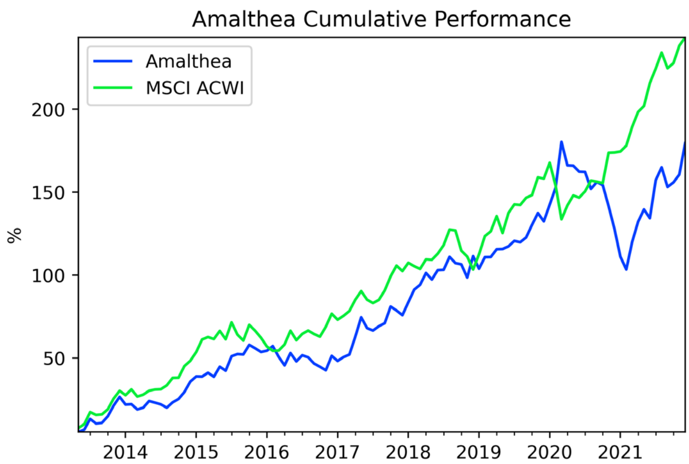
Amalthea Fund – December 2021

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%	1.1%	1.8%	7.3%							19.3%



In December the fund was up 7.28% compared with 1.50% for the MSCI ACWI (in AUD), 10.43% v. 5.74% for the quarter and 22.76% v. 25.33%. for the calendar year.

We had a very hard start to 2021 and quite a nice finish. The results for the year have been adequate. The results for the quarter good, and the results for the last month excellent.

This is an annual letter so we will give a longer perspective than our usual quarterly missives. (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]	0.88	1.31
Min additional investment	$50,000	Sortino Ratio	1.65	2.38
Applications/redemptions	Monthly	Annualised Standard Deviation	12.46%	10.40%
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	0.59	0.67
Administrator	Citco Fund Services	Cumulative return[3]	169.04%	243.26%
Auditor	Ernst & Young	1-year annualised return	22.76%	25.33%
Custodians/PBs	Fidelity, Morgan Stanley, JP Morgan	3-year annualised return	8.45%	19.08%
		5-year annualised return	12.26%	14.21%
		Annual return since inception	12.10%	15.29%

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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Twelve months ago market conditions were hostile to our strategy. The driver was a wave (perhaps more than 40 million strong) of new retail investors speculating in stocks about which they knew little. These investors often had the historical perspective of a goldfish. Many bought stocks in companies they had never heard of, recommended on the internet by people they had never met. Sometimes they did this with money they did not have.

This is what we said in our December 2020 letter:

The rise in garbage stocks has been very difficult for us. We short garbage stocks. On the plus side we look at shorting opportunities now and see a "target rich environment". Alas, recent experience tells us that the targets can shoot back.

Rampant speculation in growth-oriented and garbage stocks has had many drivers – but the one that matters most to us is the massive increase in the number, value and confidence of retail investors, particularly online retail investors, often young and with no investing experience or historical perspective. It is not uncommon to have 20-year-old "investors" ask you about call options. The widespread retail interest in short-dated, highly levered positions is reflected in massive call option volume in the most speculative retail stocks. Tesla has literally billions of dollars in one-week call options every week, even in the low-volume Christmas week…

Historically the biggest driver of our short book – and the driver that has worked best for us – is shorting stocks aggressively promoted to retail investors. We seek to find the most cynical and self-serving promoters who promote fads, frauds and failures to retail investors. But "sold to naïve investors" is a basic tell.

This tell has not worked in 2020. Indeed, it is a way to lose considerable money as a short seller. When you think the retail investors being promoted this new shiny fraud (that they cannot possibly know anything about) are hitting exhaustion, a new wave of newbies – with their Robinhood accounts – comes to bid your short up double or triple.

Remarkably things got even worse than this in the first quarter. The aggressive buying of short-dated options produced the "gamma squeeze". The idea was that short-dated options could force market makers to buy huge quantities of stock if the stock were to rise – producing meteoric though technically driven stock rises. The most important variable for many stocks became open-interest in weekly options.

