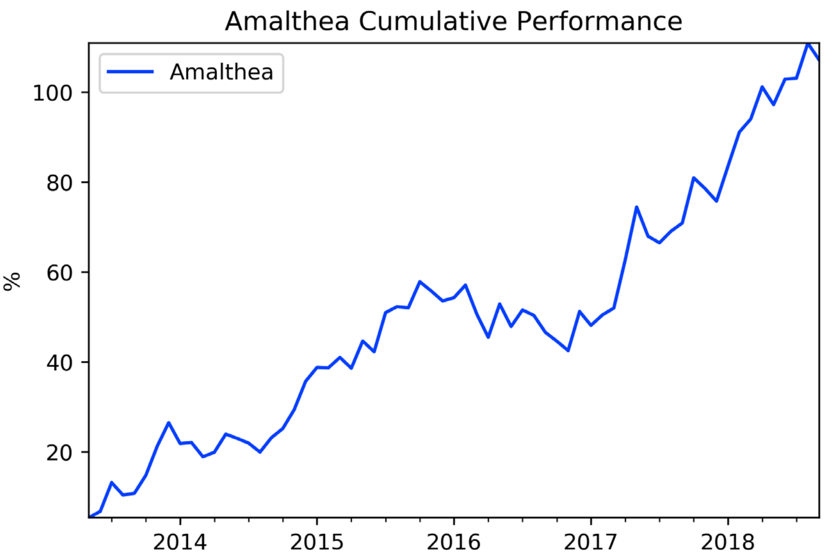
Amalthea Fund – September 2018

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 we feel 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. We believe a highly diversified short book substantially reduces risk and enables profits to be made in tough markets.

	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%	5.9%	-1.3%	-1.6%	4.4%	4.1%	1.5%	3.7%	-2.0%	2.9%	20.8%
FY19	0.1%	3.8%	-1.8%										2.1%



The fund fell by 1.79% in September. Global markets were also slightly down when measured in $A but, even so, the fund lagged by 1.5%. It has been a good calendar year – but not a particularly wonderful last quarter. The last two months we have gone (measured in US Dollars) approximately sideways but with some angst and a little volatility. (see over)

Fund Features		*Portfolio Analytics[1]*	
Min. initial investment	**Presently closed to new investment**	Sharpe Ratio[2]	1.2
Min additional investment	**Presently closed to additions**	Sortino Ratio	2.5
Applications/redemptions	Monthly	Annualised Standard Deviation	10.5%
Distribution	Annual	Largest Monthly Loss	-4.1%
Management fee	1.5%	Largest Drawdown	-9.7%
Performance allocation	20%	Winning Month Ratio	0.60
Administrator	Citco Fund Services	Cumulative return[3]	107.2%
Auditor	Ernst & Young	1 year annualised return	21.2%
Custodian/PB	Fidelity Prime Services, Morgan Stanley	3-year annualised return	10.9%
		5-year annualised return	13.3%
		Annual return since inception	14.4%

1 Performance and analytics are provided only for Amalthea ordinary class units. Actual performance will differ for clients due to timing of their investment and the class of their units in the Amalthea fund
2 Sharpe and Sortino ratios assume the Australian cash rate as the applicable risk-free rate
3 Returns are net of all fees

