Bronte Capital
Amalthea Fund

13 February 2014

Investors' Letter for January 2014

This was a poor month. Global markets fell. Your funds entrusted to us fell 3.7% - and more than the market did. We should normally outperform falling markets. Our personal view was that we underperformed our minimum standards by about 5 percent for the month – making this the second worst month in the history of Bronte. [By far the worst month we have ever had was January 2012[1] and we will provide on request the brutally self-critical letter we wrote for that month.]

At Bronte we believe some losses are worse than others. There are losses which are essentially noise – dividend capacity is maintained and the positions should revert. And there are losses which are permanent. It is not possible to accurately tell at the time which bucket these current losses go into though in January 2012 we suggested that our losses were low-quality losses and we were right. This month the losses were not likely to be of high quality either. We think some will bounce. But some – less so.

About a third of the loss was an almost total wipe-out of our "upside insurance" position – the S&P calls that we purchased to allow us to keep on our shorts in a torrid up market. Some of it was idiosyncratic portfolio positions we have that simply did not work. And another bit was Herbalife which fell about 20 percent and has since bounced somewhat. Most of the rest was in drug-stocks.

The "insurance" position was in part a mistake. We should have taken some of it off the table. The amount we should take off the table was possibly the main point of portfolio argument between John & Simon in the first part of the month. John looked at the position (and still does) and thinks it is statistically cheap.[2] Simon looks and says: too speculative take some off the table. There is a point where Simon forces John to concede – but we never got there.

Herbalife has come back a little – but to be fair they did a convertible issue to buy back stock and we think the terms are somewhat disappointing. We still like the stock – just less than we did.

But the biggest idiosyncratic problem in the month was drugs. Last month we quoted (approvingly) Nancy Reagan's advice: "just say no to drugs". We have managed to get ourselves tangled on pharmaceutical stocks all year. It got worse in January. Bloomberg monitors a basket of "development stage" biotechs, and these were up 24 percent in the first twelve trading days of January. All the biotech frauds (other than some Japanese ones)

---

[1] Applies to funds that were open at the time and not to this Amalthea Fund

2 When purchased these were priced at roughly a quarter historic volatility. They are very cheap versus history even still.

Bronte Capital Management Pty Ltd (AFS License: 334325, IARD No. 151222)
Suite 2101B Tower 1, 520 Oxford Street, Bondi Junction, Australia.
Phone: +61 2 9389 3293 • Email: simon@brontecapital.com

that we are short are in that basket. These are companies that will never have a worthwhile product – but that doesn't stop several of them having large market caps.

Finally we are short a few stocks that are sold to retail investors based on the dividends but where careful analysis reveals that the dividends are massively unsustainable or have gone "full Ponzi" where they are only sustained by raising additional capital. Strangely these stocks are considered "safe" as they are backed by dividends. When the market went down these went up (as did Treasuries). We managed to lose money on both the long and the short side of the portfolio. We think we will make very good money on these eventually but for the moment the game is risk management.

A write-up of our worst day was posted on John's blog – that post being repeated at the end of this letter.

For what is worth, because the S&P call options are now further out of the money on a day-to-day basis we are much closer to net-neutral than we would normally be. This was reflected in the last day of the month which we were near-enough to flat and the market was down sharply. It has also been reflected thus far in February which has not been a great month but has not been a bad one either.

We are getting to that point where we are wanting something to go right. We don't think we are doing silly things. Time has revealed a few analytical mistakes, but not that many. We have had a few months where the results are better than we deserve. We look at them and think "we are not that good". This month – indeed this year so far – we can look at our results and think "we are not that bad". We mostly like our portfolio. And we are pretty sure it will produce adequate results over time.

Some good news

We have a new employee. David Sachs. He is an American and more computer driven than either of us. He is going to help us in identifying and managing our short book and so far we think he is great. That should work out okay for us and for you too.

Thanks again

John and Simon

Performance

	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%		2.3%
FY14	6.0%	-2.5%	0.4%	3.6%	5.7%	4.3%	-3.7%						14.1%	

The blog post...

When the hedge doesn't work

I run a hedge fund which means I am meant to hedge risk. However if you hedge away all your risk you hedge away all your returns.

So you have in your head (or computer) some model of how the world works and what things should be correlated and what should not and you make your bets accordingly.

If your model is good and your position (stock) picking is good you should outperform some market (maybe a 40% bonds, 60% equity portfolio) at lower risk than the above portfolio.

But alas the hedges are necessarily imperfect hedges. [Perfectly hedged portfolios make cash returns - which at the moment is zero before fees...]

And with imperfect hedges sometimes the hedges don't work.

It doesn't matter how famous you are or how clever you are - you still have to deal with the time when your hedges don't work. It happens to all of us. [Truly - if you find a hedge fund manager who says they have never had "model failure" then find another fund manager.]

Its in this context (and noting his massive returns last year) that I remind my readers of aBloomberg news interview with Tepper less than two months ago.

In this interview Tepper restates his case for equity markets being cheap enough and cheap compared to (say) bonds. I don't think it is a bad case - I don't think large caps are expensive. But they are more expensive than a few years ago. [See previous Bronte comments on the state of the market here and here.] [For the record I think there is a bubble in biotech and non-telecom stocks that are purchased primarily for their dividends and English language small caps that are not financial institutions.]

The real action in the above interview happens about four and half minutes in where Tepper outlines his short case for bonds. He is not short them because he thinks that there will be inflation (in fact he doesn't think there will be). Rather he is short them as a hedge against the consequence of the Federal Reserve trying to exit QE policies.

Bluntly that hedge did not work this week and particularly on Friday.

