Bronte Capital
Amalthea Fund

14 July 2015

Investors' Letter for June 2015

This letter includes our regular monthly commentary but because it is the end of the Australian financial year we also describe the audit and distribution calculation process for the fund. As described below your statement for June will be sent out once the end of year distribution has been determined.

a) Monthly Commentary

On an unaudited and pre-distribution basis the fund was about a percent and a half better than global broad based indices over June. That was – measured in AUD – a small loss (-1.73%). We are neither happy nor unhappy with that outcome. If we could beat indices by 150 basis points every month though we would be thrilled. For the full financial year (again pre-audit and pre-distribution) the fund was up by 15.56%.

We have now beaten the market by tiny bits for several consecutive months. If we keep doing this the returns will be adequate – but we don't aim for adequate returns. We want superior returns. We just don't see how to get them safely in this market – and we do not think that this is a time to add risk. Prices are high and imbalances are pervasive. Lots of things can go wrong in capital markets.

We have a few ideas in the portfolio that we think will work out better-than-okay over five years – but it is not easy to find cheap-enough stocks – and it is doubly difficult to make money on shorts without too much risk.

Stock-picking problems: an English example

John and David have just come back from a trip to Europe. At the moment John is becoming obsessed by an English listed industrial company with extremely fine businesses weighed down by an oversized pension plan. Forgive us for not naming the stock – but it was a large British Empire conglomerate that slimmed down through asset sales and capital returns in the 1990s.

After the restructure the company was left with much smaller but much nicer businesses – ones that have truly privileged positions which you may wish to own for decades. The sort of stuff that makes us excited.

However the company is also left with a pension plan based on the much larger pre-restructuring company. Being an old pension plan it is mostly in draw-down phase at the moment (people are drawing their pension) and so the drag will be gone in maybe twenty years as most beneficiaries will have died. However until then all sorts of things can go wrong.

In a real sense the company is a bet on the stability of financial markets. It is a real business attached to a big pile of supposedly matched assets and liabilities. In a stable financial world it should wind up okay. We would like to own it except we can see ways we get very hurt indeed.

Specifically, there are no guarantees of financial stability. There are huge imbalances in our world – notably in China which has had a stock-market spike for the ages particularly in the Shenzen market. And of course in Europe.

John visited China early in the year and (as reported before) straight-laced fund managers told him that 40 percent of the companies on the Shenzen exchange did not exist in any form matching their market portrayal – but that was okay because they had the other 60 percent to play with.

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We were wary of being short given the active role being played by the Chinese authorities in supporting their market. Cautiously, we have taken only a little short exposure and then by way of offshore listings of Chinese stocks.

The other imbalance of course is Europe.

Greece

As we write this the usual solution to the Greek problem has been chosen. Just kick-the-can-down the road.

If you have not been following, don't worry, the entire thing will get replayed in six months. You can follow next time.

Here is the nub of the problem. Greece has had emigration for a long time (hence the large Greek communities in Australia and the United States) however net emigration is probably running at record levels. Capital flight is also running at a high level. These act to shrink the Greek economy thus increasing the size of the debt relative to capacity to pay thereby ensuring a periodic return of the crisis. It does not look like there is any acceptable equilibrium.

The latest Greek solution does not address this issue – and hence the problem will recur. It might be solved by surreptitiously passing enough European subsidies to Greece that there is *effective debt forgiveness*. We do not see that happening yet.

Still without a sustainable solution to the Greek debt issues truly spectacularly bad outcomes are possible.

Greece is tiny relative to Europe let alone the global economy. On its own it does not matter.

What matters is contagion.

If the Euro is not forever a run on Italian and Spanish banks is possible. These are too-big-to-bail. The losses would dwarf Lehman Brothers.

And at the moment intransigence rather than a realistic assessment is the order of the day.

The analysis of the German electorate is pretty naïve. The attitude seems to reflect Calvin Coolidge's famous quote about World War I debts: "They hired the money, didn't they". With respect to the WWI debts trying to force payment didn't much increase the likelihood of getting paid and didn't turn out to be in the US interest anyway.

The US had to work out the right solution to European debt – and the right solution involved bailing Germany out to the point that objectionable governments did not arise. [They did this after World War 2.]

Germany has to work out *the right way* to bail out Greece. But that is not how the Germans are levelling with their electorate.

If the bailout is too generous it might cause a collapse as the Italian and Spanish electorates will want a bailout too.

If the bailout is not generous enough Germany will wind up with less return on their failed investment and Europe will collapse anyway. An insufficiently generous bailout is not in German interests.

The right bailout – and it is hard to do – is one that bails out the Greek people but does not bail out the Greek establishment. The terms have to wipe out the banks and the political class and implement a new political class but they have to leave the Greek economy in a functional state afterwards. In other words the Greeks need to be bailed out but in a way that removes any incentive for the establishment in Italy and Spain to want the same deal.

If we put our bullish hat on, the path may be twisted from here to the right sort of solution. Greek politicians have been humiliated by soliciting a no vote from their electorate and signing a yes deal. They have thus proved their impotence (and humiliation is not something any politician choses). Having punished the politicians the time might yet arise for some gentle but gently increasing subsidies to offset the debt repayments.

That said this will require either the deception of the German electorate (by hiding the subsidies so deeply they do not realise what is happening) or the education of the German electorate. Neither seems easy.

There is reason to be worried a far-less-than-optimal end-game will be forthcoming. We generally think that people will come to their senses. But the easy response to a difficult question is the one they adopt. Just kick the can down the road.

Performance (Net of all fees) [unaudited and pre end of year distribution]

Last 12 months	15.6%
Since inception (annualized)	17.6%
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%	1.7%	-1.7%	4.4%	-1.7%	15.6%

b) End of Financial Year

The fund's accountant, Ernst & Young[1], will be calculating the distribution the fund will make. Last year, even though the fund showed a gain, there was no distribution as the gain was substantially unrealised for tax purposes - whereas losses had been realised. It is possible that this might occur again notwithstanding the strong performance of the fund in 2015.

In the event that there is a distribution you will receive (we anticipate in early August):

1. An annual tax statement;
2. A distribution statement; and
3. If you have elected to re-invest, a contract note detailing the number of additional units issued in the fund

If a cash distribution is determined and you have elected not to re-invest in the fund, then the payment will be made to your previously nominated bank account within approximately 2 business days of these documents being issued.

[1] The fund's directors appointed Ernst & Young as auditors during the course of FY2015 in order to have the same firm audit all of the investment manager's offshore and Australian funds. Prior to FY2015 the Amalthea fund was the only fund not being audited by Ernst & Young.

Once the distribution is determined the fund will also issue its monthly holding statement to you, which will be "ex-dividend" i.e. it will show your holdings at 30 June 2015 after allowing for the distribution from the fund.

Thanks Again

The Bronte Capital Team