BronteCapital

3 June 2011

Client Letter for May 2011

In May our USA and Australian reference accounts increased in value by 22.2% and 25.6% respectively after providing for performance fees. The Australian return benefited from a modest fall in the Australian dollar. Both these returns are about 25 percent better than global equity returns, which were negative for the month. Our USA account is now up 65.3% for the year to date.

Our returns this month were abnormal. Just to remind our clients and ourselves what "normal" is here are our USA returns for 2010:

Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
-3.6%	2.8%	10.9%	1.2%	-6.7%	-6.4%	0.7%	-5.0%	7.9%	6.3%	-3.1%	7.0%

During the whole of 2010 we were up 9.5 percent – but we had some ugly months. It was not fun. We had a large client (then our largest) leave. He came in at the wrong time and we did not do well for him.

This month

Our returns this month were a one-off. We actively seek "lottery ticket" positions in which we can make small, educated bets with dramatically asymmetric risk-reward profiles. During our time running Bronte we have had a few such bets – e.g. buying Freddie Mac preferred securities at under 2c in the dollar or Maguire Preferred Securities at 8c in the dollar. Likewise we will reverse-arbitrage takeovers when we think there is a reasonable chance of the deal not closing.

So far we have done pretty well on our asymmetric risk-reward positions (but have had nasty but small losses on a couple of technology stocks and we have had some options which expired worthless). Those losses largely occurred in 2010.

The good monthly returns in 2009 and, thus far, in 2011 are driven by getting these bets right.

We have regularly said that our good months are not repeatable. After all you do not find winning lottery tickets on the street all the time, or even often. However opportunity does arise and when it does we will take another shot at a really good month.

During the month we had a few asymmetric bets that more or less worked – but one dominated.

The dominant bet was a single put-option position. Thorough research convinced us that Longtop Financial Technologies (NYSE:LFT) was a fraud. This was a highly reputable company with big name customers (the bulk of the Chinese financial sector) and with big name stock holders (led by some of the most famous hedge funds in the world). The company was IPOd by Goldman Sachs and many of the major investment banks had strong buys on it. There was not a single public doubter on Wall Street (though we have found some private doubters).

The lack of public questioning of Longtop allowed us to get a large exposure in the stock over the date at which its audited accounts were due whilst risking less than two percent of our funds under management.

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John did the research for this stock on a beach holiday in Koh Samet. Seldom has a week sitting in lounge chairs on a beach drinking *piña colada* worked so well. John thoroughly recommends it.

Note on our returns: Our prime broker is currently marking our short position in Longtop at $3.79 per share. This price is chosen by them as the midpoint of a shadow market. We have not traded at this price though we believe it is reasonable. Indeed word out of China is that Longtop is no longer paying salaries and – now that the flow of fraudulently obtained money has been turned off – it is likely the business will fold. We think the stock is ultimately going to go to zero.

Reaction to the collapse of Longtop

The collapse of this company was a decent sized financial news story. The New York Times gave Bronte some credit. Here is an edited version:

The Audacity of Chinese Frauds
By FLOYD NORRIS

To pull off a fraud that humiliates the cream of the global financial elite, you need to have some friends. And where better to have them than at the local bank?

The fraud at Longtop Financial Technologies, a Chinese financial software company, was exposed this week in an amazing letter from its auditors, Deloitte Touche Tohmatsu. It appears to be a tale of corrupt bankers and their threats to auditors who had learned of the lies...

It appears Deloitte sought confirmations [of cash balances] from bank headquarters, rather than the local branches that had previously verified that Longtop's cash really was on deposit. And that set off panic at the software firm.

"Within hours" of beginning the new round of confirmations on May 17, the confirmation process was stopped, Deloitte stated in its letter of resignation, the result of "intervention by the company's officials including the chief operating officer, the confirmation process was stopped."

...

Deloitte may have decided to check the numbers again because it knew a growing group of bears on the stock had been challenging the Longtop story as too good to be true, questioning both its financial statements and the claims it made for its software. A month earlier, Deloitte resigned as the auditor of another Chinese company, China MediaExpress, in part because of questions about bank confirmations.

It is never good for an auditor to have certified a fraud, but Deloitte seems to have acted properly. It got bank confirmations, and it got them directly from the banks rather than relying on the company to provide them, as PricewaterhouseCoopers had done when it failed to notice a huge fraud at Satyam, an Indian technology company.

