BronteCapital
Amalthea Fund

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Investors' Letter for October 2015

October was Bronte's best month in a couple of years. It wasn't our largest absolute gain but it was the best in terms of the quality of the result given the underlying market dynamics. Given our positioning (as many shorts as can prudently be held) this was a surprisingly good month.

As noted in prior letters, we are wary of this market. Nonsense stocks are everywhere. We also see fund managers with fantastic five year records where we think almost every stock in their portfolio is dangerous. We want to take the other side.

And yet – as October proved – the market is perfectly willing to rip up. October was the best month for the S&P in over four years (+8.4%), and broad based global indices also rose by over 6% when adjusted into Australian dollars.

Being heavily short in that sort of market can be deeply uncomfortable, even injurious to your wealth.

There was a Wall Street Journal article with the unlikely title of "Hedge Funds Hit by Rebound in Global Stocks" . If you were just a momentum short-seller you got crushed. Shorting the "usual names" was a way to lose money.

Against all this – and in a market that was actively hostile to someone with our aggregate position – we came out very well in October

The first two weeks of the month (in which the general market rocketed up) were uncomfortable but our losses were manageable.

The second two weeks were very good led by, but not limited to, our well-publicised short Valeant position. Approximately 80% of our gains came from longs over the month but some 20% come from the shorts despite our short portfolio being less than half[1] the size of the longs and in the face of such a violent move upwards.

In summary, in a strongly up month, both sides of our portfolio delivered with the short side of our book performing very well indeed.

Valeant Pharmaceuticals

This is a long discussion of Valeant Pharmaceuticals describing what we knew and when we knew it.

[1] On a non beta adjusted basis. When accounting for their higher beta our short portfolio is larger.

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We apologise for the detail here – but we want to put our view on the record. It was (by far) the biggest event at Bronte during the month and it is of interest to some of our clients. John has provided these details to many people who have asked.

We are publicly bit-players in one of the major dramas on Wall Street – the collapse in confidence that is overwhelming Valeant Pharmaceuticals.

Valeant is a highly acquisitive pharmaceutical company buying mostly brand-name products with weak patent protections and raising their prices whilst cutting costs.

In the old days you would have called it a "roll-up" but the jargon has changed. It is now a "platform company" – one which can grow by putting new drugs through the same sales force and same distribution methods.

Valeant at peak had a market cap of nearly $100 billion and over $30 billion in debt, (and earlier this year completed the second-largest junk debt offering ever). *This is a very big deal on Wall Street*.

Moreover Valeant was a fashionable story with huge name hedge funds (including many deep value firms we admire) having massively oversized positions in the stock.

Valeant very publicly uses a non-GAAP accounting measure that it calls "cash earnings per share" or "cash EPS". There are a number of adjustments between cash EPS and the earnings per share in the accounts. Some of those adjustments are justified. Some we think are just nonsense. We think that their "cash EPS" is – at least to some extent – "earnings before the bad stuff". Owning the stock means trusting management's rectitude in choosing what is counted and what is not.

But it was not doubt about the accounts that has undone Valeant.

What undid them was the exposure of Philidor, a specialty pharmacy they consolidated but never admitted (and still do not accept) they owned. Philidor is an enormous mail-order operation delivering maybe fifteen thousand prescriptions per day.

Valeant went to some extent to hide their relationship with Philidor. The ownership and funding of Philidor was, and to some degree remains, a mystery.

Bronte has known about Philidor since February this year. And while the whole arrangement seemed funny, we were unable to prove it was related to Valeant. We knew something was wrong but could not put our finger on what. This was the sort of puzzle that fascinates John. John in his travels wound up chatting about Valeant with many people including several journalists as he tried to untangle it.

On 14 October Valeant disclosed that it had received subpoenas from two separate US Attorneys. John immediately (and we believe almost certainly correctly) guessed that the issue was Philidor. A blog post went out cryptically mentioning Philidor and our short position was increased a little (but alas not enough).

