BronteCapital

4 April 2011

Client Letter for Month Ending 31 March 2011

First some housekeeping

This was an eventful month – probably the most eventful in the history of Bronte – and we are very pleased with how it went. We were actively involved in a large merger-arbitrage in Australia, we had put options over suspended stock in China and we found a few new positions (mostly fraud shorts) which should provide the basis for future returns. Our US and Australian reference accounts achieved a 2% and 0.6% gain respectively. These were about 2.2% above global equity markets and the Australian result was in the face of a 1.7% increase in the currency.

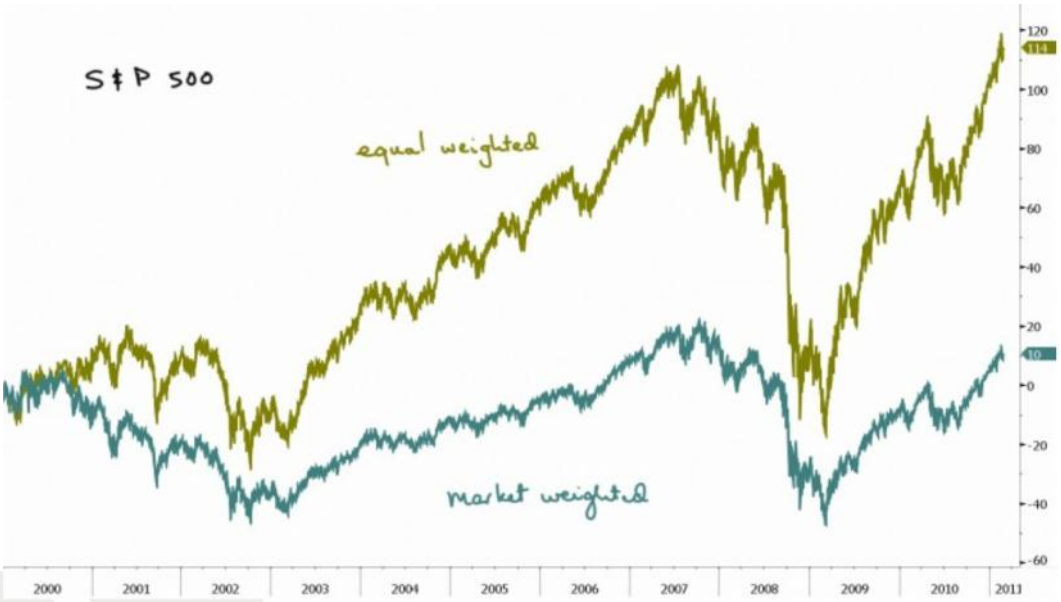
Finally we are getting some more clients. It's good to get good returns (and we have got them) but you need to get them on reasonable licks of money to have a sustainable business. We are getting there – but any introductions our clients might make would be appreciated.

Our eventful month gave us some housekeeping issues (all stated below and alas more technical than we would like). First however we will deal with the aggregate position of the fund.

Funds management issues: the aggregate position of the fund

Our view-of-the-world has not changed since last month. We think small caps are expensive and riddled with fraud. We think large caps are cheap enough without being breathtakingly cheap.

Courtesy of Tom Brakke we have a graph of the index weighted by market capitalisation versus the index equally weighted.



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The market weighted index is approximately flat for a decade. The equally weighted index (which gives bigger weight to small caps) has been a fabulous investment. Presumably being a large cap investor has been a way to lose money.

We are essentially positioned for the end of that trend. We are short well selected small-cap shares and long diversified large-cap companies. When we look at individual stocks this looks sensible. However the world is full of genius small-cap equity managers who don't see it our way. Genius in this context is a rising market.

Our only new position on this is a stake in the large-cap equity managers (as discussed last month). We think these businesses will be better-than-fine from here after having been beaten up for a decade.

Housekeeping issues: stated returns versus actual returns

Our interesting month provided a few housekeeping issues – the most important being the caveat in our results.

Our results are adequate: we beat global indices by about 2.2 percent. The difference between returns on the Australian and US funds was primarily the Australian dollar which continued its appreciation (thus reducing our returns when measured in AUD).

