

2 October 2009

Client Letter for Quarter Ending 30 September 2009

We had a solid month to cap off an unreasonably good first full quarter of operations. During the quarter – and particularly during the last month – we faced a weak US dollar – which meant that the returns for the US accounts appear *much* better than the returns for the AUD accounts. However both returns are more than adequate.

The US reference account returned 6.8 percent, the Australian account 3.6 percent over the past month.

The quarterly returns were 38.5 percent for the US reference account and 30.7 percent for the Australian reference account. These returns are more than 20 percentage points better than global markets and they were achieved despite large (and costly) short positions.

In all cases these returns are after base and performance fees.

We stated last month and we repeat that we do not think that these returns are indicative of the long term potential of the funds.

Portfolio management

Many of our long positions are doing extremely well – and our short positions are not crimping our returns too much. Shorting has been an unprofitable activity generally – but so far it has removed almost all of the volatility in the funds. Moreover as the market swung down in the last few days of the quarter (and the first day of October) the funds actually went up in value in all currencies. *Our shorts seem to be working... at least as much as they can be whilst we are losing money on all but two of them...*

Last month we wrote that we had never had a short turn truly nasty on us – though we thought such an event was inevitable over time. This month a couple of our shorts gave us grounds to be nervous. We trimmed one and left the other unchanged – and all settled down within a couple of days. We are not wedded to any short position – and will trade out of them if they become too painful.

One issue has dominated our actual trades. As our longs and our shorts have gone up we have become more levered even though our longs have behaved exceedingly well. [We started with well under 100 percent gross long position and have exceeded that level more or less continuously for the last couple of months.]

Risk management has required that we trim long positions – and we have done so (albeit reluctantly) on several occasions. The last few days, plus our continuous trimming, has brought us back into line.

We have done so few substantial trades in our portfolio that we appear almost apathetic. During the last month we purchased a very small (2 percent) position in A123 systems and put on a very small short in First Solar (1 percent) and a gold company we do not wish to name. We also increased our short in Smith & Wesson as the Obama inspired gun boom wanes.

The portfolio will not remain so static. Several of our positions are coming to maturity and a few – whilst not mature – are getting quite large simply because of stock appreciation. We need new ideas and the process for generating them is serendipitous rather than systematic. We do not know when and where we will generate these ideas.

More generally there are plenty of things we think will go up (because we think the economy will be OK). However despite thinking the direction is OK we think the risk-reward ratio is wrong. If they work they give us 50 percent – if they don't work they cost us 75 percent. *We are not interested in that kind of bet.* The mortgage insurers (such as NYSE:RDN) are in that category. We think they are going to be OK and we think they will appreciate – but we do not think we should own them.

Annoyingly we had some places we wanted to park money if the cycle got too frothy – chief amongst which was in French regional banks. *Our hidey-holes are appreciating to the point that they are no longer hidey-holes.*

Our clients know things we do not. If you are an insurance broker and you see a company reluctant to pay claims then please tell us. If you see a supplier discounting insanely or alternatively raising prices please tell us. We are in the new ideas game – and one of the advantages in being a long way from Wall Street is that we have quite different ideas from the New York/Connecticut consensus. Crowded trades are dangerous trades and very few of our positions are crowded.

One of the disadvantages is we get less idea flow across our desk.

We are trying to maximise that advantage and minimise the disadvantage.

Thanks again for the trust you have placed in us.

John Hempton
Simon Maher



Stock stories

This is a quarterly letter – and it is our intention to provide investment content in quarterlies – either regarding new positions or large positions.