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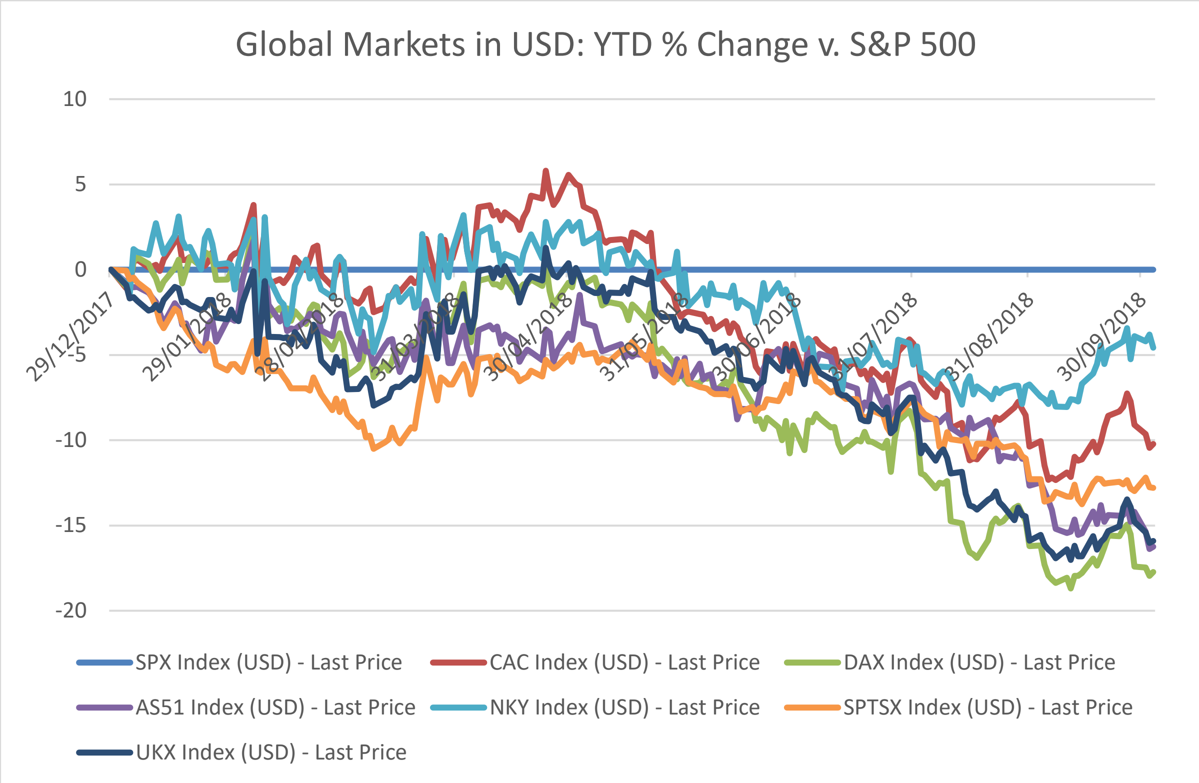
As we have remarked previously, the US market has been by far the best thing to own this year. The following chart uses the S&P 500 as the base. Almost all other markets (measured in USD) have been down this year, some sharply:



As Bronte's underlying position is long quality companies, wherever we can find them, and short dodgy companies, these market conditions have not been wonderful. We are – as we have said – long over the developed World (but particularly in Europe) and heavily short small-cap America. Our portfolio has faced a strong headwind but we haven't lost much ground. All-in-all we are happy with how we are travelling and, in this letter, we will cover the following topics:

Firstly, in this non-US downdraft, we have begun to buy some names we have admired for a long time. Most notably we purchased a half-sized position in Svenska Handelsbanken, a Swedish bank. Earlier this year we added a half-sized position in Allied Irish Bank. We have also bought a tiny position in one other financial firm that we would prefer not name. Even after buying these banks we are way underweight financial institutions versus the index. We are likely to stay that way.

Apart from those financials, we haven't bought much on the non-US downturn. Most things don't look cheap enough for us to want to get longer. That said, we continue to look. For instance, John is going to Jakarta in October to visit a research facility of one of our existing longs and to meet new companies. The Indonesian market is pretty beat up and only a relatively short flight away. We never know what we will find.

Secondly, we are continuing with our highly diversified short book. September gave us an unpleasant reminder of why we run the book so diversified. We will talk a little about that too.

Finally, this quarter we will do something we seldom do and prognosticate a little on where markets are going and why. We don't put much stock in our macro prognostications and we don't think you should either. But we want to outline – as much for ourselves as anyone else – what risks we see in the world.

