10 January 2011

Client Letter for Month Ending 31 December 2010

It was a pretty good month for Bronte and our clients. Our stated ambition is to almost keep up with rising markets and not lose too much in down markets. (We also hope to do OK in sideways markets.) We were within a percent of a sharply rising market - which given that we are nowhere near 100 percent net long is a good result. We have started the new year very well and we remain optimistic about our portfolio.

By far the most important portfolio change is that we have added a big long position: the common stock of America Online. AOL is the old and dying US dial-up internet provider - an uglier business you haven't spied lately. The idea is attractive in part because it caused near revulsion when we looked at it. Stocks sometimes get an "ugliness discount" and AOL has one of the most extreme ugliness discounts we have ever seen. (But then again the business really is extremely ugly.) The stock would be extraordinarily cheap if the management stopped trying to spend themselves out of their problems and just stored up cash and bought back stock.

Some businesses are made to die slowly (distributing lots of cash as they do) but it requires management to be really focused on shareholder value (rather than empire building) for that to happen - and alas - our big worry with this company is that the management is not quite up to it. Tim Armstrong - the CEO who came from Google - has a reputation as a builder of good businesses - and that is a problem.

We probably need only two to three good long ideas a year - so finding one is useful - and over time these ideas will generate the bulk of our returns. Meanwhile however most of the noise in the portfolio is driven by our shorts. These are designed to generate cash which we tip into our longs - we hope to turn "trash into gold". Our shorts are mostly of fraudulent but well promoted stocks. If you ever hear of a dodgy stock broker or stock promoter please drop us an email. We collect these people - and so far the collection has been profitable.

Of course regulators should also collect (and sometimes imprison) these people - but mostly they don't. Like any fraud-based short-seller we rely on the regulators to be either overworked or hopeless and to not close these guys down before we short their stock. So far the regulators have not disappointed us. Improvement in the effectiveness of securities regulation would in the short term increase our profits from short-selling but in the long term good regulators would put an end to that part of your portfolio and leave us looking for another source of profits.

There is some evidence that securities regulators are doing their job better (Mary Schapiro is almost certainly an improvement on those that went before). We even had one stock we had shorted suspended during the month - and it relisted over 80 percent lower - a small but noticeable fillip to our short term results. But ultimately our stock selection relies in part on continued regulatory failure and we take little joy in regulators doing their job well. We would rather do it for them.

Doing the regulators job has been profitable. In the past John has reported companies he considers fraudulent to regulators. Mostly he doesn't do this anymore. The best result is that the regulators ignore your observations. But worse - sometimes they investigate the short-seller for "market manipulation or the like". The USA has just introduced a bounty program for people who report fraud that results in recoveries by the regulator. If evidence emerges that regulators take the

Bronte Capital Management Pty Ltd (AFS License: 334325)
Suite 2101B Tower 1, 520 Oxford Street, Bondi Junction, Australia.
Phone: +61 2 9389 3293 • Email: simon@brontecapital.com

complaints of short-sellers seriously - and better still - start paying bounties - then maybe we will reverse that position. We are not holding our breath.

David Einhorn wrote an excellent book which was in part about how regulators pursued him because he was short a company that he thought was fraudulent and was defrauding taxpayers as well as shareholders. It is a salutary lesson - and our solution to a problem like this is to find something else to short. There are plenty of shonks in the sea. (We will leave the book writing to David Einhorn.)

Unfortunately our short positions are less well correlated with our longs than we would like - leading our portfolio to be more volatile than we would like. We manage this volatility by having a lot of small positions diversified by as many variables as we can.

We are also adding a few non-fraud shorts. One area that interests us is the extent to which Western companies have abused their (mostly) Asian suppliers. Dell is a good example. Dell takes your money before it builds your computer - it thus has negative working capital. Negative working capital is one of the main contributors to Dell's past glories - it allowed Dell to self-finance a massive expansion. However Dell has been taking an increasing lean on their supplier. Their days' payable outstanding (the number of days at which Dell pays its suppliers) has been increasing for a decade.

Ten years ago it was 56.1 days. Then 66.9, 69.4, 71.3, 73.4, 74.8, 77.1, 80.1, 71.8 and 81.2 days.

Every year they screw their suppliers a little harder. They don't need to do this. Their customers still pay them in advance. They did this because (a) they could, and (b) the US stock market demanded cash measures of performance and if you don't pay your suppliers it is "cash generating". It is also really scummy bad business practice. It costs your suppliers effort and worry (collecting from you) and generally annoys them.

