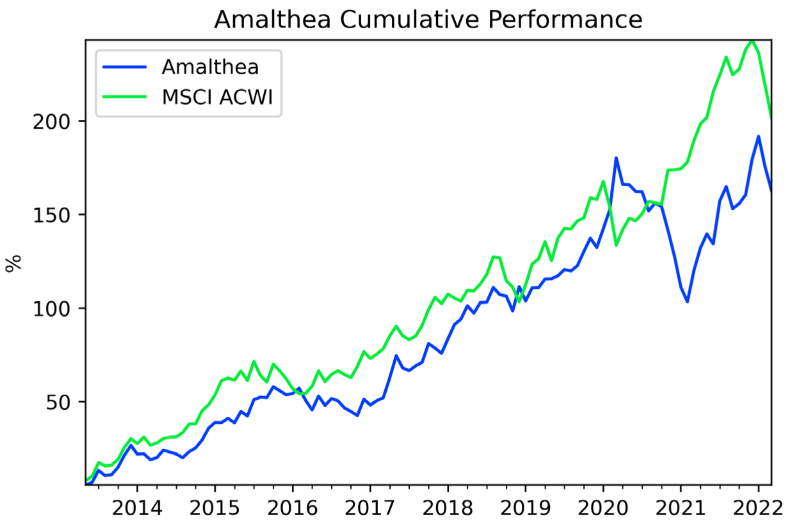
Bronte Capital

Amalthea Fund – March 2022

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%	4.4%	-5.6%	-4.6%				12.2%



Over the quarter the fund fell 5.97% whereas the globally diverse ACWI (in $A) dropped by 12.08%. The results are better than market but are nonetheless unsatisfactory.

It was, to put it mildly, an eventful quarter. (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]	0.79	1.10
Min additional investment	$50,000	Sortino Ratio	1.43	1.90
Applications/redemptions	Monthly	Annualised Standard Deviation	12.67%	10.75%
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	0.58	0.65
Administrator	Citco Fund Services	Cumulative return[3]	152.96%	201.79%
Auditor	Ernst & Young	1-year annualised return	19.49%	4.32%
Custodians/PBs	Fidelity, Morgan Stanley, JP Morgan	3-year annualised return	6.34%	10.07%
		5-year annualised return	10.77%	11.10%
		Annual return since inception	10.97%	13.19%

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

Bronte Capital Management Pty Ltd (AFS License: 334325, IARD No. 151222)
Suite 1703 Tower 2, 101 Grafton Street, Bondi Junction, Australia.
Phone: +61 2 8318 7711 • Email: investor.relations@brontecapital.com

On a top-down view, the short side of the book was profitable in the quarter and we suffered on the long side. That is perhaps as expected, as markets were down in the quarter.

Moreover, the losses in our book were in our most controversial stock (Herbalife), in an agricultural stock (Genus) and across our European long positions. We will talk about those longs at the end of this letter. But that is not how the quarter played on a day-to-day basis. Even though we made money on shorts for the quarter the action in the quarter was – mostly – on the short side of our book.

This letter will describe what for us were daily ups and downs, and then examine the big picture moves in our long book.

A quarter with two halves

This was a quarter of two halves. One good, one bad.

The first half was – at least for us – lovely.

- Highly valued growth stocks, of which we own relatively few, went down sharply. Funds that had chased performance had a very bad month. Funds we admire produced returns closer to minus 20% than minus 10%.
- Frauds and promotes pretending to be “growth stocks” went down, but not quite as sharply as the real growth stocks.
- Value stocks were mostly okay.

By the middle of the February, we were up over five percent. We were happy. Writing a letter then would have been very pleasant. We would be working out how not to sound too smug at what were (at least on a relative basis) glowing returns.

But we write quarterly, and by the end of the quarter sounding too smug is not the problem. We gave back all the good returns from the first half of the quarter and then some.
The proximate trigger for the poor second half of the quarter was Putin’s invasion of Ukraine.

We run a fairly balanced book and are mostly only marginally concerned by geopolitical events. This was different.

