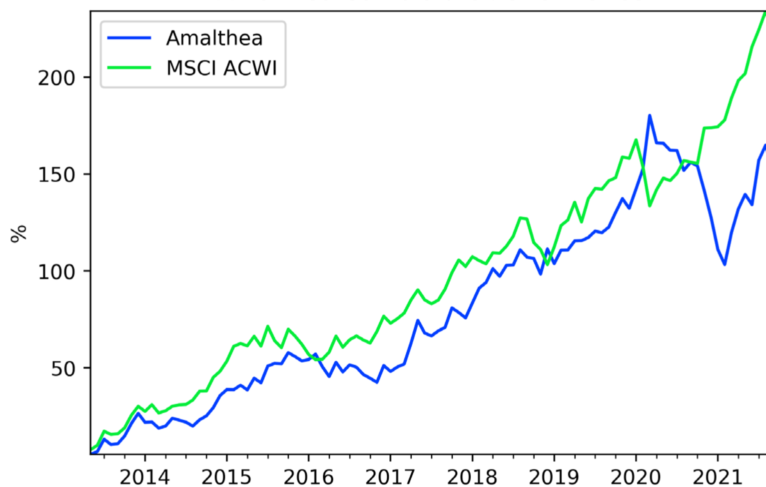
Bronte Capital

Amalthea Fund – September 2021

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%	2.2%	0.1%	0.7%	7.1%
FY20	1.5%	-0.4%	1.3%	3.4%	3.1%	-2.1%	4.3%	4.2%	11.0%	-5.1%	-0.1%	-4.8%	16.5%
FY21	-0.1%	-3.9%	1.7%	-0.7%	-5.0%	-5.7%	-7.3%	-3.7%	8.2%	5.5%	3.2%	-2.2%	-10.7%
FY22	9.7%	3.0%	-4.5%										8.0%



For the quarter the fund gained 8.05% whereas the globally diversified MSCI ACWI (in AUD) was up 2.84%. For September the results were less attractive with the fund down 4.46% compared with a loss of 2.83% for the ACWI (in AUD). It being the end of the quarter we have written a more extensive letter (see 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	$100,000 (for qualifying investors)	Sharpe Ratio[2]	0.81	1.27
Min additional investment	$50,000	Sortino Ratio	1.50	2.30
Applications/redemptions	Monthly	Annualised Standard Deviation	12.45%	10.53%
Distribution	Annual	Largest Monthly Loss	-7.30%	-8.00%
Management fee	1.5%	Largest Drawdown	-30.01%	-12.73%
Performance allocation	20%	Winning Month Ratio	0.57	0.66
Administrator	Citco Fund Services	Cumulative return[3]	143.62%	224.63%
Auditor	Ernst & Young	1-year annualised return	-1.16%	26.69%
Custodians/PBs	Fidelity, Morgan Stanley, JP Morgan	3-year annualised return	5.63%	12.69%
		5-year annualised return	10.74%	14.57%
		Annual return since inception	11.16%	15.02%

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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This has been a high stress quarter with good months and bad months – but not much achieved or lost. August was very good. But September was very poor – and would have been poorer except for a rather esoteric derivative position we do not wish to disclose. (The trade is still ongoing; the end result is uncertain and whilst the "mark" was externally determined, and our broker would be prepared to trade at that mark, we are not sure of the permanence of that gain.)

The main issue in the portfolio – dealt with at the end – is that the degree to which the long and the short side of our book hedge each other has declined sharply in this covid period. We are a hedge fund – a real one – which means we try to, and mostly do, hedge our exposures to a very large extent. The problem when the long-side and the short-side of our book de-correlate is real. We find it harder to be a hedge fund. More on that later.

End-of-Covid Effects and Herbalife

The biggest loss in the portfolio in the last month was Herbalife. Their renewed and lower guidance for the third quarter of this year is poor. This we think is an end-of-covid effect.

But let's start with a more obvious end-of-covid effect which has driven some returns. Last year – at the height of covid – there was a scare and a crackdown on vaping – especially JUUL, and especially in the United States.

