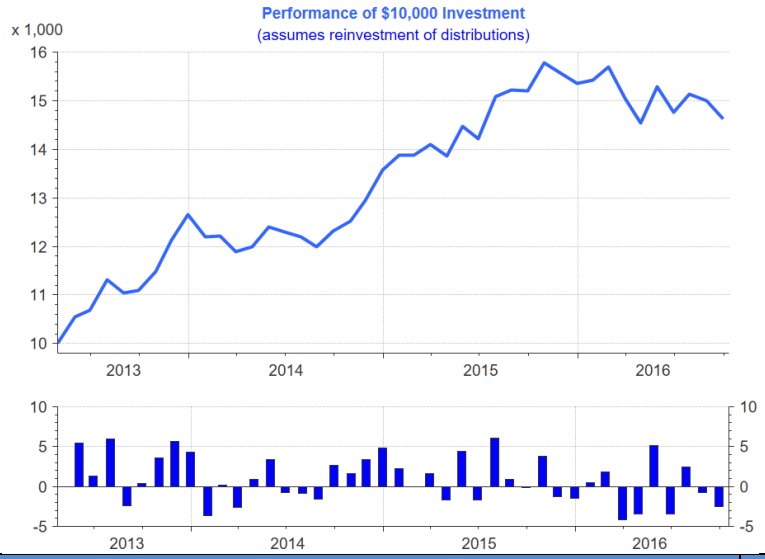
Amalthea Fund – September 2016

The Bronte Amalthea Fund is a global long/short fund targeting double digit returns over the long term, managed by a performance orientated firm with a process and portfolio that is genuinely different. Objectives include lowering the risk of permanent loss of capital and providing global diversification without the market/drawdown risks typical of long-only funds. A highly diversified short book substantially reduces risk and enables profits to be made in tough markets. The fund is an alternative to equity investing, and complement to most portfolios, and is typically an excellent diversifier which may lower overall portfolio risk.

	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%	5.1%	-3.4%	3.8%
FY17	2.5%	-0.8%	-2.5%										-0.9%



Commentary: Global markets were down when measured in Australian dollars and the fund also declined this month. The present environment looks to be a great time for short-sellers. We observe many low-quality stocks trading at high valuations that we believe will eventually trade at low valuations. We have made money on shorts and we expect to continue to make money on shorts.

(continued over)

Fund Features		*Portfolio Analytics*	
Min. initial investment	$100,000 (for qualifying investors)	Sharpe Ratio[1]	0.9
Min additional investment	$50,000	Sortino Ratio	1.7
Applications/redemptions	Monthly	Annualised Standard Deviation	10.3%
Distribution	Annual	Largest Monthly Loss	-4.1%
Management fee	1.5%	Largest Drawdown	-7.8%
Performance allocation	20%	% Of Positive Months	59%
Administrator	Citco Fund services	Cumulative return[2]	46.3%
Auditor	Ernst & Young	1 year annualised return	-3.7%
Custodian/PB	Interactive Brokers LLC	3 year annualised return	9.7%
		Annual return since inception	11.8%

[1] *Sharpe and Sortino ratios assume Australian risk free rate of 2.5%*
[2] *Returns are net of all fees*

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

Alas it's a difficult time for value investors. Finding good companies trading below their true value—the daily business of a value investor—has not been easy. And by-and-large our value-oriented longs have not performed.

And we only have a partial solution.

But let's outline the value problem.

Steven Bregman of Horizon Kinetics gave an interesting presentation at a recent *Grant's* conference (of *Grant's Interest Rate Observer* fame). He noted that the returns for taking risk are not high and shared this list of bonds and their returns:

Benchmark Yield	YTM	Sobriety Test Yield	YTM
U.S. Treasury 10-Year Note	1.7%	Russian Federation, BB+, 14-year bond	2.3%
IBM Bond, AA-, 10-Year Note	2.5%	Petrobras, BB , 4-year note	6.4%
Wendy's Bond, CCC+, 10-Year Note	6.9%	Lebanese Republic, B-, 5-year note	6.2%
iShares High Yield Corp. Bond ETF	5.6%	iShares Emerging Mkts High Yield Bond ETF	6.3%

Source: Bloomberg. Data as of 9/13/2016

This is not encouraging. For holding US 10-Year Treasuries, one can earn 1.7 percent. That is better than most European bonds which are negative yield. But the returns for taking very large and very real risks are not good. Russian Federation bonds yield only 60 basis points more. *Taking "Vladimir Putin risk" for the princely sum of 60 extra basis points of return looks like a bad trade to us, but it is where markets have been forced for lack of obvious values*.

