3 September 2009

Client Letter for Month Ending 31 August 2009

Our performance for August was unreasonably and unsustainably good. In most of our investments our analysis of the business (and predictions as to future outcomes) appears to have been more or less correct and is being reflected in stock prices.

We started our funds with three small positions in prima-facie high risk high return positions in defaulted preference shares and all three have more than doubled. Moreover the news-flow from those businesses has been entirely consistent with our initial analysis. That has certainly added considerable spice to our returns. But our returns even outside these positions have been more than adequate. Bank of America, Biota, Premiere, Energy Developments and others have provided better than market returns. We cannot expect to be so consistently right with our analysis and we cannot expect markets to continue to be so generous with us.

Further, whilst we carried substantial short positions (and have lost money on almost all our short positions) none of those have been a substantial drain on performance. In two cases (one of which we have trimmed) the business has been performing better than our original anticipation – but the stocks involved were already highly priced – and so good performance did not drive the stock prices very far. One day we will get a short position wrong and be punished. So far that has not happened.

The very good performance of Bank of America (the largest position when we founded the funds) and some of our preference share positions has meant that the portfolio has become unbalanced. Large positions have become larger. We have trimmed a little (though not very much). We believe our positions remain very substantially under-priced. However the large positions have added to the volatility of the funds. Further, as the assets we own are just not as cheap as they were when we started the funds, we believe the downside risk is larger.

That is real. We have lost about three percent in the first few days of September. And we lost that without underlying news being inconsistent with our prior expectations.

More pertinently though – as our high quality original ideas are working out faster than we anticipated we need new ideas to replace them. That will (we hope) happen – but there is more-than-a-bit of serendipity involved and at the moment we are not generating new ideas as fast as old ones are playing out. We hope to remedy that – but so-far no dice.

Once again the US dollar based clients benefited from a weak US dollar (or more precisely by a strong Australian dollar) whereas the Australian based clients faced this headwind.

Portfolio changes

As stated above the portfolio was little changed over the month. We trimmed some positions but no substantial new positions were introduced.

We added 2% to our holdings of French regional banks, and these now constitute 7% of our portfolio. On the other hand we initiated a short in Banco Bilbao Vizcay SA to add to an existing short position in Banco Santander SA. The Spanish banks have a very fine oligopoly (and hence are perhaps naturally the world's most profitable banks). The most similar oligopolies are in Australia and Canada. However they face huge economic headwinds in Spain and have (foolishly) we think confused their underlying profitability for management genius which - when combined with leverage and a reliance on wholesale funding – places the golden goose at risk.

For a little while during the month we held a small long position in Brunswick Corporation as a play on the inventory bounce occurring in global manufacturing. We exited it for a small gain after reviewing our overall exposure to the USA turnaround trade and after realizing that we had underestimated the effect of seasonality on that business. (Our analysis was faulty – the profit was sheer luck.)

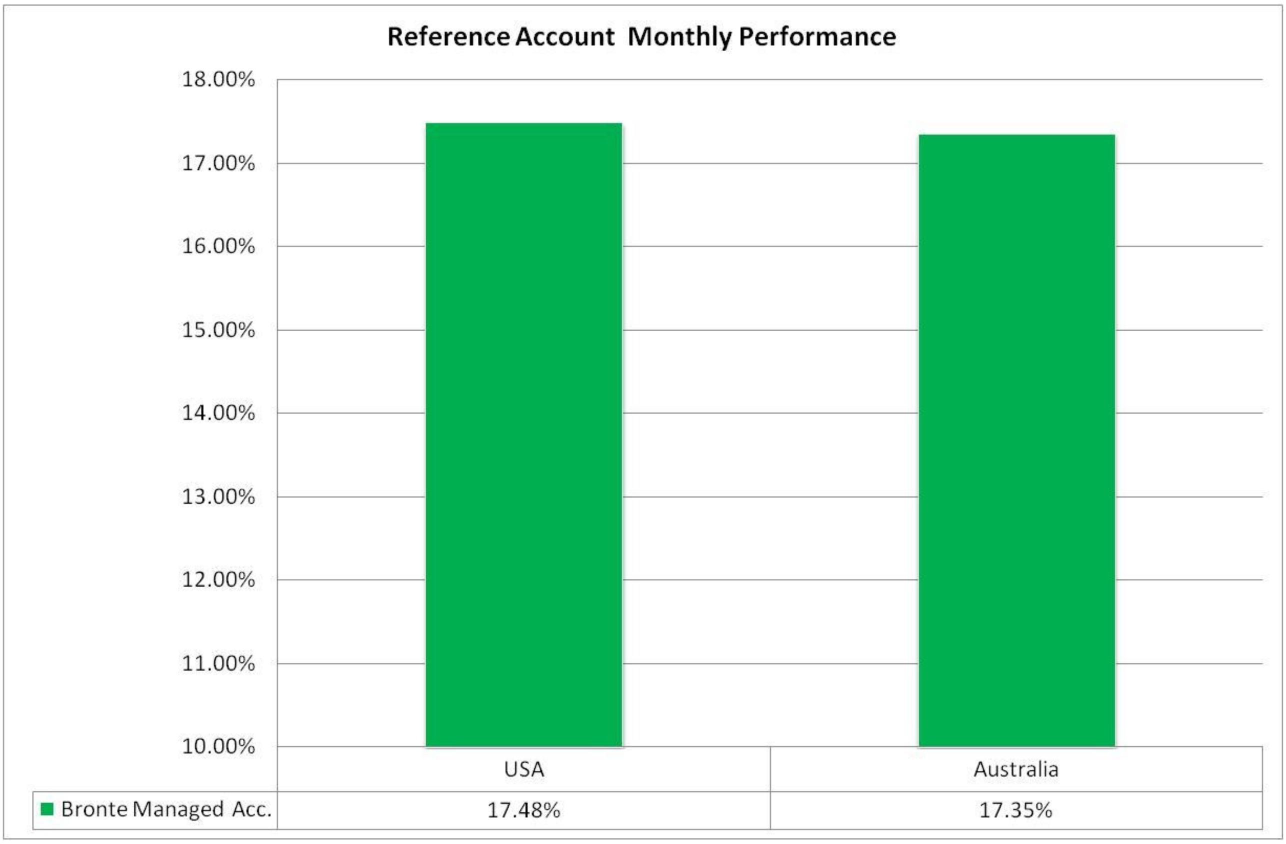
Our Australian stocks have performed strongly with Energy Developments benefiting from local greenhouse policy changes that will directly benefit its coal mine methane generation assets. AJ Lucas produced lacklustre annual results but made clear some of the value it had developed in an extensive offshore unconventional gas development portfolio. In this case Simon's analysis of the business was a few steps ahead of market understanding.