But the confirmations were lies.

"This means the Chinese banks were in on the fraud, at least at branch level," ***says John Hempton, the chief investment officer of Bronte Capital, an Australian hedge fund. He was one of the bears who questioned Longtop's claims and now stands to profit from the stock's collapse.***

> *"This is no longer a story about Longtop, and it is not a story about Deloitte," he added. "Given the centrality of Chinese banks to the global economy, it's a story much bigger than Deloitte or Longtop." ...*

Bronte was an active participant in the exposure of this fraud. We did a good deed – we made the financial market a little cleaner. And our clients profited from it.

Even net of the Longtop gains our returns were adequate. This was – as we have noted – a good month.

Why you can't expect it to continue

Chinese frauds are the richest vein of non-market correlated profit Bronte has ever discovered. When we started, John could read the accounts of a reverse-takeover stock and within twenty minutes determine it was a fraud. Complex analysis was not necessary. We got short dozens of different companies and almost everything we touched we made money on.

China Media Express was the first time we actually had to spend a few days on a stock. In some cases we found fraud in under five minutes. We simply could not understand why anyone held these stocks – but alas major mutual fund groups and sometimes even sophisticated hedge funds held the stocks. We made good money on stocks we shorted after five minutes analysis (determining that there was fraud) and by the time the stocks collapsed 80 plus percent we had forgotten what it was that made us convinced it was fraudulent. We just had the stocks marked as frauds, shorted them and forgot about them.

We lost money shorting China frauds in the latter half of 2010. But we knew what we were doing and the hard times we had in 2010 set us up for a very nice first five months of 2011.

Alas the major frauds taking five minutes to detect are gone. Almost all of those stocks have collapsed. There are one or two small positions remaining – but the gig is up.

There are still plenty of frauds in China – however it is no longer like fishing with dynamite. Precise analysis is required to pick the right stocks to short. Longtop took an intense week of work. The ones we are doing now will require two weeks. We will do the analysis – and many of the weeks will be wasted because we will work and not be able to prove fraud.

It is likely we will actually buy some of the companies we can't find fraud in. After all people are shorting without doing our level of analysis – and those people will buy back on similarly thin analysis. Some the stocks could be a wild ride both for the shorts and for the longs.

Nonetheless, it is the shorts that are our skill here. Alas as all the low-hanging fruit has been taken it is not realistic to expect us to duplicate the last five months even if we get the odd transaction very right.

We will try though.

Our stuff-up on Longtop

Longtop sounds like an outright success. It was not. We had a huge edge with this stock. We knew there was fraud. We knew how to prove it. We found the email contact for the relevant person at the auditor and told them what we knew and how we knew it. We figured the company could not pass audit – and we had a date of death. The volatility on the options was low.

And we risked less than 2 percent of your money.

There is a word for that: dumb.

We should have bet maybe 6 percent of your funds and been up more than 80 percent this month.

If we ever have an edge that big again (something we think unlikely) we will take a much larger swing at it. Of course that means you might one day have a 6 percent down month because we take a large asymmetric bet and it does not work.

We would not count that sort of monthly loss on a single asymmetrical bet as a high probability. We don't think Mr Market will give us an edge quite as large as our Longtop edge again and hence we don't think we will ever get to take that bet. We have our fingers crossed – but we are realistic too. Lightning does not often strike twice in one place.

Our pooled funds

We also run some pooled funds. Their returns this month were comfortably double-digit but they were substantially less than our separately managed accounts. That was because we had a large inflows on 1 April and that diluted the Longtop put-option position in the pooled accounts. We had to purchase many more options after 1 April (which we did) but we never quite undid the dilution.

Of course if the bet had not worked, our pooled funds would have had a lesser loss. We are going to be explaining that difference for a long time – so we thought we ought to put it in writing.

Remaining asymmetric bets

We have one major asymmetric bet remaining in our portfolio: we are betting that Bain's takeover of China Fire and Security Group (NASDAQ:CFSG) does not close. We are betting about one percent of your funds and we should have a mid to high single-digit win if we are right. That is a typical asymmetric bet for us.

We think the take-private of CFSG is really stupid and that, in all likelihood, Bain will complete the deal, lose a lot of money and that class action lawyers will pick over the corpse. Alas we still think the deal probably closes. Bain seem to have “deal-fever” and will complete despite considerable evidence that they would be better-off walking away.