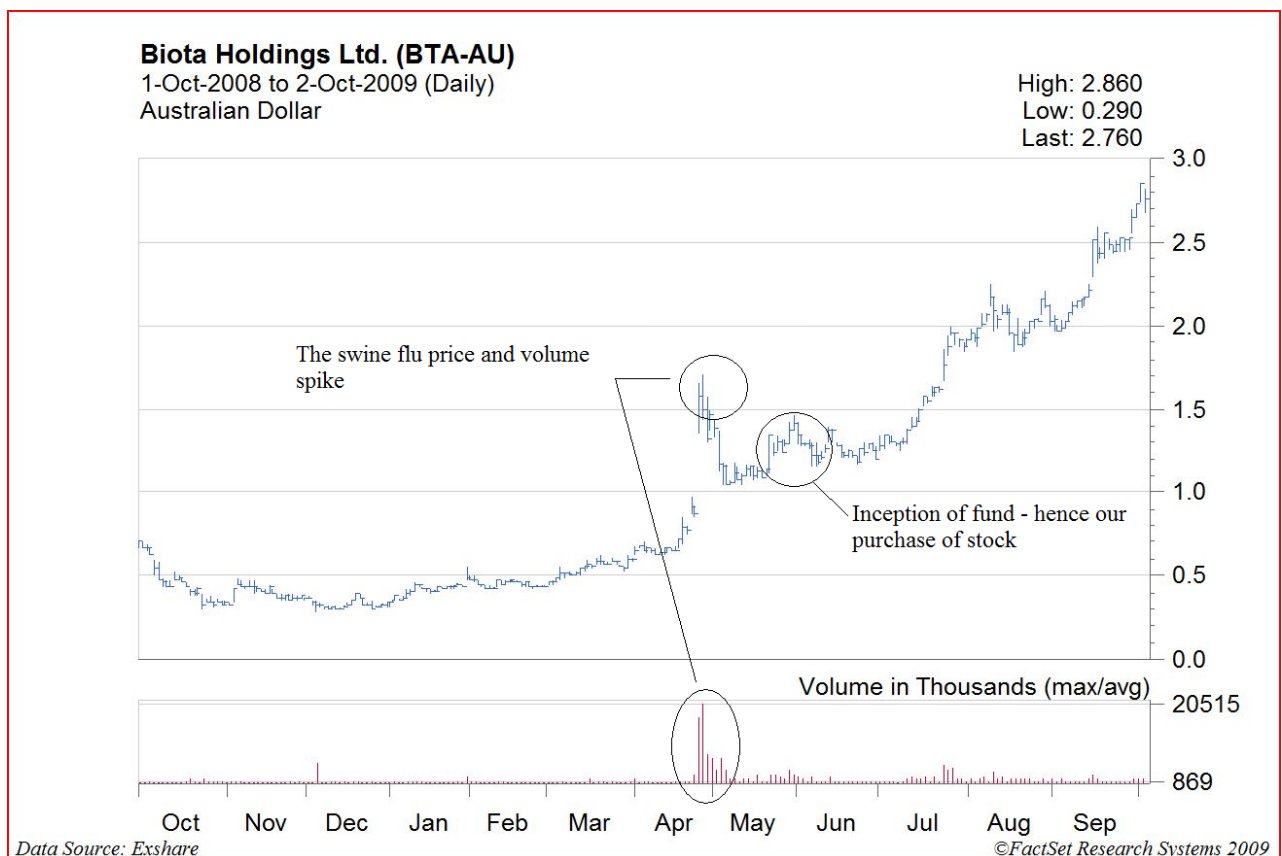
Stock story: Biota Holdings

Biota Holdings is an Australian small-molecule biotech research company. By far the most important asset is that it is the owner of roughly 7 percent of all royalties from Relenza – the distant number two influenza antiviral drug. It was a modest sized position when we started and has approximately doubled since purchase. [For the US dollar accounts the stock has been substantially better than a double.]

Governments were frightened by Swine Flu – which has turned out to be fairly modest – but could potentially have been another variant on Spanish Flu with a death toll in the tens of millions. Governments are thus building bigger stockpiles of antiviral drugs.

The main drug stockpiled is Tamiflu. Our thesis was that because Tamiflu resistance had been growing governments would choose to stockpile Relenza instead. And that is how it is turning out. Biota – a company used to scratching by on very small cash flows will wind up with cash flows equal to well over half of its pre-Swine Flu market capitalisation.

Here is a stock chart since our original purchase date:



The volume spiked heavily when the first stories about Swine Flu broke. We purchased personally into that spike – and we would have purchased for the fund if the fund were operating. It was dumb luck – but at least for this stock the inception date for the fund meant we purchased the position cheaper. The stock fell after the day-trader swine flu spike.

Thereafter the story played out more or less as we envisaged it.

However there is more luck to it than that. We did not understand the mechanism of Tamiflu resistance but we knew that it was first identified in Japan – the place where Tamiflu is most prescribed for seasonal flu outbreaks.

