

February, 2023

Welcome to Level 2

The New Paradigm of High Inflation, High Volatility, and High Risk

1. Monthly Update Quadriga UCITS Strategies

Protected US Equity, Quadriga Aqua UCITS -1.9% Feb 23

The enclosed [Aqua UCITS Feb 23 Factsheet](#) provides a detailed overview of the performance and positioning across the core equities and long insurance portfolios. The Protected US Equity Strategy combines the benefits of a core long 100% US Equities protected with a long-only Insurance Program where both components are rebalanced monthly to their neutral weights. The long only insurance has a target of 10% to 15% in **premium-at-risk** and is **managed pari-passu with Igneo UCITS**.

A switch from **Unprotected Equity to Protected Equity** is subject to a number of benefits and considerations, including:

- Switch from Unprotected to Protected Equity with **zero net cash flow** requirement.
- **Enhance protection** at expense of potential basis risk and underperformance during bullish equity markets.
- **Reduce volatility** and enhance risk adjusted returns (higher Sharpe and Sortino).
- **Reduce “noise”**. One line item, instead of two. Less emotions during extremes tend to produce better decisions.
- **Embrace hostile markets**. Buy cheap equities financed by profits on insurance.
- **Embrace complacent markets**. Buy cheap insurance financed by profits on equities.
- **Monthly Rebalancing**. Incremental Returns from Negative Correlation and Mean Reversion.
- **Attractive Entry**. Current valuations in US Equities and Insurance offer attractive entry for protected strategies like Aqua.
- **Seeding terms** class A USD ISIN **LU1871084460** a 1.5% management fee, 0% performance fee, daily liquidity at NAV.

As per the graph below, Protected US strategies can help simultaneously enhance absolute (+10.8% p.a. vs +9.8%) and risk-adjusted returns, both return per unit of average volatility (Sharpe 0.7 vs 0.5) and return per unit of "bad volatility" (Sortino 1.6 vs 0.8), whilst simultaneously enhancing capital preservation as Peak to Trough (-10.9% vs -23.9%).

	Monthly (%)	YTD (%)	LTD (%)	LTD (% p.a.)	Vol (%)	Sharpe	Sortino	Peak Trough	NAV
SPX	-2.7%	3.9%	54.5%	9.8%	19.3%	0.5	0.8	-23.9%	154.5
AQUA	-1.9%	6.3%	61.1%	10.8%	14.5%	0.7	1.6	-10.9%	161.1
Difference	0.8%	2.4%	6.6%	1.0%	-4.8%	0.2	0.8	13.0%	6.6



Passive Basket vs Rebalanced Basket

In addition to the contribution from the Equity and Insurance Portfolios, Quadriga Aqua UCITS Protected US Equity benefits from another important consideration: **portfolio rebalancing**, a mechanism that effectively behaves like a **good unemotional investor** that **systematically accumulates cheap insurance during complacent markets** (such as today) and **systematically accumulates distressed assets during hostile markets** (such as March 2020). Those investors managing the long equity and long insurance via separate legs tend to suffer from emotional distress and make the wrong decisions at the wrong time.

The following graph compares the performance of a passive basket vs monthly rebalanced basket, where the difference represents the value of **compounding capital preservation**. No crystal ball. No magic formula. Just unemotional systematic rebalancing, which in our view can be a valuable source of compounding and incremental returns in general, and during the high volatility regime we anticipate ahead.



Quadriga Igneo UCITS, -5.1% Feb 23

The enclosed [Igneo UCITS Feb 23 Factsheet](#) provides a detailed overview of the performance and positioning, including closed, restructured, and new positions. The **Total Premium at Risk** for

Igneo was **27.5%** as of the end of February, a notable increase since the end of January, with a **diversified insurance portfolio 1) across asset classes** (Equity/Credit, FX/Rates, Commodity Inflation) **2) across maturities** (short dates directional gamma and long dates Vega and duration), **3) convexity and carry** (long vanilla bias and risk premia across the forward term-structure, volatility surface, and correlation matrix) subject to constraints on **premium at risk** (long only option) and **carry** (positive, neutral and negative), which altogether seek to generate **negatively correlated alpha** during **adverse, hostile and volatile** markets, as the strategy has consistently done since launch its launch (+12.7% 4Q18, +16.5% Aug19, +42.5% 1Q20, or +22.2% Feb22, amongst others) and as we hope to do during the hostile and volatile markets we anticipate ahead of us.