- We are short promotional gold mines, a perennial part of our portfolio. They went up because gold goes up in periods of uncertainty.
- Likewise, we are short sketchy oil companies. They went up because the withdrawal of Russian hydrocarbons pushed up prices, even though many of these companies will never have meaningful production.
- Add to this dodgy uranium miners, as the withdrawal of Russian energy makes it more likely the world will build new nuclear reactors. Again, that these companies will never produce yellowcake on any scale is irrelevant.
- We are also short fraudulent companies selling alternative energy solutions. These too are a staple of our portfolio. They also rose on the hope of alternatives to Russian oil.

- Likewise, overhyped electric vehicle companies bounced hard.

We could go on.

What was unusual though is the extent to which previously uncorrelated sectors became correlated. For instance, the gold price (and gold stocks real and not) tend to go up when the economy is a mess and things are uncertain. At that same point the oil price (and oil stocks) are heading down.

They went up together with Putin's invasion. Things that had seldom been correlated became suddenly quite correlated and, at least from our perspective, it was not pretty. We have some rules of thumb about what is, and is not, correlated. They all broke.

Here we confess a sin. We were slow to reduce exposure. It should have been obvious to us that this was happening and yet we sat there with cumulatively about 20 percent short stocks in what we call a "Ukraine basket". (The "Ukraine basket" being stocks that are perceived to be Putin beneficiaries".

That was an unforced error.

At the same time, we had some longs negatively affected by Putin's invasion. For instance, we have a position in Philip Morris International – the maker of Marlboro cigarettes outside the United States. PMI also makes some modern heat-not-burn tobacco products. Russians smoke heavily and it turns out that 6% of sales were in Russia, weighted towards high margin heat-not-burn products.

Herbalife (our cheapest and most controversial stock) also has a business in Russia. That hurt a little.

Our biggest Russia/Ukraine exposure is KWS, a small German company that is the world-leader in hybrid seeds for sugar-beet production. A high single digit percentage of sales are to Ukraine and Russia, and alas the war started just before planting season.

Whist we had no direct Russian or Ukrainian exposures we nonetheless had some indirect ones.

To finish a miserable six-week period, a meme stock rally broke out. The meme stocks (or stonks in the jargon) are traded by retail investors on themes of shortage and trading appeal – the stock-equivalent of Dogecoin.

We are short, in small quantity, almost all the meme stocks. The aggregate "meme stock" position is a few percent, though no individual position is large.

We will not name any of these positions other than AMC and Gamestop, the two most iconic meme stocks and the objects of the largest short squeezes in February 2020. Note the positions are small, but they are indicative of what is going on.

AMC is an over-levered chain of movie theatres in America with (broadly speaking) slightly less attendance every year. Gamestop is a retailer of video games on DVD ROM trying hard (and maybe with some success) to reinvent itself as an alternative computer game distributor. Both these companies raised enough money that bankruptcy is not an immediately likely outcome. (Both would have gone bankrupt except for the willingness of largely retail investors to provide them with much more cash.)

Both have bad financial results. Gamestop's last financial results were terrible. And both stocks more than doubled very rapidly in March from market caps that were absurd to market caps that are more absurd. We are of course completely aware that they can double again and again after that. Their valuations are absurd but if you double the price they are not twice as absurd. They are just similarly disconnected from reality.

The reason we want to talk about them is that it is indicative of what is going on. Gamestop, the most meme of all stocks, announced a possible stock split and the stock, after market that day, traded up 17 percent. We could joke that every child knows that cutting a pizza into more slices yields more pizza. But in this market, not accepting that stock splits add value is a recipe for losing money.

The incomparable Matthew Levine however does a great job explaining why for meme stocks a stock split matters. To quote:

> While the stock market doesn't really trade in round lots anymore, the options market does: If you want to buy listed call options, you have to buy them in contracts of 100 shares. (There are weird market-structure reasons for this. Most retail stock trades are internalized, with the retail broker routing your order to some market maker who will fill it from its own inventory, and if it wants to sell you fractional shares that's fine. Listed options have to trade on the exchange, the exchange has 100-share contracts, and you can't get around that by buying half a contract from a market maker.) So if you want to buy a Tesla call option struck at $1,100 expiring on April 14, you'll pay about $5,500 for one contract ($55 per share for 100 shares). If Tesla did a 10-for-1 stock split, you could buy options for as little as $550.
>
> Again, I used to think that this didn't matter, because options trading is either (1) for professionals, who can afford $5,500 a throw, or (2) for retail weirdos, who can't be the driving force of corporate finance. But I do think that an important lesson of last year's GameStop Corp. meme-stock situation is that retail options weirdos are in fact the driving force of corporate finance, or, at least, that retail options trading is a key part of being a meme stock.

