5 July 2011

Client Letter for June 2011

The numbers this month are good when contrasted against a slightly down overall market, and the sequence of numbers (seven straight positive months – some months strongly positive) is surprisingly good. But the trend which has generated those returns (abnormal returns from shorting Chinese frauds) is – alas – getting a little stale.

We still think we can make money shorting Chinese stocks but it will require more analysis and we will make more mistakes.

The problem is that the stocks are now apparently very cheap and the shorts are often very crowded. If a company looks fraudulent it is already trading at a stated price-earnings ratio of one to three and the stock is hard to borrow. The stated price-earnings ratio is of course nonsense because in the vast majority of cases the numbers are fraudulent and the real earnings are zero or worse.

But because the stocks are crowded it does not even matter if your analysis is right and the stock eventually goes to zero – you need to hold the position at every intermediate price. If the company can convince the market that the earnings are real the stock might go up 5 fold on the way to zero – and that would be no fun for a shortseller.

Because the trade has become crowded we have spent the last month mostly reducing our risk. For the first two weeks of the month this felt stupid because we were removing highly profitable positions. The last two weeks however demonstrated that risk reduction was the right strategy: almost all of the Chinese fraud shorts bounced – some very hard indeed. We had one short which more than doubled in the past two weeks and several stocks rose 25 percent or more.

Despite that we managed OK and we were down only about 4 percentage points from peak to trough and we finished the month well. Had we not been reducing our risk we probably would have had a negative month. Simple, diligent application of our risk management guidelines made good a potentially nasty situation.

An observation though: buying back our Chinese fraud shorts feels very unsatisfactory (even though it gave us the right result). Most of the month we were buying stocks (or more precisely buying back stocks) that we thought were (literally) worthless. It pains us to pay millions of dollars for pieces of paper that will eventually settle at a price of zero rounded to the nearest cent. But to be a successful short seller you need to manage risk and that is what the month was about. The most common question we get asked is why – if you are so good a short seller – don't you open a short-only fund? The answer we give is blunt and unchanging: we do not think we can successfully manage the risk in a short-only fund. We insist on being a long fund that shorts on the side – no matter how successful our short-selling is.

We remain substantially net long – and we will as far as we can tell – be substantially net long into the foreseeable future. We happen to like large cap equities (mostly but not exclusively large cap American equities) which we think are cheap. The profits from Chinese shorts (and they are considerable) are being recycled into longs. And ultimately it is the large cap equities (not our shorts) which will determine your returns.

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That doesn't mean that the short-selling returns are over – it's just that the "easy money has been made". By October last year we were pretty sure that – to a reasonable approximation – every reverse-merger Chinese stock in North America is a fraud. That wasn't a bad bet. But now they are all trading at one to two times (mostly) fake earnings and shorting them is no longer an easy way to make money. What we need to find now is stocks that are fraudulent but do not appear to be fraudulent. We need things that have low short interests and larger market caps. We are looking outside the shady-world of reverse mergers – at companies who deal through major investment banks (e.g. Goldman Sachs, Morgan Stanley), who had regular initial public offerings and who have mainstream auditors. Some (indeed many) of these are frauds too – but their detection is much harder. After all there is a competent auditor (who has inside information) and who can't detect the fraud. Likewise Goldman Sachs can't detect the fraud. The few of us at Bronte Capital have to be doing something really clever to detect the fraud.

We will have to be doubly-clever to detect fraud on which we can earn "lottery-ticket" type returns. As explained last month we are very fond of positions where our losses are capped at (say) 2 percent of the portfolio but which have the possibility of delivering 10-20 percent months. Winning lottery tickets however are very hard to find but have been responsible for a fair part of our returns.

A case in point re the difficulty of finding winning lottery tickets: many of our new fraud shorts are in Hong Kong – a market only marginally cleaner than Singapore – but a market that is hard to short sell on. Most HK stocks do not have options whereas most US stocks do. Moreover borrows are harder to obtain in Hong Kong so our ability to make "lottery ticket" style returns are dramatically more limited. We think we will make good returns shorting Hong Kong stocks. We don't think we will continue making the returns you have seen for the last seven months.

