3 February 2011

Client Letter for Month Ending 31 January 2011

We used to judge ourselves against the global equity index (MSCI accumulation index) – our intention to keep up with the index in good times and not lose too much money *in an absolute sense* in bad times. That is a fair statement of what we intend; and it remains our stated goal to keep up in rising markets and not lose too much in falling markets.

The problem is that our portfolio is now so far from the MSCI that reckoning our performance against that index on a monthly or even a quarterly basis did not seem reasonable. Moreover the people that constructed the index wanted to charge us a fortune for measuring ourselves against an index that did not make sense to us. So we dropped it.

Pity because we are beating it by a substantial lick (well over 5 percent in the last month). And you should not take that result very seriously because we are going to have worse times at some stage – and we will want you to look through those too. (We had a few lean months in the middle of 2010. It felt miserable.)

So allow us to state January's returns with short-lived pride: An increase of 8.3% for our USA reference account and 9.5% for the Australian account.

It's our fifth good month in a row. In fact we have barely had a bad day (although one day in January we underperformed by almost a percentage point).

Pride over. We are going to let you in on some mistakes – and they were doozies.

Sky Deutschland

We own a stake in Sky Deutschland. Cable/satellite TV never really took off in Germany – it's the rich country with the lowest penetration, and one German rich guy we know (a potential client) thinks we are mad owning it. Germans won't pay for TV – and they won't pay for sport.

Nonetheless there is some evidence that is changing. The best German football players are moving back from the UK Premier League. One of my football (i.e. soccer) nutcase friends thinks it is really significant that Arjen Robben moved from Real Madrid to Bayern Munich. He thought the Bundesliga was going "pay-tv professional" like the leagues of Spain and the UK. He follows football players. I just see a buy signal for Sky Deutschland.

But Sky is not a winning proposition yet. It needs about 3 million subscribers to go from cash-flow-negative to cash-flow-positive – i.e. to be a real business. And after that it might grow into a behemoth (like BSkyB in the UK). But it is not there yet.

Rupert Murdoch (i.e. News Corp) took a position in it and installed (what we think is) very good management. But the company remained loss making. The company had a rights issue (to fund the losses) and immediately traded below the rights issue. The issue was underwritten by News Corp.

And we got thoroughly sick of the losses – it was for a while the worst stock in our portfolio.

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We did not take up our rights or buy more. We diluted our position (seriously) in what could be a lottery ticket winner.

As said – we were sick of it.

Then the stock tripled in four months. Nice for us – but we are still showing small losses and we left big profits on the table.

Oops.

And it was stupid. We are Australian and we know the long history of Rupert screwing minorities. It is modus operandi. And when Rupert underwrote the issue we knew instinctively we should buy it and we did not do it.

And you are several percentage points worse off as a result.

And it wasn't our only major recent stuff up (but it was probably the most expensive). Another was more public because John blogged about it.

Logitech.

Logitech is a maker of computer peripherals (mice, keyboards, speakers etc). John wrote it up on the blog explaining why we had taken a short position (about 1.5 percent of funds under management). We just did not believe management when they predicted sharply rising sales – after all, we are structuring our life so we need less peripheral computer equipment and we were surprised how non-universal that was. The company reported sales in line – or slightly better than market expectations – but a lot better than our expectations. We covered quickly.

It hurt the ego – but not much this month – because the rest of the portfolio was doing great.

This was the exercise of a rule from David Einhorn – the "no broken thesis rule". The biggest mistakes we have ever made in markets came from reinventing the thesis around the stock. If you own a stock for reason X (and it is a big position with considerable intellectual capital and pride committed) and X turns out not to be true it is tempting to latch onto thesis Y to justify the position. Y of course can be flimsy. Y might not justify a new position. But it is hard – really hard – to change your mind and admit to yourself you were wrong.

So we solve that problem with a simple "no broken thesis rule". If we believe X, and X is not true we close the position. We may re-initiate it – but we close it up front. This may not be transactionally or tax efficient – but it brings discipline – and will avoid what have historically been (by far) our worst mistakes.

Things we got right

We got more or less everything right except that we were more short than we should have been (it's been a rising market). Even then the shorts have not cost us dearly. We are currently running 45% short – which is about 10 percentage points higher than we would like. Some of this is that (unusually) we are short a few stocks that have (genuinely) limited upside and hence our positions have (genuinely) limited downside. This allows us to get more short.

But secondly we are more short than model just because we have so many ideas. We are finding great shorts almost wherever we look. (We are alas not finding the longs to match them.) This suggests that we should be shorter than we would normally want. And we will be – but long term only a few percentage points. The Mae West dictum ("too much of a good thing is simply wonderful") applies to long positions but we cannot and will not apply this logic to shorts. Profitable shorting requires disciplined risk control. Our shorting has been very good (profitable sometimes and not costing us in rising markets) but this is a good thing we are not willing to push.