Whilst these results are adequate they are incorrectly stated. We have a problem in valuing your assets. This is a high-quality problem: your returns are better than stated. (Our current guess is that properly accounted we will show returns about 4 percent higher than stated above. Specifically, we have multiple short positions on Chinese companies that we believe are frauds. We were betting that the shares would go down.

Several of these shares have been suspended from trading after failing to make their annual filings. Auditors have said things that are supportive of our thesis: for example they have stated they feel they can no longer rely on the representation of management. In some cases auditors have resigned or been sacked. When these stocks next trade we expect them to trade far below their last traded level – but we value the stocks based on the last traded level. We thus expect to show a profit when the stocks relist. That profit was really “earned” in March but will be shown in a later month.

The pooled fund (Callisto) has a different problem in that we have new clients coming into the fund and we need to provide a valuation for the purposes of an end-of-quarter unit price. We do not need to strike a price for a couple of weeks (and we hope the situation remedies itself in that time). However, failing a relisting we are seeking “shadow prices” for the securities from various stock brokers. Those shadow prices will be the basis for a directors' valuation if we are forced to use one.

Because we may be using a directors' valuation for Callisto but not for the separately managed accounts the returns will not match. They will be higher for Callisto this month and an equivalent amount lower in a later month when the stocks re-list.

Housekeeping issues: Change in our risk management guidelines

When we started Bronte we thought that we would take advantage of our (small) size and buy shares almost exclusively in small companies that we thought were (a) undervalued, (b) within our field of expertise and (c) lacking people looking at them.

Small caps are inherently risky – they have undiversified businesses and often considerable operating leverage. We set a guideline (not a formal limit – just a guideline) that we would only be 100% long (and we typically envisaged being 20-30% short).

As John has blogged about (and as we wrote about last month) we are finding it almost impossible to buy small-caps that we like. However large cap stocks are inexpensive. To a degree that is surprising (at least to us), our long portfolio now consists almost entirely of companies with super-strong balance sheets many with globally diversified businesses. *Our longs are just not that volatile and say 120% long them is less risky than 90% long lightly diversified small cap stocks.*

Moreover – our short portfolio has migrated further into a "short fraud" book than we originally envisaged. We held (and indeed continue to hold) the view that shorting frauds is one of the most dangerous things you can do on Wall Street. The reason is that a fraud with stated (but fake) earnings of $20 million per annum can (and indeed usually will) have stated (but fake) earnings of $100 million sometime in the future. Imagination is not bound by the same realities that face bona fide businesses. Hence, nor are stock prices. We originally thought we would only be able to find a few frauds – and our positions would be small.

As it is we have found over 50 companies we suspect to be fraudulent. Most are in China (and we have had to limit our position there) but plenty are outside China too. Because we can diversify our shorts we can have a larger aggregate short-fraud position. Of consequence we are much more short-fraud in aggregate than we originally imagined – and we are typically about 30 percent short fraud. In aggregate though, the fraud shorts are much more volatile than our (very safe) longs. In the jargon they have higher "beta".

We have found that if we are less than 100 percent long safe stocks and about 30 percent short frauds then our correlation with the market drops to an unacceptable level. We think big-caps are cheap and the market should rise – so that wasn't a great global position.

So in general we have found our desired positioning and prudent risk management winds up with a portfolio closer to 120% long and 30% short (and that is before any arbitrage positions). It wasn't our intention – and we are not sure we will have the same positioning in five years. But that is how it is now.

Finally on this – we have been buying the shares of funds management companies. They are highly levered to the market. (Our position is only 8 percent – but if the position were to increase we would have to shrink our aggregate long position accordingly.)

We should note that we currently show about 115% long and 50% short. Adjusting for the unrecognised gains described above you can take 4-5 percent off the gross short position and add 4-5 percent to the capital. So adjusted we are about 110% long and about 44% short. The shorts include several reverse arbitrages (on which our loss is capped). Net of the reverse

arbitrages and adjusted for the unrealised profit, our short position is about 35 percent. We are a little more net-short than we would like – but it is well within limits.

Thanks again for the trust you have placed in us.

