BronteCapital
Amalthea Fund

14 December 2015

Investors' Letter for November 2015

The returns for this month were uneventful (down 1.3%), about 1% better than global markets when measured in Australian dollars.

We don't like this market. The debt market is getting skittish, capital equipment looks oversupplied in almost every market and cyclical businesses do not look like they will recover in the medium term.

There are a few exceptions to universal over-build. We don't think the market is over-supplied in fuel-efficient long-haul aircraft - but that is a modest exception which matters little because the oil price is low.

Consumer good companies and health care companies have also pushed margins to hitherto unheard of levels. *Competition causes margins to mean-revert. We think there could be some problems there too*.

We think negative earnings surprises will be commonplace for the next few years.

Moreover the market is laced with companies whose valuation does not reflect either (a) questionable accounts or (b) questionable to collapsing business models.

It seems to us to be full of stocks which are uninvestible - at least at this price.

There are funds management companies who disagree with us. Their talking heads will get on TV and tell you about how their professional processes take the risk out of investing. They lie. *There is no asset class we can see that is free from risk*. Pretending the risk is not there is a good way of losing a lot of money.

But it is not only the dumb-mutual-fund-talking-heads who disagree with us.

We are finding well-informed people on the other side. Private equity funds have certain advantages over Bronte. They are allowed to do "deep dive" due diligence. [Trading equities on their sort of information is illegal and we must rely on public disclosures.] They can borrow huge sums non-recourse. [We can't.]

And they have been buying things we think are questionable.

We were (fortunately) not short Green Mountain Coffee Roasters when a JAB Holding Company investor group bid a 78% premium in a takeover. But we have been short GMCR periodically - we just were not on the fateful day.

We have questioned Green Mountain's accounts but JAB did due diligence and presumably have inside information - and they disagree with us. We will get some intellectual satisfaction if JAB blows up a lot of capital - but so far we have to allow that they have (a) more and better information than us and (b) disagree with us.

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

This is not comfortable.

Last year's "what-are-they-thinking" takeover was the bid by Cerberus [a large reputable private equity firm] for Safeway (a US grocery store). An associate of ours had been pitching Safeway as a short based on the inevitable demise of their business from losing the down-market sector to discounters and the up-market sector to Whole Foods. Fortunately, we did not act on that advice either though we agreed with it.

Cerberus disagreed. That we did not lose money there is best put down to luck. Just like Green Mountain.

We take some intellectual satisfaction that Cerberus failed in their attempt to re-IPO Safeway. Our associate who made the loss on that trade also takes intellectual satisfaction - but tartly observed he would prefer a refund.

This summarizes how we feel about this market. *We think there are plenty of ways to lose money - and alas there are relatively few ways of making money. We have a few and they may even work sooner or later - but this is not like we felt in 2011. In 2011 the market had gone up a lot and we still thought it was good value. Today we think it is a trap.*

Even cash is not a safe way to preserve wealth. Whilst we don't think there will be an inflationary end to the quantitative easing era it's a possibility we can't discount. Even cash is risky.

Against this we continue to do what we do. We are short the wildest and stupidest nonsense we can find. The reason we were not short Green Mountain or Safeway is that we had better shorts - things that would - in a bearish market be simple penny-stocks (with no liquidity) but where half-billion dollar capitalizations abound.

The world is full of quality shorts.

We have a lot of them in our portfolio.

And whilst for much of the last two years they have bled red ink, increasingly they are showing good profits.

Longs however are continuing to give us a hard time. Almost every American stock that we think has a truly fine business has a fine stock price to go with it. We don't see many opportunities. There are a few. But not many.

In Europe there is more hope. We keep finding things to invest in that are "reasonably priced" as opposed to salivatingly good. And we have done fairly well on the stocks - but have given up those gains in currency.

Most people we have said this to just suggest hedging the currency - but we are scared of that trade too even though it is the consensus trade.

