

Defy-Capital Investment Strategy

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Executive Summary

Defy-Capital runs a quantitatively driven short-selling strategy on low-market-capitalization US equities (nano- and micro-caps).

The strategy is aimed at qualified investors seeking an alternative, market-neutral source of return with an above-average risk-adjusted profile.

Data-driven analysis of historical market patterns identifies temporary “price overextensions” that are not supported by fundamental company value. These inefficiencies are exploited by opening short positions in significantly overvalued stocks and closing them once the price has corrected.

The strategy combines statistical methods, machine learning, and volatility-based risk management. Every trade is opened and closed within a single day, which guarantees a high liquidity profile and daily capital availability — the strategy carries no dependency on longer-term market moves.

Backtest (2021–2026): Over the full backtest period from 01/01/2021 to 06/02/2026, the quantitative model produced a cumulative gain of 5,437.1%, equivalent to an annualized return (CAGR) of roughly 109.8%, at a Sharpe ratio of 2.14 over the full period. This Sharpe ratio indicates an above-average return relative to the risk taken. Over the same period, the S&P 500 Index returned 105.6%. Detailed year-by-year figures are provided in the *Performance Analysis* chapter.

Live trading (2025, broker-verified): In 2025 (as of 10/29/2025), the strategy achieved a risk-adjusted annual return of 71.3% in real trading, confirmed by the executing broker Cobra Trading. Over the same period, the S&P 500 Index returned 15.8%. The gap between the 2025 backtest figure (753.4% annualized) and the 2025 live result (71.3%) is due to real-world execution effects and is broken out separately in the “Backtest vs. Live Performance” table in the *Performance Analysis* chapter — including a model calculation of what 2025 would have looked like under an assumed 33% execution error.

Capital Requirement & Capital Base

Operating the strategy targets a capital base of USD 2 million, deployed across roughly 300 trades per year (based on historical data), enabling broad diversification and a robust return profile.

Strategic Advantages

- **Market neutrality:** Independent of market direction — consistent results in both rising and falling markets.
- **Quantitative control:** Emotion-free decision-making driven by statistical models and machine learning.
- **High liquidity profile:** All positions are traded intraday, keeping capital available on a daily basis.
- **Real-time risk adjustment:** Position sizes are dynamically adapted to market volatility to minimize drawdowns.

Defy-Capital's goal is to offer investors a data-driven, risk-adjusted short strategy with systematically demonstrated outperformance versus the broad market.

Market Environment and Rationale

The market for low-market-capitalization equities (nano- and micro-caps) has structural characteristics that set it fundamentally apart from the liquid large- and mid-cap segments. These segments are marked by limited liquidity, low institutional participation, and inefficient price discovery — an environment that enables targeted short strategies with high alpha potential.

Macroeconomic Drivers

The macroeconomic environment of recent years — in particular rising interest rates, tighter credit conditions, and falling market liquidity — has hit small-cap stocks especially hard. Companies with low equity ratios and limited access to debt financing react disproportionately to rate changes.

During this period of monetary tightening, fundamentally unjustified price rallies — driven by short-term sentiment and speculation — occur more frequently. These structural tensions provide fertile ground for temporary price bubbles that demonstrably revert back to their fundamental values.

Regulatory Environment

Small-cap trading is subject to specific regulatory conditions that materially contribute to market inefficiency. Limited transparency requirements, reduced analyst coverage, and lighter disclosure obligations lead to asymmetric information distribution.

In addition, rules such as SEC Regulation SHO (the Locate/Close-Out Rule; U.S. Securities and Exchange Commission, 2004) restrict short selling in low-free-float stocks, which can lead to artificially distorted price moves during illiquid phases. Research on short-selling constraints (Diamond & Verrecchia, 1987) shows that such mechanisms increase the likelihood of short-term mispricing — and with it, the alpha potential for strategies that systematically identify and exploit such overextensions.

Structural Market Trends

In recent years, the influence of retail market participants has increased markedly. Online communities, social media platforms, and forums such as Reddit or StockTwits have both democratized and emotionalized trading behavior.

