BronteCapital
Amalthea Fund

16 April 2015

Investors' Letter for March 2015

The fund was up and beat the global index by a percent in March. More generally though, markets remain at elevated levels - testing the stamina of short sellers in particular. Let's explain how we see it.

a) There are plenty of good companies - ones that you would want to own for decades and which have superior economics - but they are 25-40 percent overpriced - and 50 percent higher than where we are excited to buy them.

b) There is more nonsense in this market than we have seen since dot-com. The two centers of market nonsense are China and Biotech, but the nonsense is widespread.

Our default position is long quality stocks, short nonsense - but it is increasingly difficult to buy quality (it is not cheap) and equally hard to be short nonsense - because nonsense is still going up - and there is a point where you have to be stupid to stand in front of the freight train.

At one level this is standard top-of-the-market behavior. In most big bull markets the silliest stocks go up hardest as the bubble peaks. In the dot-com era it was considered a negative for a company to have earnings. If it had "earnings" you had to value it on normal metrics. If it didn't you could use new-fangled metrics like page-views. This was nonsense - but people believed it.

Today the nonsense is a little more subtle. We know biotech companies that are testing drugs that have been tested before and failed. We also know companies testing widely-available substances as drugs (which are almost certain to fail but if they do succeed it will be impossible to charge high amounts for the pills). These have market caps in the hundreds of millions <u>and they seem to go up more or less continuously</u>. They are guaranteed to fail.

Shorting biotech during its strong run-up has been costly - and so we have had to cut our position. In many instances the promoters are the same people who previously promoted Chinese reverse mergers we shorted to near zero in 2011.

We will make money shorting biotech promotes one day - but not today - and we cannot predict the timing of when that day will come. So we have re-aligned our short portfolio and, on the visit to China described later in this letter, found some non-Chinese listed (but China exposed) additions to the portfolio.

<u>Differences to the dot-com bubble</u>

This differs somewhat from past bubbles.

The dot-com boom was strange - during 1999 value stocks were not expensive - and continued to get cheaper. Buying breweries in New Zealand at 9 times earnings was not a way to make money in 1999 - as they bottomed at below 7 times earnings. [No we are not kidding - John bought a huge number of New Zealand value shares during 1999.]

But if you retreated to buying value stocks you did really well over the next four to five years. The trick in 1999 was simply to avoid the heat - avoid it by miles. It didn't matter whether you bought Wells Fargo or DB Breweries (though the NZ brewery was better). All that mattered was you avoided tech or anything with a website (such as a newspaper or a dot-com). The insane bits of the market were truly insane - but much of the rest was cheap.

As long as investors could put up with underperforming badly in 1999 they were fine. [Many a fund manager found their clients were leaving and decided to get-on-the-dot-com-wagon rather than risk another six months of underperformance… However dedicated value managers had their glory years immediately after the dot-com bubble.]

At the risk of stating the most infamous four words in markets ("this time it's different") we will state that this time it is harder. If there were large sections of the market that were cheap, that we understood, we would just retreat there – but, with limited exceptions, these are far less plentiful.

There are some exceptions. We do not mind Telecom stocks. We flat-out-love some European aerospace - which competes with American companies and whose economics have improved dramatically with the stronger US dollar.

If we could short stocks at will without too much risk we would. But almost every short-biased fund in the market has been severely beaten up by market movements - and we will stay as short as we can without incurring such risk - but we are going to stay no shorter. And we will limit our exposure in those truly bubbly sectors which continue to offer (i) the lure of manufactured yield or (ii) excessive discounting of disbelief. We could fill the entire portfolio with suspect biotech stocks - but we would not be able to manage the risk. We figure at some stage this will change and we will make a lot of money short-selling - but that time is not now.

China

We have spent a while (falsely) believing the biotech sector could not get much nuttier. It kept going up when it made no sense.

But just to remind you how crazy things can get John went on a tour of China. Part of this trip was an organized study of the recent anti-corruption campaign in China (visiting politicians, bank officials who police money laundering, people who run auction houses, real estate developers). The rest of the tour was private work (travelling with one other person who spoke fluent Chinese) mostly observing companies we believed to be suspect.

We will explain how nutty it was with some anecdotes.

ChiNext

ChiNext is a NASDAQ style exchange attached to the Shenzhen stock exchange - but with lower listing standards. It is also the hottest stock exchange in the world - with almost every stock chart looking hyperbolic.

We met a local fund manager who assured us that careful research suggested that 40 percent of the companies listed on the exchange literally did not exist. [This is like the Chinese reverse mergers in the USA in 2011.]

That did not worry them though: "we have the other 60 percent to choose from".

A nameless small Chinese investment bank

We went to visit a small Chinese investment bank which had listed in Hong Kong a company we believed to be fraudulent. The most important thing we did there was note an internal plaque which listed all their companies.

We grilled them for a while and concluded we were correct. Okay - no surprise there. So we grilled them about other companies they listed - and worked out they were all frauds. 100 percent of them.