Equity markets had their worst day in yonks. The airlines (Tepper's biggest position) were not exactly good either (as they were typically off over 4 percent - double the market).

Bond markets however had a very good day. Long bond indices rose several percent in value.

In other words Tepper was long the bad stuff, short the good stuff and the short was meant to be his hedge.

His hedge did not work. Badly. I suspect he was down more than 4 percent on the day - maybe double the equity market.

As I said every single decent manager will have days when the hedge does not work. There is no implied criticism of Tepper here. [I watched that interview because I admire him...]

And I doubt his clients would be worried either. I have never watched Appaloosa pitch to clients but I suspect the risks are accurately described and I suspect David Tepper would say to his clients that if they cannot handle a low-single-digit down day or two they should not be clients. [I know Bronte would want to dissuade such people from being clients...]

But I also know what David Tepper is feeling. At Bronte we also had the worst day in our history (although it was not as bad as I think David Tepper's day was).

First you feel a little beaten up. But at some stage you need to (seriously) examine the possibility you are wrong. And at that point the emotion turns to self-loathing. It is surprising but many of the best asset managers I know really hate themselves. It's an occupational hazard - and indeed may be a pre-requisite to being really good at this game.

That said, self-loathing is not a very productive emotion. You shouldn't just stand there like a deer blinded by headlights.

The thought pattern (and this thought pattern can be ex-ante programmed into a computer if you want) has to turn to risk management - how do we behave if we continue to be wrong? At what point should we pull-the-plug and accept that we just don't get it.

The purpose of this blog post is to explore what to do with the portfolio when the hedge is not working. That is a discussion we are having at Bronte because this week it has not been working (although not in a very serious way). And I have written this from the perspective of a stock-picking long-short equity manager. [The discussion has the same intellectual components from the perspective of a computer driven trading shop - but I can't speak to the specific detail.]

Bronte's portfolio positioning

Because I don't want to give away all the tricks of the trade I am going to describe Bronte's portfolio in an idealized position. [Day-to-day situations vary.]

We have a long book which is mostly large cap like Verizon (although includes a few disclosed mid-caps like Herbalife) which should have a beta of roughly 1. On a day-to-day basis Herbalife is our highest beta stock.

We have a short book which is full of the widest and wildest range of scum, villainy, stock promotes and general nonsense we can find. The typical short position is a biotech scam stock or something like that. Some of these are very high beta indeed and the short book has a beta of about 2.

We may typically be 130 percent long, 50 percent short - but beta-adjusted we are only a net 30-40 percent long. Day to day movements usually reflect this. On a day when the market is up 1% we are typically only up 0.3-0.4 percent. When the market goes down a percent we typically go down a similar amount. To keep the maths simple I presume an ex-ante portfolio beta of 0.4 for the rest of the discussion.

As we have been right a fair bit of the time in our specific stock picks we have accumulated returns that are way better than equity market returns <u>even though we believe we have been taking less than equity market risks</u>.

This week however our performance has been bad. We have tracked down roughly 150 percent of equity market returns. Friday was - as I said - the worst day in our history - but the loss was only 150 percent of equity market returns...

But whilst Friday was the worst day in our history this month has not been the worst month in our history. We have only had one month where the model looked truly broken - and that was January 2012. We wrote it up at length for our clients. In that month we went down roughly 6 percent when the markets went up roughly 5 percent.

As our day-to-day beta is roughly 0.4 we should have been up roughly 2% in a 5% up market. Our 6 percent loss was about 8% of under performance - by far the worst month we have ever had.

In January 2012 we got both ends of our portfolio wrong. Some of our longs went down in a good market. Our shorts ripped up in our face. The letter we wrote at the time noted the largish losses we were taking on Google. [Google was one of our biggest positions and it fell from $660 to $580 or so that month. As discussed in the letter we purchased a tiny amount more...]

However Google wasn't where the action was. Our shorts ripped up in that month - some costing us more than 30 percent. Ex-ante we estimated their beta wrong.

Lets model how this looks.

Our ex-ante position was

> 130 long,
> 50 short,
> Total position 180 - ie gross leverage of 1.8 times.

At the end of the month our longs had gone up say 2 percent (substantially less than market). Our shorts had gone up 18 percent (substantially more than market).

Our position would thus be:

> 132.6 long
> 59 short
> adding up to 191.6

However we have had losses - on these numbers adding up to 6.4 percent. Our capital has decreased from 100 to 93.6.

Our gross leverage has thus increased to 191.6/93.6 - or roughly 205 percent.

This is kind of shocking - we had 6.4 percent of losses but our gross leverage increased by 25 percentage points.

This is a real hedge isn't working situation. We had no choice but to cut positions - and we cut them fairly aggressively. We would have loved to add more Google into that slide - we really would have loved it. But we couldn't. We were forced to cut positions - and could only add more Google because we chose to cut other positions.

--

Now lets compare this to this week. Our shorts have been going down - but our longs have been going down far more. (Witness Herbalife's big decline and Herbalife is not our only bad stock this week.)

Our aggregate position size has been shrinking more or less in line with our capital. We are not becoming dramatically more leveraged. And because we are not becoming dramatically more leveraged we can sit it out.

David Tepper's leverage probably* won't have changed by more than a couple of percent either. He can sit it out too.

And so we can examine (and will examine) individual positions but the market hasn't pointed a gun at our head and forced us to take off positions. Inaction is thus an acceptable policy.

So I can just go back to self-loathing then. I guess David Tepper can do the same (but I suspect he hides it better than me...)

John

*I am not privy to Tepper's aggregate positioning. All I know is from the above interview - hence the word "probably".