Collective dynamics visible in “meme stocks” such as Nikola Corporation (2020), Lordstown Motors (2021), or Camber Energy (2021) show that irrational euphoria and hype waves in micro-caps frequently produce temporary price bubbles. Academic research on attention-driven retail trading (Barber, Huang, Odean & Schwarz, 2022) similarly confirms that collective retail investor behavior can amplify short-term price distortions. Such moves are typically accompanied by:

- an exponential rise in trading volume,
- a high concentration of share ownership among a limited number of holders,
- shallow market depth and erratic price swings.

Scientific and Empirical Basis

Numerous studies — for example Barberis, Shleifer & Vishny (1998) or De Bondt & Thaler (1985) — show that behavioral biases such as overreaction and herding can lead to systematic mispricing. The classic work of Jegadeesh & Titman (1993) on momentum and reversal effects provides further empirical evidence that price moves following sharp swings are not purely random. Recent empirical research finds that, particularly in the small-cap segment, sharp price rises are followed by an elevated probability of short-term correction (Hou, Xue & Zhang, 2015).

Defy-Capital's own analysis confirms this pattern: disproportionate price gains in illiquid small-caps tend to partially or fully normalize within a few trading days.

Rationale and Opportunity

The combination of low market liquidity, emotionally driven trading behavior, and limited institutional arbitrage capacity creates an environment with high structural alpha opportunity. Defy-Capital's rationale is to exploit these inefficiencies systematically through data-driven short strategies.

Through fully automated and quantified decision processes, Defy-Capital can deliver consistent, market-neutral results — independent of the prevailing market direction or economic cycle.

Strategic Approach

Objective

Defy-Capital's strategy aims to generate an above-average risk-adjusted return through targeted short positions in overvalued nano- and micro-cap stocks. Capital deployed is dynamically adjusted to market volatility, limiting drawdowns while maximizing the alpha potential captured from market inefficiencies.

Strategy Type and Source of Alpha

Defy-Capital runs a market-neutral, short-bias strategy whose return stream rests on behavioral-driven mean reversion in illiquid markets: the strategy targets systematic mispricing caused by emotional or herd-driven investor behavior.

Such mispricing occurs particularly in low-market-cap names, where information asymmetries, limited liquidity, and low institutional participation impede efficient price discovery. The strategy's core alpha therefore stems from three components:

- **Behavioral alpha:** overreaction to news or social-media impulses produces temporary price bubbles.
- **Liquidity alpha:** illiquid names react to market forces with a lag — an edge for systematic short entries taken at calculated risk (cf. Boehmer, Jones & Zhang, 2008, on the information content of short sales).
- **Volatility alpha:** the decline of elevated volatility after speculative price spikes creates countercyclical profit opportunities.

Investment Universe

The strategy focuses on a clearly defined investment universe of US-listed, low-market-capitalization equities:

Criterion	Definition / Threshold
Market capitalization	Below USD 100 million (nano- and micro-caps)
Share price level	Above USD 2 and below USD 50 per share
Exchanges	NASDAQ, NYSE, NYSE American
Sectors	No restriction — diversified across multiple industries
Exclusions	SPACs and ADRs (regardless of price level)

Trading Horizon and Liquidity Profile

Every position is opened and closed within a single day. The average holding period is under 24 hours, so the deployed capital is fully available again as early as the following trading day.

The small position size per trade (max. 6% of total capital) minimizes overnight gap risk and allows for tighter control of exposure during volatile market phases.

Methodology

Potential short candidates are identified through a combination of fundamental, technical, and quantitative analysis, supported by machine-learning models. The goal is to detect statistically significant price overextensions before they are corrected by the market.

Core components of the analysis:

- **Fundamental analysis:** assessing potential overvaluation using key valuation metrics (e.g. P/E, P/S, EV/EBITDA, free-cash-flow yield) versus historical and peer-group comparisons.
- **Technical analysis:** characterizing notable price paths (e.g. parabolic price rises) and momentum indicators (RSI, rate of change) as a supplementary signal, not a standalone forecasting factor.
- **Quantitative models:** estimating mean-reversion probabilities using established econometric methods (e.g. Ornstein-Uhlenbeck processes, GARCH models for volatility per Bollerslev, 1986, and Hidden Markov models for regime shifts per Hamilton, 1989).
- **Machine-learning layer:** supplementary pattern recognition in price and volume data via classification methods (random forests, gradient boosting), validated through out-of-sample testing and walk-forward analysis to reduce overfitting risk.