Allied Irish Bank, Svenska Handelsbanken and banking oligopolies

Banks in very tight oligopolies are usually pretty good to own. When the oligopolistic market has a macro or demographic tailwind they are very good to own. The key examples have been the astonishing twenty-five-year performance of Australian and Canadian banks. These oligopolies are often created by crisis. In 1992 many Australian banks got into trouble: State Bank of South Australia, Pyramid, State Bank of NSW, etc. They were merged into the giant banks, one of which (Westpac) needed external capital to survive.

After the crisis Australian banks made great wads of money without any special management skill or trick. They just charged too much because they are an oligopoly. As the banking Royal Commission has shown in Australia, there is not much for which an Australian bank will not charge, including fees for dead people, fees for no service, etc. They got away with this for decades because there isn't really any choice.

There are only a few times when it is not worth owning banking oligopolies.

First and foremost you don't want to own the banks when their managements confuse position for genius and decide to do banking in markets where they have no special place. It was no surprise when ANZ Bank from Australia lost pots of money in Asia. They thought they understood banking and did not appreciate just how cushy Australia and New Zealand are. Swedbank (a Swedish bank) decided to take its winnings from the tightly oligopolistic Swedish market and go to the Baltic States. John once wrote a blog post about how they were financing flashy prostitutes and expensive German cars in Latvia. Recently executives from Swedbank visited our offices while in Australia and we were slightly worried what they might think of us. Pleasingly they told us we were almost entirely right. It helped though that one of the execs earned her stripes cleaning up the mess the bank had developed in the Ukraine. They wrote off 60 percent of the Ukraine book!

Strangely, part of the case for owning Swedbank now is that, post the Baltic crisis, the Baltic markets have become just another cushy oligopoly.

The second time it is not worth owning oligopolistic banks is when they lose any sense of proportionality in their home market. The behavior of the Australian banks (as outlined by the Royal Commission) has been shocking. They simply have not sold appropriate products to their clients and have not treated clients with any sense of decency. The Royal Commission revealed many loans to people with no chance of repaying. If such loans are 5 percent of the Australian banks' books, they will work through this. If they are 25 percent of the books, the next five years will be ugly. We don't know the outcome yet, but we don't think the Australian banks are safe to own.

Still, this understanding gives us a basis for buying certain banks. The crisis in Ireland—which featured the worst mortgage default rate for a country in history—took Ireland from an open-market free-for-all to a very tight, three bank oligopoly. Moreover the demographics look great. Brexit (which worries most Irish investors) is probably a positive too as Ireland becomes the last English-speaking common law country in the EU. We think we have seen this movie before, and we want to own these banks. We chose Allied Irish Bank over National Bank of Ireland for a bunch of minor reasons not worth going through – but we could probably own either, or both.

Scandinavia is a little more difficult. It has mostly been an oligopoly since 1992 and the banks have had plenty of time to lose money operating in emerging Eastern Europe or being a second-tier shipping bank. Some just became deeply sloppy. Danske Bank for instance is under severe pressure because they allowed money-laundering through their Baltic branches on a truly frightening scale.

In addition, the Swedish mortgage market is looking a little bubblicious. The street has a fear that this will end in tears. (As Australians the Swedish housing market looks tame – but then we have a strange benchmark.)

Throughout this, a single Scandinavian bank is almost entirely unblemished: Svenska Handelsbanken. Handelsbanken simply does things differently. They are the last of the "church spire" lenders.

Almost every bank in the world employs centralized credit scoring and assessment. Branches have become sales factories and places for advanced form-filling-out. In such a system, the branch manager has no special power.

By contrast, branches lead at Handelsbanken. Branches are empowered to grant credit, but with very sophisticated monitoring from regional and head office. Branches are not given sales (i.e. lending) targets. Staff are judged on lagged credit performance.

Because the bank gives staff no targets, it offers no guidance. An investor relations conversation with this bank is vague about what they will achieve but precise about process.