Not all is lost though. We have found and are particularly excited about a new "lottery-ticket" position. We have already bet about 2.5 percent of your money on it and we are likely to double that bet. It is not a certainty but if we are right we will make returns in excess of 40 percent. John was so excited he was literally dancing around the office (please do not try to imagine it – it was truly horrifying). Anyway we are not going to tell you what it is – so don't ask. We just thought you should know what makes us happy – and be prepared for a 5 percent loss if we are wrong! So far we have not had many losing "lottery ticket" positions – but hey – our number (meaning your number) is going to be up some day.

Seriously though – the broad themes of our portfolio: long value large-cap names in developed countries, short fraud in emerging markets – are largely unchanged. We suspect that there is so much fraud in emerging markets (particularly in China) that it may be the most serious medium term risk to the global economy. This theme could last for a while yet – the astounding returns we have made from this theme – well they won't last quite so long.

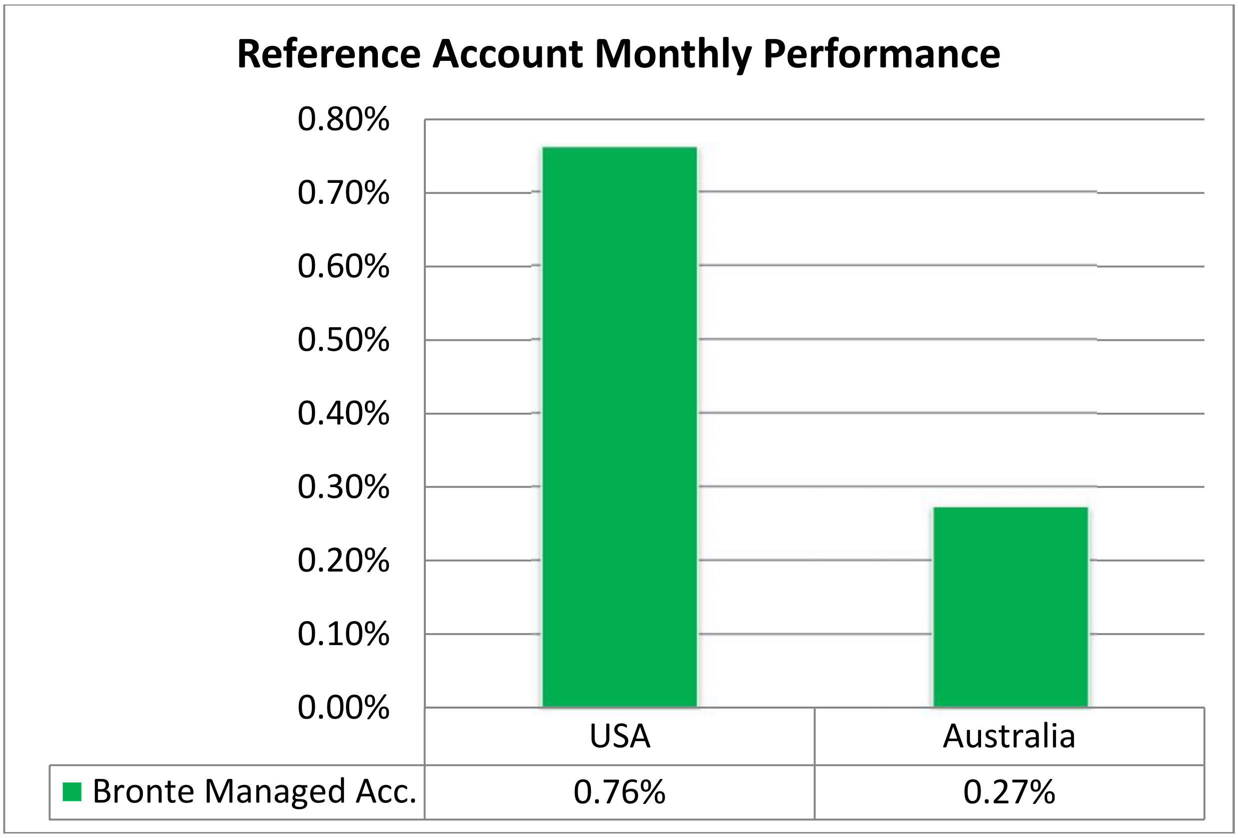
Thanks again

John
Simon

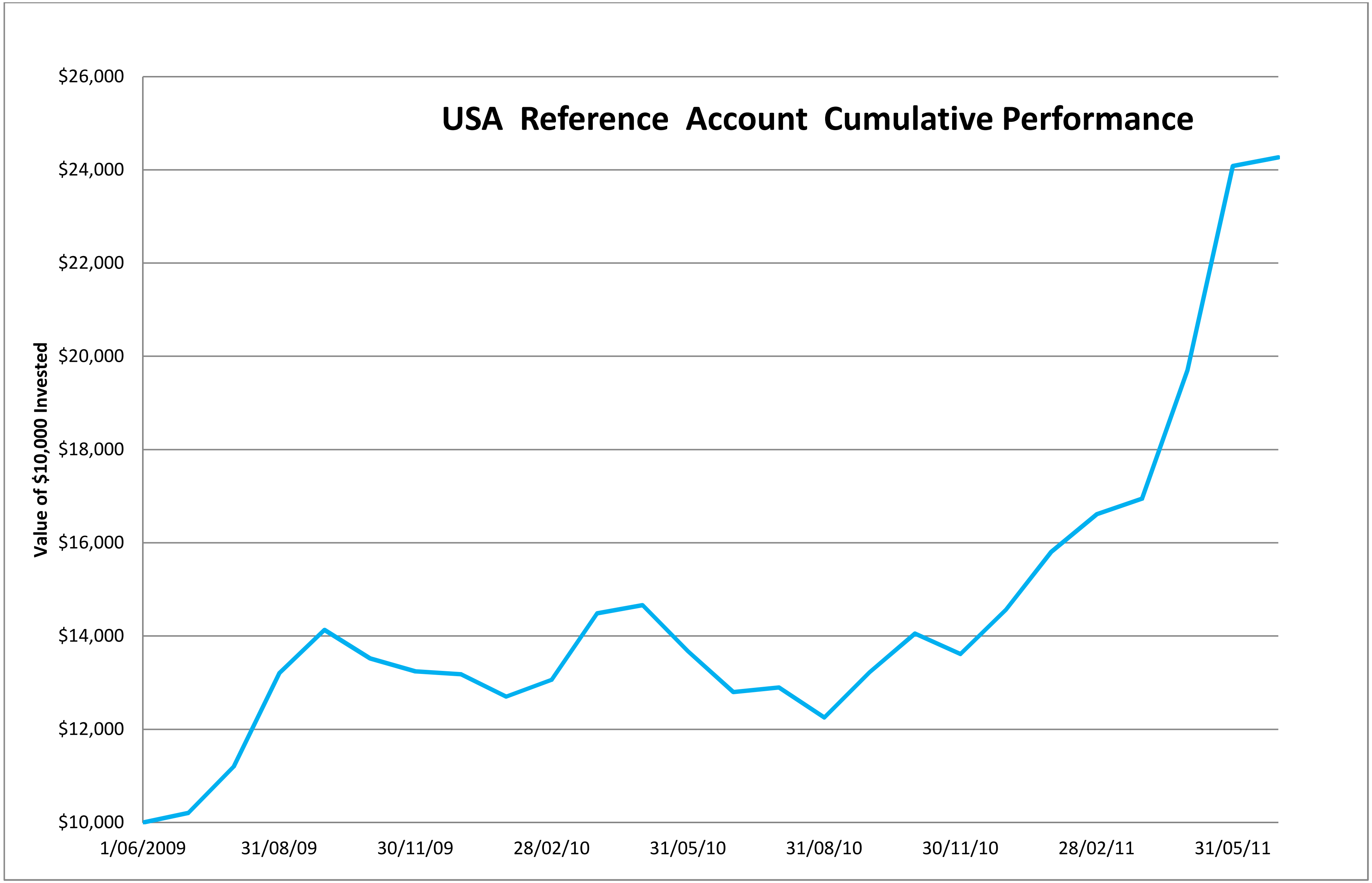
Portfolio Management

	Long%	Short%	Net Long%
USA Reference Account	114.13	50.11	64.02
Australian Reference Account	114.35	50.6	63.75

Performance Data [1]



[1] All performance data is adjusted to allow for an accrual of the annual performance fee.


