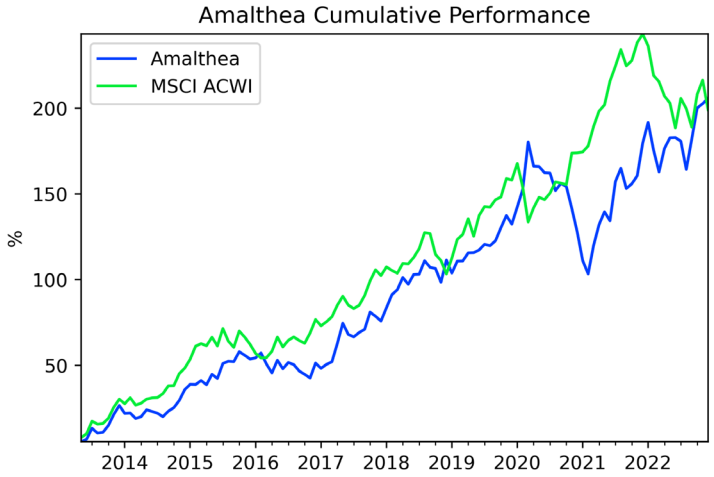
BronteCapital

Amalthea Fund – December 2022

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%	-0.4%	-3.9%	6.5%	-3.6%	3.4%	0.0%	2.2%	0.1%	0.7%	7.1%
FY20	1.5%	-0.4%	1.3%	3.4%	3.1%	-2.1%	4.3%	4.2%	11.0%	-5.1%	-0.1%	-4.8%	16.5%
FY21	-0.1%	-3.9%	1.7%	-0.7%	-5.0%	-5.7%	-7.3%	-3.7%	8.2%	5.5%	3.2%	-2.2%	-10.7%
FY22	9.7%	3.0%	-4.5%	1.1%	1.8%	7.3%	4.4%	-5.6%	-4.6%	5.2%	2.2%	0.1%	20.7%
FY23	-0.7%	-5.9%	6.7%	6.5%	0.8%	1.0%							8.1%



For December the Amalthea fund gained 1.02% whereas the globally diverse MSCI ACWI (in $A) was down 5.46%. It being the end of the quarter and the calendar year we discuss portfolio construction and some of our positions below. We also describe the capacity constraints to our strategy (coming from our requirement for numerous diverse small, short positions) and how we have improved by implementing new systems and by broadening the geographies we short stocks in. Accordingly, we have re-opened the fund to existing and new investors (see over)

Fund Features	
Investment Objective	Maximise risk-adjusted returns with high double-digit returns over 3-year periods.
Min. initial investment	$100,000 (for qualifying investors)
Min additional investment	$50,000
Applications/redemptions	Monthly
Distribution	Annual
Management fee	1.5%
Performance allocation	20%
Administrator	Citco Fund Services
Auditor	Ernst & Young
Custodians/PBs	Fidelity, Morgan Stanley, JP Morgan

Portfolio Analytics[1]		
Metric	*Amalthea*	*MSCI ACWI (in AUD)*
Sharpe Ratio[2]	0.83	0.96
Sortino Ratio	1.51	1.63
Annualised Standard Deviation	12.72%	11.04%
Largest Monthly Loss	-7.30%	-8.00%
Largest Drawdown	-30.01%	-15.97%
Winning Month Ratio	0.59	0.63
Cumulative return[3]	194.24%	199.04%
1-year annualised return	9.37%	-12.88%
3-year annualised return	8.27%	5.04%
5-year annualised return	10.90%	8.13%
Annual return since inception	11.81%	12.00%

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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This quarter mostly worked (Amalthea +8.45% versus 3.5% for MSCI ACWI in $A) and for the calendar year Amalthea is up 9.37% whereas the ACWI was down 12.88% (in $A). Not every day, and certainly not every position. But our funds are working on average.

The market was up for October and November. And we were up similar amounts. This surprised some clients because they think of us only as short sellers.

The market was down sharply in December, and we were up quite nicely.

We run a "hedge" fund, and for the moment the "hedges" are working.

More generally in 2022, the stocks in quality companies (mostly) fell. The stocks in lower quality companies (mostly) fell faster. And we operate mostly long quality, short junk. It should have been a good year for us and (mostly) it was.

