BronteCapital

Amalthea Fund

13 August 2013

Investors' Letter for July 2013

It was a good month – and returns were attractive (+6.0%). We did not quite match the S&P or World Equity Indices (both measured in AUD) but – and to tell the truth – we have more or less given up trying. We used to think equities were cheap. We don't think that any longer. To try to match indices at this point in the cycle seems to us to have a bad risk-reward profile. Our portfolio – whilst remaining net long (on a beta-adjusted basis) - is getting distinctly less net long.

[We are however unlikely to ever become net-short because we do not like the risk-profile of a net short portfolio... We have seen more than one sad story of a brilliant short-seller impaled by bad risk management.]

Notably (and this is an achievement for a fund manager who is net long) we were up during the first full week of August 2013. That week the Dow fell 1.5 percent and the S&P 500 and Nasdaq slipped 1.1 and 0.8 percent respectively.

Our view that big caps remain relatively attractive hasn't changed. We are also finding some things we actively want to own. We have increased our holding of Amerco [the owner of the U-Haul business and orange trucks in the US]. As luck would have it Amerco produced very good results after we increased the stock to being one of our biggest positions (we figure it is on about seven times forward earnings). We are also finding some things to buy in Europe – but these are smaller positions in the portfolio.

The market-topping blow-off risk

Our general position remains: we are long a modestly diversified collection of very high quality businesses at attractive prices and short a highly diverse range of scum, villainy, and stock promotes globally.

Our portfolio will perform poorly in a market where honest, ordinary but well run companies go sideways or down and where the most atrocious companies levitate. This sometimes happens at the end of a bubble. [In the first two months of 2000 it paid to own all the technology stocks that later went to zero – but we have no idea how to actually time a trade like that...]

The US market started exhibiting "blow-off behaviour" in mid-May. Prior to mid-May it was just no fun being a short-seller in a bull market, and after mid-May it was actively horrible - with high-short-interest stocks behaving with lethal intent. Fortunately we panicked early and wrote in our June letter about how we were actively reducing positions.

That said – we did not duck this entirely. Almost every day during July some short in our portfolio went up by more than 10 percent. Fortunately these were tiny positions. There is clearly a lot of pain out there in hedge-fund land. John has New York business journalists phoning him seeking stories of, and explanations for, hedge-fund pain.

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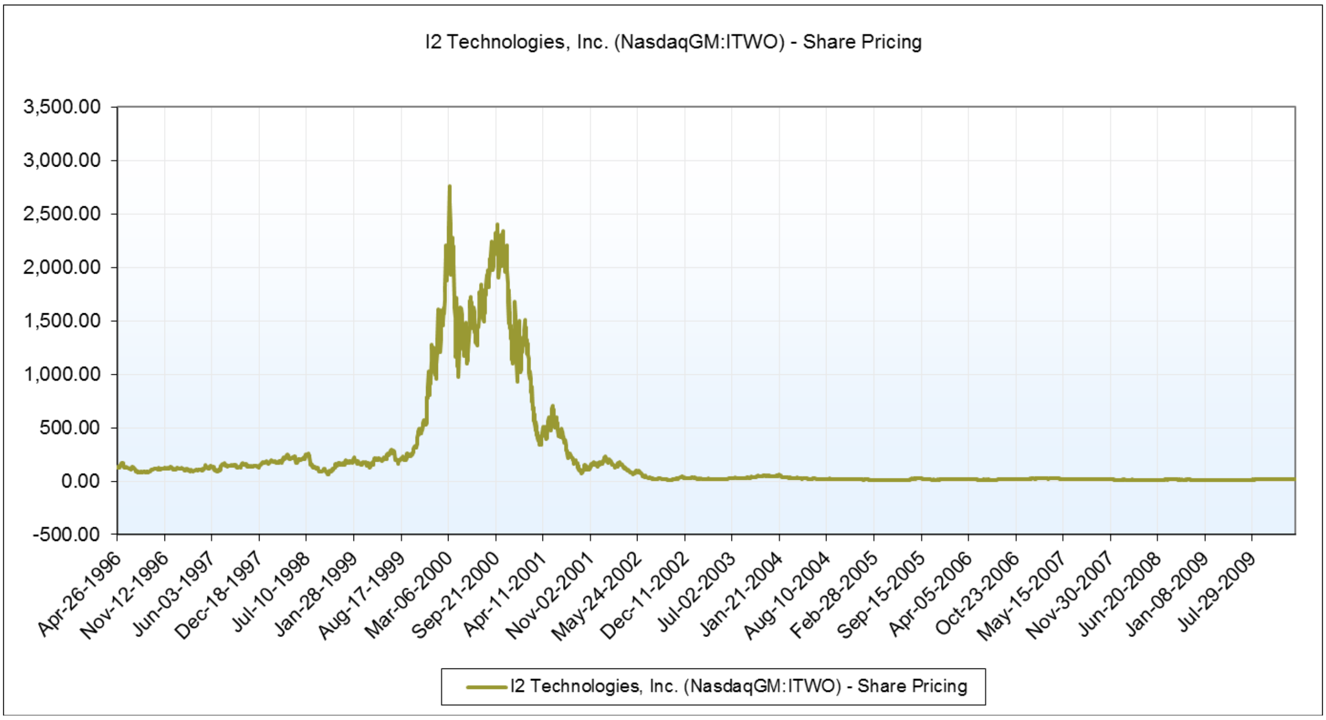
Our relatively good start to August is because we are still holding a large short portfolio, mostly however not the New York fashionable shorts. These worked during that week. Oh, and Amerco reported great numbers.