Bain we think are suffering what Warren Buffett calls the “institutional imperative”. Institutional inertia (including inertia at Bronte) is a reason why stupid decisions can be made repeatedly.

We try to exploit other people's inertia and avoid our own – but it is a constant battle.

The rest of our portfolio

Given our large profits on the short side we have struggled to stay long enough. If we had a 5% position in a stock the 25 percent movement in our portfolio means that by month end it was a 4% position.

We have had to buy stocks continuously throughout the month – but we are substantially less long than at the beginning of the month.

Keeping long enough is a high-quality problem – but it is still a problem. We really do believe that you want to be long: we think large cap equities in particular are inexpensive.

The lower quality problem we have explained above. We think this vein of super-normal profits in shorting Chinese frauds is going to be – well - less super-normal.

So, now to knuckle down for some really hard work, finding the next one-off gain. There are no guarantees.

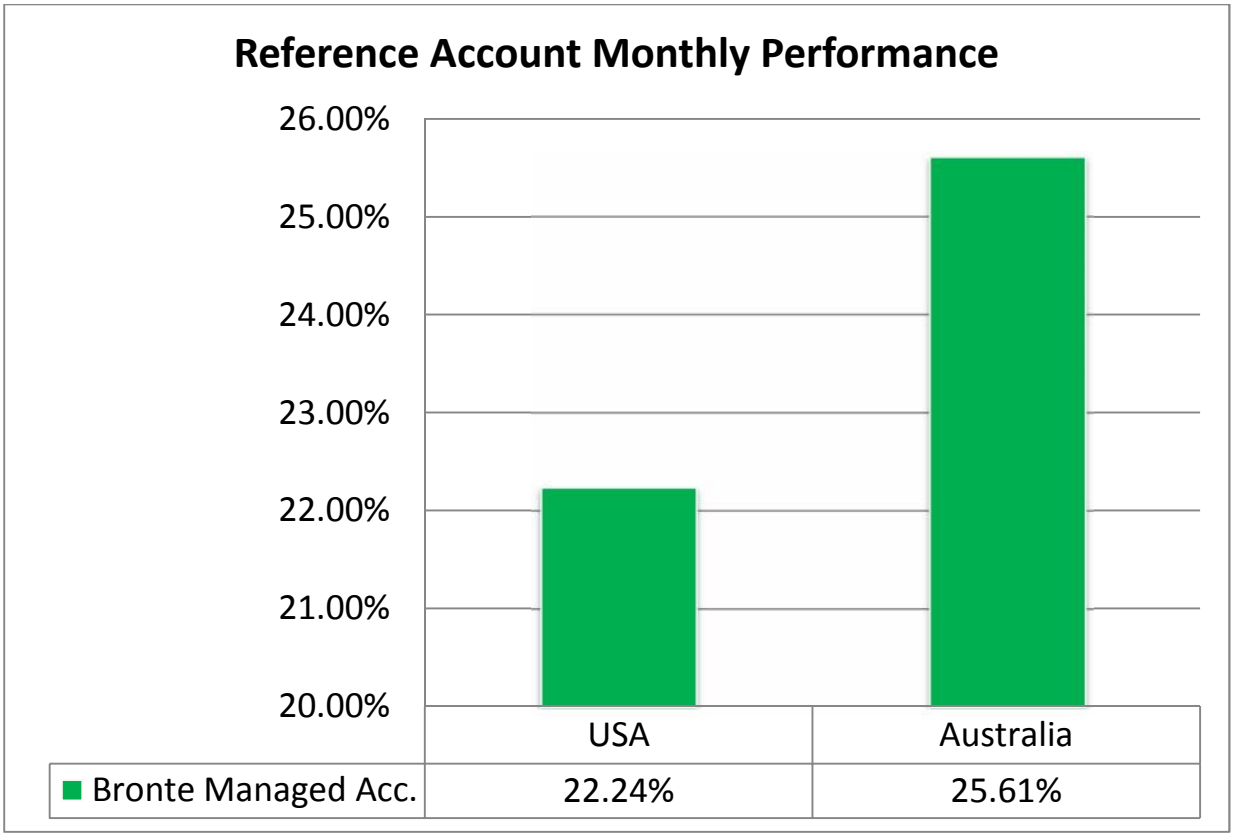
And the bulk of the portfolio will be run the way it normally is: long value large caps and short dozens of small positions in stocks we believe fraudulent. Alas the short-book keeps shrinking. And because the short-book keeps shrinking that is where we are focusing our time. We need new ideas. Thanks again for the trust you have placed in us.