At the same time cigarette smoking (that is stick volumes) had stopped their relentless decline and actually started to tick up.

There were two effects, and it was impossible to disaggregate them. Pre JUUL, stick volumes fell 1-2 percent every year. After allowing for price increases that decline meant there was plenty of value left in the big tobacco companies.

After JUUL the decline rate fell to 4-6 percent per year. Vaping it seems was bad for cigarette stocks and the stocks weakened – becoming – seemingly quite cheap. The case for allowing vaping too was quite strong. Vaping is probably two orders of magnitude safer than combustible cigarettes – and, whilst it is not a healthy habit, if it was driving falls in combustibles then net-net vapes were almost certainly a positive.

With the crackdown on JUUL the decline in vaping was sharp – and cigarette volumes picked up. This made big tobacco stocks appear very cheap to us indeed.

But it was impossible to tell whether the changed trend in smoking was the vaping crackdown, or whether it was work-from-home. After all, smoking at the office is rather difficult. You go outside and stand – shamefully – at the door where everyone can see your vulgar habit. Work-from-home may just be smoke-from-home.

We bought the cigarette stocks – and we were unsure whether we were getting cheap but distasteful companies or whether we were getting a true bargain. If cigarette volumes ceased to fall tobacco companies were astonishing bargains.

A year has passed. And we can now answer that. Good news for the world but not for a small part of your portfolio. Smoking volumes have resumed their seemingly remorseless declines. The cigarette companies are still cheap enough – but they are not astonishing bargains.

Our main nicotine bet is however on Swedish Match – a tobacco company without a cigarette business and which is a beneficiary of the ongoing shift away from combustibles. Swedish Match is unusual – it is the only large and growing nicotine product company in the world. It too had Covid effects that are hard to disentangle – however the return to the office may be good for Swedish Match because you can consume Zyn (their growth product) at the office.

Now, let's go to a position that matters for the portfolio. Herbalife.

Herbalife is – as we have discussed many times before – a multi-level marketing scheme selling weight-loss shakes.

The idea is simple. If I replaced six meals a week with low-calorie protein shakes and I walked an extra 15km a week I would quickly lose 15-20kgs. It would be good for me.
It is also well-nigh impossible to do.

One solution is to hire a personal trainer (usually of the opposite sex) and have them nag you. You will do tough stuff for an attractive member of the opposite sex. More realistically you could just have your friends nag you. And that is why this works so well as a multi-level marketing scheme. The person who sells you the shakes has an incentive to keep you on the diet.

We have looked at many distributors and we see a weight-loss program – implemented for (literally) millions of people – which works about as well as any weight-loss health program that ever existed. That still means it fails most of the time – but it works enough that we can be proud of owning this stock and the health benefits it provides.

Herbalife, it turns out, grew well during COVID. This was initially a surprise to us – as we thought Herbalife depended on the personal touch to make the sale. But, instead, weight loss and associated social clubs moved online – and – in many cases were the main social outlet the customers had.

We will keep it simple and focus on North America – but below are the volume points – a consistent measure of volume – over the past few years by quarter. You will notice that in almost all years except 2020 the peak volume is in the second quarter (highlighted in green). That is unsurprising – people diet for summer. It's that beach body thing. We have talked to distributors in Florida, and they have peak volumes in the opposite seasons – but for the same reason.

In 2020 the volume growth was large, and volume peaked in the third quarter. The third-quarter peak was global. Lockdown saw a boom in weight-loss at home.

	2015	2016	2017	2018	2019	2020	2021
Q1	298	320	303	303	331	356	466
Q2	305	347	284	336	356	492	505
Q3	285	312	261	309	331	501	427
Q4	268	271	251	280	300	386	

Note the guided volumes in the third quarter of this year highlighted in blue. Third quarter volume is up sharply on two years ago – but down sharply on last year.

We do not know whether this volume decline is a new downward trend or whether it is just a one-off decline, off a very fast growth period in lockdown.