Within a few days Roddy Boyd of the Southern Investigative Research Foundation (SIRF) published on Valeant. He had worked out many things that were unknown to us.

Boyd's article did not move the stock. Based on his and subsequent reporting Philidor appeared to be a mechanism to deceive insurance companies into covering prescriptions that they would not otherwise cover.

Then Andrew Left (of Citron Research) published an article that floridly accused Valeant of using Philidor to fake their accounts. That day, Valeant stock fell 40 percent intra-day and precluded our planned increase in the short position.

We were nicely short and we made some money but nowhere near as much as we would have made had we purchased the options prior to Citron's article. [If we had succeeded we would be up double-digits this month.]

The big problem with Left's piece is that it drew fundamentally the wrong conclusion. Valeant was not using Philidor to facilitate "channel stuffing" (though confronted with an undisclosed and apparently related party, a high degree of suspicion is not unwarranted). Valeant answered with a conference call with most of the Board and executives present and maybe 5000 people listening live. Valeant stood behind Philidor and (accurately) denied Citron's accusation.

Later that week however, helped along by impressive investigative reporting by SIRF, The Wall Street Journal, ProPublica and Bloomberg, insurance companies were coming to the same conclusion: Philidor was a device to deceive them. They promised to no longer make reimbursements for pharmaceuticals distributed by Philidor – almost exclusively Valiant products.

Within 24 hours Valeant announced it would no longer work with Philidor. Philidor announced it was closing.

Before Philidor was exposed Valeant stock and bonds had traded lower. The proximate issue was that their pricing strategy had come under political pressure. The drugs mentioned were Isuprel and Nitropress, small volume out-of-patent drugs that are life-saving in some hospital procedures. Valeant raised their prices substantially.

Valeant began to walk away from its acquisition-and-price rise strategy stating that they would not be doing many acquisitions of products which they thought were mispriced. They were already conceding to the politics.

However Philidor threw the price rise strategy into sharp relief. It was always a mystery how Valeant raised prices so dramatically for branded drugs with generic equivalents. With Isuprel and Nitropress it was obvious - there was no alternative. However Valeant also charged over $500 a tube for cream to treat Athlete's foot and where generic substitutes existed.

Philidor turned out to be part of the explanation. By using a captive pharmacy Valeant could prevent generic substitution, at huge cost to insurance companies. The exposure of Philidor took a potentially toxic situation and splashed it over the front pages of the financial press.

We have made very good money on this trade – but nowhere near as much as we should have. Valeant remains one of our biggest shorts, but it is no longer our largest short. For many reasons, we think the company faces existential threats. The bond market believes bankruptcy is a possibility, with debt trading around 85 cents in the dollar. Prices for credit default swaps indicate the market thinks that the chance of bankruptcy is almost 50 percent.

However reputable fund managers (including some we admire) think differently. Some have purchased more stock. Valeant's market capitalisation is still more than US$25 billion and including debt it trades at more than five times sales.

The stock is cheap if you believe the cash EPS represent sustainable underlying cash flows. Ultimately though that is a question of whether you trust management. Historic cash flows—actual cash collected—are a low proportion of the claimed "cash EPS".

Our short thesis has been very much outside the hedge fund consensus and so far we have been right – but there are many unknowns.

Summary

Returns were very nice this month – and a significant proportion were obtained against, rather than with, the violent market movement.

We are proud of that.

For reasons explained above we did not optimise what we knew about Valeant and we did not get all the trades we wanted executed. If we had we would have made solid double-digit returns. But we missed that and we apologise.

We thank you again for the trust you have placed in us.

The Bronte team

Performance (Net of all fees)

Last 12 months	26.0%
Since inception (annualized)	20.0%
Largest Monthly Gain	6.1%
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%
FY16	6.1%	0.9%	-0.2%	3.8%									11.0%