And that sums up where we are. Despite a market that has had a serious downdraft, retail investors speculating on out-of-the-money call options and other levered gambling instruments are a significant driver of stock market performance. Especially for the band of stocks that are "sold to retail".

It is not a comfortable position for us.

So here we are: despite having a profitable short book in the quarter, we are left with risk management problems. The Ukraine bucket described above and, to a much lesser extent, the meme stock basket (over two dozen stocks) has started to hurt us. We have had to do what is euphemistically called “risk management” but is really cutting positions that have cost us money.

That is okay, we will do it, and we think the short book will continue to make money as it did this quarter.

We just wish our short book would make money in a less volatile fashion. And we think that likely too: this sort of retail mania is likely to subside. Indeed, the retail mania of March 2022 was only a shadow of the craziness of February 2021.

The long book

On a day-to-day basis during the quarter, the action was in the short book. But as noted the short book was profitable over the quarter.

The long book in aggregate however was just not very good.

Some of this was Putin-driven (such as KWS). Some of it was European driven as a few of our highest quality European stocks fell from what are expensive levels to less expensive levels. Some of the movements were just strange.

The two biggest losers were Genus and Herbalife.

Genus is an agricultural stock and as agricultural prices go up one would think it would benefit. But it is not so obvious. Genus’s is the world leader in pig genetics, their main business, selling “superior pig” genetics to pig farmers around the world. In this context “superior pig” means a pig that converts grain to meat more efficiently in largely factory piggeries (although also in free range pig farms).

About half the world’s pork is consumed in China. As China goes into Covid lockdown, pork consumption fell. But the grain price is rising, driven by Putin’s invasion. There is a squeeze on piggeries everywhere, but an intense squeeze on piggery profits in China. This is clearly impacting Genus negatively, and the stock reflects it.

Herbalife is a large and volatile position, and in this quarter the loss on Herbalife is about the same size as our aggregate loss. It is worth explaining why there is volatility. Herbalife – as explained in previous letters – sells diet shakes through multi-level marketing plans. The idea is simple enough. If a regular overweight person were to replace 5-8 meals a week with high protein low calorie alternatives (such as a diet shake) and were to walk an extra 15km a week they would lose a lot of weight.

The problem is sticking with the diet. It is hard. Most people fail.

Your friendly Herbalife distributor however wants to sell you diet shakes. They will cajole you, nag you, go hiking with you, do all sorts of things to keep you on the diet – and that sometimes works. Indeed, it quite often works.

We have visited many successful Herbalife distributors, and even with them most people who sign up for the diet fail. But those who succeed stay as customers for many years. Now imagine someone who successfully signs up 10 participants to the diet. Realistically 70-80 percent of them will have dropped out in a year. (It is a diet) but the remainder will stick around for many years.

A small-scale distributor might realistically have 10 good sign ups a month. Most of those will drop out but if 20-30% stay around they might have a reasonable book of business in a few years. The business grows even though most customers leave. We have visited a few such distributors.

Now imagine in Covid it becomes very easy to sign people up. (It was – they were stuck at home and the Herbalife clubs were organized over zoom). And imagine for six months the number of people being signed up goes to 20 per month. (These are realistic numbers). Then it reverts back to the old ten per month.

Then what will happen is you will get a massive jump in sales with the new sign-ups. And then a decline of sales as the pop-and-drop months age through the system.

That is what we believe is happening now. The company has declining sales but, we believe, no negative change in the underlying economics of the business. We will know with some certainty if the decline in sales reverses in the third quarter of 2022.

But the net effect is that the stock is very weak. (The conventional thinking goes: who wants to buy shares in companies with declining sales?)

The stock now trades at 7-8 times earnings, and the company is buying back as many shares as it reasonably can from existing cash flows. We think the sales will start increasing again from the third quarter as the covid-pop-and-drop cohort works through the system. And thus, this will be a very fine stock indeed.