John
Simon

Portfolio Management

	Long%	Short%	Net Long%
USA Reference Account	113.3	49.9	63.4
Australian Reference Account	114.4	51.1	63.3

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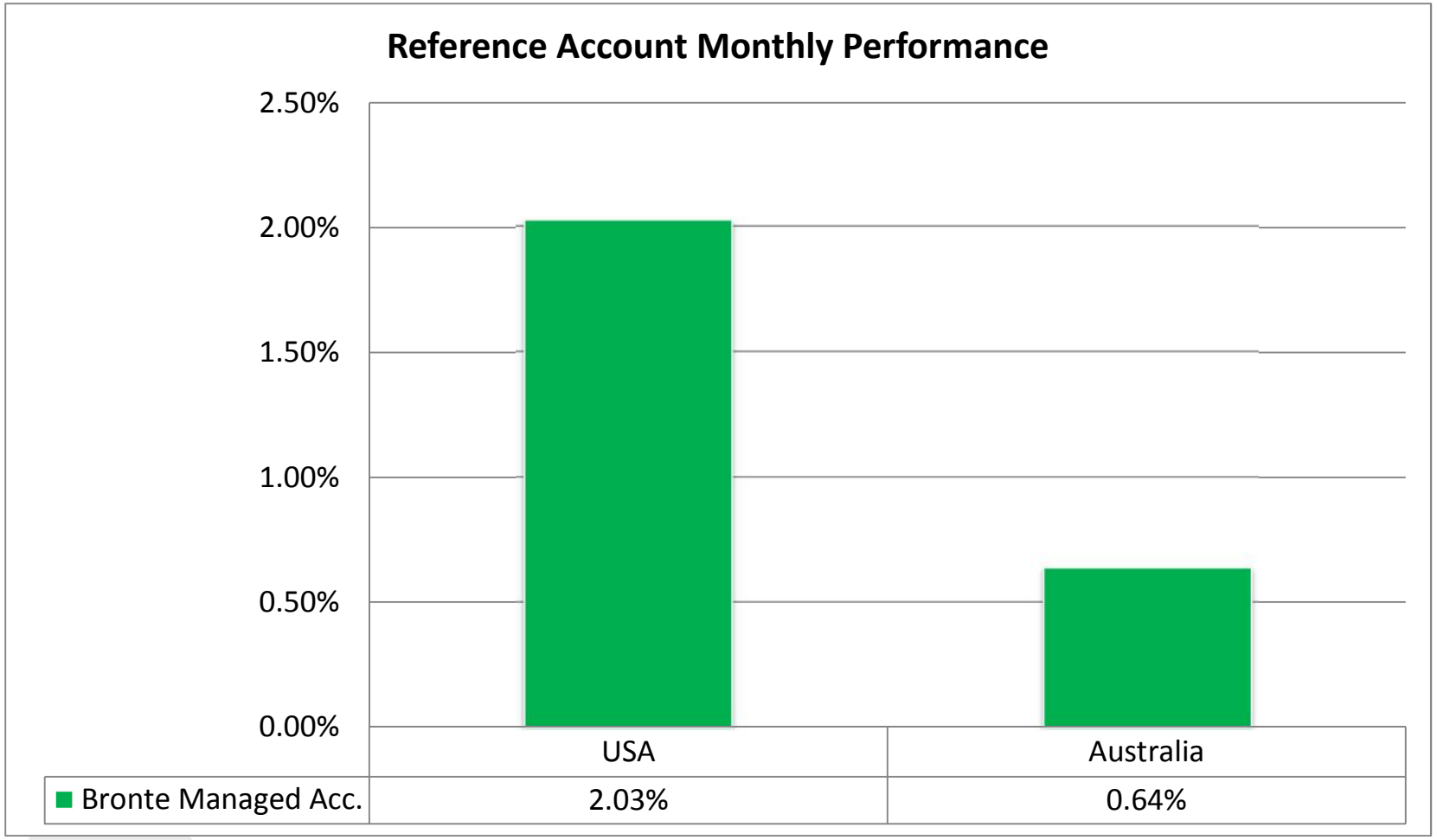
Performance Data [1]