The most notable gamma squeezes were in Gamestop (a retailer of computer games on CD ROMs) and AMC (a levered owner of multiplex movie theatres).

The perception (with some basis in reality) was that these massive moves were driven by shorts covering. This flame was fanned by people we regard as crooks – people who are in the business of selling their flim-flam companies to Wall Street. They managed to convince goldfish investors the high short interest in their promote was a reason that they should buy it. This "get shorty" attitude on Wall Street has resulted in a massive financial transfer from Main Street (but particularly youthful "investors") to promoters. 2020 and 2021 were a time for stock fraudsters to get dynastically wealthy.

Whatever. A “get shorty” situation was threatening to us. The stock promoters were getting wealthy mostly at the expense of naïve retail investors – but alas also partially at our expense.

It was not pleasant.

What to do about it?

There were several things we did about this.

We shrank (even further) the size of our short positions – especially if there was a high borrow cost or high short interest. This meant a few things. The number of shorts we have doubled over the year. This was possible because it was a target-rich environment, but it also required considerable investment in portfolio management technology.

Secondly the amount of our portfolio which has a high borrow cost or high number of days to close (indicators of excessive short interest) has fallen and continues to fall. We suspect that this makes us less attractive to our prime brokers but so be it. We have always been wary of “crowded shorts”. This fear has been amplified.

We also shrank the size of positions in gamma-driven stocks. This involved considerable math.

Every day we download all option positions for stocks traded in America. We assume that the options are being delta-hedged by market makers and we estimate how many shares the market makers hold to hedge appropriately. We also estimate how many shares market makers would need to hold as a hedge if the stock were to double. The difference is how many they would need to buy – and is a very good estimate of how many shares would need to be purchased in a “gamma squeeze”.

We have done this for every stock in America – something that would be impossible without computers.

We have shrunk positions in any stock susceptible to a gamma squeeze to trivial levels. (4 bp positions are common.) As gamma squeeze risk has reduced our position size has increased. This is but part of the investment we have made in portfolio management tools.

Results lately

The market is within a whisker of all time highs. And yet our short-book is doing well. The retail mania has slowed. The most excessive sign of retail mania – massive investment in short-dated far-out-of-the-money options has slowed dramatically. We are far less scared of a gamma squeeze in one of our names than we were in February.

In the past six months we have made money on our short book despite the market taking out many new highs. There is plenty of alpha there.

Our long book however is dull and has not kept up with the market. To some degree that is expected – we have as we have repeatedly stated – been avoiding the heat of the market. But we remain unable to find investments in high quality companies we would like to hold for decades at prices that we find acceptable.

However, shorts have been giving us cash and we are deploying that cash in more longs.

This has meant we have bought a plethora of small positions in value stocks or – at least in stocks which we don't think are nauseatingly overpriced. We have small positions in companies as diverse as General Mills (a large breakfast cereal company) and Sotera Health (a company which uses Cobalt 60 to sterilize medical products).

Two longs have underperformed notably recently. These are Swedish Match and Herbalife. We have used profits from shorts to slightly increase those positions as well. Both stocks we regard as cheap – but we are by nature nervous when doubling down on losing positions. (Attached is a blog post John wrote on that issue several years ago explaining our reticence.)

The market in general

The S&P 500 has had 71 closing all-time highs this year and has finished a quarter of a percent from an all-time closing high. Despite undeniable market strength we are seeing losers everywhere. Strategies that have performed very well are now performing badly.

The two big losing strategies have been

a) Buying overhyped retail stocks

b) Hyper-growth at any price.

As noted, we are short overhyped retail stocks. We are benefiting from that.

But we have not been short the growth-at-any-price companies even though we regarded several of them as suspect. The poster-girl for growth at any price has been Cathie Wood at Ark Invest. The flagship fund (an ETF with ticker ARKK) is down 26 percent in the past six months. Her genetics fund (ETF with ticker ARKG) is down 34 percent in the past six months.

These are not small losses – the Ark complex peaked with over 50 billion in assets.