Fannie and Freddie preferreds

Over the time we have been running Bronte our small speculative position in Fannie and Freddie preferreds has substantially added to our volatility. We purchased these at roughly 2c in the dollar. They traded to almost 4c in the dollar and then collapsed to 1c in the dollar. They added a couple of percent to our returns in the last month. We think you should discount that.

The Fannie and Freddie preferreds are an-out-of-the-money option – a lottery ticket if you will (which is why the position is small). We happen to think they are a very good bet indeed – and we will continue to ride the lottery ticket. But when we purchased at 2c in the dollar the likely outcome was a 100 percent loss of capital. Now they are trading at 5c in the dollar the likely outcome remains a 100 percent loss of capital. Not much has changed really.

Our bad months were bad in part because we lost a few percent on these positions. Our good months have been good in part because we made that few percent back. We think you should ignore it either way.

The start of February

February is not old – but our month opened really well. John is going back to read our letters from the middle of last year to ground himself.

We also need some **long** ideas. We will listen to anything you come by – the more unfashionable the better. We don't need short ideas. We have plenty.

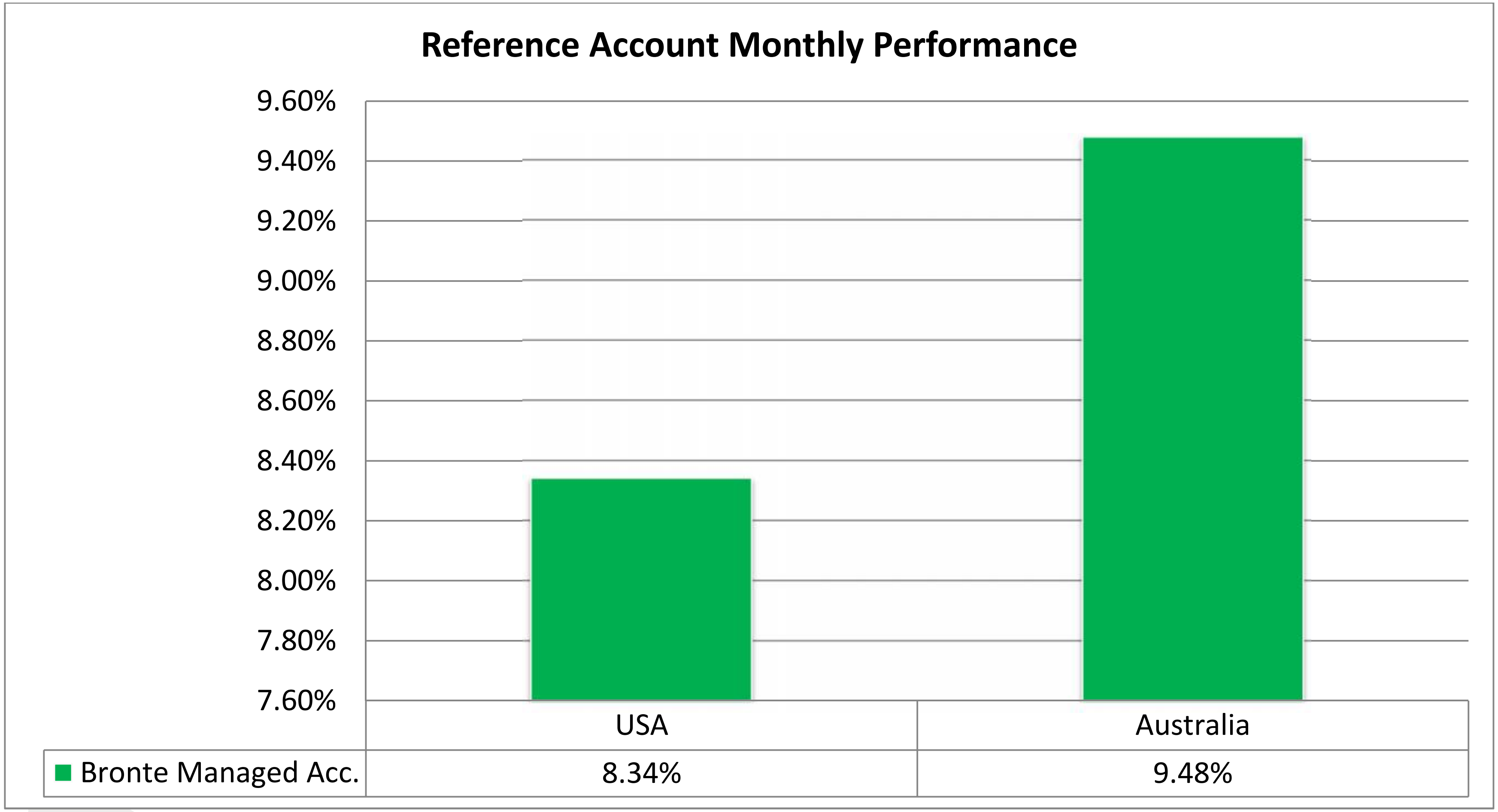
The last longs we put on are AOL (and it is hard to be less fashionable than dial-up internet) and a Dutch insurance company (an idea we stole from a big name hedge fund manager). Dutch financials are also unfashionable.