The reason this is interesting is that the dynamic in China is changing. There are stories about labour shortages and we are beginning to see stories about how some companies are bringing the product manufacturing back to the USA because Chinese costs are rising and Chinese suppliers are getting stroppy. Labor shortages of course put the power back into the supplier's hands.

Also inflation in America is 1 percent plus or minus 2 percent - but in China it is probably over 10 percent. Late payment hurts the Chinese far more than it benefits the Americans so it is utterly logical that the lean on Chinese suppliers should end. This will strip billions of dollars in cash cumulatively from Western companies.

We have no position in Dell (it is hardly the only offender). We are short Logitech at least in part on this analysis - and we are finding the area fruitful to examine. Still - these will remain small positions individually and in total. The right way to describe our portfolio remains as a collection of global value stocks with a side-line in which we take a large number of small short positions in fraudulent companies diversified as much as we can.

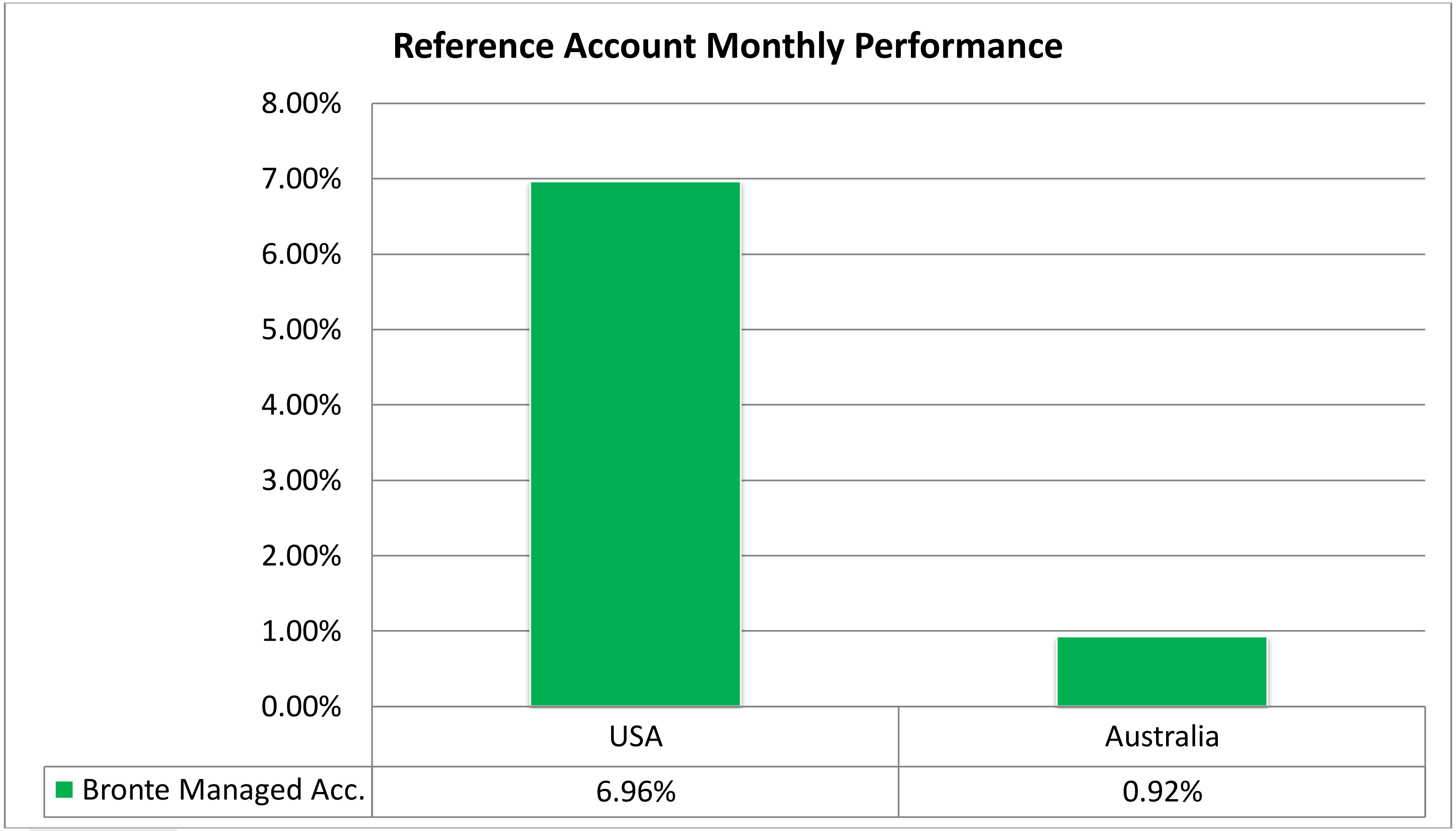
Thanks again for the trust you have placed in us.