Along comes a story which makes our original stock thesis massively better. Here it is:

Tamiflu in Rivers Could Breed Drug-Resistant Flu Strains

By Janet Raloff, Science News September 30, 2009 |* 8:10 pm |

The premier flu-fighting drug is contaminating rivers downstream of sewage-treatment facilities, researchers in Japan confirm. The source: urinary excretion by people taking oseltamivir phosphate, best known as Tamiflu.

Concerns are now building that birds, which are natural influenza carriers, are being exposed to waterborne residues of Tamiflu's active form and might develop and spread drug-resistant strains of seasonal and avian flu.

For their new study, Gopal Ghosh and his colleagues at Kyoto University sampled water discharged from three local sewage treatment plants and water at several points along two rivers into which the treated water flowed. Sampling started early in December 2008, as flu season got underway. The researchers sampled again at the height of the seasonal flu onslaught in early February and again as infection rates waned.

Tamiflu's active form, oseltamivir carboxylate, or OC, turned up in the treated sewage on every occasion, the researchers report online Sept. 28 in *Environmental Health Perspectives*. Values were in the low nanograms-per-liter range during the first and last samplings, and reached a high of almost 300 ng/L at one outflow during the flu's peak, a week when there were 1,738 recorded flu cases in Kyoto.

River residues showed up during only that second sampling — from low-nanogram levels at most sampling points to a high of 190 ng/L in a portion of the Nishitakase River where treated sewage accounts for 90 percent of the flow.

Computer modeling has shown that OC should survive sewage treatment, noted Wolf von Tümpling Jr. of the Helmholtz Center for Environmental Research, a federal institute in Magdeburg, Germany. Ghosh's team is now the first to confirm this, he said. Von Tümpling's own data show that once exposed to sunlight, OC will break down, albeit slowly. Concentrations would fall at best by half every three weeks, he said.

If correlations predicted by earlier studies are correct, concentrations measured at some river sites in the new Kyoto study seem "high enough to lead to antiviral resistance in waterfowl," Ghosh says

And the Kyoto team didn't test during a pandemic, when Tamiflu prescription rates might be 10 times higher, von Tümpling notes.

Indeed, the expected coinciding hits by seasonal and H1N1 swine flu this winter, could send Tamiflu use skyrocketing. In a July 14 letter, Food and Drug Administration deputy commissioner Joshua Sharfstein noted that "there is no adequate, approved and available alternative to the emergency use of certain oseltamivir phosphate products for the treatment

and prophylaxis of influenza.”

Once ingested, virtually all Tamiflu will end up in the environment in the active form, noted environmental chemist Jerker Fick of Umeå University in Sweden. The reason: Tamiflu becomes active once the body converts it into a carboxylate form. Roughly 80 percent of an ingested dose becomes this OC, which the body eventually excretes. The body sheds the remaining 20 percent of Tamiflu in its original form, but this phosphate form is immediately turned into the active, carboxylate form when it reaches a water treatment plant, he said.

Two years ago, Fick’s team published data showing that most sewage-treatment technologies will remove “zero percent” of any OC present. And ducks love hanging out around warm, nutrient-rich outflows of treated water during winter-flu season. While sampling for waterborne OC last year in Japan, “I saw it myself,” he said.

If Tamiflu resistance does develop in exposed birds, the affected flu strains will probably be conventional seasonal and avian-flu strains, which claim thousands of lives each year, and not H1N1. That’s because H1N1 seems to bypass birds as it spreads among people, noted William Schaffner, chair of preventive medicine at the Vanderbilt University School of Medicine in Nashville, Tennessee.

He also notes that U.S. policy is more conservative than Japan’s when it comes to Tamiflu use. Federal guidelines, he said, recommend that “Tamiflu be reserved for treatment of the very sick and anyone who is immunocompromised.”

We had no understanding whatsoever that Tamiflu would be a serious environmental pollutant. It just did not figure in our thinking. However restrictions on and worries about Tamiflu are wonderful for our holding in Biota and we probably will further profit from them.

We remind ourselves though that there is no reason that the story might not have been entirely the other way around. Relenza could have caused pollution problems and we might have been facing losses and we would be forced to explain them to you. Moreover the explanations would not sound convincing (even if true).

Our returns have been more than acceptable so far. We hope this convinces you that there has been more than a touch of luck in those returns.

