Bronte Capital
Amalthea Fund

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Investors' Letter for February 2015

Let's get the mea-culpa out of the way. We have not picked stocks well for this market on the long side - and we have got the currency positioning wrong. The currency positioning has been particularly tough for anyone who has a weighting towards European stocks. The Euro has fallen against any comparable currency. This may come as a surprise because the fund has done well since inception – but remember that we are a global fund and the Australian dollar has been in decline. We are saying that we should have done better than we have over the last 12 months

Below we are going to explain why getting it a little bit wrong is natural at this part of the market cycle but we are getting it more wrong than we should.

On the plus side our short-stock picking (which is really the place where we think we add most value) has not been lethal despite an outright hostile market. Being short in this melt-up market is not profitable. It will be when the market is different and we kind of like our shorts - but we wish we had just gone all-in long 24 month ago - and life would have been much happier.

MTU Aero Engines - a microcosm of the good bits in our portfolio

MTU is a stock we truly like and which we believe will have vastly higher earnings in a decade. It is precisely the sort of growth/value stock which we would love to fill our portfolio with. [A task we are finding abnormally hard as markets are far from cheap.]

MTU is a very sophisticated German manufacturer of parts for civil and military jet engines. It was once the main aero-engine manufacturer for the Nazi war machine but these days largely makes components for engines made by Pratt & Whitney, General Electric and (to a lesser extent) Rolls Royce.

It is an equity participant in several major jet engine consortiums - owning for instance 4% of the consortium making the GEnx engines [which is GE's new engine for wide-bodied plane] and more importantly up to 15 percent of various syndicates for Pratt & Whitney engines. The P&W engines will power planes like the A320 NEO - one of the two main narrow-body work-horse planes of global civil aviation. These 15 percent stakes are for new engines - MTU has only single-digit percentage stakes in old engines - so there is true growth in market share here.

The new planes are about 10-15 percent more fuel efficient than the planes they replace - and the engines are thoroughly tested. There is little doubt that the (huge) forward order books will materialize.

At the moment though, MTU Aero Engines is eating considerable development costs (some of which are being expensed and some of which are being capitalized) and the revenue has not yet arrived. Earnings are being suppressed. Moreover United Technologies (who own Pratt & Whitney) have given a profit warning driven in part by the development costs of these engines (making earnings suppression even more obvious).

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But as the engines are delivered (and the associated maintenance bookings materialize) earnings should rise a lot. This is a genuine growth stock with a teens multiple. The main problem is that the growth will take some time to materialize. Aircraft manufacture is a long-cycle business. A plane takes many years to develop and the engine has maintenance streams for maybe 35 years after the delivery of the first plane.

This is the bad part of the cycle. More profit warnings (as per the United Technologies warning) are possible as they ramp up manufacturing capacity. And the bad part may last a few years yet. The earnings are highly likely - but they are many years away.

Stock performance

The stock chart since the beginning of the year seems to indicate we have this stock right. The light blue line looks like a truly great move - up 28 percent.

However this line is misleading. The stock is quoted is Euro. The dark blue line is quoted in USD and is up only 12%. Measured in USD MTU Aero Engines has appreciated nicely but the Euro chart vastly overstates the case.

The currency moves are wildly good for the company

Whilst the stock has only moved up a little (measured in USD) the business itself has become wildly more valuable. This company sells jet engine components as part of various US dollar consortiums. Jet engines are a truly global market priced in US dollars - and MTU really does have its cost base in Euros. *Future profitability has risen massively and you certainly can't see that in the stock price*.

Some of our other European positions have a much more domestic focus (e.g. retailers and regional banks in France). In these the weak Euro does not increase the value of the underlying business. And we have suffered the currency decline anyway.

Our results would have been adequate if we had held our Euro denominated stocks but not held the Euro. We do not do these things (believing in part that the currency is a partial hedge to the economics of the business). But in retrospect it would have been wise not to be quite so long the Euro.

