high of 80.86 in November 2008. Although we do not think there will be a repeat of such event, there are many significant geopolitical and systematic risks lurking in the back ground to cause one to be vigilant. We do not believe the low level of volatility seen currently fully accounts for these macroeconomic risks. The CBOE VIX is measured by the market's expectation of 30-day volatility implicit in the prices of near-term S&P 500 options. These options include both out of money puts and calls. The reason why VIX is renowned as the market fear gauge is because the premium paid on S&P puts rises when investors purchases them as insurance fearful of market declines. However, the low VIX seen today is also contributed by the low price on S&P 500 out of money call options. The call options, which give the buyer the right, but not the obligation to own the index in the next 30 days, are at their cheapest level since the current bull market began five years ago, according to research from Credit Suisse. This indicates investors' reluctance to chase the market higher.

An in-dept look through market breadth also confirms the ascent in equities of late lacks conviction. Here are some of observations:

- Volume in the S&P 500 futures has been as low on some ordinary trading days as it used to be only on holidays

- Fewer stocks are pushing the indices higher. A year ago, ½ of the stock would make new highs when the index did. Now it is just 1 in 19 stocks

- Number of new highs relative to new lows is slowly but surely decreasing. NYSE ratio between new highs and lows stood at 319 as S&P flirted with 1,850 in December 2013. While the S&P rallied towards a higher high in March of this year, the breadth ratio only managed to post a reading of 291. Recent record high at above 1,900 on the S&P was achieved with an even lower ratio of 151



Source: Standard & Poors, NYSE, ShortSideOfLong.com

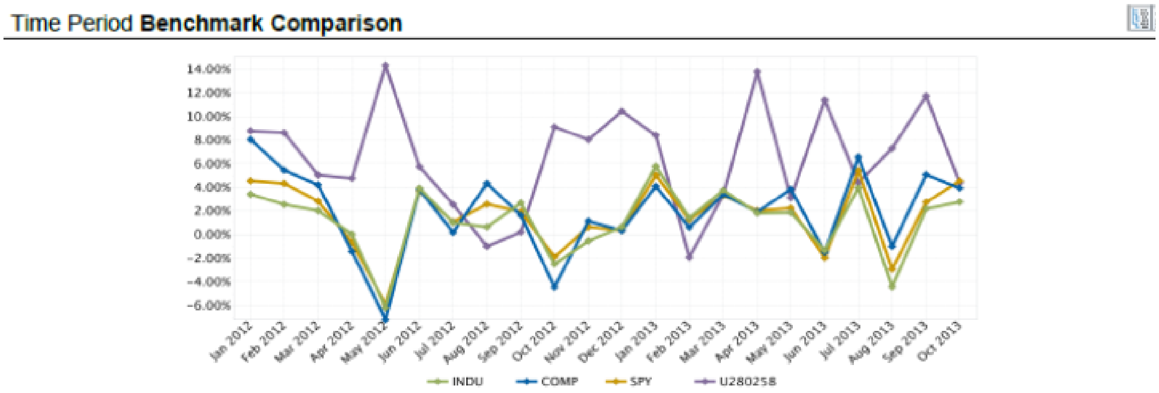
So with market at all time highs and lack of conviction to chase it higher, why aren't investors purchasing put options as insurance to lock in their gains? To answer this, we examine another unusual and puzzling phenomenon in the market. With the US Fed pulling back on bond purchases from 85 billion a month to now 45 billion, many investors expect the US Treasury yield to rise as demand diminished. To the contrary, the yield on the US 10-years has declined from approximately 3% at start of the year to 2.45% now as demand remains robust. The behavior in the bond market goes against conventional wisdom. Why are investors piling into the bond market if the rise in equity indicates an increased appetite for risk?