John
Simon

Portfolio Management

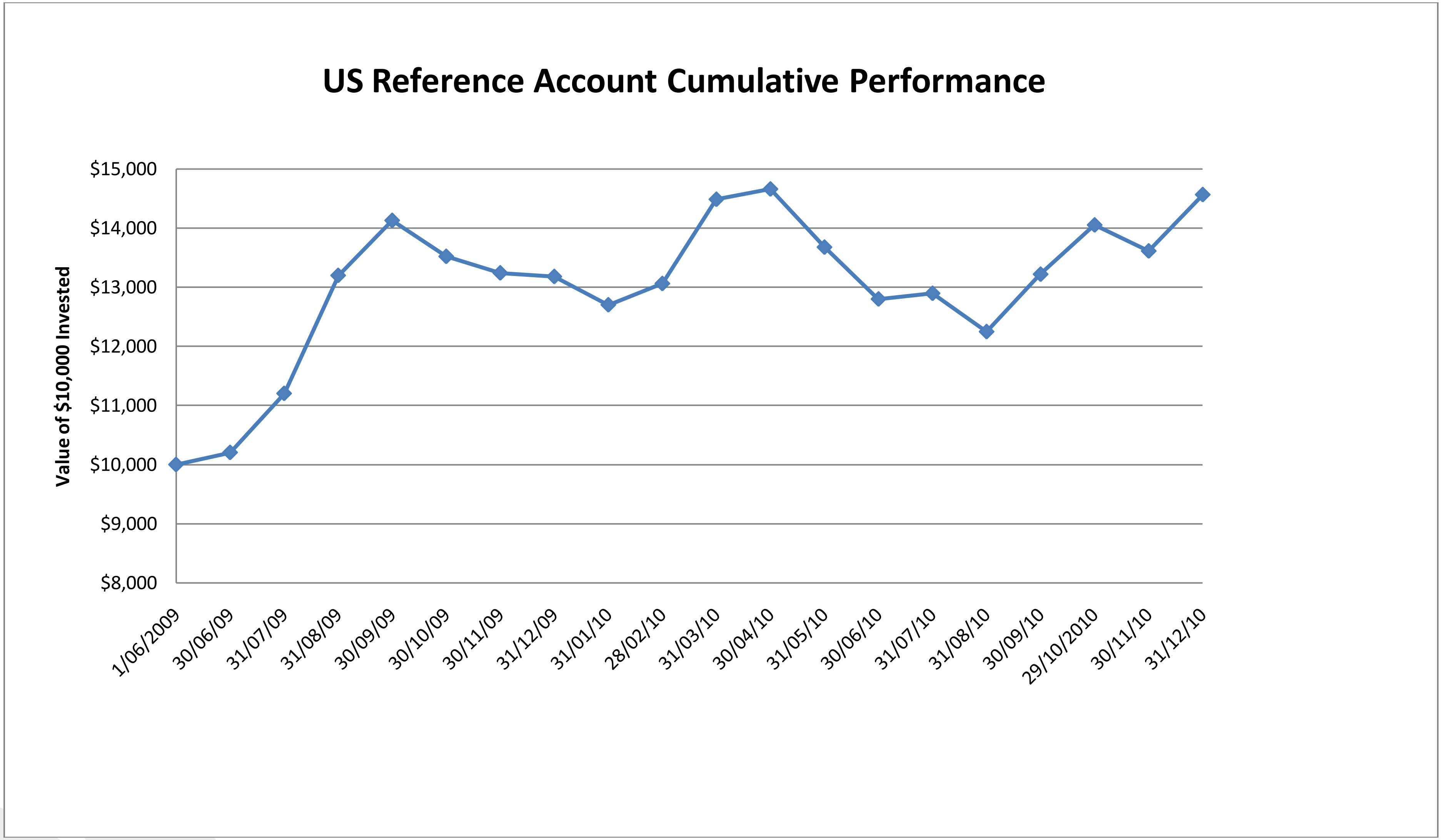
	Long%	Short%	Net Long%
USA Reference Account	120.67	46.28	74.39
Australian Reference Account	121.11	49.74	71.37

Performance Data [1]



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

Bronte Capital Management Pty Ltd (AFS License: 334325)
Suite 2101B Tower 1, 520 Oxford Street, Bondi Junction, Australia. Phone: +61 2 9389 3293 • Email: simon@brontecapital.com