That said - it is an error we are not about to correct. Europe looks competitive at this exchange rate. [Yes we know that it is perverse to describe Europe as competitive - but it is…] We think quantitative easing (and the associated currency weakness) will do good things for the European economy - and - in an investment sense - we hope to stick around and enjoy it.

<u>The nature of late-bull markets</u>

There is a recurring theme in late-stage bull markets - and we believe that the US is in such a bull market.

a) Short-termism becomes absolute. Stocks go up hard but react badly to short-term earnings impacts. There is sensitivity to day-to-day news that is flat-out irrational. The idea of holding something that will earn much more in a decade is anathema - instead you want to hold the things going up “today”. Long term stories are described as “dead money”.

b) Stories become more important than the nuance of accounts. People become willing to pay for speculative story-stocks (dot-coms with no earnings in yesteryear, biotechs today),

c) Roll-ups and conglomerates become a thing which people pay a premium for. Owning them makes fund managers rich...

d) Extending that, people who you think are outright dangerous outperform by so much you get jealous. People who have made fortunes on Valeant, Transdigm, Middleby and other roll-ups where high stock prices have made continued acquisition (and continued roll-up accounting) a self-justifying and self-fulfilling circle. Momentum investors in these stocks are lionized as heroes.

These are market characteristics that fill us with dread and your portfolio with “underperformance”. Generally we strive to (i) own long-term value stories (and long-term is not the order of the day) and to (ii) short story-stocks without substance. Roll-ups with rubbery accounting are also natural shorts for us.

A world where nobody cares about long-term stories and our natural shorts keep going up is unpleasant. At these prices we don’t think you should own too many US equities. We are net short US stocks (on a beta-adjusted basis) but we are happy enough with Europe - and - dare we say it - as the AUD goes down there may (eventually) be some value in our home market too.

But until the final blow-off of this American bull market you can expect under-performance. And if the Euro keeps crashing you can also expect some.

But we <u>really like</u> our portfolio - and we think we will make very good money over the next few years. Moreover we are not taking too much “bubble risk” in doing so. Managers owning hot stocks are beating us - and we do not intend to do anything about it.

We wish it were possible to be tied like Ulysses to the mast and enjoy the siren-song of the bull market but without the risk of falling to death in the sea. Maybe someone can get out when they recognize the top. George Soros has famously picked a few tops that way - but we are not George Soros. The investment world is littered with the corpses of “bull market operators”. And we intend not to suffer that fate.

Herbalife - a major change this month de-risking the position

Herbalife is a weight-loss and nutrition company whose main product is diet shakes sold through a network of millions (yes, millions) of (mostly) home-based distributors. It is almost - by revenue - approaching the size of Avon.

It is also highly controversial and recently been a disappointment in our long book.

Herbalife guided down earnings again (about half the downgrade was a result of currency and half from changes in their distribution rules). We believe the nuanced explanation.

Background to our position

In 2012 Bill Ackman - a very famous New York hedge fund manager - presented a three hour “hit piece” on Herbalife alleging that it was a pyramid scheme and a sustained and globalized criminal organisation.

We almost immediately purchased the stock. This was a trade.

We did not think that Herbalife was a worthy long-term investment. Indeed we thought the opposite. We believed every word Bill Ackman said. [He is a fantastic presenter and very credible and indeed we were pleased when he followed us into a position in Fannie Mae and Freddie Mac stock – a position we had opened in 2008 and which has been a multi-bagger over the intervening years – albeit a tiny holding now.]

The trade was simple. Bill Ackman expected the Government to close Herbalife - and we thought that was fanciful - at least in the short term. Governments work to timetables that are different to market timetables. We thought the stock would bounce.

And it did.

If we had exited the stock entirely then we would have been happy enough.

Instead after we put the position on we started doing research. Lots of it. And we could not quite believe what we saw. Bill Ackman was wrong on almost every substantial point in his original three hour presentation. We concluded - and it remains an unlikely looking conclusion - that Bill Ackman was deluded. The reason this remains an unlikely conclusion is that Bill Ackman has hired the best lawyers and the best investigators and spent (his claimed number) about $50 million researching this company. We wondered how - after spending all that money - he could remain deluded.