Cathie Wood has been complaining of an irrational bear market in "innovation stocks".

Maybe – but this is a bear market that is occurring when the NASDAQ index (the usual index for growth and tech) is up 12 percent in six months and 29 percent in a year and indices of tech stocks are regularly making new highs.

What really has happened is that the market has narrowed. Champions are falling and the money is pouring into a narrower and narrower collection of unbroken stories which continue to rise unabated.

This is what happened in the tech bubble where the market became very narrow indeed, led by a small coterie of nearly perfect tech stories – and where value stocks became extremely cheap.

We are not there yet. But we hope we do get there – because the years 2000-2005 were very good years for sensible value investors – and we think we know how to play that game. We think we would perform very well in a post-bubble market.

Australia

Australia it seems is on a slightly different trend to the US markets. We think (though we could be wrong) that the reason is that the retail mania in Australia happened later than the retail mania in the rest of the world. Peak lockdown (and hence peak gamble-from-home) was in August 2021. This was well after lockdowns eased in other jurisdictions.

Following this pattern, we may bend our short book towards Australia in a few months. Australia has a lot of frauds too. We have discussed the reasons before – but a large captive superannuation (private pensions) market where people are effectively forced to save their salary into market mechanisms is the underlying issue. Australian super, as a policy, has mostly worked well – but it has produced a ready market for scammers to sell garbage products to the financially endowed, but less sophisticated.

Australia's defamation laws have also allowed the crooks free reign. You simply can't criticize them publicly or you will face a defamation suit. We have seen several places where crooks have been shielded by Australia's defamation rules.

Our corporate regulator (ASIC) has piled on too. The Australian defamation rules have a specific legislated exemption – you cannot defame a company with more than ten employees. But ASIC has begun legislating by regulation. If you criticize a company publicly which you have traded you can expect a regulatory inspection, thirty thousand dollars plus in legal bills and that is only if you are lucky. ASIC has taken to accompanying the Federal Police on knock-your-door down raids on completely honest short-sellers.

We see no evidence of poor intentions at ASIC, but their actions make it less likely that corporate crime will be uncovered in Australia. In the past we (and a few others) fed tip-offs to ASIC – some of which have resulted in crooks going to prison. But if you tip-off the new ASIC (or the press for that matter) about a crime you are more likely to get a subpoena than a thank-you note. The consequences are obvious.

ASIC through its actions have improved the environment for scamming in Australia.

Australia always has been good for scammers, but now it is golden.

Bluntly: we think millions of people will lose thousands of dollars of their superannuation to fraud. And we think ASIC's policy, made without legislative backing, has made the situation worse.

We will short frauds in Australia. But we won't tell anyone any specific details because that will annoy the regulator. The frauds will continue. There will be a transfer of retirement money from working Australians to crooks. That is how the game is rigged here.

The future

We think the retail mania has plenty more to unwind. Short books should do well in this environment. For reasons stated above we think this will – at least relative to the size of the economy –play out particularly strongly in Australia.

If so, our short book will provide plenty of cash which we can deploy into long investments.

It has been another roller coaster of a year. One that tested us severely but one in which we developed new tools and brought on several talented new staff members. The underlying strategy remains. In spite of markets moving ever higher our short book came back, and the risk management around it has been improved significantly.

We wish all our clients a happy new year.

The Bronte Team

Blog post from 2017

When do you average down?

The last post explained why I think a full valuation is not a necessary part of the investment process. A decent stock note is 15 pages on the business, one page on the management, one paragraph or even one sentence on valuation.

Valuation might normally be a set of questions along the lines of "what do I need to believe" to get/not get my money back.

But I would prefer a simple modification to this process. This is a modification we have not done well at Bronte (at least formally) and we should do better. And that is the question of averaging down.

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Warren Buffett is famously fond of "averaging down". If you liked it at $10 you should love it at $6. If it goes down "just buy more". And in the value investing canon you will not find that much objection to that view.