Position Management

The risk management framework dynamically sizes positions based on current volatility analysis. The average risk taken per trade is guided by the Kelly criterion (Kelly, 1956), while volatility thresholds and historical drawdown data are used to adjust and smooth risk.

- **Maximum risk per position:** 6% of total capital
- **Stop-loss level:** calculated from intraday volatility (ATR-based)
- **Take-profit level:** mean-reversion target per the statistical model
- **Diversification:** max. 16 concurrent positions

This systematic approach ensures that the risk taken on any given trade is never subjective, but fully data-driven and rule-bound.

Research and Decision Process

Defy-Capital makes trading decisions based on a structured, data-driven approach that combines quantitative analysis, fundamental valuation, and technical signals to efficiently weigh opportunity against risk. The goal of this multi-stage research framework is to identify, from a broad universe of candidates, the stocks most likely — with high statistical confidence — to be showing short-term price overextensions.

Screening & Preselection

Every stock in the target universe (NASDAQ, NYSE, NYSE American) is filtered daily against defined criteria, including price change, trading volume, fundamental valuation metrics, and volatility patterns. Only names showing significant deviation from historical normal behavior are carried into the shortlist.

Signal Architecture and Model Governance

The signal architecture is built by combining several data sources, including price, volume, and fundamental data. These are processed by proprietary quantitative models that generate trading signals from historical and current market data.

To keep the models performing well, they are continuously retrained and improved on new data, allowing them to keep adapting to changing market conditions and remain robust against structural shifts.

Under model governance, every new model iteration is reviewed before deployment through extensive backtesting, out-of-sample validation, and real-time comparison — a process that safeguards model stability and guards against overfitting.

This combination of data-driven signal processing, self-adaptation, and validation keeps the overall system adaptive, stable, and consistent in its decision logic.

Decision & Position Sizing

Once a signal is confirmed by the model, position size and the corresponding stop-loss and take-profit levels are calculated using quantitative risk models that account for historical volatility, ATR values, and the expected mean-reversion range.

Position sizes are set by the risk management framework with the goal of limiting drawdowns and optimizing capital allocation.

Monitoring & Adjustment

All open positions are monitored in real time. Positions are reduced or closed in response to significant market shifts, elevated risk, or structural signal deviations.

Risk Management

Risk management is a central pillar of the trading strategy, designed to limit losses and ensure the sustainability of capital allocation.

- **Quantitative stop-losses:** Every position carries a quantitative stop-loss level that risks a predefined share of total capital per trade, keeping the portfolio stable over the long run even when individual trades move unexpectedly.
- **Risk of extreme price moves:** Nano- and micro-cap stocks carry an elevated risk of extremely sharp price moves that can prevent a position from being closed at the desired price — for example when prices gap from halt to halt. Analysis of historical market scenarios over recent years shows that positions had to be liquidated at worse prices in only a very small share of cases.
- **Dynamic risk adjustment:** Based on this analysis, a dynamic system was built that flags trades with an elevated risk of extraordinary price moves early and adjusts position sizes accordingly. Historical testing shows that this dynamic risk control stabilizes performance and materially reduces the impact of extreme price moves (see Figure 1).
- **Value-at-Risk (VaR) & Expected Shortfall (CVaR):** Based on the strategy's historical weekly returns over the full backtest period, the strategy shows a weekly VaR of 7.3% (95% confidence, historical simulation; methodology per Jorion, 2006) and a CVaR of 10.2% (per Rockafellar & Uryasev, 2000), both relative to total capital.
- **Stress tests / extreme scenarios:** Analysis of the strategy's largest historical drawdown event (November 2024–May 2025, a realized decline of 35.96%) illustrates how dynamically reducing

position size during the identified risk phase could have cushioned the drawdown, with essentially unchanged performance over time (see Figure 1). The risk-adjusted curve shown there is not an independently computed simulation — it is a simplified illustration that shrinks the actual decline by 30%.