We remain *very worried* about a "crap-levitates" market and our incremental shorts are *mostly* valuation shorts rather than our usual promotes. We think we will be okay with those because they are unlikely to be correlated with high short interest stocks.

Let's reverse this and think back to the greatest market blow-off in our lifetime: the last few months of the tech bubble.

A portfolio long higher quality technology stocks and short lower quality ones did well over a decade (Cisco, Microsoft and Oracle are still here) but it did <u>very poorly in the short run</u>. At the end of the bubble the important companies with real earnings (e.g. Cisco) told the truth about those earnings (they were not going to meet expectations) and the companies with no earnings (and only hope) continued to spin the bull-story. A particular favourite: I2 Technologies – an over-hyped (but real) software "giant" during the bubble – peaked for a second time in September 2000 – well after the Nasdaq peak. *Later they paid a civil penalty for misrepresenting a billion dollars in software revenue*. The chart is below.



We can just imagine a clever hedge fund manager who was long "quality tech" and short ITWO and its ilk because he worked out that they were fudging their revenue. Short term – if his position had been large enough - he would have bled very badly indeed and might not have be able to hold the position.

This is the blow-off risk we are most worried about. We are worried about being “right” but punished for it. And our only solution is to find things *well away from the heat of the market*. The stuff away from the heat of the market is not well advertised so, alas, we need to work even harder than usual.

Our current “crap-levitates” index is the difference between the (relatively high quality) S&P 500 index and the (very low quality) MSCI US Small Cap Growth index. The lower-quality index outperformed by a further 2.3 percent in July (providing a headwind to our performance).

In 2000 the right solution was to be short a small amount of tech (maybe 5 percent of the portfolio) and long the value stocks of the ordinary economy). That was a strange market where there was a large amount of stuff that was *forgotten amongst the hype*. Sure it would have been good to be short more than 5 percent in technology – but only if you picked the top of the market – a feat beyond our abilities.

We don't think there is an easy option any more as to what you should be long. Unlike in early 2000 there are not large selections of cheap stocks to be found. So let’s consider this by what we think you should not own...

We are not fond of say retail real estate (but that is a consensus view so don't credit us with any intelligence and we would normally want to be long against consensus). We are not fond of emerging markets (China, Indonesia, commodity currencies like the AUD and Brazil). Alas even that is becoming consensus. We are really not fond of coal (which in part informs our view on Indonesia). We can't think of much that is scarier than Russia – a corrupt resource economy at the end of the resource cycle. We are also not fond of stocks that are sold on the basis of their yield (which means most of the US listed Master Limited Partnerships (MLPs) and some other odd Ponzi-like companies).

Of these the only place we have substantial shorts is in the Ponzis (and those shorts are expensive to maintain as we need to pay the Ponzi-dividends until they stop). But if we found a Ponzi-Indonesian coal company we probably wouldn't short it. Too obvious. The short would be too crowded.

How to measure ourselves

We have always described ourselves as a long fund with exotic shorts on the side. And we are still that (we still believe we need to be net long). We have explicitly stated that our goal is to nearly keep up with sharply rising markets, sharply outperform falling markets and do well over cycles (which we think will result in double-digit returns). That goal hasn't really changed.

We are wary of putting too many completely crappy shorts in the portfolio and we are now shorting some higher quality companies on valuation. This is unusual – but we are getting very nervous about the 1999-2000 “crap levitates” market and we want to not get too long – but also avoid the risks that are causing so much pain to the New York hedge funds that have all been to the same idea dinners or Manhattan bars, and have the same trades on.

Concentrations in high short interest stocks in the US panicked us in Mid-May, and we remain panicked. This may all sound too nervous for most people. But we think that paranoia is not a bad way of running a funds management business.

We note that we have been paranoid ever since founding Bronte and it has not hurt our returns much. We think it makes sense to be more paranoid just as the market conditions that led to great returns are eroding.

Thanks again

John and Simon

<u>Performance</u>

	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Fin Year to Date Return	Average Monthly Return
FY13											5.4%	1.3%		4.2%
FY14	6.0%												6.0%	