USA Reference Account Cumulative Performance
Value of $10,000 Invested
$26,000
$24,000
$22,000
$20,000
$18,000
$16,000
$14,000
$12,000
$10,000
1/06/2009
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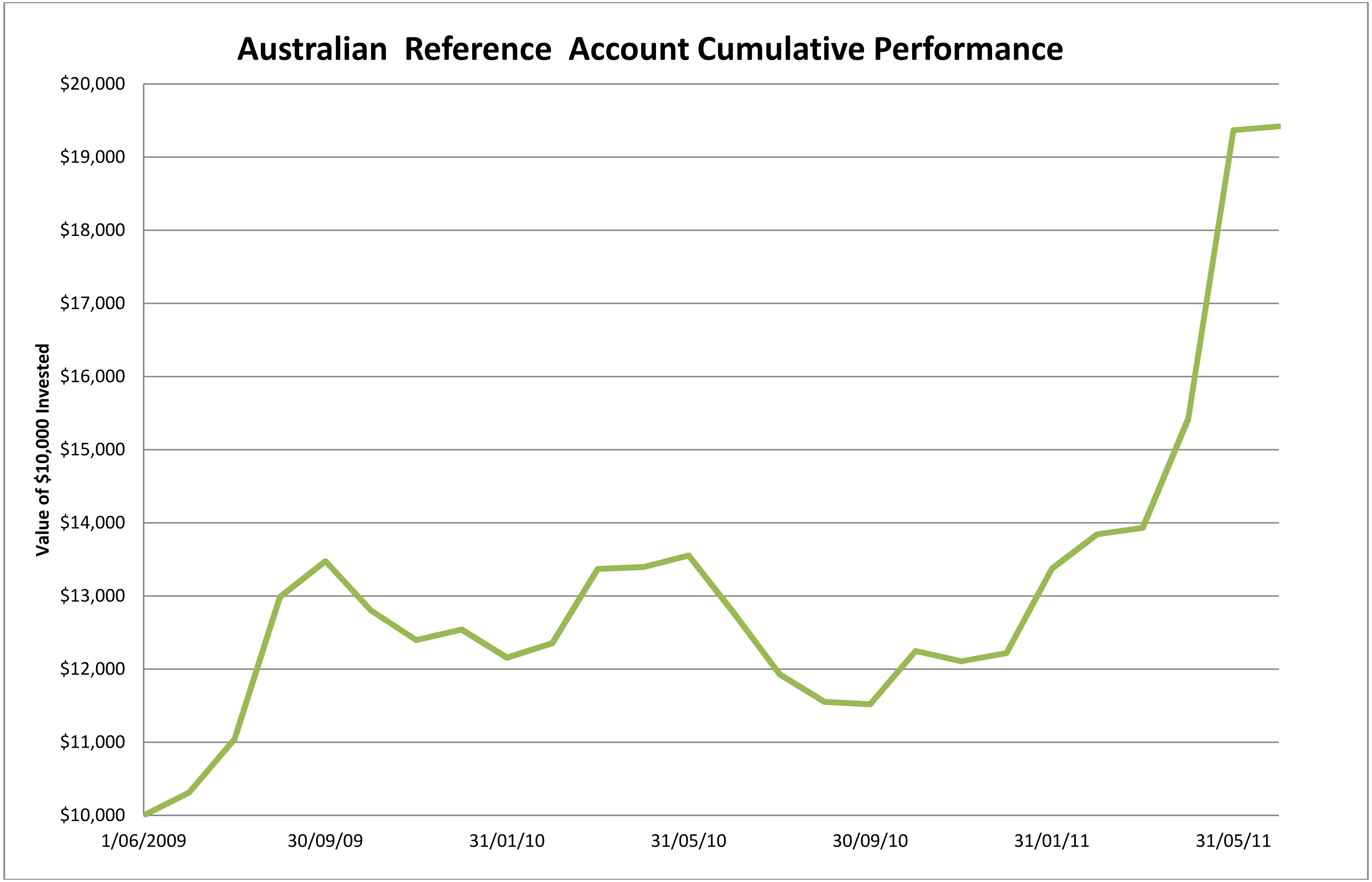
Australian Reference Account Cumulative Performance
Value of $10,000 Invested
$20,000
$19,000
$18,000
$17,000
$16,000
$15,000
$14,000
$13,000
$12,000
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