The consensus logic is simple enough. Mario Draghi has said explicitly he will do whatever it takes to solve the European financial issues. *Rarely has a central banker told you so explicitly what he is going to do.*

And so the logic is to listen. Go long the stocks. (Money-printing makes stocks go up) and be short the Euro. After all Draghi is going to print a lot of them.

HEDJ is an exchange traded fund marketed in the US. Its positioning is simple, long European equities hedged back to the US dollar. This has had amongst the biggest inflows of all US ETFs. [The trade really is the consensus and it has been a great trade.]

Our reason for being unsure the Euro is going down however is that (a) it feels pretty cheap in many of the European countries already and (b) Europe has disproportionately benefited by the fall in energy and commodity prices. Europe has had an improvement in their terms of trade, and terms of trade improvements are usually correlated with currency appreciation. After all witness the moves in the Australian dollar - up during the commodity boom and down as the boom ended.

Looking for longs

John and Luke (our new analyst) have just got back from trudging around Northern England, the Netherlands and Belgium looking for longs. You know we are dedicated when we give up a Sydney summer for Manchester in winter.

We wound up on visits to chemical companies, semiconductor capital equipment providers people who make valve equipment, telephone companies and many others.

Luke whose career was in high-end research based manufacturing was a great addition. We were walking through a chemical plant when Luke pointed out steam-traps in the boiler system. We got the engineer to tell us who the supplier was and what the supplier did and we got the answer we expected. We have a small long in the supplier (Spirax-Sarco). This sort of shop-floor confirmation is invaluable. It reduces our error rate.

The privileges of company visits

The whole process of visiting companies is often a privilege. You might for instance imagine you know what a jet-engine testing facility at Rolls Royce looks like. You don't. The scale is amazing.

We visited many factories and one clean room. This was Luke (on left) and John visiting the ASML factory in Einhoven Holland. ASML makes advanced lithography equipment for the semiconductor industry.

We wish we could show you the factory - but we can't. They would not let us have a camera. However Luke (with his PhD in plasma physics) could ask precise questions about the technology and we received <u>some</u> precise answers.

Rolls Royce

Every long book has a disaster somewhere, sometime. Our biggest is Rolls Royce.

Rolls has a privileged position: it is one of only two makers of engines for wide-bodied jets in the world. Moreover, this privileged position should last a long time. It is inconceivable than there will be a meaningful new entrant to the industry in the next decade. Further Rolls currently supplies the jet to the most fuel-efficient plane in the world - the A350. Alas (as of the time of visit) only 11 of these planes are flying and the production levels don't ramp up for some time.

By 2018 they should be producing 15 or so of these planes <u>per month</u>.

Rolls has a lot of businesses that are in some trouble at the moment. Airlines are delaying orders for new wide-bodied planes because the fuel price is low. [The main advantage of the new planes is they burn less fuel.] Also Rolls makes very large diesel engines that are disproportionately used in the now deeply distressed oil industry.

On top of this there is a hint of mismanagement <u>and</u> the company may have capex requirements for the A350 ramp-up.

It's not obvious that they have enough cash to make it through to when there are enough A350s flying around to give them truly large annuity maintenance streams.

And if they can't make it that far they will dilute us (meaning you) raising equity to protect their credit rating.

One of the main purposes of our trip to England was to visit the Rolls Royce factory. And our question was whether we could - on the ground and by talking to mid-level staff - assess whether they are going to get through the cash-lean period. *We think they are - but there is still too much uncertainty to make this a comfortable position.*

And whilst, when you talk to mid-level staff, you can see they are managing costs to achieve that objective we note with some irony we received a very nice lunch indeed. The cost-cutting clearly hasn't permeated investor relations.

Given we did not solve the Rolls Royce problem I think we have to describe our trip to Europe as only a marginal success. But we learned plenty - and we think it will help us make money - or at least avoid a few mistakes.

Thanks again…

Performance (Net of all fees)

Last 12 months	20.3%
Since inception (annualized)	18.7%
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%	-1.3%								9.5%