Bronte Capital
Amalthea Fund

15 November 2014

Investors' Letter for October 2014

It is not an original thought - but it neatly explains just how strange October was.

Nobody - and we mean nobody - has ever said that they predict a rapid ten percentage point decline in the stock market and then a twelve day rally back to new highs.

It didn't quite happen that way - but it was darn close. The market dropped 9.8 percentage points (from intra-day high to low) and rose 10.8 percentage points.

Investors don't like to be whip-sawed by the market like that. It naturally means they get a little wrong-footed. But due to fairly conservative positioning and good risk management we did okay and were not whip-sawed in the same way.

We were up for the month and ahead of global indices by month end. See more discussion on this below.

Fortunately our shorts were not very costly primarily because we did not carry popular shorts.

Our biggest loser was Rolls Royce which lowered guidance based entirely on its non-aviation businesses. Our reason for owning the stock was entirely the aviation business and we were surprised the market was surprised by the downturn in diesel engines. (Shipping companies are having a tough time of it and a lot of the engines are used in upstream oil and gas and the oil price is falling.)

The big intra-month swing

In the middle of the month we were way ahead of markets (albeit still down modestly). We thought this would be a banner month – driven by good profits on our shorts. As the market rose our edge over the index shrunk but we finished ahead of it.

Spikes in volatility (like October) expose people who are running with too much leverage. We are hearing on the grapevine of a lot of pain from some fund managers. We had one outlier-bad-day in the month - but no real pain. [We talk about that outlier day below.]

The reasons for the drop seemed rational enough to us. We think the market (particularly small caps) is expensive. Europe looks ugly - with a central bank tied by German anti-inflationary obsessions when what they really need is printing presses. China looks uglier - excessive construction and even more excessive corruption are becoming obvious. Signs of Chinese capital flight are evident in our home town of Sydney where the newspapers routinely discuss the large number of Chinese residential property buyers seemingly oblivious of price – but determined to obtain a parachute.

The US hardly looks good for equities. Quantitative easing is ending. Given the correlation between the Fed's balance sheet and market indices that might matter.

Bronte Capital Management Pty Ltd (AFS License: 334325, IARD No. 151222)
Suite 1703 Tower 2, 101 Grafton Street, Bondi Junction, Australia.
Phone: +61 2 9389 3293 • Email: investor.relations@brontecapital.com

Finally the market is laced with dubious stocks (frauds and promotes on which a long-term return is nigh impossible). Shorting them finally seems to be working a little. But only just.

Still – despite our belief that the drop was rational the market did not drop. We remain unable to predict short term market direction.

Our results this month are 8 parts risk management, 2 parts stock picking and in no way correlated to our (in)ability to pick general market movements.

Shire PLC

Perhaps the defining market event during the month was the collapse of the AbbVie merger with Shire PLC. Shire is a profitable company and we owned a small position prior to the merger announcement. We know enough about cross border tax to distrust the "inversion" rationale for mergers – and sold.

Our reason for owning however was mostly to hedge the biotech shorts which we have in abundance.

When the deal collapsed we found out that more than half the stock was owned by hedge funds who had levered themselves to earn narrow (but levered) spreads. Given well-telegraphed uncertainty as to tax treatment this struck us as far too aggressive.

The day the deal failed popular fund positions were unwound across the board. Lots of funds are short the Australian dollar and, as a global fund with very few Australian assets, Amalthea is short as well. That trade moved sharply against us for a while.

There are a few well known popular shorts amongst hedge funds. They all rose sharply. We were hurt only a little by that because we have spent the last two years diversifying our shorts and hence the pain we had was small and short-lived.

Our losses versus index that day were about 1.5 percent – the only "bad day" we had in the month. It gave us some pause. We tried to imagine how bad it could get.

Had we been 5 times as levered or ten times larger in "popular positions" we would have had a bad month. This was a month that punished people with popular positions. Fortunately, and attractively to our investors we think, we are quite different from that.

Herbalife

Everybody asks about Herbalife – the company that Bill Ackman has labelled a pyramid scheme and taken an enormous bet against.

Our position is fully sized. We will simply not put more on because of risk-management rules. That said – it is – at pixel time – about 6.9 percent of our long book.

The results the company printed for the third quarter were poor. Growth went to zero – and that was not in our projections. We did not predict the bad growth number. And we were wrong-footed in the short term. Nonetheless, a poor third quarter number will not be the most important share price driver over time and we are focused on medium term positions through the cycle. We have done enough work to satisfy ourselves that Bill Ackman's main thesis is wrong. This is not a pyramid scheme. We believe they will settle all allegations with the Federal Trade Commission for a modest fine and some rule changes – just as they recently announced to resolve a class action suit. We believe the share price should rerate significantly once this uncertainty is removed.

Hence, we still like the stock a great deal. However unless the growth number picks up the upside is far more limited than we originally thought. With the "retrospectascope" we would have sold more at prices greater than 70 and bought it back at this price. But hindsight is 20-20.

Despite low growth, the stock is cheap. Longs that are cheap are genuinely rare (after all, this has now been a prolonged bull market). But incrementally we like the position less than last month even though, in a portfolio context, there are few attractive positions like this which give us some long beta against a short book of high beta stocks.

Thanks again

John and Simon

Performance (Net of all fees)

Last 12 months	9.1%
since inception (annualized)	16.2%
Largest Monthly Gain	6.0%
Largest Monthly Loss	(3.7%)
Max. consecutive Gain	14.6%
Max. Drawdown	(6.0%)

	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	YTD
FY13											5.4%	1.3%	6.8%
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%	15.2%
FY15	-0.9%	-1.6%	2.7%	1.7%									1.8%