John
Simon

Portfolio Management

	Long%	Short%	Net Long%
USA Reference Account	125.37	45.35	80.02
Australian Reference Account	125.49	47.58	77.91

Performance Data [1]



[1] All performance data is adjusted to allow for an accrual of the annual performance fee. During January the actual 2010 performance fee was paid resulting in extinguishment of an excess accrual for the USA account and an under accrual for the Australian account.

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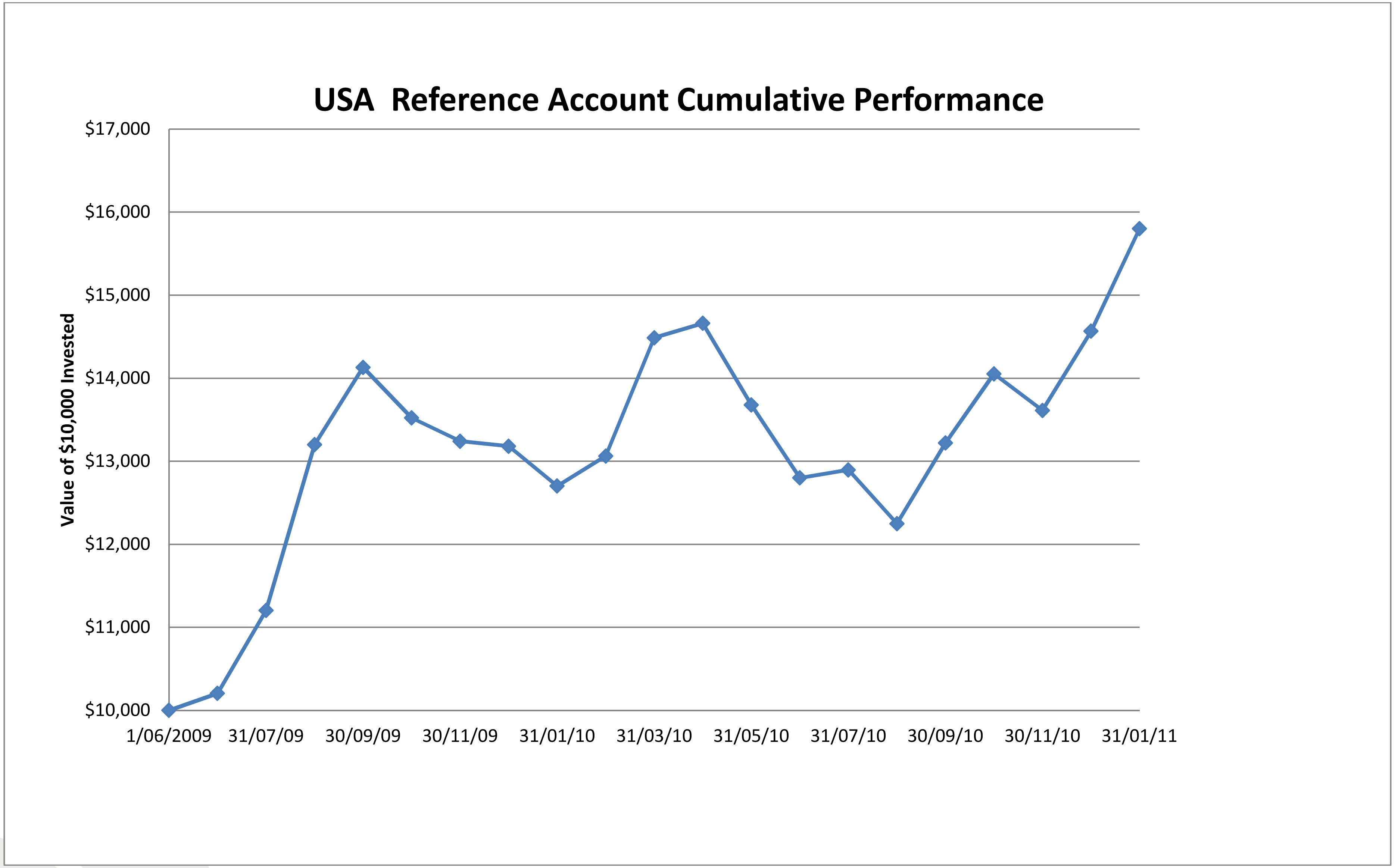