We say the "book" is working. But, if we are being self-critical, it is not working quite as well as we would like. 2022 was a hard year for most fund managers. Very few funds are up, and we are. And we are up despite having been net long during a market downturn. But we would prefer to be up more. Our short book has performed extremely well but parts of our long book have been less resilient than we would like – or in truth less resilient than we expected. We still generated alpha on our long book, but the process felt generally unsatisfying and the alpha on longs is small.

When long quality, short junk works and does not work

Long quality, short junk has been studied for a while. Using quantitative measures of quality (such as profit margins, consistency of earnings etc.) and constructing a long quality, short junk portfolio has been shown to produce acceptable risk-adjusted returns in many markets. Cliff Asness built a very large asset manager (AQR) on automated strategies using these signals.[4] The summary of one of his papers (for which he provides a large data set) is as follows:

> *Quality stocks — those of companies that are profitable, growing and well managed — command higher prices on average than those of unprofitable, stagnant or poorly managed companies, which we refer to as "junk." While that is to be expected, the "quality margin" is puzzlingly modest, although high-quality stocks have consistently delivered high risk-adjusted returns. Indeed, a quality-minus-junk (QMJ) strategy, in which an investor goes long high-quality stocks and shorts low-quality stocks, has earned significant historical risk-adjusted returns in the U.S. and 23 other countries*

[4] John does not want to pass Cliff without a personal anecdote.

> I was at a book launch in New York where I had been a minor source in the book. (See All the Devils are Here.) It was a weekday night, and I was in casual clothing. And it rained while I walked to the Midtown function. This was when Bronte was a start-up and we were nobodies. Anyway, I came to the function soaked and looking more like a drowned rat than a finance professional. Cliff Asness introduced himself, and taking pity on me introduced me round the function almost as an old friend. Remember Cliff was a huge name on Wall Street and I was a nobody. I disagree with Cliff on plenty of things – but I will state it here. As a person I can't fault him. He is a lovely man and if you get a chance to meet him you should enjoy it.

Cliff Asness separated quality from junk quantitively and at scale. And we do it at extreme personal effort.

Alas, and to anyone who has followed our returns, this strategy does not work all the time even though it works well on average.

Our positioning works when good quality companies outperform poor quality. Over cycles this is true, and most of the time this is true. But there are outlier events, most extreme at the top of generational bull markets. In June to September 2000 the highest quality tech stocks (Microsoft, Cisco etc.) markedly underperformed the long-forgotten hype stocks like i2 Technologies. We would have done poorly then.

But worse – in November 2020 to February 2021 the truly awful stocks went up hard as vast numbers of new "investors" with a gambling mentality entered the market for the first time. (Remember something like 40 million online brokerage accounts were opened at the peak of Covid.) These investors – almost systematically – bought the companies with the greatest "gambling potential" and not things that met *any* of the tests of "quality" in Cliff Asness's paper.

We don't see a near term future like that. There are plenty of garbage stocks that are still going to zero (or at least to cash backing) and still have substantial market caps. And high-quality companies – although not cheap – are back to maybe 2017 valuations.

We think long quality - short junk will continue to work – outperforming falling markets and perhaps, in our case, even outperforming modestly rising markets because we are slightly levered to quality. We expect bounces in the garbage stocks – but they are suckers' rallies. They will last long enough to finish off the latest generation of crazy speculators and that is all.

Even if the market goes "back to the races" we do not think we will see a repeat of the junk-market excesses of early 2021. Many retail investors have now lost substantial money in rubbery stocks and crypto, and it usually takes ten plus years to find another generation of suckers to pump full of nonsense.

Some self-assessment

Whilst our results are okay now (and over the history of Bronte), we would at least like to know that our significant efforts in finding individual stocks means we are better than what is really a simple quantitative model.

On shorts our analysis[5] shows that over the long term, and more so recently, we have generated "alpha" on the short book. We have had well over a thousand shorts in the history of the fund and currently have about 500 shorts – and those stocks have simply

[5] We use Bloomberg AIM and Novus (which is a portfolio intelligence platform) to separate out the performance over time of our short and long books

performed atrociously (which means shorting them has generally, but not always, been good).

Alas it is only on the short side where we can be so confident. And, on the long side, the self-assessment is less rosy.

We are not bad long investors – but we cannot argue from our data that we are spectacularly good long investors. We put a lot of effort into finding "quality" and especially "quality at a reasonable price" but that effort has, for longs, led to only modest outperformance[6].

This year the performance of our longs was bolstered by Phillip Morris buying out Swedish Match. At that point it was among our largest positions. While this improved our numbers for the year, we were unhappy with the deal. We feel it was a modest price and would have returned much more than this over the medium to long term.

