

14 January 2016

Investors' Letter for December 2015

We break with custom in two ways in this letter. First, the market is a big place, so we are generally reluctant to reduce its vicissitudes to pithy summaries. Second, we usually prefer our own bromides to those of others. With those caveats, we share the words of a sell-side market strategist quoted in Barron's—okay, three departures from custom—who summarized 2015 (and our December) as “violently flat.” Ignoring its provenance, that epitaph certainly captures the feeling.

Thanks to our shorts, by mid-month we had out-performed sharply. And then we gave up those (relative) gains as the market rallied. The “Santa Claus rally” (the week before Christmas) is a cliché. But he still got us.

Over the month we can't be unhappy with the results. Just not particularly happy. We want to do better for you. We slightly beat markets but not by enough to claim any form of victory.

Otherwise, our positioning hasn't really changed. A recent exhaustive review of the short book in the midst of the Santa Claus rally mostly led us to maintain (and in some cases add to) existing positions. On the long side, we are working on a new fairly major position in the fund, though we are not prepared to reveal the name (at least yet).

The stock is a mid-cap - about \$2 billion market cap - has been listed for about a century and was once a giant company. The company almost entirely self-liquidated by paying special dividends in the 1980s. All that is left is an oversized pension obligation (clearly bad) and a small, very high quality specialty chemical company. We have known about it and followed it for some time and admired the business.

Thirty percent of sales are to the oil-and-gas exploration and development industries. As a result it has had several earnings warnings. Stocks with negative earnings momentum - even slightly negative - are being punished at the moment, so the stock has become cheaper and inched towards a price where we are happy buying a large quantity of it.

We are buying a half-sized position now with the expectation that it may grow to be full-sized if the stock takes another leg-down.

Calendar 2015 results, 2016 prospects

In 2015 Amalthea generated a positive return, matched the USA S&P 500's total return and handily beat broad-based global stock market total return indices which were up 10% for the year measured in AUD but down 2% in USD. We also managed to dodge some of the slings and arrows that nicked many long-short equity funds we admire.

But the results (when the AUD decline is filtered out) were not thrilling. They were positive but only just - and we have often said there is little functional difference between +1 percent and -1 percent. (There is plenty of psychological difference - but neither result is particularly good - and they do not differ by much.) The school report should say “adequate, can do

better”.

The markets have been decidedly skittish thus far in January and we like that. As we are always at least slightly net long, a down market isn't a windfall. But the shorts will give us cash and beaten down longs provide good opportunities. So far however longs have not fallen far enough for us to salivate over them. But it is in rough markets that our strategy should yield out-performance.

We thought that 2015 would be a bad market. The flood of money from the Fed was sharply reduced and valuations were very high (and rose higher). As it was, global broad based indices fell but only by very low single-digits, punctuated by big swings. Again, to borrow a phrase: violently flat. (Or, if you prefer, aggressively sideways.)

What worked and did not work in 2015

For us what worked was our shorts, particularly in the second half of the year. Some were spectacular. Flotek for example was a company that claims to have a world-beating software application that helps them sell unique “nano-chemicals” to the oil-and-gas fracking industry. We demonstrated that data used by their software was faulty, at least in part. The stock halved when the company, to its credit, acknowledged the issue.

Most prominently we remain short Valeant - among the most popular hedge-fund stocks of this cycle. To our eyes, Valeant is a potentially lethal mix of byzantine accounting, ongoing legal issues (up to and including potential insurance fraud from its associated direct pharmacy, Philidor), several years of little-noticed but rapid senior executive turnover, and debt. Lots of debt. We think the stock has much further to fall.

While they are amongst our most “public” positions, Valeant and Flotek are - by design - only a small part of our overall short book. Most of our short return was generated the old-fashioned way, with diversified bets against overhyped stories told by people to whom you would be ill-advised to lend your bicycle, let alone your savings. Shorts worked generally for Bronte in 2015, especially in the back half of the year.

Our longs however were problematic. Herbalife was a good stock in 2015 but mostly in the first half of the year - and even then it did not recover its losses from 2014. Only a few of our longs other than that made money at all. This doesn't surprise us. Markets started the year expensive and remain expensive. It was hard to make money on longs in 2015.

Two things worked in longs and for the most part we did neither of them. These were US stocks where the earnings and particularly revenue momentum continuously surprised on the upside (especially “FANG” stocks) and long European stocks with the currency hedged back to US dollars.

Let's take them in order. Momentum revenue stocks have worked almost regardless of valuation. FANG - an acronym for Facebook, Amazon, Netflix and Google - have been the standouts, and we had only one small position in Google (a position we have held since 2011). We are not proud to own it even though it has done well - and we have been progressively selling it on the way up.

Here is a rough-sort-of-calculation on Facebook and Google which shows how richly valued they are.

1. Global GDP is roughly \$77 trillion USD,
2. The highest advertising spend in the world as a proportion of GDP is the USA at about 1.3 percent. Most the rest of the world is below 1% and usually a fair bit below 1%.
3. Suppose that the whole world gets a reasonable developed country level of advertising spend – say 1 percent of GDP. Global spend is 1.0 percent of 77 trillion dollars is 770 billion dollars. This is enormously generous.
4. Suppose - and this is also enormously generous - that Facebook and Google get to be 30 percent of this or \$231 billion in advertising spend. (This is over three times current revenue.)
5. Suppose - and this is more reasonable - that having achieved global domination their pre-tax margin is 40 percent. (Google is running about 25 percent these days...) Then the pre-tax earnings would be \$92 billion.
6. Suppose (and this is a little harsh) that they actually have to pay 30 percent tax on this. Then the post-tax earnings would be about \$65 billion.
7. Now suppose that you want to put that on 15 times absolutely terminal earnings assuming everything goes right. The valuation should be \$970 billion dollars.

Well the combined market cap of Google and Facebook is about \$780 billion.

If everything goes right for them then you should get - from here - a reasonable return. But the world is complicated and plenty of things can go wrong.

The most expensive momentum stocks in the world are priced - if not for perfection - but for a rosy scenario. Whilst we have been trimming our Google position as it rose, we don't feel compelled to sell it entirely, as alternatives are similarly expensive or more challenged.

The other thing that worked in 2015 was European stocks IF you hedged the Euro exposure back to USD. We observed in our last letter that HEDJ - an ETF that did precisely that - was an unusually consensus and risky investment. And so it has turned out to be in the New Year. We have seen plenty of great returns this year based on this trade. We think 2016 will be more problematic.

With only a few days in 2016 under our belt, we still see many attractive short opportunities in a market that is not yet substantially cheaper. And though we've still got a ways to go before valuations have us buying longs with gusto, our "watchlist" is slowly stirring from its extended hibernation. Opportunities are emerging and in the meantime our long / short positioning provides us with significantly greater asset protection than high beta momentum chasers. Moreover, the Australian dollar bounced heavily at year end and so the recent return of the currency's decline has been beneficial.

Despite the "aggressively sideways" label, 2015 was a year of growth for Bronte: Our shorting success is largely attributable to David's studious oversight and Georgina and Luke joined the team, greatly improving our operations, our knowledge, and our collective ability. The expanded team is settling in well – and we think will generate opportunities for our clients.

Thanks again...

The Bronte Capital team

Performance (Net of all fees)

Last 12 months	13.1%
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%	-1.4%							7.9%