2. The Anti-Bubble Report March 23 Preview: "Welcome to Level 2"

The Anti-Bubble Report for March 2023, called "**Welcome to Level 2**", will be emailed to you over the next few days from my 36 South email address (please see further below details of the strategic partnership between 36 South and Quadriga Asset Managers), expands and complements our global macro analysis and contrarian investment thesis "**The New Paradigm of High Volatility, High Inflation, and High Risk**", that in our view will dominate global markets for the foreseeable future, and total reversal from the previous decade, which was dominated by "Low Inflation, Low Volatility, Low Risk", or perhaps more accurately "**Artificially Low Inflation, Artificially Low Volatility, and Artificially Low Risk**".

Enclosed a high level preview of "**Welcome to Level 2**" that will discuss the three main components of the New Paradigm.

1. The New Paradigm of High Inflation

- We are in Level 2. Inflation no longer negligible. Investors must make money in Real terms, not just Nominal terms.
- Frogs in Boiling Water. It is all about inflation expectations. When they are low, Central Banks are in control. When high, Central Banks lose control.
- Real Inflation vs Official Inflation. Investors and savers are not stupid. In our view Real Inflation is approx. 2x Official Inflation.
- They can not print Energy or Real Assets. Central Banks and Governments can subsidize energy (print EUR or USD) but can not print energy.
- When "Growth" is not enough. In Level 2 economists must differentiate "Nominal Growth" vs "Real Growth". Massive difference.
- In the "Twilight Zone", Level 1 and Level 2 co-exist. Investors thinking in Level 1 are confused and fooled by nominal data and performance.
- The Damage from decades of Monetary and Fiscal policies without limits is already done.
- Yield Curve Control, the mechanism that transforms credit bubbles into inflation.
- End Game: Central Banks will Print More, not Less. From a game theory perspective, the game is designed to end in Stagflation.

2. The New Paradigm of High Volatility

- Twilight Zone between Level 1 and Level 2 likely to translate in higher realized and implied

volatility.

- Divergence of forecasts by analysts: from Hard landing to Soft landing to No Landing = volatility.
- Reflexivity of Bubble vs Anti-Bubble. Artificially low volatility = artificially high prices via virtuous cycle. Watch out for the vicious cycle.
- Realised volatility is the Speedometer of markets but does not compute the real risk of the portfolios. Watch out for spike in volatility.
- Chronicle of a Crisis Foretold: The triple whammy of Volatility vs Correlation vs Liquidity
- Disconnect between Macro Vol vs Equity Vol = Bear Market Rally, Short Squeezes. Will be wild.

3. The New Paradigm of High Risk

- What is left tail? In Level 2 we need to watch out for both Nominal and Real Left Tail.
- Nominal Left Tail (equity credit sell off). Loss of capital.
- Real Left Tail (inflation spike). Loss of purchase power.
- False Diversification = Hidden Leverage.
- Equity Risk Premia. Equities are expensive both in absolute and real terms.
- From TINA (There Is No Alternative) to TARA (There Are Reasonable Alternatives) to TAGA (There Are Great Alternatives) in nominal terms...
- From Bubbles too big to fail to Stagflation.
- Slow Motion Crash. Watch out for Credit Defaults.

4. Implications for Portfolio Construction

- The Football Team Analogy: the striker, the defender/goalkeeper, and the coach.
- Embrace Volatility. Don't fight it.
- Epsilon, Compounding on Capital Preservation.
- Unemotional vs Emotional Portfolio Rebalancing.
- Protecting Strategies vs Protected Strategies
- Long Only Options. V@R 100.
- Long Inflation Bias. Beware of assets that are short inflation.
- Equity divergence. Equity Margins vs Inflation: Price Power vs Purchase Power.