We do not want to give up on searching for quality at a reasonable price and we still think over time that we can provide substantial alpha on our longs.

Why don't we run all short?

If your (measurable) edge is predominantly in shorts, then – so many people have asked us – why don't you run a short-only fund?

The answer, which is satisfactory for us, is that we think it doesn't work. Short only funds lose money.

The problem is that you get whipsawed to smithereens.

Imagine for instance you have a short only fund where the stocks are typically 2 beta but where, because you are good at it, the shorts go to zero over an average of ten years.
On first blush you make ten percent a year.

But it is not so simple. You start 100 percent short, and the market goes up ten percent. Then because you have 2-beta stocks your shorts are suddenly up 20 percent. Alas your funds are thus down 20 percent. You rapidly wind up 120 short, on only 80 of capital or 150 percent short. You need to buy back a third of your position.

Having done that the market drops 10 percent. (We demonstrate a complete inability to predict these drops). And your shorts are good – they are down 25 percent. So now you are 75 short on 125 of capital. You are only 60 percent short. To remain a short fund you need to short more.

Every time the market goes up you are forced to buy. When it goes down you sell. As markets fluctuate you wind up buying high and selling low, and that loses money. And we don't like that.

[6] As evidenced by analysis in Novus of our oldest fund (commenced in 2010) and measured in USD

And we do not think this problem is solved by being only short a little bit. We are convinced that a 100 percent net short fund would face intolerable "whipsawing" if the market were to be volatile over 10-15 percent ranges. A 50 percent net short fund would be vulnerable to 20 percent net ranges. Indeed, we think that being net short at all is dangerous.

We refuse to run a short only fund for clients who are not actively rebalancing elsewhere. Moreover, we don't want to be short by accident and it's very hard to estimate how short we really are. We have our Math PhD carefully estimate the beta of our portfolio and the error within this calculation. The error term is regularly around the 30 percent range – so if we targeted 10 percent beta, we would in fact be something between 20 percent short and 40 percent long. So, we deliberately run a positive beta strategy. This has been a difficult discussion over the last 24 months and if anyone has had an epiphany on beta we would love to hear it (it would have been nice to be net short the market as the market fell).That said, this leads us to a strange position. We are short sellers who refuse to be net short.

At the time of writing our measured beta versus broad global indices is about 45 percent, and against US Large Cap indices is about 40 percent. The error terms around these estimates are – as stated above – large. Because we remain bearish on general indices, we would like to manage these numbers down a little – though for reasons explained below that is turning out to be harder to do than you would think from the outside.

So how to make use of our skills?

We are very good at short-selling, and our edge appears statistically robust. In the history of Bronte there was only one sharp period of underperformance on the short book and that was from sometime in October 2020 until Valentine's Day in 2021. That underperformance however was sharp.

At the time we wrote that finding good shorts was like "shooting fish in a barrel". It really was very easy. Alas the fish shot back.

Our experience over this period has led to us thinking more about how we can better hedge our short book.

Bronte was built on the idea of a best of breed long book and best of breed short book and we are still committed to that. However, the lack of correlation between these two books has caused fluctuations in the portfolio that we would prefer to avoid.

Our aim remains the same:

We want to build a best of breed short book by finding the scummiest companies across public markets.

On the long side, we are still committed to the idea that what you ultimately want is 15-20 stocks in very high-quality businesses which will be bigger and better in a decade – with the aim of holding them for that decade or longer – and where the stocks were bought at attractive prices. We are committed to finding the "Buffett portfolio".

But we are investigating what we could add to this to better hedge our short book to provide improved risk-weighted returns. We hope to provide more detail on this work in coming months.

The problem of staying short enough

As the market falls our longs fall and our shorts fall. We have net made a small amount of money. But this has meant that our gross exposure has fallen sharply.

All year (with very few exceptions) we have had to add to positions. We are a hedge fund – and we add to both sides – trying to use the profits from our shorts to add to longs at lower prices.

But net-net our shorts have done so much better than our longs we have had to add far more to shorts than longs. Indeed, almost every time we add we have been adding more shorts than longs.

And despite that our beta has been rising for the past six months – simply because many of the shorts have disappeared – going down 90 percent or more.

Despite adding substantial shorts all year our measured beta has dropped only a tiny bit over 2022 – and has crept up by about 20 percentage points since the middle of the year. We are, at writing, still adding more shorts than longs. We still find it easier to find good shorts than good longs. And the number of truly cheap stocks we know is low. So, we would rather, and within the limits of risk management described above, be somewhat shorter.