- **Liquidity risk:** The extreme-case simulation shows that the risk of having to close positions at an unfavorable price due to liquidity constraints remains controllable, and that losses can be limited through dynamic position sizing.
- **Currency risk:** The strategy trades exclusively USD-denominated equities; capital deployed and returns are reported in USD. Investors whose base currency is CHF therefore carry an additional USD/CHF exchange-rate risk, which can affect the return realized in their home currency independently of the trading result. Defy-Capital does not currently hedge this currency exposure.
- **Risk transparency:** Risks can never be fully eliminated. Extreme price moves are an inherent risk of shorting low-market-cap equities and a natural part of the strategy. Short selling carries theoretically unlimited risk, since losses can exceed the capital deployed and result in liabilities beyond the capital committed.

Risk management aims to minimize the probability of capital loss and to keep positions under controlled management. At the same time, these risks are the price of the potentially higher returns generated by exploiting short-term overvaluation: risk and return are directly linked, and the strategy balances both through dynamic position sizing.

Figure 1 shows the strategy's actual equity curve during its largest drawdown event to date (marked in red, real trading data) alongside an illustrative curve with dynamically reduced position size during that risk phase (marked in blue). The blue curve is not an independently computed simulation: it is the real curve with every decline below the starting level shrunk by 30%, purely to illustrate the intended effect of dynamic risk adjustment — outside the risk phase, both curves are identical. Because very few moves of this magnitude occurred in the historical data, the effect of dynamic risk adjustment can be illustrated through this one event, but not backed by broad statistical evidence.

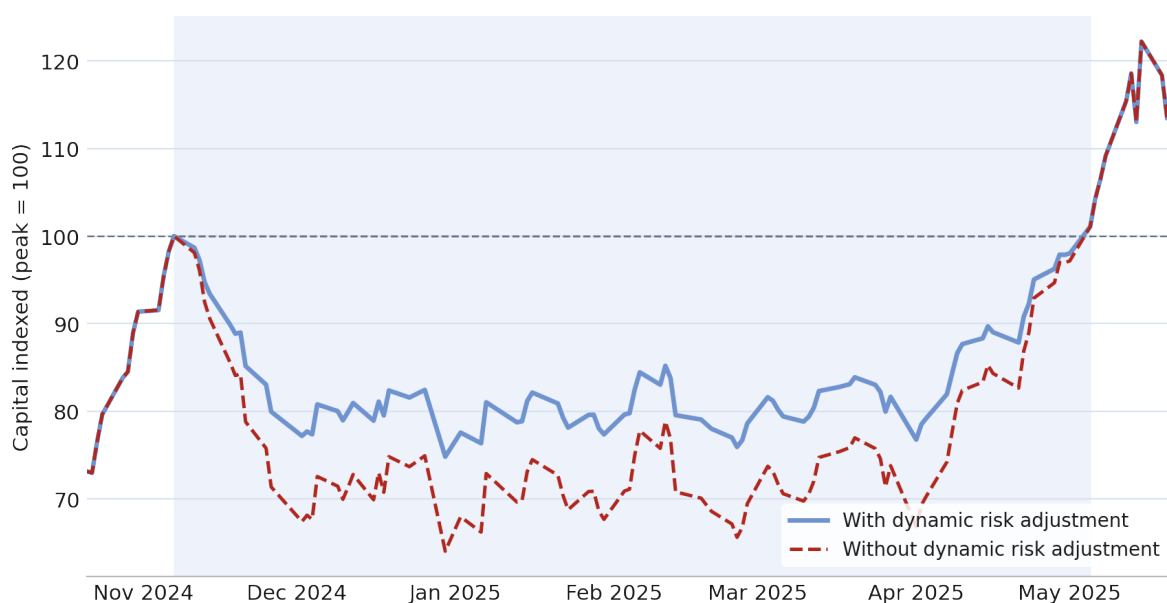


Figure 1: Strategy equity curve (real trading data) during the largest historical drawdown event (Nov. 2024–May 2025). The “with dynamic risk adjustment” line is an illustrative curve with a 30% smaller decline, not an independent simulation.