We have talked to distributors – and the answer is mixed. Most distributors – especially the ones we talk to – think that growth will resume. But they are successful distributors who have a record of growth and are personally optimistic people. We do not know what weighting to put on this.

Meanwhile, the company is trading at 9x earnings, is buying back stock with the incremental cash flow, and buying it back in a way that seems designed not to move the stock. (That is probably because they plan to buy it back for the next few years as cash allows.)
We think it is cheap – but you know the risk as well as us. Is this turn-down an end-of-covid effect or is it the marker of a permanent and nastier trend?

The observant amongst you will notice that the second quarter of 2017 was a massive and surprising shrink. This was the quarter in which the company implemented its required regulatory changes. The decline then was short-lived – but also drove the stock down sharply – albeit temporarily.

The matching of our book

Mostly we think about managing individual positions and the meaning of stock specific data points (like the decline rate in smoking). But we have a portfolio management problem which has been irking us and for which there is no obvious solution. **The long and the short side of our book simply do not hedge each other as well as they used to**.

We need a quick reminder of how we are positioned

We are, as we have stated, long relatively high-quality companies that we think we can hold for decades. Some we think are cheap (Herbalife, Regeneron). Most are not and it is hard to justify holding most of them (other than on a relative basis).

Google when we bought it back in 2011 was 6x revenue. It is now about 8x revenue. That is ten times greater, and is larger than we thought even possible. There is no question that the best growth is behind them – but the price to sales multiple has increased.

Companies we love are very expensive. Croda is the best specialty chemical company we have ever seen. Alas that is also at almost 8x revenue. 8x revenue is an awful lot to pay for a specialty chemical company.

It all brings to mind Scott McNeally's famous quote about why it was completely crazy that Sun traded at ten times revenue at the height of the bull market.

> At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?

Even the (few) high quality companies we can find at reasonable valuations have recently had little correlation to our short book. (Regeneron for instance seems poorly correlated to our biotech shorts and Herbalife does not seem well correlated to anything in our portfolio.)

The short book – state of play

Against this we hold a short book of the craziest promoted stocks that you can imagine. Lockdown has driven crazy promotion to levels we could not prior imagine. Mass delusion is common.

For this you need an explanation of how we got here. Let's start with a standard dictionary definition of delusion.

> *Delusion: an idiosyncratic belief or impression maintained despite being contradicted by reality or rational argument, typically as a symptom of mental disorder.*

A delusion is a false belief which someone holds, and which they will continue to hold even when faced with contradictory evidence. Whilst the standard definition tends to class delusion as a form of mental disorder the dirty truth is that we all (yes me, yes you) have a tendency towards delusion.

We also have to deal with the society around us – and in society there are plenty of people who will not hold our false belief, and indeed will contradict it at any opportunity. To maintain delusion requires considerable work. And most of us are lazy – and so we – rationally – give up on our false beliefs.

There is an important exception though – and that is when your social milieu shares your false belief. Then it is reinforced by society and flourishes. It might even morph into more ridiculous false beliefs.

The classic book on manias – stock market and otherwise – is *Extraordinary Popular Delusions and the Madness of Crowds*. The delusions flourish in a crowd. Crowds can and do go mad.

We alas live in the age of delusion – and to a remarkable extent the internet is to blame.

The internet – find your own crowd

What the internet does is allows you to find a crowd far away from your ordinary social milieu. You may care a lot about 17th Century French clocks – but nobody around you cares. On the internet you can find people who have devoted years to the study of 17th Century French clocks. You have found your crowd. You could live quite a cheerful life simply corresponding with and socializing with these people. It may be a more fulfilling life than was afforded to you before the internet.

But you might also find a crowd who believes that the vaccine is a population control device and all the people in power (Biden, Merkel and even Australia's Scott Morrison) did not take the vaccine but simply took a saline injection. That belief would be laughed at in any ordinary mixed society but there are self-reinforcing crowds online that hold that belief and many similarly ridiculous beliefs.

