Bronte Capital
Amalthea Fund

9 February 2016

Investors' Letter for January 2016

Our results this month are good. The Amalthea fund had the benefit of a falling Australian dollar but the underlying portfolio still performed significantly better than distressed global markets and our return for the month was positive (+0.48%).

Mid-month however we looked a bit better. In the first week of the year (when markets declined sharply) we were up. That is very good as despite our short selling pedigree we are slightly net long.

In the next week (also a down week) we fell but only a tiny bit. Our lead on the market was large.

The final two weeks of the month when the market bounced we underperformed. We bought a little when the market fell. We even covered some shorts but so little that it barely counted.

In the end we significantly outperformed widely held global market indices (by 3.8% in the case of the Amalthea fund) but we are nonetheless frustrated.

An example of this is with our shale-oil shorts. Here is the issue:

1. We are short some previously high flying shale companies. They fudged their numbers in good times - and in bad times their bankruptcy is inevitable. Indeed, their bankruptcy will be part of getting the oil price back up. We think most of these go bust at any oil price less than about US$90 per barrel.
2. The oil price at the moment is unsustainably low. Nobody is making any money at a US$30 oil price. As nobody is making money people won't drill. The drill count in America is falling precipitously.
3. As the drill count is falling precipitously and existing wells will decline, supply will fall and prices will rise.
4. Short-term, at least, the stocks are highly correlated to the oil price.

So what we have is companies for which we are very sure the end game is bankruptcy - but they may in the short term go up (as the oil price bounces). If we were omniscient we might trade them - buying back our short and replacing it when the bounce happens. But we are not omniscient (and nor is anyone else). Trading them when the end-game is so certain seems crazy to us. But the day-to-day bounces (some of which happened in the second half of January) are frustrating. It feels like we should do something - but the right thing to do is nothing.

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We have thought about hedging trades - e.g. buying oil futures - or buying higher quality oil companies (like Exxon) but we are uncomfortable with those trades. The oil-forward curve is steep making the hedge expensive. Exxon is not a cheap hedge either - it has not fallen anything like enough to reflect the change in its business prospects.

And so we are left with small and volatile short positions for which we think we will get paid well - but which cause us considerable angst in the short term.

To some extent you are paying us to accept your angst; and to not do anything too silly.

We are succeeding on both accounts.

The illusion of control

More generally this is a bear market. Bear markets are characterised by a slow drift down, removing all premium valuations from market sectors but punctuated with violent and unpredictable rallies. The market has so many trend followers that movements against the trend are violent as people want to trade the shift.

The typical bear-market spike-rally is 8-12 percent with bigger moves in the lower-quality stocks.

Trading those violent reversals requires ice water running through your veins which is unlikely for most of us, and looking at the truly lousy performance of some trend-following investors we doubt they have it either. They project an illusion of control but instead can incur large trading costs as they chase the market up one hill but then down another.

We lack that illusion. Realism is not a pleasant state - but at least it will stop us doing anything silly.

The valuation conundrum

Warren Buffett wrote two articles in Fortune about the valuation of the entire US stock market. They have had a large influence on Bronte.

The first was written in late 1999 when the dot-com boom was in full swing. The second in December 2001 when the market had retreated a great deal.

In it he outlined his favorite measure of stock market pricing - the ratio of the market cap of the S&P500 to GDP. This is our favorite measure too.

And so far in this bear market that ratio has not fallen below 100%. By historic standards the market is still expensive. We are not going to substantially lengthen our exposure until we think the market is more reasonably priced.

We have two measures of when we will do that:

(a) the market cap to GDP gets to an historically buyable ratio (about 80 percent); and/or
(b) we can't find dozens or even hundreds of dubious stocks promoted for the purpose of separating "investors" (meaning speculators) from their money.

Neither of those conditions are in place. So we are not substantially changing the portfolio.

And the market is having irregular but violent bear market rallies. Inevitably these will claw back some of our short gains and tempt us to dynamically micro-manage positions. Whist we will always manage the portfolio to contain overall and individual position risk, our focus is on the end game - frustrating as that can sometimes be.

Longs

Whilst we are frustrated on a day-to-day basis some stocks we like are starting to become more reasonably priced. We have done small amounts of incremental buying largely funded with profits from our short book.

We hope to do much more of that. And when stocks are cheap enough we will do it aggressively. Opportunity will come. It always does.

A short note on Australia

John spent a week on the road with Jonathan Tepper from Variant Perception (a UK based macroeconomic advisory firm). We were checking out the real state of the Australian property market and the underwriting by Australian banks and visited several lenders and property developers in the middle Western Suburbs and the periphery of Sydney.

We wish to hold most of our research private - but for the record we wish to state the loan underwriting standards of Australian banks are considerably worse than the banks state and worse than official pronouncements on this issue.

We have begun to take Australian positions (mostly short) for the Amalthea Fund. This is easier done for the Amalthea fund than for our non-Australian accounts. There will therefore be differences in performance between our Australian and non-Australian funds greater than simply the effect of different underlying base currencies. We have tried to avoid this so far but we think there are decent opportunities here and we would be remiss not to take them for our Australian based investors.

Thanks again…

The Bronte Capital team

Performance (Net of all fees)

Last 12 months	11.1%
Since inception (annualized)	17.1%
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	FYTD
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%	0.5%						8.5%