However, we can be wrong: the decline in sales might be indicative of something much worse going on in the business. We have said we should know for sure when the company reports its third quarter results sometime in the fourth quarter of 2022. We will report back to you in the end of year letter as to whether we are right.

The other losers in the portfolio were European stocks, generally, as Europe was weak all quarter.

The future

Our portfolio will work fantastically well *if we can hold it* but violent rallies in our short book make it hard to hold what will eventually be a winning hand.

John has a friend who has far more aggressive investment practices than Bronte. He is mostly a venture capitalist. And John wrote to him with envy a while ago – amazed that all the most rubbery investments could get passed out in Special Purpose Acquisition Corps (or SPACs). Venture capital had become heads I win, tails I dump my losers on the market for a profit. The response was instructive.

> Question: in a world of relatively low rates and high inflation, where would you put relatively "non-risk" capital? I have far more exposure to risk assets (growth stocks, crypto etc.) than I need — so when I get distributions I tend to try to allocate into investment real estate, personal real estate, or hold in cash. What else would you do today?

And the question is genuinely hard. Asset prices are very high. Some asset prices are simply inexplicable. (Can anyone give a cogent story about why the market capitalisation of the cryptocurrency Dogecoin is still – after considerable falls – about $20 billion? Meme stocks are similar.) But even the old safe assets are expensive. Bond yields are atrociously low versus current inflation and will become “confiscation certificates” if inflation does not revert to very low levels. (Contra: We first heard the phrase “confiscation certificates” at the beginning of a nearly 40-year rally in bond prices.…) Inflation protected bonds have sharply negative yields. They are already explicitly “confiscation certificates”. Australians are well aware just how expensive residential real estate is. Positive returns from here require that the prices become even more untenable for the next generation.

Consumer staple companies (traditionally the safest of safe investments) are priced off bond yields and at this price are not safe. Indeed, in a world with sharply negative real interest rates the market expectation is that investors collectively will lose money from here.

We think that negative real returns for investors over the next five years are likely. The sharply negative yield on inflation linked securities is not irrational in a world where other assets are similarly overpriced.

We hope to be on the other side – short the crappiest stocks, long the sensible stuff. But we are cognisant that a random event such as Putin invading Ukraine can cause a worthless uranium stock with a market cap of half a billion dollars to become a worthless uranium stock with a market cap well over a billion dollars. And we can be on the wrong side of that trade.

A note to the Australian clients

We have seldom had such large conflicting forces driving the Australian dollar. Obviously, the Putin inspired commodity price squeeze is good on average for the Australian dollar. But we think that is too simplistic. The Putin-led commodity rises are focused on things that Russia does well – such as oil or nickel.

The oil price should stay high. But Australia is a net importer of oil. Australia is a (very big) exporter of natural gas, but much of that is on long term contracts and there is little there that should drive the Australian dollar. (Some of the natural gas contracts are indexed to oil prices and the Australian dollar should benefit from those.)

The swing commodities here are nickel and copper. We do not think, though we could be wrong, that the sanctions will have much effect here. Russia will just truck those commodities over the land border to China and global supply will not be much impaired.

Offsetting this, China looks to be in a Covid-driven mess.

Locking down for Covid might make sense whilst a vaccine is being developed (although some argued against it). The case for locking down when there is a good enough vaccine is very weak. But for some reason China is committed to the local vaccine which – whilst being better than nothing – is not good enough to stop widespread death and misery. The result is a peculiar series of very tough lockdowns in China.

A stop in the Chinese economy is hardly good for the commodities Australia exports – and hence not good for the Australian dollar.

On average – and we hate to prognosticate about currency because we are not very good at it – we do not believe the bull case for the Australian dollar. We are very reluctant to hedge a rising Australian dollar although a few clients have asked us why we do not.

Again – we are outside any area in which we have expertise – but we are very wary of losing money on hedges if the Australian dollar goes down and those losses force us to sell what we think are winning positions in the market. We do not want to be too categorical here as we have at various times hedged some positions in the Australian dollar – but only when we think the currency is way too weak or way too strong. When we do not have strong opinions, our bias is to be unhedged.

Thanks again

Bronte Capital