The stand-out high return asset there is Wendy's CCC+ ten year bonds for 6.9 percent – giving you an extra 5.2 percent over Treasuries for carrying the risk of a hamburger joint. Hamburger risk, if you'll pardon the pun, sounds more digestible than Putin risk—until you look at the balance sheet of Wendy's, which is very highly levered largely from company stock repurchases. Historically, credit ratings in the single-B and double-B range are given to debt instruments that should repay you provided nothing within the usual range of expectations goes wrong. Credit ratings in the CCC range are reversals of that – holders get paid only if something goes right. Risking a substantial loss of principal to earn a 5% extra return does not seem sensible to us. Ultimately we have little solution for this other than to observe that value stocks are getting a little cheaper.

Our longs have mostly been "value stocks," which have generally underperformed the broader market. We got some longs sort of right (without any hits and more than a few small losses) and our shorts have made some money. The result is very small net losses, a result we think acceptable but not good. We are unwilling to take a lot of extra risk to receive only a little extra return. A good business can be a losing investment if purchased too dearly. We would of course be better off had we owned only the hottest momentum names – but we will never chase momentum this late in a business cycle. It's a strategy that works well until it doesn't and we doubt our ability to "jump off" momentum-driven stocks better than others[3].

At some point our shorts will work extremely well. We are short what we believe to be some truly awful companies, and we are proud of our ability to unearth them, and we are investing in tools to improve this process.

We continue to actively search for quality stocks to buy at the right price. One option would be to simply hold cash until the time when valuations are more appealing. But as we can find what appear to be highly attractive shorts, we much prefer these as they can actively generate cash when the market turns. The goal is to be well positioned when stocks become cheap. Whilst we find this market difficult as value investors, we remain convinced of the

[3] Truth be told we are extremely good at selling momentum stocks. We just do it early. We are not very good at staying on a momentum trade. It is said that you don't lose money getting off too early – but you certainly underperform at the late stages of a boom.

attractiveness and eventual success of the strategy.

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Still the main purpose of this note is to share some stocks we have been buying. This should tell you how we spend our days.

Albany International

John blogged about this company but did not give away the whole story. The original blog post is here.

Background

Albany is a high-tech weaving company whose main business (where it is the world leader) is machine clothing: the fabric used as a conveyor belt in paper mills. Paper is formed from pulp slurry spread on a belt that allows the water to be drained away. Each of the process stages in which paper is rolled between large rollers and the conveyor belt that carries it requires a tailored type of machine clothing.

This is naturally a pretty good business, as better machine clothing makes better or cheaper paper, and switching one's supplier is difficult once a paper plant is optimized. Moreover, machine clothing is a consumable, and is thus not hugely vulnerable to the paper capital equipment cycle. Alas there are competitors – most notably the papermaking machine OEMs – but even the competitors we find seem to have sustainably high margins.

This sounds attractive to an investor, but the paper industry is in decline, and thus machine clothing is a good business in decline. In the past Albany has guided for the (very slow) decline in this business, and their numbers are consistent with guidance. Some paper sectors, like tissue, are not in decline, and to the extent that Albany can steer away from newspaper and office paper they should manage. But the company explicitly says that their job is to run this business at as slow a decline as possible.

Albany International had lots of other businesses in the past but sold them all to focus on machine clothing and aerospace.

Albany's aerospace business comes from weaving carbon fibers. In the carbon fiber business there are a few dominant fiber providers (Toray in Japan, and Hexcel in Stamford for aerospace carbon fiber) and a few resin companies (e.g. Hercules).

The carbon fiber fabrics are mostly made by formerly high-tech fabric makers. Almost all carbon fiber weaving companies started at the technical end of fabric manufacture.

Albany's position in aerospace looks good – but there is almost no revenue now (about $100m), and it runs at a loss. They have projected $450 million in revenue in a few years.