Once upon a time these people would have been friendless crazies. But the internet allows them to find friends – and friends reinforce their craziness.

Covid induced craziness

Covid has turned the volume of craziness up. Covid gave us all an excuse (indeed often required) that we substitute our local community for an online community. Now everyone was compelled to find their friends and their meaning and their social support online.
Now it was easy to surround yourself with those who reinforce your delusions. And even push further on your delusion – pushing people to crazier and crazier beliefs. Lockdown plus the internet turned people crazy (and stupid).

So much stupidity. And some so obvious. We have found endless mirth in people, who once seemed sensible, arguing with Professor Peter Doherty (a Nobel Prize winner) about the function of T-Cells.

In the stock market

We are short stock market delusions – mostly but not entirely delusions promoted by people who have a vested interest in promoting delusion.

AMC is simply an extreme example of what is probably a non-promoted delusion. It is a highly levered company owning multiplex cinemas. (Full disclosure – we are short a tiny position – about a tenth of a percent of our fund.)

Business prospects for AMC are poor.

Every year large screen televisions and home theatre equipment become cheaper. Every year the attraction of the couch at home versus the multiplex improves. It looked – pre-Covid – to be a slow burn to bankruptcy.

That is not guaranteed though. Hollywood might come up with a better offer. Or AMC might be saved by some new technology (such as a truly realistic 3D that does not give you headaches).

Post Covid, AMC looks like a fast-track to bankruptcy even after it has raised over a billion dollars from mostly retail investors.

AMC is the subject of a widespread delusion that believes that hedge funds manipulate the stock in "dark pools" and with massive numbers of fake shares. They allege the US Securities Regulators are in cahoots with Citadel (a large market maker) to manipulate the stock. They also believe by ganging up (people power) they can "democratize capitalism" and destroy the dastardly short sellers.

You might laugh, but the shares are owned by over 4 million individual shareholders – more than almost any other company in America.

Here is a court case filed by a retail investor which explains the alleged massive conspiracy to manipulate AMC shares. It is comically delusional. But that does not matter. What matters is that literally millions of people believe this conspiracy. Nobody in a position to truly know believes it. But millions do.

We have corresponded with many retail investors, and it does not matter what we say – we cannot shift their beliefs. They have the comfort of their (massive) online community to support their delusion.

We can find – at various scales – hundreds of stocks like AMC that are propelled by delusion. Mostly those delusions are promoted by people with a vested interest in fostering delusions – after all there is a lot of money in it.

However, lockdown has meant – and this was a surprise to us – that shorting delusion became unprofitable. We think this will unwind as people form more normal social groups. Crowd-held delusions have always broken in the past.

Our problem

The correlation between our longs (ordinary businesses) and our shorts (usually just promotes, but now widespread organic delusion) is becoming worse. The correlation was never that strong – but it is clearly less strong than it was pre-covid. It is almost like there is a "real world" out there and a "fantasy world" only weakly linked to the real world.

Sometimes this is good.

On the first day of October the Russell 2000 (an index of the smaller 2000 out of a total of 3000 US stocks) was up 1.69 percent yet we made money on our short book. Our short book consists of over 500 stocks, mostly small caps, and previously very well correlated to the Russell 2000. It is almost inconceivable that you could pick 500 stocks that divert from an index by that much.

But quite often it has been bad. Many days our shorts have gone up in a manner disconnected from the market.

That makes it harder to hedge – it also means we have irregularly been forced to have what we call a “risk management discussion” which is a euphemism for “we have lost money and we need to ensure we do not lose much more”.

The future

We like this set-up.

The scale of delusion out there is large. Our long book is overpriced – but it is not *enormously overpriced* and some of it is outright cheap. Our short book however is simply crazy – breathtakingly crazy.

The unwind should be good for us. We just need to manage risk (risk being caused by the lack of correlation) until it works. And we are managing – albeit with some stress.

Thanks again for placing your trust in us.

Bronte Capital