BronteCapital

Amalthea Fund

13June 2013

Investors' Letter for May 2013

The fund opened this month. A little later than we intended and right at the back end of the Australian financial year. But we took the view that there's no better time than right now – and the investing gods blessed us with a substantial fall in the Australian dollar in the first month. This is a major contributor to the 5.4% gain (net of all fees) that the fund generated over May. It is an adequate start but if we had fully invested all of the capital at the commencement of the month rather than taking a couple of days to do so [we mostly use algos to put on positions] we would have been up a further percent

Both of us, (John Hempton and Simon Maher) are initial investors, and we will be investing further amounts over time. We wish to thank our other initial investors in the fund for the trust you have placed in us.

We have never done a large scale "big bang" launch for any of our funds. They have started small and grown over time on the back of performance and interest from sophisticated investors. As with our other funds it is not appropriate for a start-up fund to bear an unreasonable administrative and audit burden and so, just as we do with all our funds, the investment manager and trustee, Bronte Capital Management Pty Ltd, has committed to fund these expenses until the fund has reached at least $35m in net assets.

We have tended to write relatively detailed monthly letters for all our funds and separately managed accounts. Our investors seem to enjoy them and we find the discipline helps our investing.

The remainder of this letter is the same as we have sent our other funds' investors. It is a mostly good story that we tell. It explains our thinking going back a few years, and how that translated into very good returns. Our intention with the Amalthea fund is for you to be able to look back on our letters and identify thought, strategy and process that has delivered value for your investment with us.

Focus Media

During the month, our big asymmetric bet on the Focus Media acquisition not closing turned out to be a disappointing dud. Private Equity along with a consortium of banks funded the takeover of the company despite some glaring issues in the accounting. We can't say we wish them well. If subsequent problems are revealed John, in particular, will be enjoying that most unfortunate of pleasures - schadenfreude. Schadenfreude is not a productive pleasure; we would prefer a refund of our small losses.

A two year scorecard

In May 2011 (just over two years ago] John wrote to our foundation client saying that he thought large-cap equities were not particularly expensive. The letter was reprinted on his blog and we will reprint it here. It explains why we have done *relatively* well:

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Letter to a client

Mike*, our foundation client and a dear friend, sent us a really bearish broker note as if John Hempton - a shortseller by inclination - needed to get more bearish. He was adjusting his portfolio accordingly. We won't be.

Here - with a few corrections and expansions - is my reply:

> Dear Mike
>
> The bear case always sounds intellectually more convincing than the bull case. And it is in this broker note too. Intellectual sounding and convincing.
>
> But America is still an amazingly innovative country, humans are ingenious and most of the imbalances will sort themselves out. Big cap equities are cheap relative to almost all other assets (especially relative to small cap equities, cash and bonds and to many assets such as commercial property that require leverage). Cash yields almost minus 3 percent after inflation and less post tax. Bonds are scary as hell and yield minus 1% after tax and inflation.
>
> Big though difficult-to-run companies are at low teens multiples. Great franchises are at mid-teens multiples. Tesco (UK) which is a truly great franchise - is at a 14 PE ratio. And the Pound is historically cheap. WalMart and Target - both slightly less good franchises - are at 12 times. The difficult parts of Silicon Valley (eg HP) are well under 10 times PE ratios (and we feel no need to own that one). The less difficult parts of Silicon Valley (Google for instance) are at a high teens PE ratio once you take out the excess cash. We own that.
>
> Own equities. Don't kid yourself. Mega-cap equities are generationally cheap compared to other assets - and certainly compared to the cash/bond/levered asset complex.
>
> Just don't be blind about it. The places that there have been high returns (Asia, small caps, smaller resource companies) are riddled with fraud. Twenty five years of deregulation and the high levels of innovation mean we have high and rising levels of stock fraud. Fortunately there is much less fraud risk in mega-caps.
>
> Don't own Australia or the iron-ore-coal-steel complex. It has run too far and has been too easy to make money. Too many stupid/aggressive/greedy people are doing too much expansion. Some of these people are stupid - but they have made <u>much</u> more money than you or me so they must be right!
>
> I can find dozens of reasons to be bearish - but I look at it dispassionately and I am bullish on big caps, and bullish on America. The problems will sort themselves out and the American exceptionalism (decent institutions, free enough markets and a willingness to take risks) will work their magic again.
>
> Anything that takes you out of real assets (businesses and

property that generate real cash flow) and puts you into nominal assets is - with a ten year time-frame - a bad idea. (And why is your personal account any shorter dated than that?)

