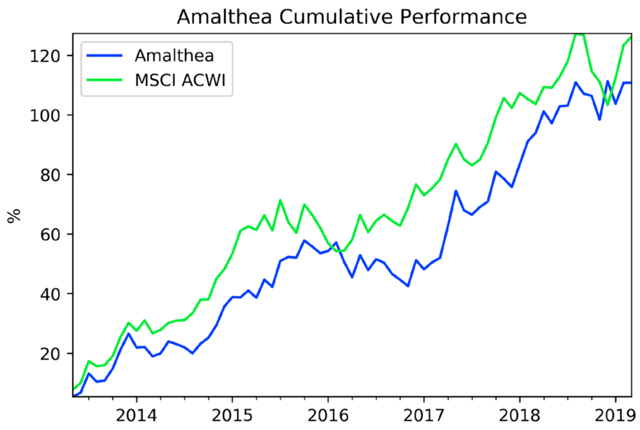
Amalthea Fund – March 2019

The Bronte Amalthea Fund is a global long/short fund targeting double digit returns over the long term, managed by a performance orientated firm with a process and portfolio that we feel is genuinely different. Objectives include lowering the risk of permanent loss of capital and providing global diversification without the market/drawdown risks typical of long-only funds. We believe a highly diversified short book substantially reduces risk and enables profits to be made in tough markets

	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	FYTD
FY13											5.4%	1.3%	6.8%
FY14	6.0%	-2.5%	0.4%	3.6%	5.7%	4.3%	-3.7%	0.2%	-2.6%	0.9%	3.4%	-0.8%	15.2%
FY15	-0.9%	-1.6%	2.7%	1.7%	3.4%	4.9%	2.3%	-0.1%	1.7%	-1.7%	4.4%	-1.7%	15.6%
FY16	6.1%	0.9%	-0.2%	3.8%	-1.3%	-1.4%	0.5%	1.8%	-4.1%	-3.4%	5.1%	-3.4%	3.8%
FY17	2.5%	-0.8%	-2.5%	-1.3%	-1.5%	6.1%	-2.0%	1.6%	1.0%	7.0%	7.2%	-3.7%	13.6%
FY18	-0.9%	1.5%	1.1%	5.9%	-1.3%	-1.6%	4.4%	4.1%	1.5%	3.7%	-2.0%	2.9%	20.8%
FY19	0.1%	3.8%	-1.8%	-0.4%	-3.9%	6.5%	-3.6%	3.4%	0.0%				3.9%



By some measures the first quarter of 2019 was the best start to the year for decades. The globally diversified ACWI was up 11.3% in $A. However, we were not positioned for such an over-joyous up-market and remained flat across the quarter.

Bronte will rarely keep up with a market that rises this fast, especially if the starting valuations are still high. We are congenitally unwilling to buy things just because they are going up. So some relative weakness in our performance was expected, although we (cont. over)

Fund Features		*Portfolio Analytics*[1]		
Investment Objective	Maximise risk-adjusted returns with high double-digit returns over 3-year periods.	*Metric*	*Amalthea*	*MSCI ACWI (in AUD)*
Min. initial investment	**Presently closed to new investments and additions**	Sharpe Ratio[2]	1.1	1.2
Min additional investment		Sortino Ratio	2.2	2.4
Applications/redemptions	Monthly	Annualised Standard Deviation	10.8%	10.3%
Distribution	Annual	Largest Monthly Loss	-4.1%	-5.4%
Management fee	1.5%	Largest Drawdown	-9.7%	-10.6%
Performance allocation	20%	Winning Month Ratio	0.59	0.65
Administrator	Citco Fund Services	Cumulative return[3]	110.8%	126.3%
Auditor	Ernst & Young	1-year annualised return	8.6%	11.1%
Custodians/PBs	Fidelity, Morgan Stanley, JP Morgan	3-year annualised return	11.8%	13.6%
		5-year annualised return	12.1%	12.3%
		Annual return since inception	13.4%	14.8%

1 Performance and analytics are provided only for Amalthea ordinary class units. Actual performance will differ for clients due to timing of their investment and the class of their units in the Amalthea fund
2 Sharpe and Sortino ratios assume the Australian cash rate as the applicable risk-free rate
3 Returns are net of all fees

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think we are capable of being bold when things are really cheap.

That said, against our internal views of what we think we should achieve the quarter was three to five percent light. It was not a great quarter.

Making this observation we should note that for the prior quarter we may have been 6-8 percent ahead of what we internally expected. The fund was also flat then whereas the ACWI in $A was down 10.6%. This result (and that result) is within the range of normal.

With that constraint we thought a fair bit about what we did wrong and we concluded that nothing is broken in any meaningful way. Our longs performed slightly worse than benchmarks but there is only a percent or two in it. Our shorts hurt a fair bit. But in over-joyous party markets really low-quality stocks fly.

To some degree the trick to doing well this quarter was to do really badly in the December quarter. Our worst stock in the December quarter was our best stock this quarter. Some shorts that cratered last year came back with a vengeance this year.

That said we have learned a few lessons about how to get longer in a panic.

