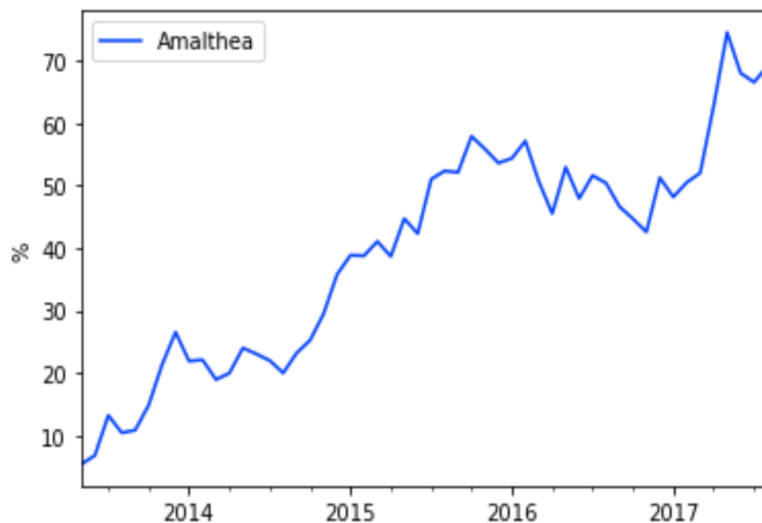
Bronte Capital

Amalthea Fund – September 2017

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%	-1.3%	-1.5%	6.1%	-2.0%	1.6%	1.0%	7.0%	7.2%	-3.7%	13.6%
FY18	-0.9%	1.5%	1.1%										1.8%



Our results have been good this quarter. This outcome was pleasing as our shorts held their own against a 6% rally of the Russell 2000 in Sept (+5.3% QTD). Gains were broad-based amongst our longs and we continue to add shorts (preferentially new shorts) to balance the growing long tilt of the portfolio rather than trimming winners. We do note though that European valuations, which were mid-cycle, are now testing the upper bound of our "reasonable" range. As we write this we see declines in the AUD from highs of $0.81 in Sept and with those recent moves the currency headwind was "only" 1.9% for the quarter.

Fund Features		*Portfolio Analytics*	
Min. initial investment	$100,000 (for qualifying investors)	Sharpe Ratio[1]	1.0
Min additional investment	$50,000	Sortino Ratio	2.1
Applications/redemptions	Monthly	Annualised Standard Deviation	10.7%
Distribution	Annual	Largest Monthly Loss	-4.1%
Management fee	1.5%	Largest Drawdown	-9.7%
Performance allocation	20%	Winning Month Ratio	0.6
Administrator	Citco Fund services	Cumulative return[2]	70.9%
Auditor	Ernst & Young	1 year annualised return	16.6%
Custodian/PB	Fidelity Prime Services	3 year annualised return	11.5%
		Annual return since inception	12.9%

[1] *Sharpe and Sortino ratios assume the Australian cash rate as the applicable risk free rate*
[2] *Returns are net of all f*

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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

Our results have been good this quarter.

This outcome is particularly enjoyable given the strong headwinds our shorts have faced. We are short quite a few US-listed small-cap stocks, a difficult place to be as of late: in September, the Russell 2000 was up over six percent in Sept. The Russell (a very broad index) has its large cap segment (the Russell 1000) and then 2000 smaller companies. Among the 2000 smaller companies are a few (often hard-to- detect) gems, but also the widest variety of drossy small-caps imaginable.

Despite a "melt-up" in this index of which many of our short names are members, fortunately, our shorts have not hurt us as much as they could have. Our longs have performed nicely year-to-date, which presents the ongoing challenge of maintaining our desired exposure. Left unchecked, such happy circumstances would tilt the portfolio away from our target exposure levels. We have thus redoubled our efforts to add new shorts. We have evaluated simply increasing our short exposure by expanding existing positions, but as a number of these stocks we are short are now "laggards" we are preferentially adding fresh names to the portfolio.

Another alternative would be to cut our long positions, but with our preference to let compounding work its magic and given our longs aren't at outrageous valuations we are content to let these high-quality businesses force us to increase our shorts.

Within our Long Portfolio, we did reduce the size of our Herbalife position, reducing it to our second largest position. In part this was because our *effective* position keeps increasing as the company buys back stock but primarily this is just ongoing routine portfolio risk management. We have also trimmed or exited a few minor long positions.

To take a step back, our big-picture view of the world is mostly unchanged. Equities are expensive and the world remains risky. We find many good companies, but at prices that make them unappealing as investments. Indeed, we have found only two new stocks that excited us as longs this year. (We discuss these briefly below.)