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

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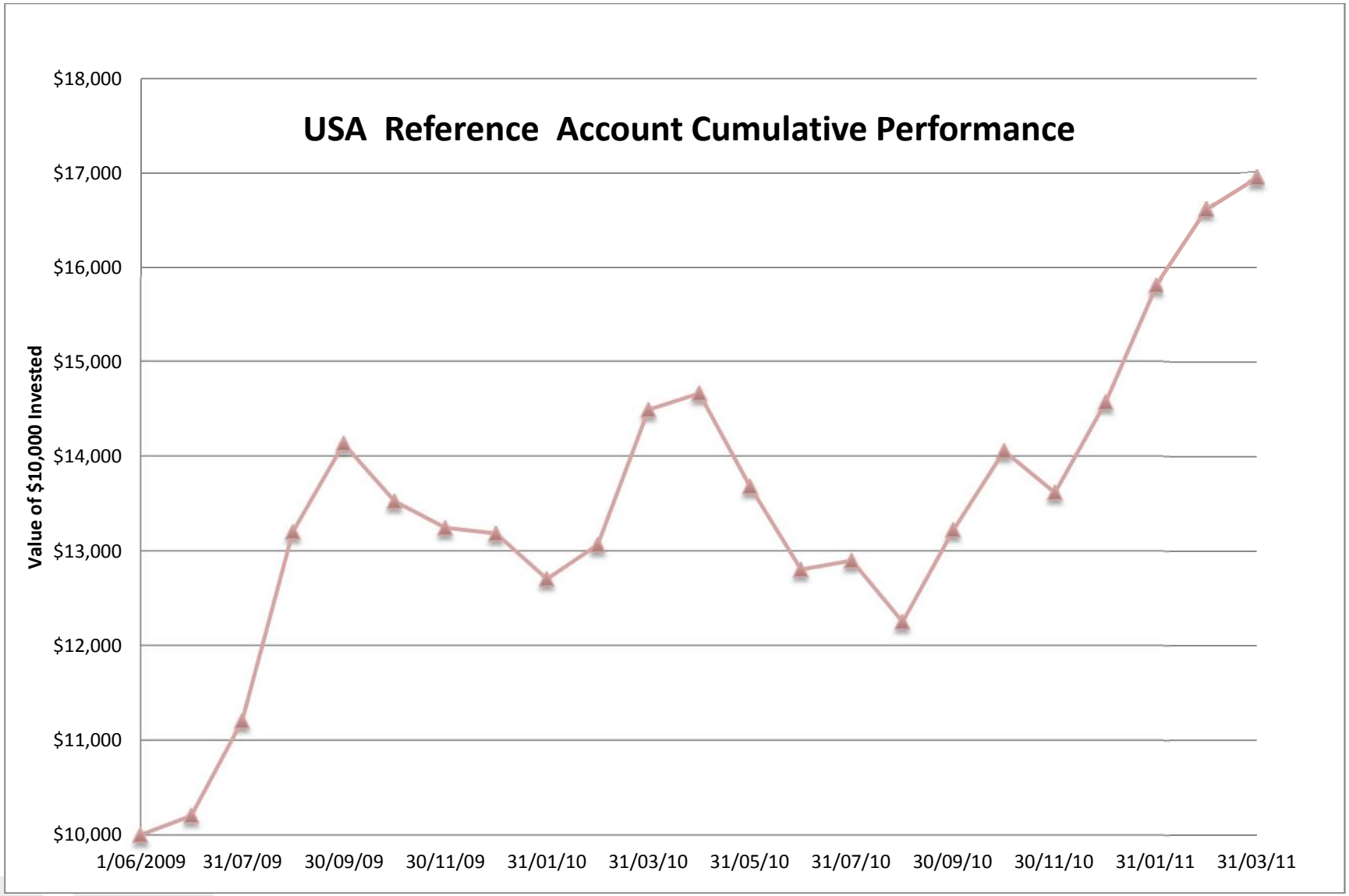
USA Reference Account Cumulative Performance
Value of $10,000 Invested
$18,000
$17,000
$16,000
$15,000
$14,000
$13,000
$12,000
$11,000
$10,000
1/06/2009
31/07/09