Our work program consisted of verifying that revenue guidance and estimating the associated margin. Aerospace revenue is often surprisingly predictable. Plane orders are well known, and the build schedule for a plane (typically around 40 per year, depending on the model) is well known and built into delivery schedules. The pricing of a component for a plane is known years in advance (and usually contractually determined anyway) so aerospace is one of the few industries where one can often predict revenue five years hence with fairly high accuracy.

Albany's Aerospace business

As noted in the blog post, a short origin story for Albany's aerospace business can be found here…

LAMINATED COMPOSITES, USED IN EVERYTHING FROM THE skins of fighter planes to golf-club shafts, have one big flaw: They tend to come apart when the resin holding their layers together cracks under stress. Borrowing from the ancient art of braiding, Albany International Corp. in Albany, N.Y., has come up with a way to make laminated composites stronger. It's common to braid layers of a composite separately, but Albany International goes further by braiding each layer to adjoining ones. Anchored together, they can't slide past one another like cards in a deck--the leading cause of cracking in laminate resins.
The company's Multilayer Interlock Braid technology is starting to find applications, according to the inventor, David S. Brookstein, who remains a consultant to Albany International after becoming dean of the School of Textiles & Materials Technology at Philadelphia College of Textiles & Science. The U.S. Army has used some of the prototype material to build inflatable arches for a portable hangar. And Brookstein says the company hopes to work with a large medical-device company to adapt the process to make a hip implant whose stiffness could be customized.

The only problem with this explanation is that it is from a 1995 story on Bloomberg.

Now 21 years later, it is rather bold to assert this is a technology whose time has come. Slow-adopting technology is not the norm (although aerospace technology is often slower to be adopted because the safety-testing processes are so long dated).

Albany has been making fairly bold claims though and is guiding for $450 million of aerospace revenue by 2020.

The core to this claim is that they make blanks, an input to composite front-fan blades for the LEAP engine.

LEAP is the successor engine to GE/Safran's engine for the narrow-body market (i.e. 737s and A320s). The current CFM engine is the most successful engine in the history of commercial aviation. That engine has been one of the core sources of GE's profit over recent decades.

The importance of this program to Safran is easily verified. Safran posted a video of their US plant on YouTube. It is clearly co-branded with Albany International. More importantly they have a video on their own website of the French Prime Minister visiting one of their plants in France. This is clearly part of the JV as many of the staff are in Albany uniforms. All of this was to build fan blades for a jet engine which up until very recently has had only minimal revenue impact on Albany's accounts.

And it is hard to overstate the difficulty of this project. That fan you see at the front of the jet engine is surprisingly challenging to manufacture. The fan generates about 80 percent of the thrust of the engine, which subjects it to extreme forces. Most importantly it needs to withstand a goose flying into it without blowing the engine apart (if you are really interested, the US testing requirements are described in part here). Such stresses make carbon fiber fans very difficult to manufacture, because the layers of laminate have a habit of slipping apart.

Safran has told us that with GE they solved the problem of carbon fiber fans for large engines using traditional laminate carbon fiber in the 1990s. By contrast until Albany came along all fans for narrow-body jet

engines were metal. And even those are very hard to make. (The delay on the Pratt & Whitney geared turbofan engine at the moment is because Alcoa is having difficulty delivering fan blades.)

The challenge for small, composite blades is surviving a bird-strike. Smaller fans must handle similar bird-strike forces—a standardized goose traveling at a standard test velocity—over smaller cross-sectional area of a thinner blade. And Albany fans can do that.

By the time we worked all this out we were deeply excited about the company. If you can do really important things in aerospace and where there is no realistic competitor, you normally earn margins of about 30 percent. Margins like that on $450 million of (fairly easily verifiable) revenue would put Albany on a very low price earnings ratio. This would meet the Bronte stated goal of *the engineering approach to value investing*.

Alas it was not quite to be. Through connections, we sought out, found, and talked to a person at Safran who knew a great deal about the joint venture with Albany.

The image is joint venture. The videos linked above sure make it look like a joint venture. But the image is not everything. As Safran explained it to us, Albany is just a supplier – albeit a supplier giving them a super-important, difficult to produce and otherwise irreplaceable part.