This view of valuation is almost without limitation as to country or sector. Sure, European equities are cheaper, but after this year's performance we can no longer say they are "mid-cycle priced", rather that they are priced at the upper-end of most reasonable ranges. The best you can say is that they do not appear to be insane.

A recent cover from *The Economist*, reprinted below, roughly sums it up:

Such a view *does not mean* that now is the time to go wildly short. Equity volatility remains very low. It is commonly observed that equity volatility is serially correlated: big down moves don't happen when volatility is low, they happen after implied volatility moves higher. In other words, the story remains the same: the market is expensive, but we do not see any particular reason why it cannot continue to rise.

That said, we are not Pollyannas. We are not going to throw caution to the winds and embrace this bull market. We are essentially going to maintain our net market exposure as low as we prudently can. Our agenda is simply to be "stock pickers" rather than get on the bandwagon. If the market continues to rise—especially if the riskiest classes of small-caps (like the aforementioned Russell 2000) continue to outpace the overall market—we will perhaps underperform based purely on our (deliberate) net exposure.

Australia

Australian housing is a microcosm of the overall asset valuation picture. Almost two years ago Jonathan Tepper of Variant Perception and John Hempton went for a tour of mortgage brokers in Western Sydney. The goal was not to determine *when or even if* the Sydney housing market would cease its ceaseless rise. Rather, we simply aimed to determine whether bank underwriting standards were good or bad.

In our view, they were unambiguously bad. The banks' diligence appeared to be weaker than widely believed. We had no trouble finding a broker who could help you "embellish" your loan application. Some banks (and bankers) were less diligent than others, and the brokers could identify them for you. Such brokers preferred the lenders they considered to be easier to deceive.

In this regard UBS has been surveying Australian mortgagees in recent years and the results are not encouraging. For example, they discovered that a third of customers with interest-only loans did not even know they had interest-only loans. How this happens is that brokers

compete in part by structuring the lowest monthly payment, placing customers into homes they cannot actually afford. This is the same behavior that was seen from brokers prior to the mortgage crisis in the USA.

But bad underwriting does not imply the housing market is going to fall, just as high equity prices do not imply that the stock market is going to fall. What it does indicate, in our view, is that the asymmetry is against you: in a retreat, the downside will be larger than expected. And the assurances of responsible parties (say, banks or fund managers) that they have done their due-diligence and that they are prepared should be regarded with suspicion.

That is not just how we feel about Australian housing—it is how we feel about markets globally.

Longs

As we stated above we have become excited by only two longs this year. The first one we are happy to discuss: Visa. We bought a sizable position in Visa early this year. The logic was simple enough. Visa is a very high-quality business taking a very small amount (basis points) of every transaction on its network.

Profits were rising for two reasons:

a) The integration of Visa Europe, and
b) The advent of smart-chips and other things that drive transaction volumes, especially small transactions. It is now common to buy your coffee merely with the tap of a card.

The smart-chip integration happened earlier in Australia than in the rest of the world, so living here gave us a (slight) advantage in seeing how this has panned out.

When we purchased Visa shares, the stock had a price/earnings ratio about 5 points higher than the market, though the company enjoyed obvious growth and some potentially excess capital that could be used to buy back stock. Even after the (then hypothetical) buy-back, the PE ratio was about 25. We thought this an okay value, but we do not imagine Ben Graham (the godfather of value investing) would have cheered.

Fortunately, the stock has continued to rise, such that today's PE ratio is closer to 40. We still think it is okay, but Ben Graham has gone from not cheering to jeering slightly from the sidelines.

If you see a technology that removes the Visa or MasterCard networks from mass transactions let us know. We haven't yet seen a serious contender. Google Pay and PayPal still largely clear through Visa. The much-discussed blockchain technologies are extremely useful for distributed, low-volume transactions that require an immutable register (such as warehouse receipts), but they have so far been unwieldy for mass-market usage. But owning a stock like Visa at nearly 40 times earnings potentially facing technological attack (if

not current threat) makes us jittery. The position is for sale if we see a genuine threat materialize.

The other small long we have purchased this year is a supplier to the agricultural industry. Ben Graham might be with us on this one. Notably, agriculture is one of the few industries (along with timber) that is in a genuine downturn. Grain prices are low, and fertiliser prices have followed them down. Further, the company is based in Europe, where markets remain slightly cheaper compared to the US. The conditions are right here to find value.

We are not naming it because (a) we do not have a full position and (b) our research is ongoing, including an upcoming trip to meet the company, competitors, and customers.

Our hunt continues for new ideas both short and long. We hope to make Ben Graham—and you, our valued clients—cheer.

Thank you again for your support.