Portfolio leverage

By the end of the month the leverage of the portfolio had again grown. The longs had gone up sharply and the shorts had again cost us some capital. We remain over 100 percent gross long even after netting off arbitrage positions and reducing some holdings as described above. We do not expect this to be the normal position. In general we anticipate being closer to 80% gross long – and we anticipate further trimming positions though few of our positions have reached prices where we would be happy selling them.

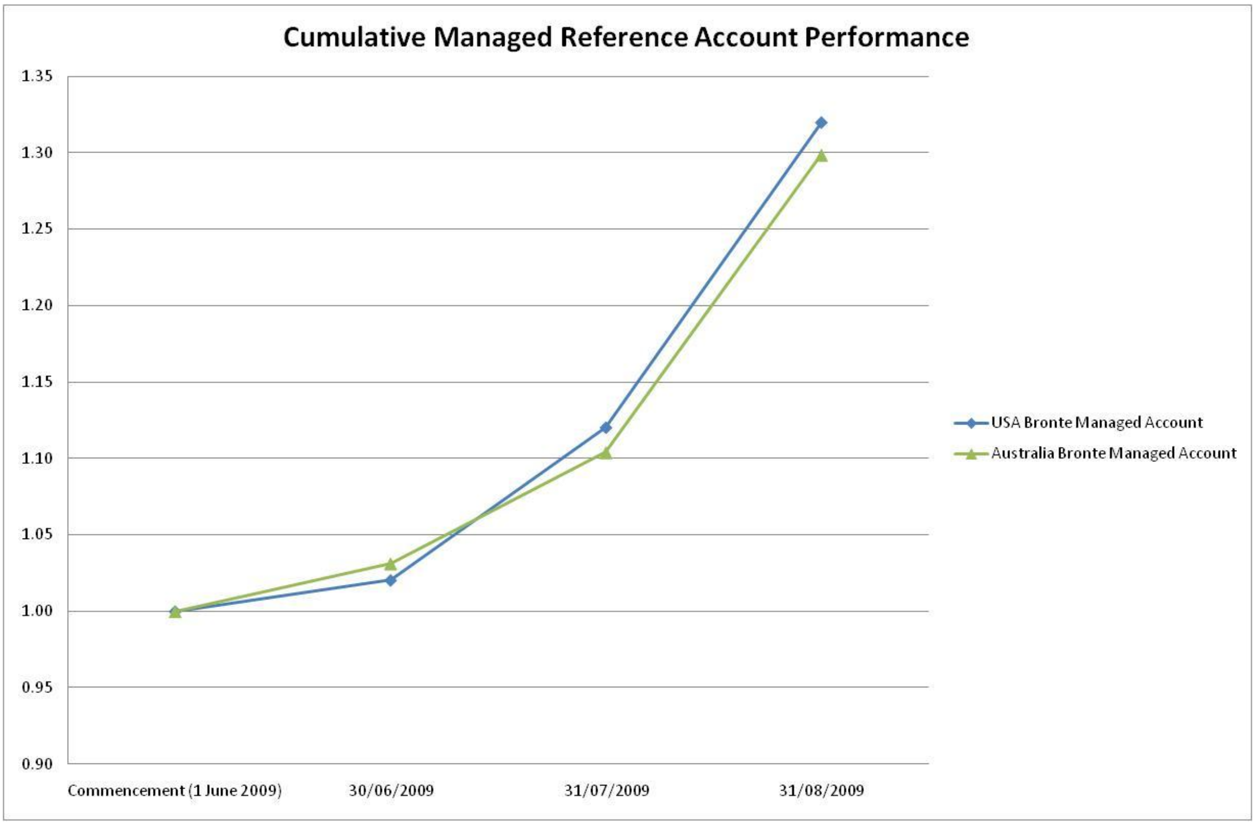
Performance data[1]

Monthly returns



[1] All performance data is now adjusted to allow for an accrual of the annual performance fee and we are no longer showing the data for the benchmark MSCI All Countries World Net Standard Core Index due to copyright licensing requirements.

Since inception



The start of September has seen a modest correction. In general, we are seeking to find less cyclical stocks to move into the portfolio, as the recovery focused stocks mature.

We thank you again for the trust you have placed in us.

John Hempton
Simon Maher