The market bottomed Christmas day last year. Many of our shorts had fallen a long way and many of our longs had dropped, but only a little. We knew the position was extended and we knew we had to get longer.

The core Bronte model is to take profits from shorts in a down-market and reinvest them in the stocks of good companies at the newer (and lower) prices.

The problem we had was that almost no business we liked had fallen to a price where we wanted to buy it. And for those that had we dithered too much (because frankly we had not done enough work to get comfortable in a panic). So, in the face of evidence that we should have been buying, we dithered.

This will change in the future. On <u>really sharp movements</u> where we know we should be longer (as per Christmas day) when we don't have "shovel ready" individual targets we will just (and on a temporary basis) buy the index. It is not that we want to own the index – it is just that it allows us some time to readjust into the stocks we really wanted to own.

If we had done that we would have bought 10-15 percentage points of index. We would have sold it again by the end of January and it would have made a little over a percent difference to our performance. It wouldn't have solved our (relative) difficulties in the bounce – but it would have helped.

<u>Changes in the long portfolio</u>

There have been a few changes in the long book this quarter. Henkel (a German industrial glue and consumer-good conglomerate) is a stock we have been long in quantity since the inception of Bronte (in 2009). Recent results are less than stellar. Henkel is a highly profitable business with good margins on incremental sales and an unfortunate slowing in sales growth. We still like the business (just not as much) and we think it will do okay over the next decade. But it was once one of our bigger longs and it is now one of our smaller ones. Moreover, the CEO of Henkel we strongly admired (Kasper Rørsted) is now CEO of Adidas (and to some extent your money followed him).

The bigger change is that we took an average size position in General Electric. This surprises people. They question how a small fund based on the wrong side of the world can have an edge in assessing one of the biggest and most complex (and most followed) stocks in the world. Moreover, GE has deep problems at the moment and has suspended their dividend and hired an external CEO. Critics might ask (and with good reason) why you think you have any edge in buying into that.

This is only partly fair. John has been following GE closely since 2000. In his old job John was responsible for a very large short in GE. It worked okay.

And we have followed GE more closely because it is the main competitor to many other companies we are interested in from medical scanning equipment to industrial gas compressors used in plastics plants.

In almost every case where GE competes with another company we are looking at the GE business has at least equality if not superiority. For example, GE's engine business is clearly better than Rolls Royce or MTU Aeroengines (both of which we own). GE's medical imaging business is probably on par with or better than Phillips. There are exceptions – for example GE had a business in the North of Italy doing high-end compressors (say 1000 bar) for petrochemical plants. That wasn't very profitable – and it has largely withered away.

But GE went wrong in several ways.

The most important way (by far) is that GE is the poster-child for buying back too much stock at the wrong price. The company repurchased nearly 100 billion dollars in stock at prices way above the current price. Aggregate repurchases are larger than the current market capitalization and the company has too much debt.

The second problem is that GE's biggest business (making kit for electricity generation) is on the wrong side of history. For decades renewables required subsidies. That is not true any longer. Solar plus battery looks like it will be forever cheaper than coal. Wind (where GE has a position) is unlikely to be quite so cheap but it is still workable (and particularly so in windy places). The large profit streams from power generation are unlikely to recur.

To make matters worse GE bought Alstom, a large French based maker of power generation kit. Billions of dollars evaporated.

Notwithstanding this, we are fairly confident about the value and sustainability of GE's businesses. We are regularly told of their strength by their competitors. But that strength is obvious when you work out the revenue per employee. Here is a list:

	Revenue (billions)	Number of employees	Revenue/employee (USD)	Notes
Power systems	27.3	59700	$457k	Revenue off 22 percent
Oil and Gas	22.9	65800	$348k	Separately listed also problematic
Renewables	9.5	22900	$415k	Still growing
Aviation	30.6	48000	$637k	Growing nicely – Boeing 737 Max problem
Healthcare	19.8	53800	$368k	Growing nicely – but since sold the best business – the old Amersham.

These are pretty nice numbers. It is churlish to think that these are anything other than industrial businesses of the highest quality.

The asset side of the balance sheet is okay.

The problem is not the asset side of the balance sheet. It is the liability side.

Firstly, there is a lot of debt (mostly from share buybacks).

Secondly there are pension funds, unfunded to approximately $30 billion, and even that funding gap is calculated using possibly questionable actuarial assumption. GE had to contribute $6 billion to the pension fund during 2018 – this creates real cash draws on the parent.

Finally, the ghost of GE Capital (once a very big business, now a small one) haunts them with old liabilities (such as reinsuring long-term care liabilities) costing them lots of money.

It is the pension fund and the ghost of GE Capital that are hard to assess.

Long term care

It is worth an aside about long-term care.

Long term care insurance is the business of insuring people against the need to go into a nursing home. It pays for their nursing home coverage if required.

This is an area that John once knew really well and has strong views on.

Conseco – still the seventh biggest bankruptcy in US history – and at core a long-term care insurer – was a central stock in John's life. John spent several months working on it and he shorted it to zero.