But averaging down has been the destroyer of many a value investor. Indeed averaging down is the iconic way in which value investors destroy themselves (and their clients). After all if you loved something at $40 and you were wrong, you might love it more at $25 and you almost as likely to be wrong, and like it more still at $12 and could equally be wrong.

And before you know it you have doubled down three times, turning a 7 percent position into a 18 percent loss.

Do that on a few stocks and you can be down 50 percent. And in a bad market that 50 percent can be 80 percent.

And if you do not believe me this has a name: Bill Miller. Bill Miller assembled a startling record beating the S&P ever year for fifteen straight years and then blew it up.
Miller had a (false) reputation as one of the greatest value investors of all time: In reality he is one of the biggest stock market losers of all time and a model of how not to behave in markets.

How not to behave is to be a false value investor, buying stocks on which you are wrong, and recklessly and repeatedly average down.

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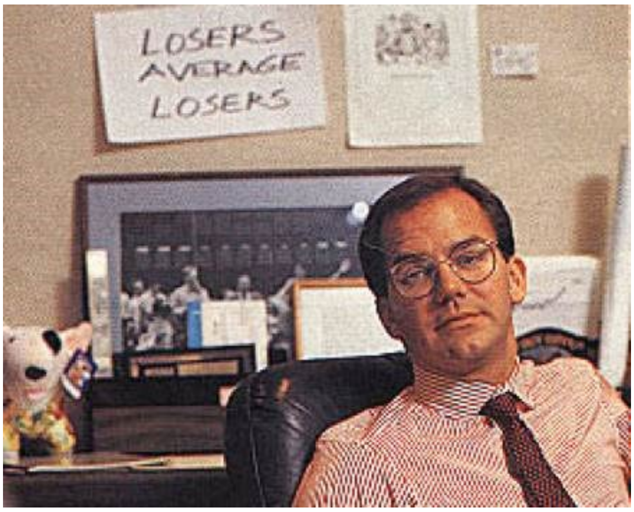
At the other end traders who (correctly) think that people who average down die. The most famous exposition of this is a photo of Paul Tudor Jones - with a piece of paper glued to his wall stating that "losers average losers".



And yet Warren Buffett and a few of his acolytes have averaged down many times and successfully. And frankly sometimes I have averaged down to great success.

At least sometimes - the Bill Miller slogan is correct: "lowest average cost wins". Paul Tudor Jones may be a great trader - but he is not a patch on Warren Buffett.

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I would love it if I had an encyclopedic knowledge of every mid-cap in Europe and could buy the odd startlingly good business when tiny and cheap. But the task is too large. The world is complicated, and I can't cover everything.

But when I look at tasks that can be achieved by a four-analyst shop I have one very high on my list of things we can do and should do: We should get the average down decision right more often.

So I have thought about this a lot. (The implementation leaves a little to be desired.)

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At a very big picture: averaging down when you are right is very sweet, averaging down when you are wrong is a disaster.

At the first pick the question then is "when are you wrong?", but this is a silly question. If you knew you were wrong you would never have bought the position in the first place.

So the question becomes is not "are you wrong". That is not going to add anything analytically.

Instead the question is "under what circumstances are you wrong" and "how would you tell"?

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When you put it that way it becomes obvious that you must not average down (much) on highly levered business models. And looking at Buffett he is very good at that. He bought half a billion dollars' worth of Irish Banks as they collapsed. They went approximately to zero. But he did not double down. He liked them down 90 percent, he did not like them more down 95 percent.

By contrast these are the stocks that Bill Miller blew up on: American International Group, Wachovia, Washington Mutual, Freddie Mac, Countrywide Financial and Citigroup. They were all levered business models.

By contrast you can probably safely average down on Coca Cola: indeed Buffett did. It is really hard to work out a realistic circumstance in which Coca Cola is a zero. And if it is still growing there is going to be a price at which you are right - so averaging down is going to go some way to obtaining an average cost near or below that price.