And yet when we visited Herbalife distributors and talked to Herbalife customers we consistently found stories that falsified Bill Ackman’s conclusions.

A hypothesis is that what Bill Ackman is suffering is possibly the worst case of confirmation bias we have ever seen. Bill Ackman had a conclusion. He then went searching for “facts” that backed that conclusion.

And the $50 million he spent attracted a rag-tag of hangers on - who supplied him the information he wanted and collected more checks. In other words if you have a conclusion and your research budget is large lots of people will (for money) provide "research" to back your conclusion.

This position is supportable. When we trace the people who are openly supporting Bill Ackman we find a rag-tag bunch of people we would normally regard as penny stock promoters and other hangers-on such as priests who have been (credibly) accused of things like electoral fraud, rigging applications for government grant money and even joining the Black Panthers.

Self-deception is a huge and continual risk in money management and we must always protect against being deluded ourselves

Although Herbalife has investors such as George Soros and Bill Stiritz of Outsiders fame, the Wall Street consensus would probably be that we (along with them presumably) are deluded.

During the entire time we have followed this stock Bill Ackman has remained the most credible presenter we have ever seen - and the New York consensus - both media and investor - remained that Bill Ackman was right.

Along the way we have met several Herbalife distributors and customers who have bought great gobs of stock on the view that Mr Ackman is wrong. The most extreme is a policeman in Little Havana (Miami) who gave John a t-shirt with the slogan "Ackman lied, ask him why". This was a take on the old Herbalife slogan of "lose weight now ask me how".

Herbalife became a non-consensus position and in 2013 it was our biggest winner. The stock went up and up - and we trimmed the position many times along the way. However Bill Ackman attracted supporters one of whom (Senator Markey) was in a position to influence the debate.

Eventually the Federal Trade Commission (the FTC) started a formal inquiry into Herbalife. The FTC is the key regulator for Herbalife and FTC action is an existential risk for the company. The stock has been weak ever since.

We did not believe that the FTC action would amount to anything substantial enough to cause real damage to the business and so as the stock declined we acquired more. Eventually we got to the point we were "full" and our internal processes limited buying more. **We told clients that we were not adding to the position.**

Still the stock went down and continued to go down.

In 2014 Herbalife was our biggest loser. It is still substantially above our original purchase price and we have sold some and repurchased some along the way - but for new clients the losses on this stock have been kind of rough. We regret not selling the lot when it was more than a double for us.

We still think Mr Ackman is wrong but - frankly - the market does not agree with us. Although the stock is cheap it still must successfully close out the FTC's investigation.

The recent news

There is recent news which we believe radically de-risks our position.

The Wall Street Journal reports that Federal investigators are looking into whether people, including some hired by Mr. Ackman or by firms he has retained, made false statements about Herbalife's business model to regulators and others in order to spur investigations into the company and lower its stock price.

Mr Ackman has confirmed that (sub) contractors of his have received subpoenas.

There is a presupposition here - which is that the Feds believe that the stories told by short-sellers to regulators are false. This means the chance that the regulators will close Herbalife is much diminished. That substantially de-risks our position.

It also suggests the Feds - who themselves have done a lot of research - have come to a position similar to ours. At this price and with Herbalife now a much smaller fund asset **we might add a little more Herbalife stock**. Despite being controversial it remains the best value opportunity we can find in today's market.

The future

The company has changed its distribution model and sales volume has fallen. The company claims that this sales volume fall is temporary and growth will resume. We have done considerable checking on the ground and we believe the company's analysis is justified. Herbalife is a deferred growth stock - but the growth is only deferred a quarter or two.

We would be surprised if - over the next twenty four months - Herbalife were not the best stock in our portfolio.

This of course remains a wildly non-consensus view on Wall Street.

Thanks again

John and Simon

Performance (Net of all fees)

Last 12 months	13.6%
since inception (annualized)	19.6%
Largest Monthly Gain	6.0%
Largest Monthly Loss	(3.7%)
Max. consecutive Gain	15.7%
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%	3.4%	4.9%	2.3%	-0.1%					12.8%