Just don't get greedy by buying things you do not understand: you will be ripped off.

The underlying fraud level is as high as I have ever seen it.

Oh, and we are also bullish on France and Germany. Old Europe has manufacturing and production power of enormous levels. (Remember what they produced to fight wars? Their productive capacity is very high and Americans have forgotten that. They do engineering as well as anybody. And Germany no longer has a restrictive monetary policy to crush its consumer market.)

Also the French are in that lovely position of having convinced newly rich Asians that they are the arbiters of good taste. There are few higher ROE businesses. France has played Asia better than America.

We can see plenty of reasons to be bearish - but just the frauds makes our portfolio short enough. Indeed we are plenty short and likely to remain so until I can't find frauds with ease.

Beyond that, there is a lot of pessimism around. It has got to be time to be bullish. We certainly do not desire being 125 percent net long or hyper-aggressive like that - but we will take steps to become incrementally longer. We are if anything too short.

J

*Mike is not his real name.

PS. I want to stress again that my cheap mega-cap equities are **relative** to other things a rich guy might own - such as small cap equities, bonds, cash, commercial property or gold. There are ways cash could be a better investment - hard deflation. Long bonds are probably the best investment in that environment. I do not see that happening (though I did think it a possibility 18 months ago). Equities were generationally cheap in absolute terms March 2009. I was buying but nowhere near enough - and indeed we carried some losing shorts through the second six months of 2009.

The letter looks pretty good now, and the returns our clients have seen over the last twelve months are a direct result of work we did and the thinking we put in about two years ago. The market is like that. We, meaning you, are paid on stuff we have thought and have done, not on what we are doing now.

Anyway let's go through the letter recommendation by recommendation:

- The starting call - Tesco which we still own has not been great and the turnaround is appearing more difficult. That was a dud.

- The Great British Pound is slightly cheaper compared to the USD so that was also a dud. It was a dud we doubled down on by buying a large stake in Vodafone.

- Walmart and Target have both been fine investments; up about 40 percent plus dividends. We only owned Target. It is pretty hard to pick the charts apart but we suspect that operationally we might be in the wrong stock. We did not think that income disparity in the US would continue to widen. However it has and a widening income disparity favors Walmart over Target (Target is just too up-market]. Also we think the very-cheap-very-diversified retailers are the last ones displaced by the web. Walmart is about the safest name in retail.

- Hewlett Packard, which we explicitly stated we did not own, was an okay short over that time. We were short but we did not do as well as the chart suggests as we were too aggressive with put options on the premise of an underfunded pension fund – which proved unfounded.

- Google which we owned has been a fine stock. However after the appreciation we own much less of it. We were about 7 percent in the stock at $550 and are just above 4 percent in the stock at $870.

- Explicitly not owning the Australian iron-ore-coal-steel complex has been a good call. We were short a few iron-ore names. Those mostly worked for us.

- Our French and German industrial names have had more than adequate returns. Our French liquor companies have continued to sell a lot of highly priced Cognac in Asia.

- The place we have been mostly wrong is on shorting certain frauds. We have had irregular wins in this (alas we will not name names]. We have also had a few losses. This is a bull market and bull markets tend not to be the best time-or-place for exposing frauds. Still our short book is not a failure. It contains a few wins and very few disasters.

- The general call to be long big-cap stocks and avoiding Asia/China/Resources was not a bad call. This continues to be our call but *we are far less convinced about it now than we were two years ago simply because the price has changed.*

Since writing the above letter we have become increasingly convinced that the big-cap telephone carriers are going to have <u>very substantial revenue growth</u> based on increased wireless broadband usage in a favorable pricing environment. This is where a good proportion of our profits have wound up.

So far these stocks behave like bond-alternatives. When the ten year bond is weak AT&T is weak (even though the broader market might be strong). We have <u>a very non-consensus view</u> on the prospects for the wireless sector. But the bond-sensitivity of our Telco positions is one factor which can affect the short term performance of this position until our view plays out, or not, over the medium term.

Thanks again

John and Simon