Performance Analysis

Backtest Performance Analysis

Overall Performance

	2021	2022	2023	2024	2025	2026*
Annualized return	23.9%	26.4%	74.0%	14.5%	753.4%	108.0%
Sharpe ratio (4% risk-free rate)	1.53	1.10	2.03	0.43	4.44	4.56

* 2026: actual return through the last recorded trade (06/02/2026), not annualized.

For the markedly higher return level from 2025 onward – driven mainly by a higher number of trades, not by better per-trade performance – see [Notes / Observations](#).

Risk

	2021	2022	2023	2024	2025	2026*
Annualized volatility	23.7%	18.6%	26.4%	44.2%	48.9%	38.7%
Maximum drawdown (calendar year)	8.56%	7.44%	25.43%	35.96%	16.79%	8.92%
Recovery period	22 days	52 days	70 days	126 days	43 days	14 days

Recovery period: time the strategy needs to recover from its yearly low and reach its previous high again.

Backtest vs. Live Performance

	2021	2022	2023	2024	2025	2026*
Execution error	no data	no data	no data	no data	-33.3%	no data

Execution error: the gap between the return simulated in the backtest and the return actually achieved in live trading. No comparable live data exists for 2021–2024 or 2026, since full-scale live trading began in 2025 and 2026 does not yet have a long enough live track record.

For context: applying the same 33% execution error to the 2025 backtest figure (753.4% annualized) implies an “as-if-live” annualized return of roughly 502.6%. This model calculation illustrates the order of magnitude of the execution error only and does not replace the actual, broker-verified live performance (see the *Live Trading Performance* section).

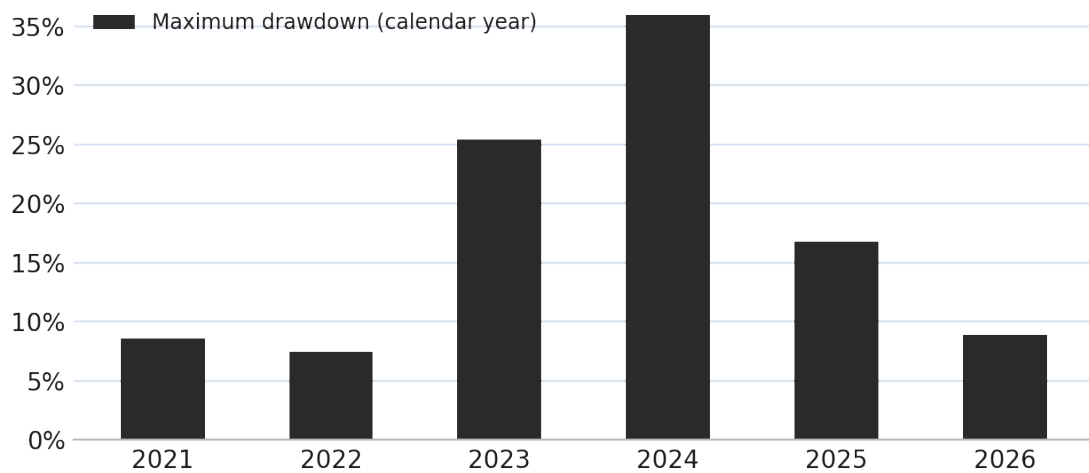
Capital Utilization

	2021	2022	2023	2024	2025	2026*
Return on Capital Employed (ROCE)	133%	147%	411%	81%	4,186%	600%

ROCE measures profit relative to capital actually deployed, not total available capital. Under a 6%-per-trade position limit with roughly three positions open at once on average, only about 18% of total capital is actually committed at any given moment — the rest sits out of the market. Measured against that actually-deployed capital, ROCE is materially higher here than under a classic buy-and-hold capital commitment, where the full capital base would be tied up continuously.