USA Reference Account Cumulative Performance
Value of $10,000 Invested
$17,000
$16,000
$15,000
$14,000
$13,000
$12,000
$11,000
$10,000
1/06/2009
31/07/09
30/09/09
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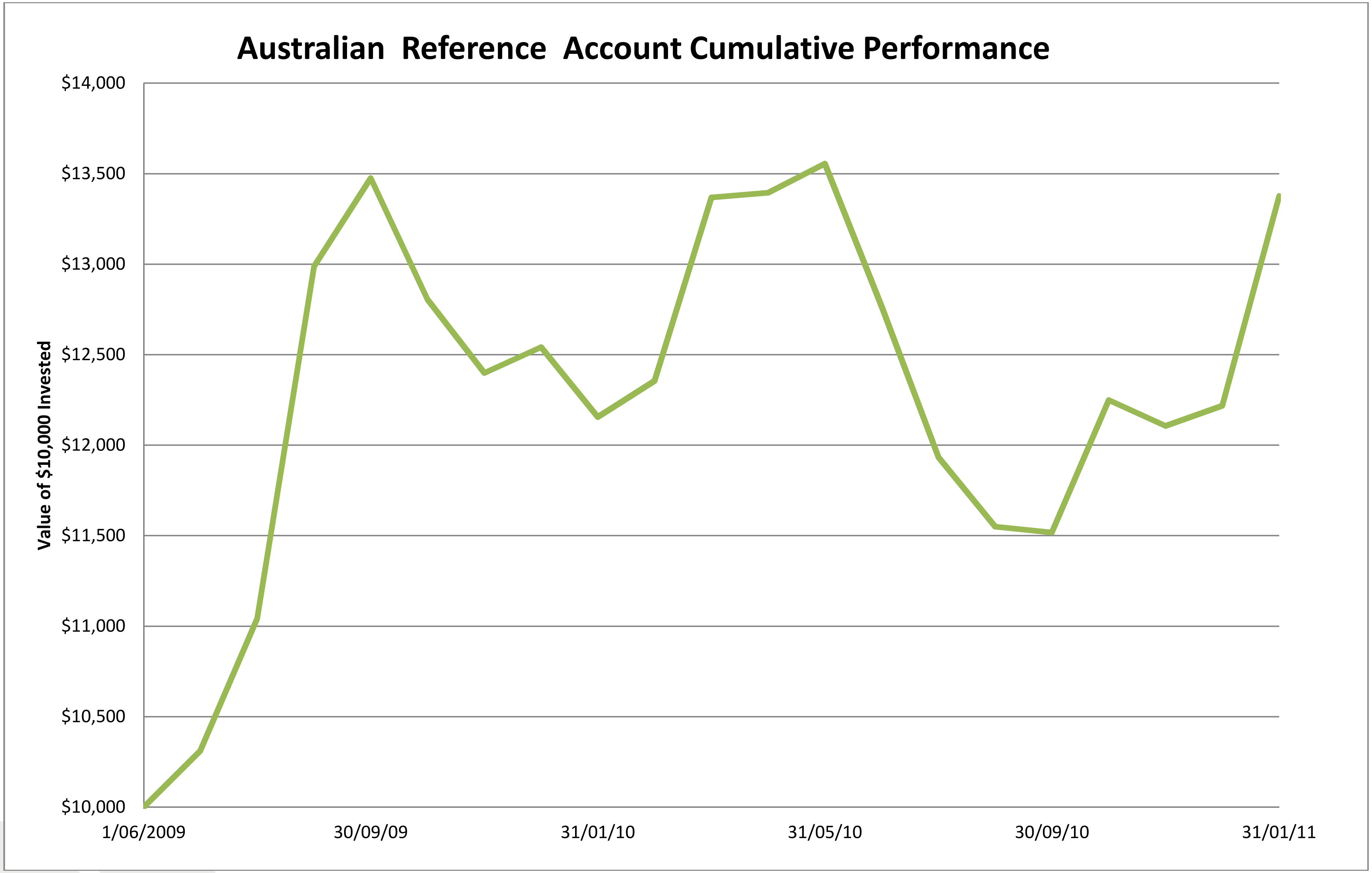
Australian Reference Account Cumulative Performance
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$14,000
$13,500
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1/06/2009
30/09/09
31/01/10
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