Importantly a very large proportion of staff remuneration is in a share purchase agreement where the shares cannot be sold or pledged until the staff member has reached age 60. The scheme is called "Oktogonen". All staff (from lowly clerks to the CEO) have shares in Oktogonen, and the number of shares one receives depends primarily on longevity with the bank rather than seniority. You cannot cash your Oktogonen stake by retiring early. A 60-year-old staff member who has worked his entire career at the bank can now cash about Euro 2 million.

The entire bank must reach certain profitability targets before making contributions to Oktogonen, and such contributions are non-linear: big improvements in profitability result in even bigger contributions.

Staff are thus allergic to credit losses as it affects both their annual contribution to Oktogonen and the value of their existing stake, as Oktogonen owns a substantial amount of shares in the bank itself. It sounds almost socialist but this is a truly capitalist enterprise. The staff are deeply concerned about profitability and credit losses, and the bank has performed considerably better over time because of it. Handelsbanken was the only Scandinavian bank to not need any government support in the 1992 crisis. It also came through the global financial crisis unscathed.

John recommends a 2011 book about the bank, called A Blueprint for Better Banking (don't worry, it's in English). When the book was written Handelsbanken was about the most expensive bank in the world (on a relative basis) so whilst we have long admired the company we have never bought shares. Nowadays Handelsbanken is priced at the middle of the range. It is not cheap – but it is not expensive either. It is a superior business in a great oligopolistic market. But we are late in the cycle. Scandinavian mortgages could be moderately problematic. We think that Handelsbanken has maintained its underlying credit standards, and has avoided systematically lending to people who can't pay. We think a superior business at a reasonable price will yield a good result over the long term.

Amarin Corporation – our little short-disaster of the quarter

We often short stocks because they are associated with bad people or bad behaviors. Experience has shown that birds of a feather flock together and that bad past corporate behaviour is likely to be repeated.

As this is a laborious process, we have sought to at least partially automate it, as we have mentioned in prior letters. Certain people in our database, to the best of our knowledge, always treat shareholders badly. Some do so only some of the time. The analysis and decision to short is thus always manual.

For good reason, though, guilt by association doesn't stand up in a court of law, as it does not provide proof beyond a reasonable doubt. Such guilt is only statistically likely. Our standard for shorting is thus not a courtroom standard: we will short things on a reasonably articulable suspicion while we continually look for evidence to reject our short thesis.

Sometimes however that relaxed standard just gets it wrong, and Amarin is a case in point. We saw several relationships that made us suspect, and those relationships had previously been nearly 100 percent reliable. This time, we were wrong.

Amarin were testing a proprietary fatty acid preparation for effectiveness at reducing heart disease. This is similar to things that have previously failed. But this time it passed with a big and statistically significant reduction in a large-double-blind study. We were wrong and in a big way. This is fantastic news for the World and we will probably all be dosing ourselves on Vascepa in the near future. But it wasn't great news for our portfolio.

We were short the stock at below $3. The stock is now above $16. We covered at $10.40 on the way up. We should have gone long. The result is truly fantastic and Amarin should have a big drug.

Our position was only 0.35 percent before the rise – so our loss was just over 1 percent. This wasn't pleasant but is entirely manageable. As per our risk management guidlines we cut the position immediately. There was no difficulty in doing so because the stock became extremely liquid on the day of the announcement. But it reminds us yet again why our short positions are so tiny. We also reviewed the sizing of each of our existing biotech shorts, and we have steadily been diversifying with a larger number of small positions.

By contrast, we had several shorts during September that fell 50 percent in a couple of days. Again these were small positions, typically about 0.3 percent of the portfolio. Alas it takes many of these to make up for one Amarin. We are running almost 200 shorts. We are going to (by accident or, heaven forbid, by error) find an Amarin every now and again. We had a similar disappointment in May last year. It will happen again one day too.

The value we add on the short-side is often not striking it big in individual names—though they help, and we certainly try. Rather it is the process of taking small bets against a multiplicity of names, which allows us to profit while controlling risk. As we get better at this (and we are improving) we should be able to further diversify our shorts. The impact from a mistake like Amarin will, we expect, be commensurately smaller.