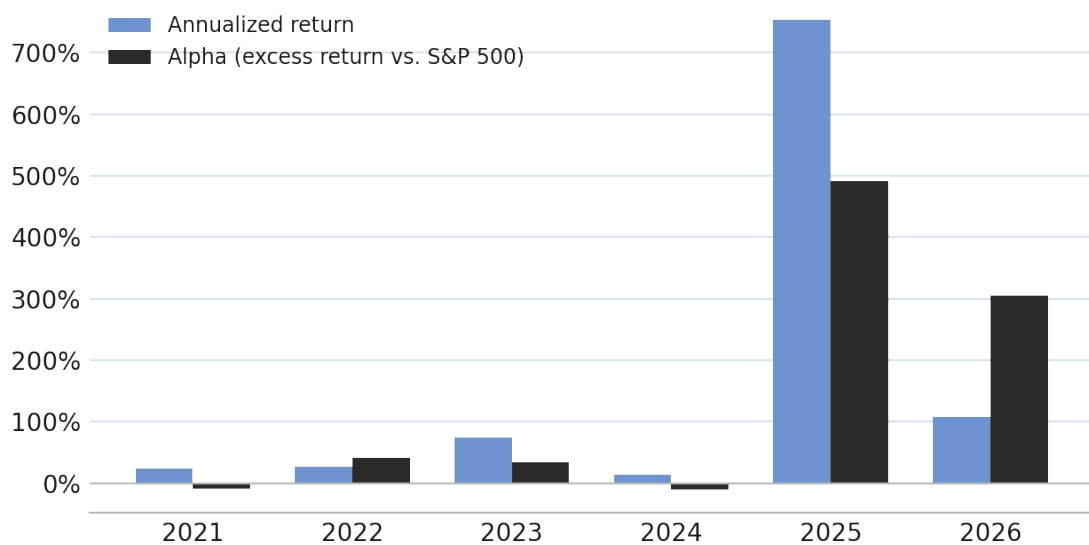
Trade Metrics

	2021	2022	2023	2024	2025	2026*
Win rate	73.6%	70.7%	69.4%	64.5%	68.0%	68.3%
Average gain	21.0%	19.4%	23.5%	25.6%	26.3%	26.1%
Average loss	41.8%	34.4%	37.8%	44.0%	36.5%	34.6%
Number of trades	87	116	206	439	609	186



Benchmark Comparison: S&P 500

	2021	2022	2023	2024	2025	2026*
Alpha (excess return vs. benchmark)	-9.0%	41.8%	34.7%	-10.4%	490.9%	305.6%
Beta (market sensitivity)	-0.011	0.002	0.130	0.025	0.023	-0.162
R-squared	0.000	0.000	0.006	0.000	0.000	0.004



Conclusion: The backtests show a cumulative strategy gain of 5,437.1% from 01/01/2021 to 06/02/2026, with a maximum cumulative drawdown of 35.96% over the full period. Over the same period, the S&P 500 Index returned 105.6%, with a maximum cumulative drawdown of 25.4%. Every calendar year analyzed shows a positive return for the strategy, though the strategy did not outperform the S&P 500 in 2021 and 2024.

Live Trading Performance

The broker-confirmed cumulative performance across all individual trades (2025 YTD) is 1,161%, showing that the strategy also delivers a clear excess return (alpha) in real trading. Based on the modeled risk parameters, this translates into a risk-adjusted annual return of 71.3%.

During the ramp-up phase, trading was carried out at a reduced position size, so the realized dollar profit for 2025 comes to USD 14,053.

Notes / Observations

Analysis of the 2021–2026 data shows the following market developments:

- **Rising trading activity:** The number of trades executed per year rose steadily — mainly the result of higher market volatility, which more often produces situations the strategy classifies as price overextensions. Because the average profit per trade stayed constant, annual profit rose overall.
- **Comparable per-trade performance:** 2021–2023 show per-trade profitability similar to 2025 and 2026 — the lower annual return in those earlier years stems mainly from the much smaller number of trades executed, not from weaker strategy performance. 2024 is the exception: with a noticeably weaker return per trade, it is by far the weakest year in the observed period.
- **Rise in risky price moves:** In parallel, the frequency of “risky price moves” increased (see the *Risk Management* chapter) — in line with the broader rise in momentum, volatility, and trading volume across the market.

These developments confirm the importance of a robust risk management system for delivering stable results even as market phases grow more dynamic.



Figure 2: Strategy equity curve vs. S&P 500, 01/01/2021–06/02/2026 (log scale).