Moreover they worked out that we knew what they were doing. But this did not end the meeting. They asked us to describe our business, how many clients we had, what we invested in. Then they offered us something we will never forget. If we buy their issues they would kick back half the money (your money dear clients) to us under the table. From their perspective any new source of victim money was a good source - even if it had a 50 percent charge.

Third tier city property development

There are vacant skyscrapers in all Chinese cities up to and including Shanghai. However the property market is not properly insane in the first tier cities.

It's when you get to the third tier cities that it becomes comical. We went to one - about 120 kilometers from Guangzhou mainly with the intent of looking at the (idle) factories of listed companies we might short. We drove through 20 kilometers of idle factories - mostly originally built to manufacture auto parts.

And when we were finished we visited some property developers. One beckoned us with a giant Roman Style viaduct with Greek statutes on it. Inside were perfectly manicured gardens with thousands of Spanish style villas - all vacant - all locked with U-bolt bicycle locks. We got to the central-sales office which will - one day when this is a functioning community - be the town center.

There is a restaurant that has never opened, a bar which is full of the fanciest French spirits in unopened bottles and lots of sales women all selling property. The only functioning business is one that rents wedding dresses so young Chinese can have European style wedding photos done without leaving the Guangzhou region. The sales office is photographed below and we promise you that this building was entirely wasted.

We asked how many of the villas were sold (about 80 percent though we are not sure whether to believe them). We asked whether they had kept their value on resale - but they assured us that none had ever been sold in a secondary market. We asked if any were rented and what their rental yield was - but none had ever been rented.

We asked how many were occupied - and they answered about 20 percent but extensive searching failed to find <u>any</u> that were occupied. The U-Bolts were ubiquitous.

There was no public transport and the drive to your third tier city was 30 minutes - but car parking spaces were uncommon (not that there were more than a few cars on the highway). However we solved the problem of how you get to work. Wandering around the garden we found a heliport. It had never been used of course - but hey - what better way to get to your empty villa in nowheresville.

After this we went to visit a development from Evergrande. Evergrande is listed in Hong Kong and will be known to our Australian clients because the Chairman (Xu Jiayin) was forced by Joe Hockey (the Australian Treasurer) to sell his $39 million house because he lacked proper foreign investment approval.

The properties were properly delusional, with no public transport and nowhere to park your car. We asked where the car parks were and the sales office told us they would dig these out later. [The giant model of the development contained no car parking.]

This was the more completed part of the development. The ones under construction were not being finished (or at least not being finished fast):

The absence of car parks or transport made us wonder whether they were even built with the intention of ever being occupied.

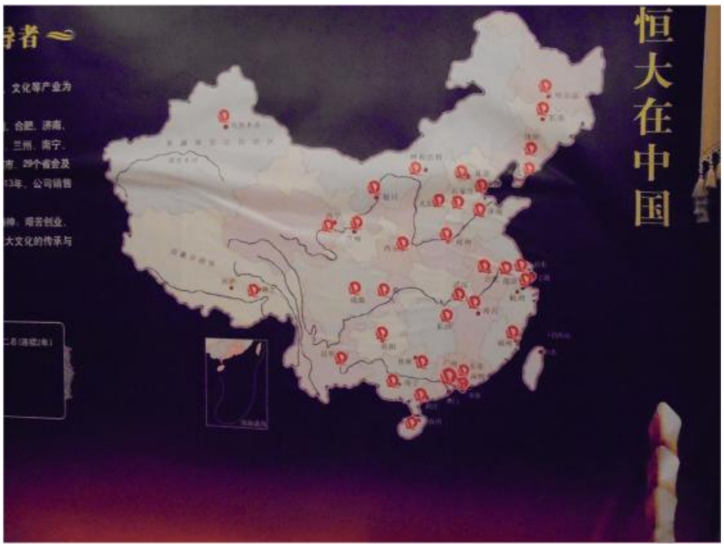
Some bank financed this. It makes (say) Bank United - a bank whose loan book consisted entirely of Florida apartment construction loans pre-crisis - look uncontestably prudent.

—

Politics

In China we met government officials who described the Philippines as “small devils” and Japan as a “big devil” and told us that the aim of Chinese economic development was to be rich enough to subjugate Japan. Japan would be a client state within 30 years.

We thought this was government bluster - but it has infected the party-connected private sector as well. Here is a map of Evergrande property developments found at the above site:



We want you to notice the little extract of the sea border:

That sea border goes all the way to the Philippines. We hope it is bluster. We think it is bluster. But whatever - there is a lot that can go wrong here - and markets are not priced for it.

New Operational Expertise at Bronte

We have welcomed Georgina Taylor to Bronte as our Senior Operations & Compliance Analyst. Georgie is originally from England but has been living alongside the ocean beaches of Eastern Sydney, and so working at our office suits her very well. She has a strong pedigree in funds management in both Sydney and London and we're very glad to have her on board.

Thanks Again

The Bronte Capital Team

Performance (Net of all fees)

Last 12 months	18.6%
since inception (annualized)	19.7%
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%	1.7%				14.6%