Of course even Coca Cola is not entirely safe. You could imagine a world where the underlying problem was litigation - where some secret ingredient is found to be a carcinogen and where the company faces an uncertain future of lawsuits. It is not likely - and if it happens you are going to get at least some warning that this is a circumstance on which you could be wrong. Whatever, outside that circumstance on which you might be warned, Coca Cola is not a leveraged business model subject to bankruptcy and is almost entirely unlikely to halve four times in a row. You can average that one down.

Operationally levered business models

Not every business model is as as safe as Coca Cola. Indeed almost every business model is more dangerous than Coca Cola. A not financially levered mining stock can halve five or six times. If you have a mining company that mines coal at $40 per tonne, has no debt and the price is $60 a tonne it is going to be really profitable. But prices below $40 (highly possible) will take profits negative. Add in some environmental clean up and some closing costs and it is entirely possible that a stock loses 95 percent of its value. Averaging down when down 40%, some more when it halves, and then halves again and it will still lose two thirds of its value. The difference between averaging stuff like that down and doing what Bill Miller did is only one of degree.

It is still a disaster. And you will have proven Paul Tudor Jones adage: losers average losers.

Obsolescence

There is another iconic way that value investors lose money - and that is technical obsolescence. Kodak was made obsolescent and was a value stock all the way down to bankruptcy. The circumstances on which you might be wrong (digital photography going to 95 percent of the market) could have been stated pretty clearly in 1999.

You might thing it was worth owning Kodak as a "cigar butt stock" - plenty of cash flow and deal with the future later. There was a reasonable buy case for Kodak the whole way down. But technical obsolescence is always a way you should be wrong. When the threat is obsolescence you are not allowed to average down.
Bill Miller averaged Kodak down. Ugh.

If I could improve our formal stock notes in any way I would like an ex-ante description of what circumstances we are allowed to average down a particular stock, and how much. We have a default at Bronte - and the default at Bronte is that we have a maximum percentage for a stock (typically say 9 percent but often as low as 3 percent depending on how we assess the risk of the stock) and as the fund manager I am allowed to spend that whenever I want but I am not allowed to overspend it. If we have a 6 percent position with a 9 percent loss limit and it halves, I am allowed to add three percentage points more to the exposure. But that is it. Simon, being the risk manager, isn't particularly fussed if add the extra when the stock is down 30 percent of 50 percent, but I can't add it twice. If it is a position on which we agree we are allowed to risk 9 percent then I am allowed to risk 9 percent.

We will not fall for the value investor trap of losing 18 percent on a 7 percent position. We have made a modification of this over time. And that is every six to nine months I get another percentage point to add. That is at Simon's discretion - but the idea is that the easiest way to find out whether you are wrong is to wait. After a year or two the underlying problem will usually become public. If time has not revealed new information, then we are allowed to risk more.

But we can and should do better with ex-ante descriptions under the circumstances in which we are prepared to add and circumstances where we are not. The problem is that you can wind up in a mindset where you always want to add, where you think the world is against you and you are right and you will just be proven to be right.

Clear ex-ante descriptions of the issue (which require competent business analysis) might help with that problem.

The bad case of averaging down

The iconic bad situation to average down is a levered business model involving fraud. It is surprisingly common because people who run highly levered business models have very strong incentives to lie or to cover it up when things turn to custard. I can think of two recent examples: Valeant and Sun Edison.

Much to my shame I added to my (small) position in Sun Edison as it fell. Ugh. But also this was a highly levered business model and thus by definition the sort of place where losers average losers. I should not have done it - and I won't in future.

But the highly levered business models apply fairly generally. When Bill Ackman rang Michael Pearson and asked if there was any fraud at Valeant he already had the wrong mindset. Then he added to a large holding in a company with over 30 billion dollars in junk-rated debt. Losers average losers.

Incidentally our six-month rule (before you were allowed to add) would have saved Mister Ackman a lot of extra losses. Time has revealed plenty about Valeant. And it would have saved me at Sun Edison too.

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Whilst I think that someone asking me (as per the last blog post) for a valuation on every stock is absurd, I think it is entirely reasonable for them to ask "under what circumstances would you average down". If you can't answer that you probably should not own the stock. I should insist on it with every long investment.

John