Operational Implementation

The trading strategy is executed through Cobra Trading, a US-based broker specializing in active short selling. The broker was chosen for its excellent execution speed, stable trading infrastructure, and its ability to efficiently short hard-to-borrow stocks.

Cobra Trading works with recognized clearing partners and regulated financial institutions. Client funds are held in segregated accounts, separate from the firm's own operating assets, protecting client capital in the event of the broker's insolvency.

Compensation: Because Defy-Capital does not operate a collective investment scheme, no standardized fund fee structure (e.g. a fixed management fee) applies. Compensation is instead profit-based and set individually for each private loan agreement (profit-participating loan) between the contracting parties.

Compliance & Disclaimer

Regulatory Notice

Defy-Capital is not a licensed financial institution under the Swiss Financial Institutions Act (FinIA) and does not constitute a collective investment scheme under the Swiss Collective Investment Schemes Act (CISA). Defy-Capital is not supervised by the Swiss Financial Market Supervisory Authority (FINMA). The activities described here take place exclusively under private profit-participating loan agreements and are not directed at the public. No public advertising or collective fundraising takes place.

No Investment Advice or Solicitation

The information in this document serves solely to describe Defy-Capital's trading strategy in general terms. It does not constitute a recommendation or a solicitation to buy or sell any financial instrument. This document does not replace individual investment, legal, or tax advice. Prospective investors should seek independent advice before participating and carefully assess their personal risk capacity.

Risk Notice

Trading equities — in particular short selling small- and micro-cap stocks — carries elevated financial risk. Investors bear the risk of losing the capital deployed in full, and in extreme cases incurring liabilities beyond it. In particular market conditions (e.g. strong momentum, elevated volatility, or trading halts), actual exit prices may deviate materially from planned ones.

Defy-Capital employs a quantitative risk management system to monitor and reduce such risks. These risks cannot be fully eliminated, however — only limited. Such market risks are an inherent part of the strategy and are directly linked to the return opportunity it targets.

Historical Data

The performance and backtest data in this document are based on historical simulations and, in part, on actually executed trading activity. These results serve solely to illustrate the strategy and how it works. Past results are not a reliable indicator of future performance or profit. Market conditions can change at any time, and future results may deviate materially from historical simulations.

Disclaimer of Liability

All information in this document has been prepared with due care. Nonetheless, Defy-Capital and its representatives accept no liability for losses, damages, or consequential costs arising directly or indirectly from the use of this information. Participation in Defy-Capital's trading activities is at the investor's own responsibility and risk.

Glossary

- **Alpha:** excess return versus a benchmark index, adjusted for the market risk taken.
- **ATR (Average True Range):** a measure of a security's average price swing, used to calibrate stop-loss levels.
- **Beta:** a measure of a strategy's sensitivity to broad market moves; a beta near 0 indicates market neutrality.
- **CAGR (Compound Annual Growth Rate):** the geometrically smoothed annual growth rate of an investment over multiple years.
- **Conditional Value-at-Risk (CVaR) / Expected Shortfall:** the average loss across the scenarios that exceed the VaR — capturing the scale of extreme losses more precisely than VaR alone.
- **Kelly criterion:** a mathematical formula for determining optimal position size based on the probability of winning and the risk/reward ratio.
- **Maximum drawdown:** the largest observed decline in capital from a prior peak to the subsequent trough.
- **Mean reversion:** the statistical tendency of a price to return to its long-run average or fair value after deviating from it.
- **Nano-/micro-cap:** equities with very low market capitalization (in this document: below USD 100 million).
- **R-squared:** a measure of how much of a strategy's return variation can be explained by the movements of a benchmark index.
- **ROCE (Return on Capital Employed):** a measure of profit generated relative to capital deployed.
- **Sharpe ratio:** the ratio of average excess return (over the risk-free rate) to the volatility taken on; higher values indicate a better risk-adjusted return.

- **Short bias / short position:** a trading position that profits from falling prices by selling a borrowed security and buying it back later.
- **Value-at-Risk (VaR):** the estimated maximum loss over a given period that is not expected to be exceeded at a stated confidence level (e.g. 95%).

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