Stock story: A123 systems

A123 is perhaps the most atypical stock we have ever purchased. It’s a battery maker from the Massachusetts Institute of Technology battery lab. The battery specifications are amazing but the company has incurred losses of more than a dollar per dollar of sales. It remains loss making and will almost certainly lose money over the next two years.

On specifications (and on its gold-plated customer list) the stock had a very hot initial public offering – probably the hottest globally in 2009. We tend to avoid hot IPOs.

However we note the people involved in A123 and are fairly sure that the company can reduce its operating cost per kWh of battery sold to a level which makes economic sense. If they can do this the batteries will become economically very important both in hybrid and electric cars but also in some niche grid applications (such as in cities with congested transmission).

We are far less sure that the company will be able to keep competition out of the high performance – high capacity battery industry – and hence we are less sure that the company will be able to earn

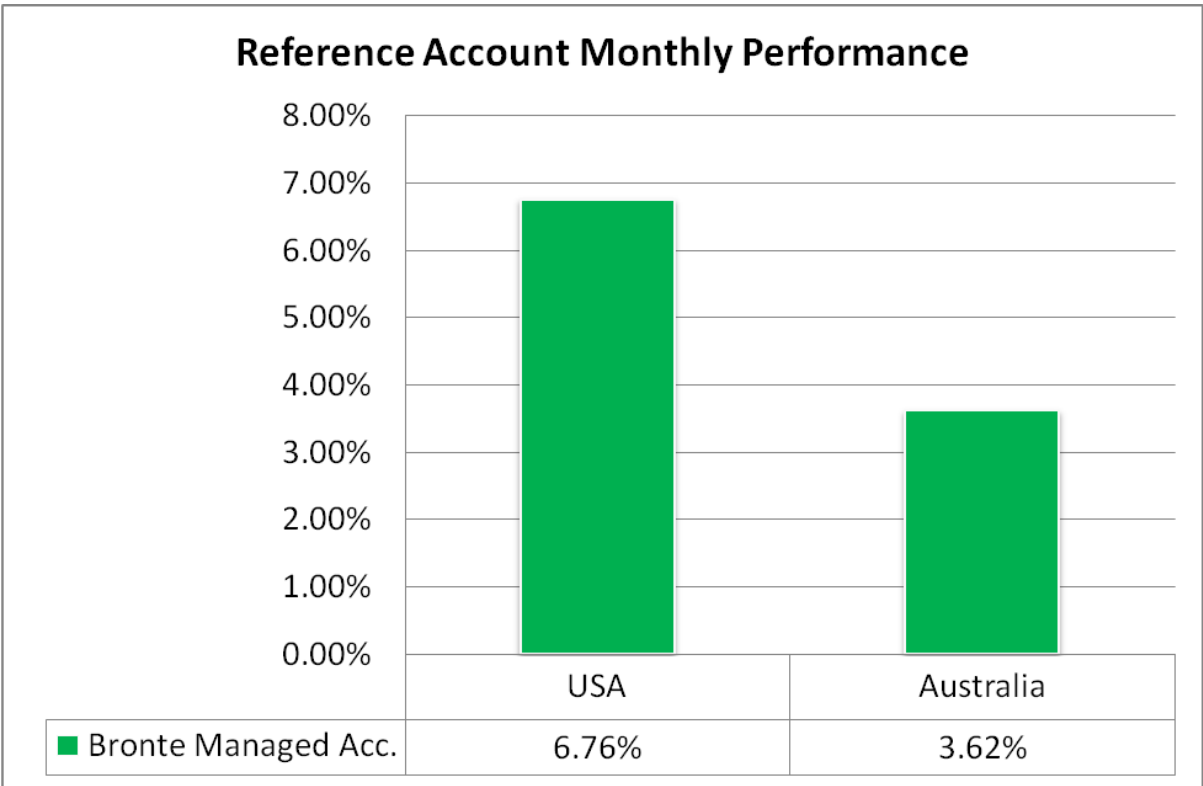
decent margins as it scales up. There are serious competitors and competing technologies such as very large capacitors linked with traditional batteries.

The end uses for this battery are well within our fields of expertise (particularly energy trading and grid management – an area Simon has made a career in). The technology however is not – and to say we are uncomfortable is to understate it.

It is an atypical speculation on our part – but we thought you ought to know that we have taken it.

Performance data¹

Monthly returns



¹ All performance data is adjusted to allow for an accrual of the annual performance fee

Since inception