John
Simon

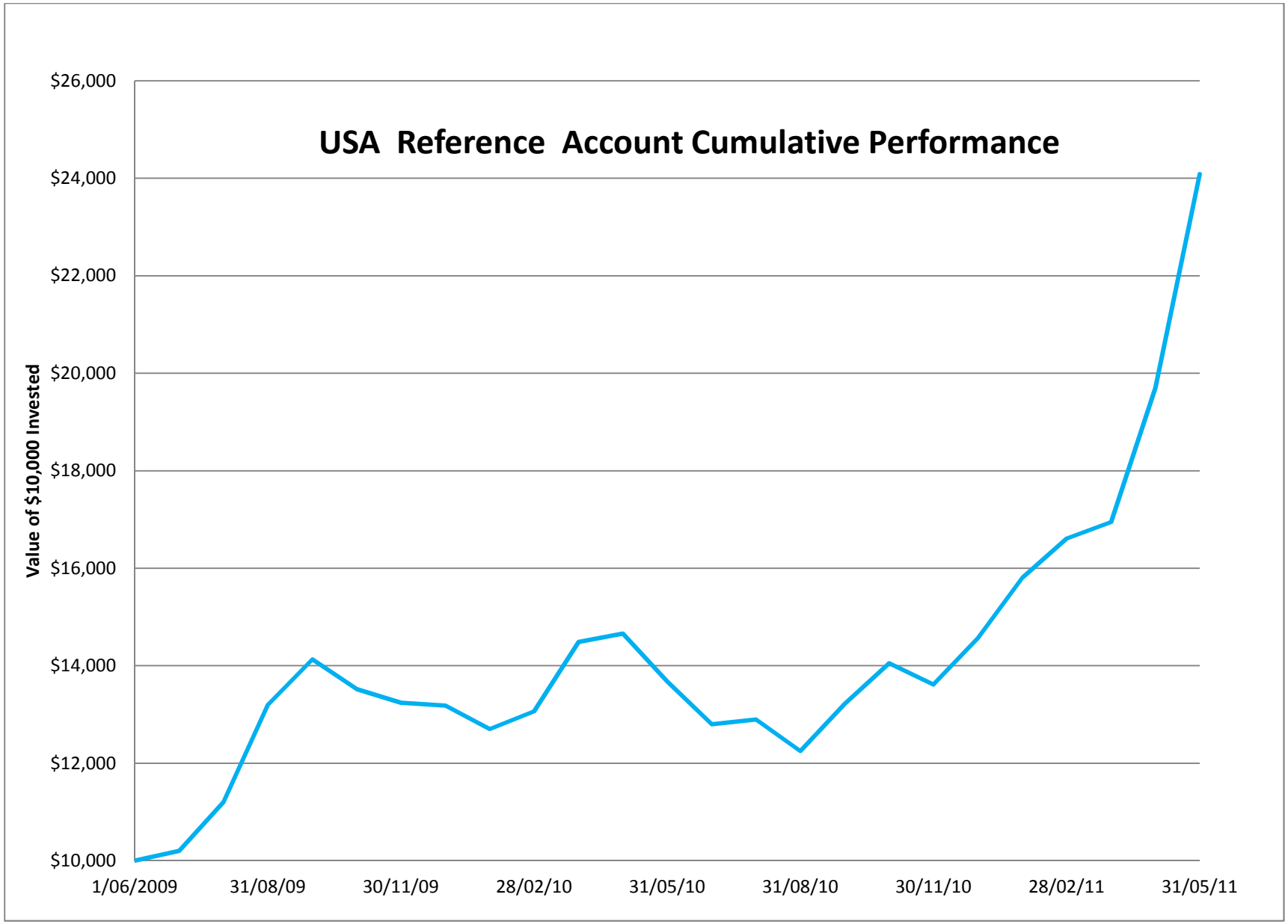
Portfolio Management

	Long%	Short%	Net Long%
USA Reference Account	108.1	40.0	68.2
Australian Reference Account	108.9	39.9	69.0

