11 May 2016

Investors' Letter for April 2016

April was our worst month of relative performance in several years. Whilst our investment time frame is longer than an individual month and we don't manage the portfolio for monthly results it is nonetheless instructional to review the underlying performance contributors.

As we describe further below the losses were focused on our short portfolio so one might wonder in markets like this - why bother with shorting?

We believe there are great benefits in maintaining a short portfolio over the long run, particularly in a portfolio context:

- Shorting provides insurance against a market decline. These declines tend to occur a minority of the time, but when they do occur are tremendously painful and hence best avoided by prudent investors. Given the macroeconomic backdrop, the next decline could be very painful. Investors should remember than no matter what central banks try, it will be very unlikely that markets will avoid a full investment cycle, which includes a down market
- Shorting opens up a wider opportunity set. The reality is that there are many more poor investments than there are good investments, particularly currently. Long only investors simply can't profit from share price declines or do enough to protect themselves in bear markets.
- Shorting can also enable long only investing to be done in greater quantity or done more safely than would otherwise be the case.
- Shorting also provides opportunity for rebalancing to add additional value to a portfolio.
- Shorting adds to portfolio diversification. A portfolio that includes shorting can provide more consistent and less volatile returns than one that doesn't.

Investors who are absolute return or outcome orientated, or who want to achieve positive returns more consistently really need to consider shorting as an essential part of their portfolio. Stock markets can suffer tremendous falls at time, or decline for long periods of time. Shorting enables this big risk of investing in equity markets to be mitigated.

And when it is not working, as was the case last month, chances are investors' other investments are doing well and they're making money elsewhere.

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But back to April, we have had bad months before and we will have bad months again. All of our bad months have happened when stock markets rally hard. We tend to have our worst months when everyone else is doing fine. More generally our portfolio positioning is allergic

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to sharp rallies. It is easy to explain why.

We tend to own shares in companies of the highest quality. We short shares of very low quality – companies without earnings – sold to shareholders on hype and where our underlying thesis is often material misstatement by management.

High quality companies generally have predictable earnings at reasonable returns on equity. It is hard to get speculatively excited about them. But lower quality companies by their nature do not have predictable earnings and hence it is easier to get speculatively excited about them.

Sharp rallies – particularly rallies that focus on the weaker parts of the market – thus cost us on the shorts.

Underperformance of quality is a feature of the top end of all bull markets. For thirty years at the top of bull markets there have been stories about how Warren Buffett is past it whilst some gunslinger hot-shot manager is minting it.

And if our underperformance were just of the Warren Buffett type we would be entirely unconcerned. Alas our declines are of lower quality than that. We got squeezed on some shorts and had to cover to reduce risk.

The basic idea is common enough to short-selling. A stock that starts at $10 and goes to zero is a great short unless it goes via $60. If you were (foolish) enough to be short 3 percent of your portfolio in such a thing you would be deeply wounded. At $60 the short would be 18 percent of the portfolio – or actually more because the portfolio would be down 15 percent.

You would be so overweight you have no choice but to cover. And, so even though the stock goes to zero (eventually), as a short-seller you lose money.

And that covering makes the temporary quotational losses permanent.

We try to avoid this risk two ways:

(a) By keeping our short positions very small so the impact is not too serious if spurious rallies occur, and
(b) By cutting the losses if they get too large – no matter what we think of the end-value of the position.

The loss cutting comes after what we call a "risk management discussion" which is really hedge fund code for admitting you have lost money and prudence dictates that you are about to make those losses permanent.

And this month we had a "risk management discussion" which means some of the down-draft you see in the portfolio is a (small) but permanent loss of capital.

So this month involved some Warren Buffett style underperformance where good stocks temporarily underperformed and some (unfortunate but small) short-selling related permanent loss of capital.

On the plus side May has started very well. Our largest loser in April (a long) has more than recovered its losses in May. We have recovered all of our losses and we are very happy with how we are travelling.

Thanks again

The Bronte Capital team

Performance (net of fees)	
1 Month	-3.4%
Calendar YTD	-5.3%
Financial YTD	2.3%
Since Inception (Annualized)	13.3%
Largest Monthly Gain	6.1%
Largest Monthly Loss	(4.1%)
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%	1.8%	-4.1%	-3.4%			2.3%

Portfolio Analytics	
Sharpe Ratio[1]	1
Sortino Ratio	1.9
Annualised Standard Deviation	10.1%
% Of Positive Months	61%

Fund Features	
Investment objective	Maximise risk-adjusted returns with high double-digit returns over 3 year periods.
Inception	May 2013
Minimum investment	$100,000 (for qualifying investors)
Applications/Redemptions	Monthly
Distribution	Annual
Management Fee	1.5%
Performance Fee	20%
Administrator	Citco Fund Services
Auditor	Ernst & Young
Custodian/PB	IB LLC

[1] Sharpe and Sortino ratios assume Australian risk free rate of 2.5%

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