30/09/09
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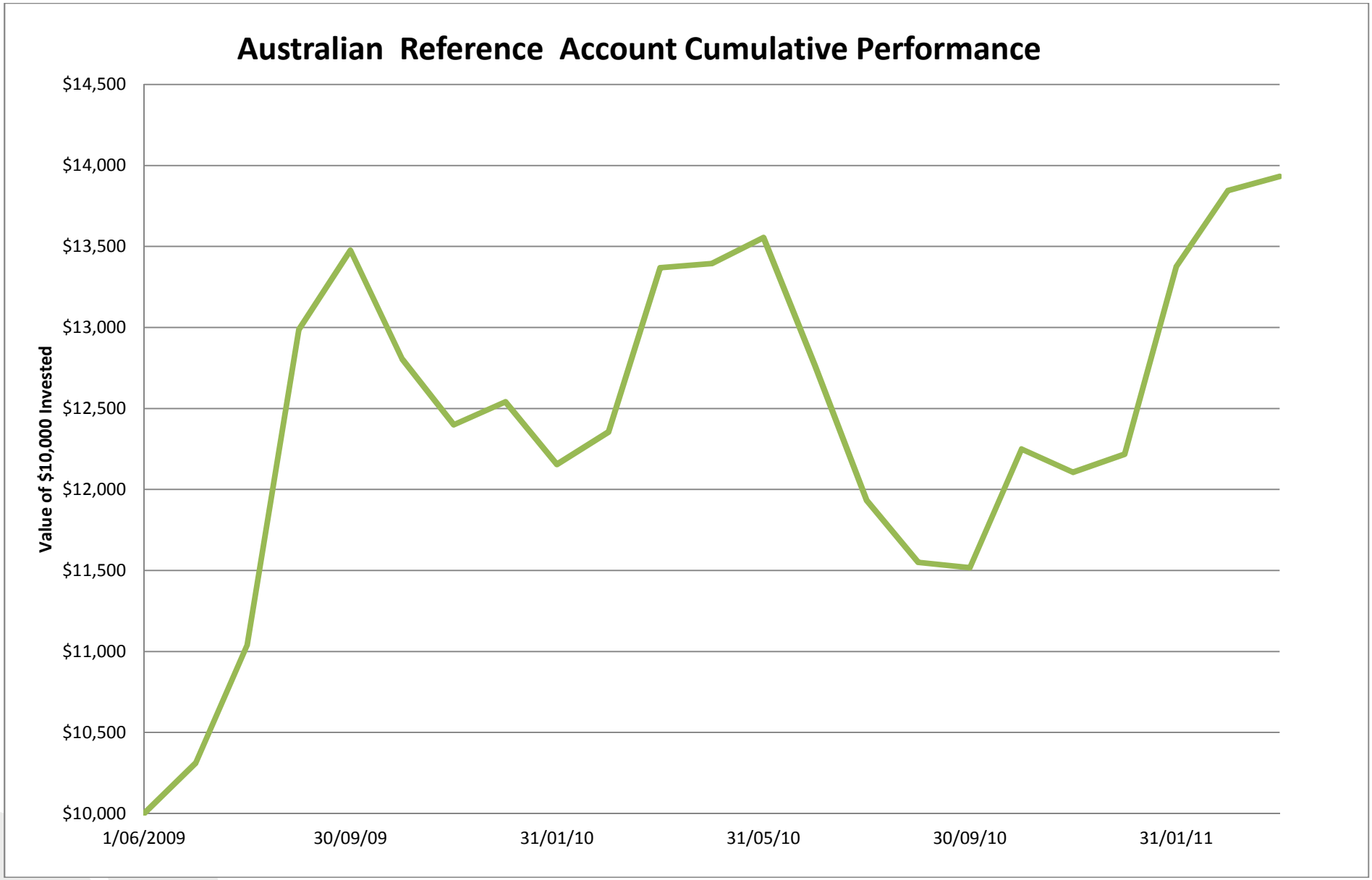
Australian Reference Account Cumulative Performance
Value of $10,000 Invested
$14,500
$14,000
$13,500
$13,000
$12,500
$12,000
$11,500
$11,000
$10,500
$10,000
1/06/2009
30/09/09
31/01/10
31/05/10
30/09/10
31/01/11