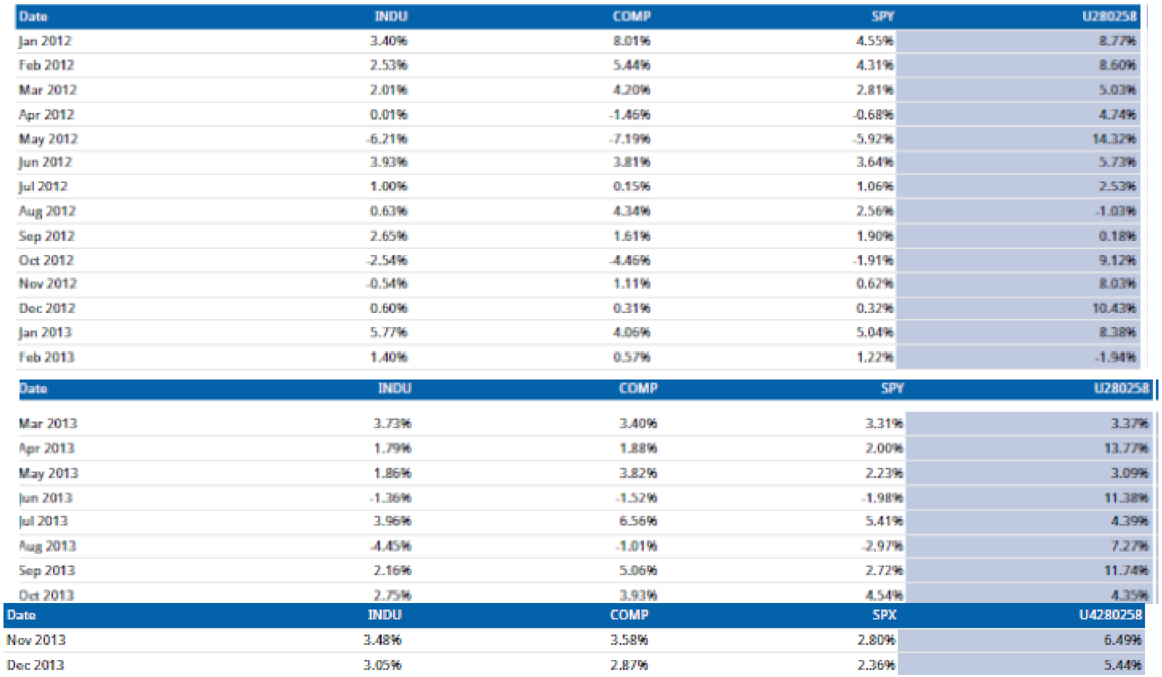
Linking the two market observations of low price for equity puts and high demand for US Treasury, we suspect that instead of insuring portfolios through the conventional approach by purchasing puts, smart investors are insuring their downward exposure in equities by going long in the US Treasury. If the equity market subsequently reverses or corrects, safe haven buying of bonds will drive prices higher. For investors that have already longed, this serves as a hedge against the losses in their equity portfolios. Unlike purchasing puts in which the investor does not earn any yield while holding the instrument, holding US Treasury will generate yield for holders in the meanwhile. This makes holding Treasury more attractive than simply purchasing equity or equity index puts in a market decline.

Investment Opportunities:

1. GDB Monthly Income Fund

Fund managed by GDB Capital. Event-driven investments using hedging strategies and combinations of long/short positions in equities, futures, and commodities and their derivatives. Fund targets gross pre-tax IRR of 20% per annum, and returned 108% in 2012 and 194% in 2013. GDB will insure against investment losses up to 5% of original investment. Following are the benchmark comparisons of GDB Fund performance against the major US Indices.

