Amalthea Fund

12 October 2013

Investors' Letter for September 2013

We were up 0.38% - which is close to the return generated by global broad based indices when measured in $A. Moreover, we did this with a reduced net exposure. Our beta-adjusted net exposure is now very low. Over the same month our USA fund returned 4.25%. The difference is essentially the steep run up in the Australian currency over September.

Traditionally we have been a "long fund that shorts on the side", shorting truly rotten companies. Our day-to-day movement is usually in the same direction (but with lower beta) than the market. On up days we under-perform, on down days we beat. Over time, we try (and mostly succeed) in eking out basis points. That is changing. We do not like this market much at all – value is hard to find (except maybe in Europe and we are genuinely scared there). We are <u>much</u> less comfortable with our net long position. We intend to have lower beta-adjusted exposure going forward and we have been doing this primarily by adding to shorts. And then adding a little more.

<u>Diversifying our Short Book</u>

Historically, we have pursued immense stock-specific diversification in our short book. We will typically have well in excess of 100 short positions at any given time. We attempt to diversify our short book in many ways such as by jurisdiction, industry, and exchange – plus other less conventional metrics. Our short book, however, has been concentrated in one way: it is populated mostly by what we suspect to be frauds or stock promotes (colloquially known as pump and dumps).

Our fraud/promote shorts are volatile. We have always believed that this leg of our portfolio should be limited in individual and total size because of its potential to move in ways very disconnected from reality. This is the main reason for our "short-on-the-side" stance.

As we add to shorts we simply can't extend our fraud-promote shorts indefinitely as <u>that would be inconsistent with prudent risk</u> management.

So our incremental shorts are of a different ilk that we believe traverse a number of themes that not only add diversity but diminish beta as well. These themes include:

-short some "cyclicals" which the market is pricing as "growth stocks",

-short high-value companies with some technological challenges, and

-jurisdictional shorts, the most notable being Sweden, which we discuss below.

<u>Short Sweden</u>

One big change is that we have started shorting Swedish mega-caps on valuation. Sweden is a safe, well run country with a high domestic savings rate and a very strong home bias for investing. The neighbourhood has been pretty rough lately so the home bias has become even stronger – and the locals have been bidding up stocks to what seems to us to be ludicrous levels. We don't know what breaks this market – but we want to be on the other side of the trade. We have a few positions.

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Most of these positions are high quality companies at even higher valuations. For example, we are short Atlas Copco – a maker of air-compressor and vacuum equipment some of which gets sold for pneumatic drills, some of which goes to the mining industry. We think it is a cyclical but the market is not valuing it that way. Atlas Copco is not alone: everything in Sweden looks expensive except maybe Electrolux (and we are unlikely to buy shares in a white-good and vacuum cleaner manufacturer in a high cost country).

The point, however, is clear. Atlas Copco is already priced well over two times sales and is unlikely to double on us. Stocks that double on you whilst you are short are commonplace with frauds and promotes. Our Atlas Copco position (by comparison) poses us (meaning you) very low risks. And it's a desirable short anyway.... It's a cyclical and the market perceives otherwise – moreover the cycle (mining capital equipment) is already moving against them. Finally Atlas Copco is large cap and liquid. And it provides us protection against what we perceive to be expensive global markets.

<u>The Fruits of Our Efforts</u>

This month we have had a handful of days where our movement has been *in the opposite direction to the market*. We were down one day when the market was up and up several days when the market was down. This happened very rarely until this month. The change is a reflection of our new, lower net exposure. This year has been an atrocious year for short sellers. We think the tide will soon turn. We still expect to lose money in any strong downward market movement. We just aim to keep the losses manageable. This month, we did better than that: we produced a return in a strongly up market despite our reduced net exposure. For Australian investors the movement in the $A erased the gain in the portfolio – and this will happen from time to time given the volatility of our currency – but we are nonetheless pleased with the result. At the commencement of the fund significant gains arose from the currency decline.

<u>After month-end</u>

There has been one large change in the portfolio after month end. We have reduced our Herbalife position by several percentage points. Herbalife however remains one of our largest positions and we remain convinced that the short-thesis so well publicized on Wall Street is incorrect.

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%		2.1%
FY14	6.0%	-2.5%	0.4%										3.8%	