US Reference Account Cumulative Performance
Value of $10,000 Invested
$15,000
$14,000
$13,000
$12,000
$11,000
$10,000
$9,000
$8,000
1/06/2009
30/06/09
31/07/09
31/08/09
30/09/09
30/10/09
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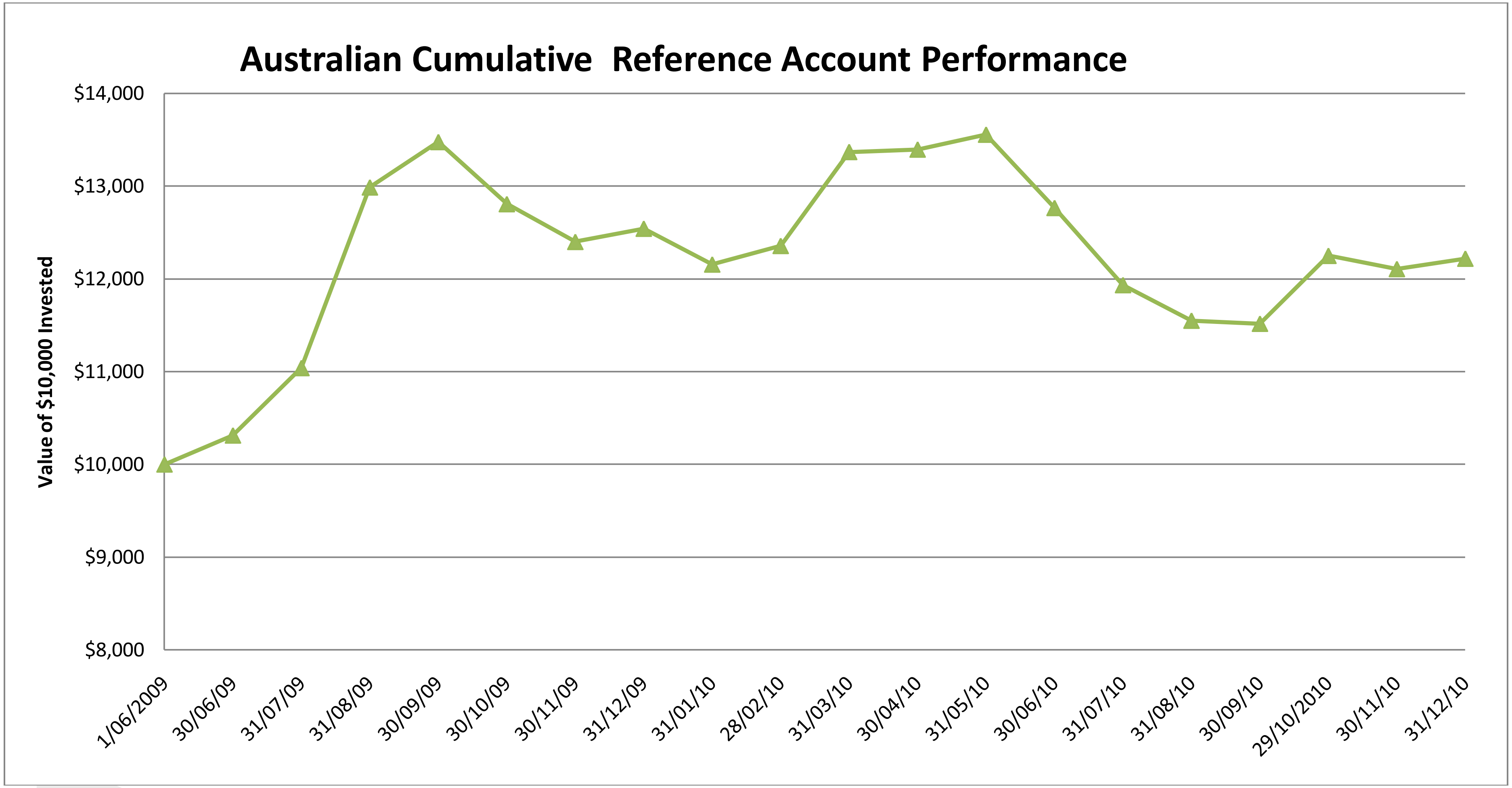
Australian Cumulative Reference Account Performance
Value of $10,000 Invested
$14,000
$13,000
$12,000
$11,000
$10,000
$9,000
$8,000
1/06/2009
30/06/09
31/07/09
31/08/09
30/09/09
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