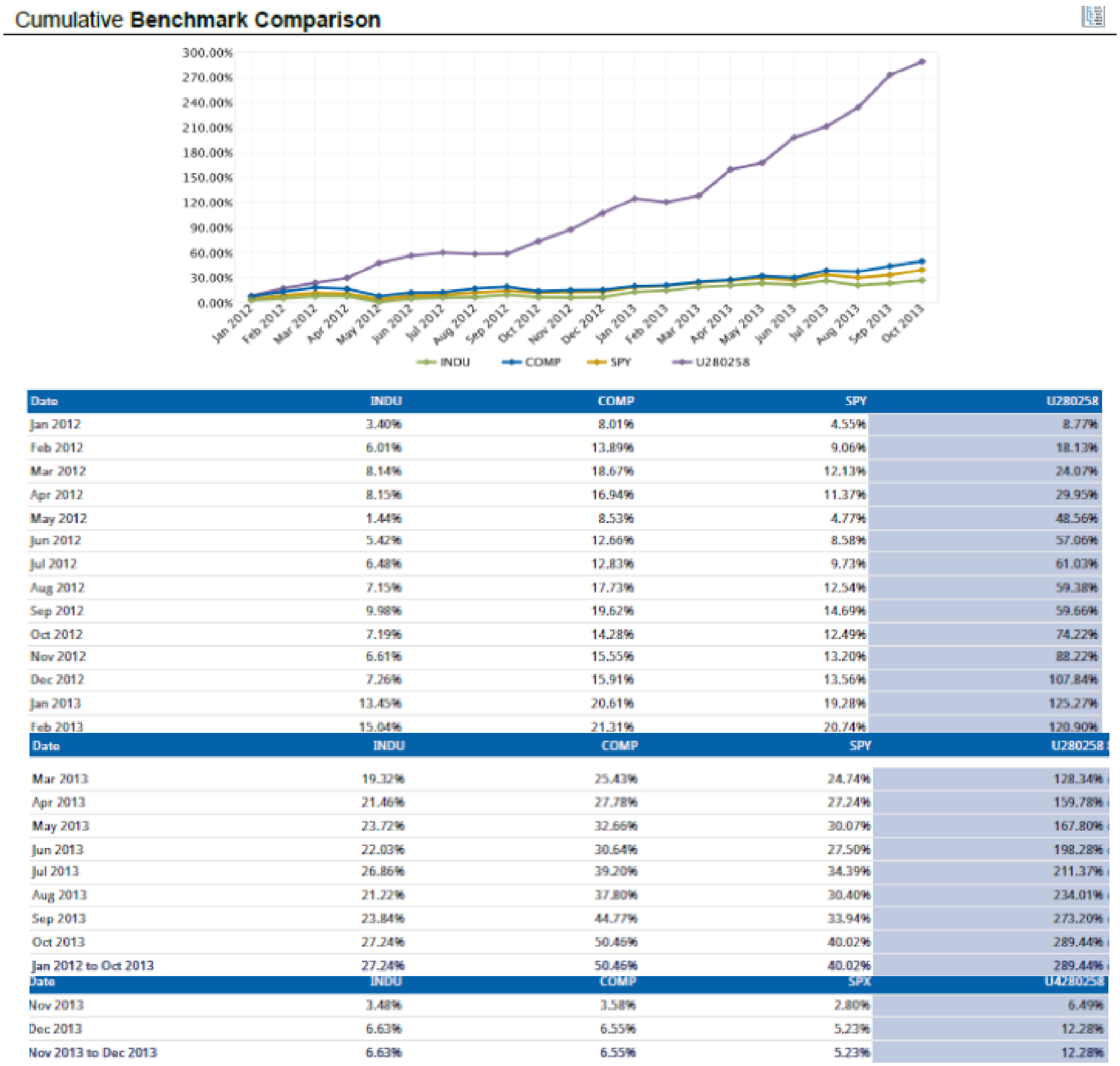

Time Period **Benchmark Comparison**



Date	INDU	COMP	SPY	U280258
Jan 2012	3.40%	8.01%	4.55%	8.77%
Feb 2012	2.53%	5.44%	4.31%	8.60%
Mar 2012	2.01%	4.20%	2.81%	5.03%
Apr 2012	0.01%	-1.46%	-0.68%	4.74%
May 2012	-6.21%	-7.19%	-5.92%	14.32%
Jun 2012	3.93%	3.81%	3.64%	5.73%
Jul 2012	1.00%	0.15%	1.06%	2.53%
Aug 2012	0.63%	4.34%	2.56%	-1.03%
Sep 2012	2.65%	1.61%	1.90%	0.18%
Oct 2012	-2.54%	-4.46%	-1.91%	9.12%
Nov 2012	-0.54%	1.11%	0.62%	8.03%
Dec 2012	0.60%	0.31%	0.32%	10.43%
Jan 2013	5.77%	4.06%	5.04%	8.38%
Feb 2013	1.40%	0.57%	1.22%	-1.94%

Date	INDU	COMP	SPY	U280258
Mar 2013	3.73%	3.40%	3.31%	3.37%
Apr 2013	1.79%	1.88%	2.00%	13.77%
May 2013	1.86%	3.82%	2.23%	3.09%
Jun 2013	-1.36%	-1.52%	-1.98%	11.38%
Jul 2013	3.96%	6.56%	5.41%	4.39%
Aug 2013	-4.45%	-1.01%	-2.97%	7.27%
Sep 2013	2.16%	5.06%	2.72%	11.74%
Oct 2013	2.75%	3.93%	4.54%	4.35%

Date	INDU	COMP	SPX	U4280258
Nov 2013	3.48%	3.58%	2.80%	6.49%
Dec 2013	3.05%	2.87%	2.36%	5.44%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Cumulative **Benchmark Comparison**

Date	INDU	COMP	SPY	U280258
Jan 2012	3.40%	8.01%	4.55%	8.77%
Feb 2012	6.01%	13.89%	9.06%	18.13%
Mar 2012	8.14%	18.67%	12.13%	24.07%
Apr 2012	8.15%	16.94%	11.37%	29.95%
May 2012	1.44%	8.53%	4.77%	48.56%
Jun 2012	5.42%	12.66%	8.58%	57.06%
Jul 2012	6.48%	12.83%	9.73%	61.03%
Aug 2012	7.15%	17.73%	12.54%	59.38%
Sep 2012	9.98%	19.62%	14.69%	59.66%
Oct 2012	7.19%	14.28%	12.49%	74.22%
Nov 2012	6.61%	15.55%	13.20%	88.22%
Dec 2012	7.26%	15.91%	13.56%	107.84%
Jan 2013	13.45%	20.61%	19.28%	125.27%
Feb 2013	15.04%	21.31%	20.74%	120.90%
Mar 2013	19.32%	25.43%	24.74%	128.34%
Apr 2013	21.46%	27.78%	27.24%	159.78%
May 2013	23.72%	32.66%	30.07%	167.80%
Jun 2013	22.03%	30.64%	27.50%	198.28%
Jul 2013	26.86%	39.20%	34.39%	211.37%
Aug 2013	21.22%	37.80%	30.40%	234.01%
Sep 2013	23.84%	44.77%	33.94%	273.20%
Oct 2013	27.24%	50.46%	40.02%	289.44%
Jan 2012 to Oct 2013	27.24%	50.46%	40.02%	289.44%

Date	INDU	COMP	SPX	U4280258
Nov 2013	3.48%	3.58%	2.80%	6.49%
Dec 2013	6.63%	6.55%	5.23%	12.28%
Nov 2013 to Dec 2013	6.63%	6.55%	5.23%	12.28%

Total 301.72%