Performance Data [1]



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


USA Reference Account Cumulative Performance
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$22,000
$20,000
$18,000
$16,000
$14,000
$12,000
$10,000
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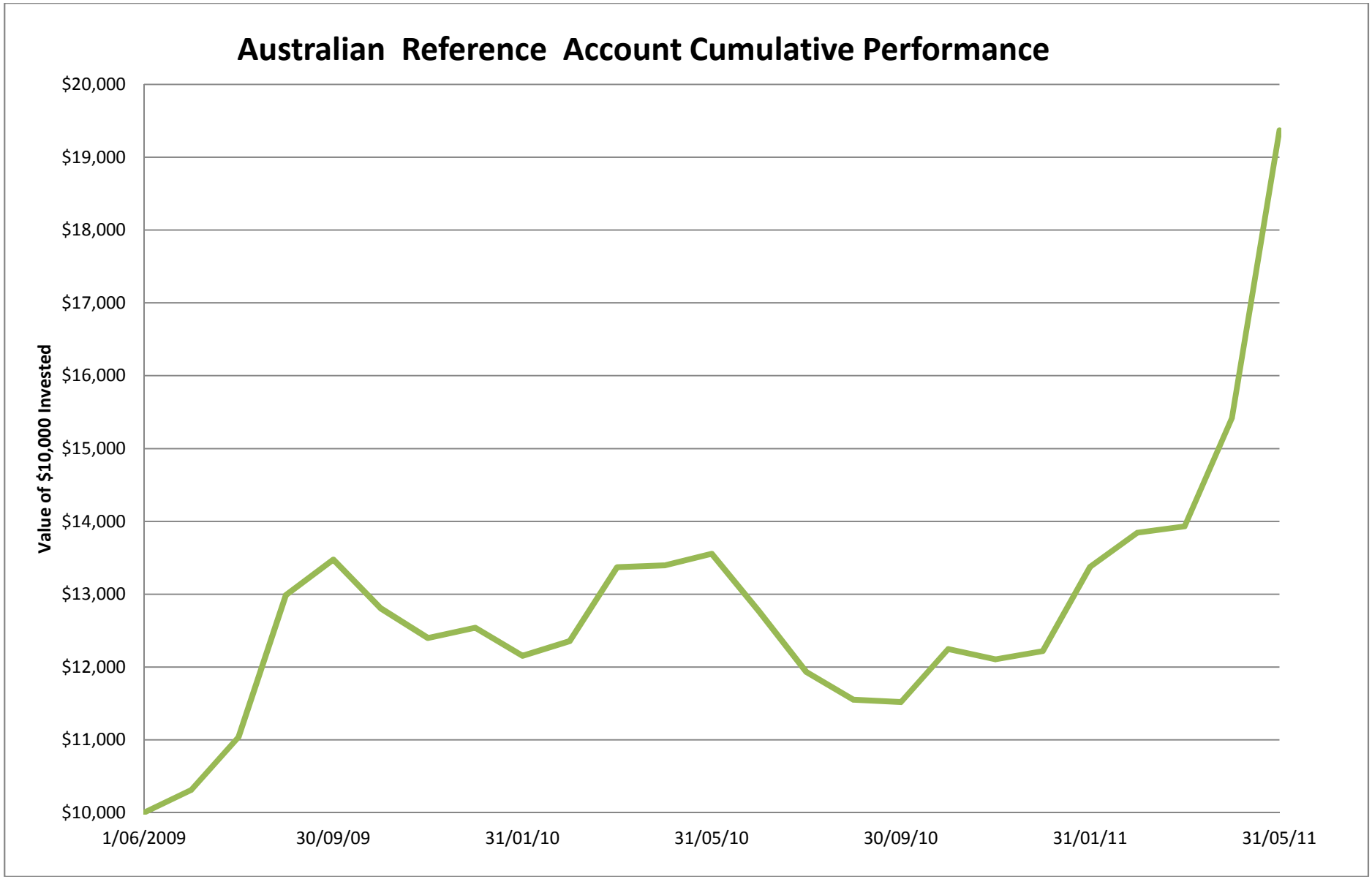
Australian Reference Account Cumulative Performance
Value of $10,000 Invested
$20,000
$19,000
$18,000
$17,000
$16,000
$15,000
$14,000
$13,000
$12,000
$11,000
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31/05/11