Confession Time: Herbalife

We have been publicly long Herbalife in size on our view that the company was widely misunderstood by Wall Street. This has not worked.

Herbalife sells weight loss shakes through a multi-level marketing scheme.

The view of Wall Street elites – following Bill Ackman's public presentations – is that Herbalife is a scam ripping off low-income and desperate people.

Our view – having visited literally dozens of Herbalife distributors – is that what was really being sold was community support for weight loss. Weight loss shakes as a controlled diet will work for losing weight – but it is terribly hard to stick to this diet.

If you buy it through a multi-level marketing scheme (rather than say through WalMart or GNC) then the person who sold you the shakes has an incentive to make you stick to the diet. They will cajole etc.

This is all true. And the company sales (measured in volume points) have increased (with volatility) for decades.

Alas, volume points exploded during Covid. People organized online communities for weight loss. But the existing sales structures atrophied. When Covid went away many of the online-style customers ceased being customers and the old customers did not fully return.

This surprised us.

We believed the sales would continue to do well. We drank the Kool-Aid. The management also believed that sales would continue to do well. They drank the Kool-Aid. Importantly though they bought back stock on the presumption that the sales will continue to do well. This has left the company precariously over-levered. In hindsight, given the leverage, we should have scaled back the position earlier. It is nowhere near as over-levered as many of our shorts, but it is still not a great situation. We have a lot of theories as to what was behind the underperformance – though we do not know which of these theories is correct. That matters – because some of these reasons for sales declines are explicitly temporary and sales will bounce. And some are not explicitly temporary – in which case the stock is not as obviously cheap as it looks.

The CEO (who we personally liked) was fired and the old CEO (who we also admire) was brought back.

We have chatted to some senior distributors – and they are optimistic for a rebound in sales. But our experience is that senior distributors – who are, above all, can-do salespeople – are congenitally optimistic. We should take their optimism with a decent sized pinch of salt.

We will keep you in touch. We are not selling the position – but we are also not substantially adding to it. We think it is in the very-cheap but problematic bucket now – though nowhere near as cheap as the stock we describe next.

So how cheap is cheap? A quick look at GAM Holdings AG

GAM is a position in which we have about a tenth of a percent of your money invested. We would not write this up except that it is an interesting vignette into stock picking.

We may lose one tenth of a percent of your money – or we may make anything up to a ten bagger. It doesn't look good though – and we are only mentioning it to show you what market valuations look like at extreme lows.

For your investment it is a trivial bet. But it is also an illustration of why we think it better to buy good companies at reasonable prices rather than bad companies at stunningly cheap prices.

Our bookshelves are laced with history books about long and brutal market cycles from the past.

They are a continuous reminder of how overpriced stocks can get in a market bubble. But they will also tell stories of stocks that are improbably cheap during market busts.

John (at his old firm) remembers the story of how the dominant chewing gum company in Korea was trading at about half cash at the height of the Asian financial crisis. It was improbably cheap and provided a quick ten bagger.

But we haven't seen much like that in this cycle until now.

So, let's demonstrate an extremely cheap stock and the sort of problematic situations that give rise to improbably cheap stocks.

GAM was founded as "Global Asset Management" in 1983 as an "open architecture" asset management model. In 1999, it was acquired by UBS and then in 2005 by Julius Baer.

The asset manager picked up the cost structure of Swiss Banks – and this is not a good thing. Swiss Banks used to have the world's best franchise. Switzerland was a place to leave your money hidden from your home-jurisdiction tax authorities. The money was stuck and secrecy rather than low fees or performance was the basis for Swiss asset management. Swiss Bank asset management wasn't very good (it didn't need to be) and it had high fees and a bloated cost structure.

After the 2001 terrorist attacks banking secrecy became problematic. After all you could not be sure you were not managing money for Al-Qaeda. Eventually Swiss financial institutions gave up secrecy and even surrendered the identities of large numbers of tax evaders. After that Swiss Banks had middling performance, bloated cost structures and angry clients. It was not a good position – and profits were destined to go down.

The major Swiss banks (especially Credit Suisse) tried to offset the earnings decline by doing more business and taking on more risk. In Credit Suisse's case this did not work well, and the bank got a (deserved) reputation for being "accident prone".

But it wasn't just the banks that did that. The independent asset managers were inflicted with this disease.