And because the part is so hard to do and the entire GE/Safran engine program depends on this part – Safran chose to supervise Albany very closely. Safran built the plants and bore most of the capital costs. The plants are structured so that Albany makes blanks for the fan downstairs and Safran turns them into finished fans upstairs. Safran provided almost all the expertise in getting approvals in place and the like. Moreover if Albany fails to deliver Safran has an option of buying the business at a deflated price (making absolutely clear where the bargaining power lies). And for all this Safran controls the margin – somewhere above 15 percent – but not the 30 percent we were hoping for.

This still makes Albany a reasonable investment. But not staggeringly good. If you were only allowed twenty investments in your life, Albany would not presently be one of them. That said, we think it unlikely to lose money over a few years and more than likely to make high single digit return.

John wrote a blog piece about the twenty-punch card investment philosophy. We wish we could find twenty punch card investments. But at this point in the cycle to some extent the portfolio is being filled with things that are better than cash (but certainly not spectacular). And this is but one.

Elementis

The second long we will give you we are much more excited about, and it is a bigger position. Elementis is a global specialty chemical business listed in the UK. There are a lot of moving parts, but the key business is rheology modifiers most notably organoclays.

A rheology modifier is something that changes the viscosity of a liquid depending on flow conditions. This is best explained via something familiar to most of you: nail-polish. When painting on nail polish, one wants it to go on easily and evenly—but then stick and not drip once painted. What one really wants is a different viscosity under shear stress. That is the business of the rheology modifiers.

Most rheology modifiers go into coatings, with household and industrial paint being the main uses. Another key use is modifying the viscosity of mud that is pumped down an oil well to lubricate the drill bit, commonly called drilling mud.

There are several suppliers of viscosity modifiers in household paints. Again, through connections, we found and chatted with the person at Dow Chemical who runs their rheology modifier business, which is largely based on modifiers for acrylic paint.

Elementis is strong mostly in industrial paints where they are the world leader in "organoclays".

Some background is needed here. Clays have electrostatic surface charges. (It is these charges that allow clays to hold cations like potassium ions and hence make soils fertile.)

The electrostatic surface charges give clays some strange rheology characteristics – where for instance they are sticky when you step in them – but once the stickiness breaks the clay can be wildly slippery (allowing you to slip over in the mud).

Clays are also water-wet, meaning they easily saturate in water – but don't necessarily mix with oils very well.

However if you replace some of the cations with polymers (making an organoclay) you can modify the way clay interacts with water, oil and other organoclay molecules. This is the basis for Elementis' business. (And why it is useful to have a science PhD on staff!)

Organoclays are not quite a commodity, but one can buy simple organoclays on Alibaba sold in bulk to the paint industry. In specialty applications, modifying the polymers yields an extensive array of rheological effects.

Moreover some clays are better starting material for this task than others. The most common clay used for this is a widely mined clay called bentonite. (All of the Alibaba examples are bentonite.) Bentonite is used in kitty litter (it absorbs water) and in oil drilling mud.

But much better properties can be had with a rare clay called hectorite.

Elementis owns the largest hectorite mine in the world, giving them a lead in organoclays.

This meets many Bronte tests for a fantastic business. The product is a small thing that makes big things better (which gives it a lot of pricing power) and it is a consumable. And there are some pretty solid defenses against excessive competition.

Alas the biggest use is in very specialist paints (particularly for ships) and in very specialist oil drilling applications (deep sea, complex horizontal drilling). Both these businesses are challenged at the moment. There is also the issue of the long-term decline of solvent-based coatings (which use organoclays) vs. water-based paints (that use different rheology modifiers).

So what we have is a very high quality company with a strong competitive position that has missed earnings six times running due to the cyclical nature of their customers' business. Meanwhile it has a reasonable dividend that is (alas) just covered by earnings. The PE ratio is about 13-14. We think this will work fabulously in the end.

Management recently changed, and the new team is from BP's lubricant business – another specialty chemicals company with a global footprint. We think they will do

fine. We bought our big position around Brexit at prices fairly near the low.

This is likely to be a very long term holding for Bronte. It's the sort of company which we think will give very good returns over the decades.

We sincerely wish we could find more stocks like this trading at low prices. So we will keep looking.

Thanks again