5. Additional Supportive Information

Previous issues of the Monthly Anti-Bubble Report available on request.

Live Webinar [Real Conversation with Hedgeye Keith McCullough](#) (recorded Mon 6th Feb 2023), where we discuss some important topics, including:

- The new paradigm of “**high inflation, high volatility and high risk**”. The next decade will be very different from the previous decade.
- Why Central Banks are **trapped between bubbles and inflation**, both their creation.
- Why **Central Banks will print more, not less**, as they will be forced to intervene to contain credit bubble collapse created by higher rates.
- **Yield Curve Control** is the mechanism that **transforms credit bubbles into inflation**. Watch out for Japan.

- The “**Frogs in boiling Water**” analogy. Implications for global markets and portfolio construction.
- How Currency wars has shifted from “beggar thy neighbour” to “**export inflation**” and thus why stronger USD is a wrecking ball for global.
- How the investment game has 3 levels: 1) nominal returns, 2) **real returns**, 3) real returns after taxes. We are now decisively in level 2.
- Why **China a credit time bomb**, likely to eventually implode via weaker CNH. Watch out for HKD peg.
- Energy subsidies another example how Governments don’t solve problems, simply **delay, transfer, transform, and enlarge problems**.
- Why **Geopolitical risks remain high**. Mind the tail risk from miscalculation and nuclear escalation in Russia / Ukraine.

Additional information. In case of interest, please find enclosed additional information about our contrarian ideas and framework:

- [Gold's Perfect Storm](#) (Financial Times Insight Column, front page written edition 8th Aug 2016)
- [The Energy World is Flat](#) (Financial Times Insight Column, 18th April 2016)
- [Real Conversation with Keith McCullough](#) (Hedgeye, 6th Feb 2023)
- [China is Running out of Options](#) (Macro Trading Floor, 24h July 2022)
- [How to hedge Inflation](#) (Kitco News, 30th Sep 2022)
- [Bitcoin: Bubble or Anti-Bubble?](#) (The End Game Series, 9th Feb 2021)
- [Portfolio Construction Masterclass](#) (Real Vision, 3rd Aug 2020)
- [Hmminar with Grant Williams](#) (Hmminar #15, 21st May 2020)
- [False Diversification](#) (MacroVoices podcast, 11th June 2020)
- [The Perpetual Search for Extreme Optionality](#) (The Felder Report Podcast, 1st Sep 2019)

3. Positive News (re-send)

As announced in December, I am pleased to inform you of my appointment as **Member of the Management and Investment Committee at 36 South Capital**, the \$2 billion AUM industry-leading investment manager with a 21-year track record specialized in global macro, volatility, and tail risk. I joined 36 South in **January 2023** at the firm’s headquarters in **London**, reporting directly to **Jerry Haworth**, CIO and Co-Founder of 36 South, where, in addition to my new responsibilities, I will remain fully focused and dedicated to the management of **UCITS offering**, namely **Quadriga Igneo UCITS** and **Quadriga Aqua UCITS**, together with **Alfonso Torres**, Senior Portfolio Manager.

My appointment is a positive development for both 36 South and Quadriga, as **36 South** expands its investment team and range of investment strategies it manages and advises, and **Quadriga** continues to host and support **Igneo and Aqua** within its **Luxembourg UCITS umbrella**. For the avoidance of doubt, there are no operational changes to any of the strategies, which remain available via the Quadriga platform and with the exact same terms and conditions. Current investors do NOT need to do anything. Prospective investors continue their due diligence as

normal. Any questions or clarifications, please contact me directly anytime. Thank you!

I hope the ideas and strategies will be of your interest and remain at your disposal for any additional information or clarification you may need.

Quadriga Strategy	Class	MTD	YTD	LTD	Factsheet	Newsletter
Igneo UCITS (USD)	A	-4.8%	-9.7%	-20.5%	Igneo Feb23	Subscribe
Aqua UCITS (USD)	A	-1.9%	+6.3%	+61.1%	Aqua Feb23	Subscribe

Best regards and much health to all!

Diego