GAM – as an open architecture model – had inadequate central risk control and incentives to take more risks. It did not work well.

The biggest – but not the only disaster – was that they had a star fund manager who bet huge proportions of his fund on illiquid mark-to-model securities guaranteed by Greensill Finance. (Greensill Finance has since gone bankrupt.) This was their biggest fund – they gated it – blew up their reputation and money started leaving them.

This was doubly a problem because they had – and still have – an absurdly bloated cost structure.

So, at the end of the last half GAM had 27 billion Swiss Francs of funds under management, another 30 or so billion of funds for which they provided low-value custody/accounting services, 171 million Swiss Francs net cash at the holding company and a market cap of

about 120 million Swiss Francs. You could buy a very large asset manager with almost 200 million of revenue for under the cash on the balance sheet.

This is astonishingly cheap. It wasn't that long ago when asset managers traded at 3-5 percent of funds under management. GAM stock has fallen 99 percent since peak.

The problem of course is the bloated cost structure. GAM couldn't pay their staff and have anything left of that 200 million in annual revenue. Without cost cutting they have, at best, a few years left. And markets, and hence funds under management and revenue, have continued to fall making the situation even more difficult.

A market upturn and all will be well for a while. Brutal cost-cutting and you can probably make 5-10x your money on the stock. But the management hoped for the former and seemed unwilling to do the latter. Those bloated fat-cats they needed to fire were of course their friends.

Just before Christmas the press reported that "GAM Holding is working with investment bankers at UBS on strategic options including a sale". That is an abrogation of responsibility to fix it themselves – but alas that responsibility was abrogated some time ago. The Christmas gift to us is that we will probably be taken out at a profit albeit there is also a possibility that worse is still to come. The Christmas gift to the staff of GAM is that someone is almost certainly going to fire a large proportion of them shortly.

The problems with ultra-cheap stocks

GAM is an illustration of the problem with ultra-cheap stocks. Firstly, the market cap was trivial – we were buying at around a 100 million Swiss Francs market cap. And the stock was shockingly illiquid – we had to buy it aggressively to get a position of a tenth of one percent of our funds under management.

The other problem is that stocks get this cheap for reasons. You can't buy a company like this and pretend it is anything other than a hot mess.

And that is why we will never realistically do lots of this. A stunningly good company (of which we know a few) when it trades at a decent price is a far more realistic proposition. We can deploy a lot of capital in those. And we should get reasonable returns, but we are unlikely to get rapid ten baggers. Great businesses at reasonable prices alas remain hard to find.

Reopening the Fund

We originally closed the fund[7] to new clients when we felt we were at approximately half the capacity of our opportunity set, which is constrained by our requirement for numerous small short positions. As the bull market went into overdrive – and especially in the early part of 2021 – those capacity constraints melted away.

[7] This fund re-opening commentary is intended solely for our Australian domiciled Amalthea Fund and Australian clients

They melted away for two reasons:

a) Our systems have continued to get better – allowing us to find and manage more shorts
b) Markets went haywire delivering more shorting opportunities to us.

We used some of that capacity to run some additional funds for existing clients. It is an open question as to how much capacity we ultimately have (once we have found and shorted all the rubbery stocks in the world). We however have some measures of that:

i. Recently a motley crew of villains were indicted for fraudulently hyping stocks to retail. We had independently found every stock they were hyping and had been short most of them. Our limitations were on the cost of borrowing these stocks and their liquidity.
ii. Also, a scientist was indicted for presenting misleading data in a biotech scam. We had independently identified every stock that he had worked for in the past. Again, we had shorted most of them.

In America it seems we are not missing many opportunities.

But we are finding opportunities in other countries. We are shorting more in Korea and there are opportunities in Europe. Historically the German securities regulator has been a peculiarly bad and weak regulator thereby encouraging fraudsters. There are more than a few opportunities for short sellers in Germany. Alas since the Wirecard scandal German securities regulators have been addressing their problems and regulatory performance is improving. Maybe that will limit future opportunities.

There are other countries with terrible regulators – but it is not sensible for a fund manager to criticize their regulators – and hence we will not name them. We only named the German regulator because they themselves have acknowledged and are trying to fix the problems.

Anyway – as we are going to open to new clients we will be visiting prospective clients a bit this year. It is not a lot of capacity – so the marketing trips will not be long. But get in touch with Andrew Reeves if you are interested.

Thanks again for the trust you place in us.

Bronte Capital