Where markets are now

We are not macro-investors and we claim no special insights that would enable us to make money investing in (or shorting) levered treasury bonds. We do however have to be at least moderately macro-aware to assess some investments. Investing in the Irish banks or Svenska Handelsbanken makes us look at the economy of Ireland or Sweden just to make sure we are not doing something <u>really</u> stupid. In this case we are not worried by Ireland, more worried by Sweden, and we have a non-consensus view that there is a reasonable chance that Brexit works out really well for Ireland.

Still if you had put 2009 John Hempton in a spacecraft – to orbit the earth for a few years before returning – and upon returning told him that in 2018 US unemployment is 3.8% and growth is over 4% and then asked him what the Fed Funds rate would be, he would have said five to six. It is at two.

Historically, every time that the US economy gets below four percent unemployment the subsequent five-year stock market performance is awful. (Yes – when the economy is going that well the stock market goes down.)

Why?

a) Because interest rates are headed up. It is famously the Fed's job to "take away the punch-bowl" as the party is really getting started; and

b) Because labour is finally getting some bargaining power against capital. And as the labour share is 60-65 percent and the capital share is in the teens, a small movement in labour share has a disproportionate effect on capital share. Labour getting bargaining power is not good for earnings.

And yet. Interest rates are rising very slowly. And labour is simply not gaining any apparent bargaining power. Wage growth is subdued.

The most dangerous four words in stock markets are "this time it's different". And whilst we don't really believe that, the best arguments in favour are:

a) The unemployment rate is not really four percent. Rather, there is a lot of hidden unemployment vis previous cycles via the gig economy. There are lots of Uber drivers who are making poverty wages and are really hidden unemployment. The economy can grow a long way before there are genuine shortages; and
b) The economy has consolidated to the point that not only do companies have pricing power when selling their outputs, but they have pricing power when buying their (mostly labour) inputs, and like good monopsonies they will not bid up wages.

The latter thesis is the subject of Jonathan Tepper's book: The Myth of Capitalism – Monopolies and the Death of Competition. Jonathan is a close friend of John's so we are very familiar with the argument.

Whatever: we are not sure.

At the risk of giving our readers recommendation overload, on this we recommend an interview on Real Vision with Stanley Druckenmiller (also available on YouTube). Druckenmiller has possibly the greatest investment record ever. Working for George Soros, his public record is twenty years at over 30 percent without a down year. He is struggling with the same things we are.

As he puts it, at the beginning of 2018 central banks were printing an extra trillion dollars per year in quantitative easing. By the end of 2018 this number should be zero. This is a substantial incremental tightening of money markets. The first things to weaken in the face of monetary tightening, he argues, have been periphery markets – witness the stress in Turkey, Indonesia and a few other markets. As a macro-guy he tends to think liquidity drives outcomes, and those markets become less liquid earlier.

Druckenmiller also contends that the US market is very expensive against all historical measures except the price to earnings ratio and the price to long-term interest rate. Margins/profitability sit at what appear to him to be unsustainable highs, as per our above discussion on profit share, and he isn't one to utter the dangerous words "this time it is different". Instead he thinks that central banks will tighten, not on a pattern, but they will sneak small interest rate rises in when they can.

And at some point the market will react badly, dropping 10 to 15 percent possibly as a precursor to going down a lot more. Whether it goes down a lot more depends on how much bad underwriting there has been in the bond market, and whether a credit cycle results. For our part, we observe what looks like poor underwriting in lots of places. We suspect Druckenmiller does too – but whether this is a small correction or a large bear market remains unknown.

Druckenmiller also reveals that he has been short a few times this year and backed off because the markets kept powering their way up, leading him to wish he never tried. But he is going to have a go again at some point.

If Mr Druckenmiller can't time this market we won't try. But we suspect the weight of risks are to the downside – and we are in general happier being shorter than our usual weighting because we think the risks are to the downside.

We think that is particularly true in the US. But we – like Mr Druckenmiller – have been wrong on that. And we may continue to be wrong on that for some time.

Thanks again for placing your trust in us,

The Bronte team