John wrote about the long-term care business in a blog post in 2012. Here is a cut-down version starting with the assumption of using a commissioned agent:

> The commissioned agent makes friends with people who run nursing homes.
>
> When the kids (now middle aged) visit a nursing home they might put their (elderly) parents into, the insurance broker is notified. The insurance broker then sells them a policy for their parents.
>
> Of course the policy is going to be used. The people who buy long term care insurance are precisely the people who are going to claim. It is a disaster.
>
> Eventually the policies become so expensive (to cover the losses) that people who won't claim never buy a policy. Adverse selection becomes total.
>
> Long term care sold by agents is possibly the worst business in the history of insurance.
>
> But then long-term care doesn't need to be that awful. Indeed, there is (at least) one company that does it well.
>
> That doesn't make long term care a good business - but it might make it an acceptable business.
>
> That company is (and this will be a surprise to many of my readers) is Genworth. The same Genworth that was a spin-out of crappy long-tailed insurance businesses from GE Capital. It includes a mortgage insurance company (with what is probably a toxic Australian exposure) and a long-term care business.
>
> Here is what they do to make the long-term care business acceptable.
>
> They employ a sales force of 60-65 year old people on salary not commission. Because they are on salary not commission they have no incentive to write bad risks. They do not troll for business in nursing homes.
>
> This sales force visits the home of leads and has a cup of tea or coffee and a social chat. They might spend twenty minutes having a chat.
>
> They will find out what the lead's husband or wife is doing.
>
> They will find out whether the lead is doing the New York Times crossword or reading sophisticated books.
>
> And whether they play golf or do some exercise.
>
> They will look for pictures of the grandchildren and ask questions about them.
>
> They will observe and ask about the pile of toys and children's games in the corner.
>
> And only then will they ask anything that looks like an underwriting question but they will have already decided whether to underwrite the business.
>
> Here is what is going on.
>
> People who have stable relationships into old age tend not to wind up in nursing homes. They

> look after each other. Singles are the biggest risk and asking about a spouse is the critical question.
>
> Doing the New York Times crossword or reading sophisticated books indicates no Alzheimer's disease. That removes another major insurance risk.
>
> Golf suggests some physical fitness - and removes more risk.
>
> The children's toys however are - after a solid marriage - the next largest risk mitigating factor. If the grandparents look after the grandchildren that creates a reciprocal obligation. The children are far less likely to put granny in a nursing home if granny is a part of their own kid's lives.

Now the long-term care business that is hurting GE is the old Genworth business. Even the best long-term care business in the trade is behaving awfully – and people are projecting how bad it might be based on the history of other long-term care businesses.

We have a hunch (and it is only a hunch) that the reserve strengthening is probably nearly done here.

If it is, we can be more confident about GE than the market is. But as you can see this is still a hunch based on what we think are pretty good priors.

Still we worry about GE. If any of our readers have deep insight to some of their troubles, please contact us.

One final observation about GE. John met Larry Culp when he was an executive at Danaher in 2001. It is a long time ago – but he was competent manager of the highest order. He is now CEO of GE. We think the leadership of GE is in good hands.

Larry Culp can't make the GE Long Term care business run any better than it does. They wrote much of this business more than a decade ago and the losses will come in as they come in. But he is less likely to make big mistakes than many other managers.

We like GE (quite a lot actually) and it is our process to use profits from our shorts to buy good companies especially when they fall on hard times. But we will never make GE a very large position as it is highly levered and zero is within the normal range of outcomes. We are simply not prepared to risk a large position on such a dangerous stock.

Finally – and in full disclosure – John was a source for this story in Barrons (written at a price a fair bit above here). Andrew Bary did a pretty good job of outlining the (considerable) negatives in the stock.

Other longs and processes

There is a long we have increased our holding of in the past quarter. It is run by a very conservative family (who own a majority of shares) and we believe it is a bunch of reasonable businesses trading at a very big discount because of holding company structures.

The signal was that the company is buying back stock and increasing net family ownership. This is enough for us to want to increase our ownership as well.

We do not wish to disclose the company as we may wish to buy more.

Also, we visited Japan for three weeks and we will visit again. Japan is full of very good businesses often run in a shareholder unfriendly way and trading at very steep discounts. We found a few things to nibble on there – and with some work we might find enough good things in which to buy meaningful positions.

The problems with Japan however are non-trivial. Companies have life-time employment obligations. Combined with technology businesses that sometimes become obsolete makes the country full of value-traps. Domestic companies also must deal with a rapidly shrinking domestic population. Many companies are surprisingly inward looking. Competent multilingual executives who can take the best of Japan to the world are rare.

That said, thirty years of deflation has produced some cheap and good companies. It is our job to find them.

Welcome Dr John Graham

The Bronte team has expanded. We hired Dr John Graham – a highly academic mathematical whiz. We do not have much use for representation theory but there are many heuristics we use to trade and manage the portfolio which we think are okay but have never been tested or optimized.

We literally do not know how much a decent mathematician can improve Bronte – but our guess is quite a lot. We will let you know how it goes.

Thanks again for the trust you have placed in us.

The Bronte team