BronteCapital
Amalthea Fund

15 September 2014

Investors' Letter for August 2014

Our results this month are poor. They are not threatening (we manage our risks better than that) but they are not consistent with what we expect from ourselves or you should expect from us.

Our year of fighting irrational upward movement in junk stocks and lacklustre performance from our longs continues. We don't think our portfolio is silly - just that it isn't working.

We have reduced our net exposure relative to past years simply because we find it very easy to find good shorts (stocks that should trade radically lower over the next five years) and very hard to find good longs.

That said - low net exposure this year has not been a way of making money.

Just how irrational is this market

We have a few stocks which we use as indicators of where we think this market is. One is Nanoviricides (NNVC). It's a company with what we believe is a nonsense technology of using nanotechnology to attack viruses.

We do not need to argue whether it is a nonsense technology though. At 29 April the *New York Observer* published an article which amongst other things observed that the Chief Scientist had faked his PhD.

We quote:

> [W]e doubt NanoViricides is ever going to be much more than it is today: a company rife with conflicts of interest, bogus résumés, nonexistent scientific ratification of its "technologies" and a remarkable tendency for exaggerating not just the promise of its drugs, but almost every other thing they talk about, too.

It continues:

> You may recall the bird flu scare of the fall of 2005. NanoViricides was quick to announce that August that the government of Vietnam's National Institute of Hygiene and Epidemiology had "extended an invitation to the company to help in the battle against bird flu." ...
>
> Clearly not the types to miss the chance to talk about something, the company announced its intention to go to Vietnam to do that talking, after which they intended to "redevelop" FluCide-I into AvianFlucide-I. In March 2006, they reported that the results from a mouse study of FluCide made the drug "worthy of filing an Investigational New Drug Application" with the F.D.A. Alas, it's been eight years and not only has no I.N.D. been filed, there's no longer any word of AvianFluicide on the company's web site.

The press releases continue like this for nearly a decade, but the company has yet to get a single drug out of the lab. There have been no human clinical trials, and not a single I.N.D. filing with the F.D.A.

Since then of course the stock is up. As is the cost-to-borrow the stock, presently almost 36% annually, so we are not even short.

At this point, the tally of actual PhDs on our team (one, in genetics) may well exceed the number of actual PhDs on NNVC's management team. The point though is that one can know the Chief Scientist has faked his PhD and still lose money. And you lose money before borrow cost.

The company has $200 million in market cap and trades over a million dollars a day - this is plenty liquid enough for us to be short 30bps (our typical position).

We encourage you to read the article by Duff McDonald[1] (It is brutal. But it tells you just how hard it is to make money shorting junk.

Quality minus Junk

Our basic position remains. We go long quality stocks (and most of our long book is pretty dull but high-quality large-cap longs) and short the most aggressive fads and promotions we can find.

Quality minus junk has suited us for a while - but has not worked this year.

[1] http://observer.com/2014/04/west-havens-nanoviricides-has-big-goals-and-big-

Cliff Asness and his team at AQR Capital published a paper[2] which shows long term outperformance from a "quality minus junk" portfolio over very long periods. It outperforms handily in all 24 countries surveyed - though has underperformed in some periods - most notably in the melt-up period at the end of a bull market.

We are not entirely happy with their quantitative definition of quality (we prefer more subjective tests) but the idea rings true. There are some truly lousy things in financial markets and if you short them and go long real businesses you should do okay - provided you can manage the exposures during the blow-off period of the bull market.

For better or for worse we think we are in that blow-off period at the moment. This year has been about "risk management" rather than "making money". We are sure the "making money" will come again though. We can't tell you when.

Asness's quality minus junk index underperformed most in the lead up to the dot-com blow off and outperformed very dramatically afterwards. The underperformance in the blow-off period was damaging if you were not focused on risk control.

Not everyone has focussed on risk control though - and we are watching our competitors in (particularly short-sellers) exit the business with alarming frequency. When this is over competition should be low and we might make a lot of money.

A hedge fund failure

We do look at what goes wrong elsewhere and why.

There was a letter in the Wall Street Journal from a failed hedge fund manager (Andrew Cunagin). Cunagin blamed anyone but himself: bluntly the market was irrational and he had lost money.

Strangely our view of the market is similar to his, though we strongly disagree about the role of a fund manager. We have minor issues with his view of high frequency trading (our view is that it is irrelevant).

What we strongly disagree with is his view that it wasn't his fault. It is incumbent that the fund manager seeks to manage risks wherever they might be - and <u>one of the risks in this world is that the market could get more irrational than you thought possible</u>.

Our portfolio might have been <u>very similar to Cunagin's</u> except for one thing: position sizing. We size positions so that when losses happen (as they inevitably will sometimes) they are manageable. Andrew's failure wasn't necessarily stock picking (though there probably was some of that). His failure was portfolio management.

In the past we have had two lengthy periods when performance was basically flat. After each of those we had a period of extremely good returns. We are now eight

[2] http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2312432

months into a third period of not making money. It is not much fun for you our dear clients and it is less fun for us.

But we promise to continue to manage risk and stay rational. That is all we can promise but it worked well at the end of both prior periods of poor returns.

Thanks again

John and Simon

Performance

Current financial year return	-2.5%
Last 12 months return	8.7%
Return since inception (annualized)	14.6%
Cumulative Return since inception	20.0%

	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
FY13											5.4%	1.3%
FY14	6.0%	-2.5%	0.4%	3.6%	5.7%	4.3%	-3.7%	0.2%	-2.6%	0.9%	3.4%	-0.8%
FY15	-0.9%	-1.6%										