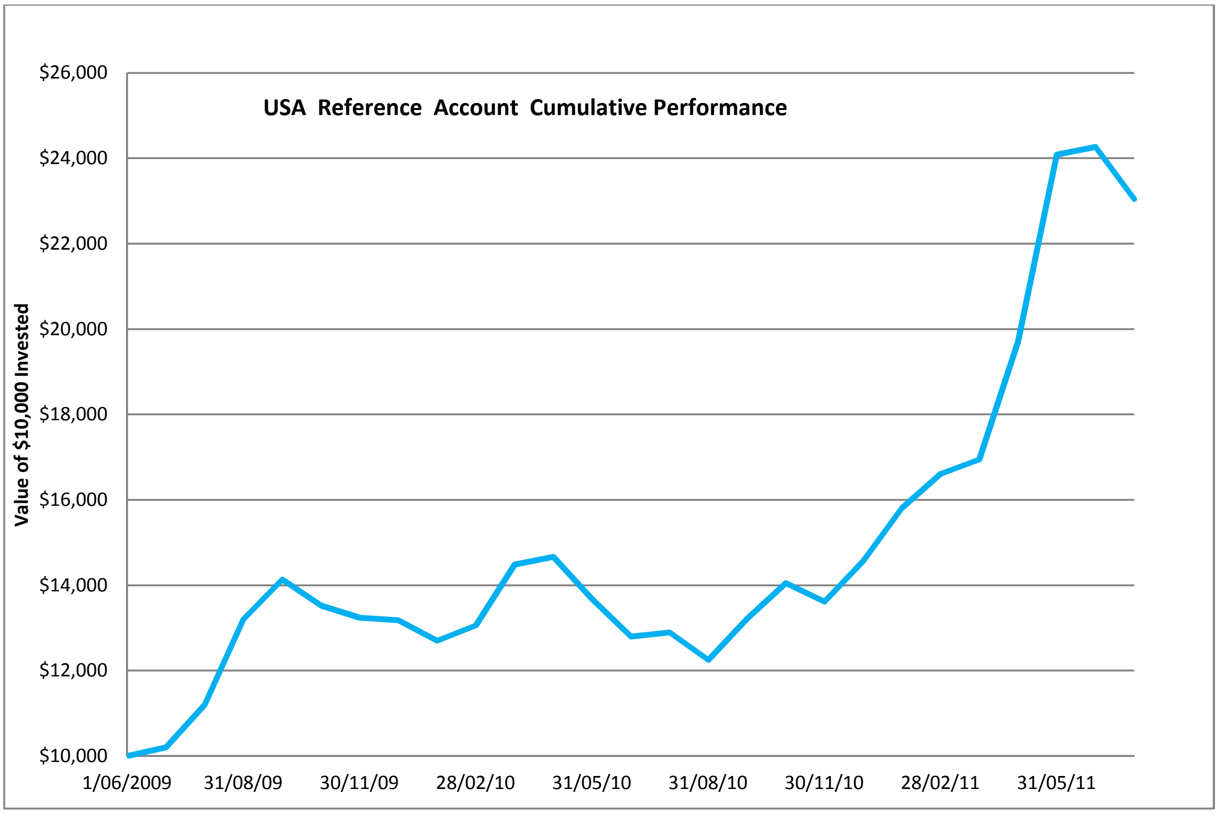
4 August 2011

Client Letter for July 2011

We are going to start this letter with our USA cumulative performance chart.



See that last month. It roughly describes how we feel. It is the letdown at the end of a really amazing party.

There is some consolation: we stopped drinking a few weeks before the party ended covering a lot of our risks especially in now-popular Chinese fraud shorts. The chart tells you we did not cut enough (but hindsight is 20-20). We told you that last month's flat results were a triumph of risk management (and some considerable luck). This month's results are less attractive – but fundamentally not threatening.

This month has started better – not that we are minting money - but we will get to that.

Background to our last six week's performance

We are a long fund with an active (mostly fraud) shorting business on the side. The benchmark position is roughly 100 percent long and 30 percent short – with the longs being relatively large positions in well chosen value stocks and the shorts being numerous tiny positions in a rag-tag collection of companies run and promoted by scumbags and villains.

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We vary from that benchmark position in lots of ways. We are not averse to small, speculative long positions (we for instance have purchased defaulted debt at below 10c in the dollar – positions we thought were OK but where many people would think them worthless). We also sometimes short real businesses in decline (e.g. we once shorted Nokia).

Also we will take large short positions where we can limit losses – either by using put options or by shorting debt.

We don't really know a good benchmark for the portfolio. For a while we used the MSCI global (which does reflect our longs) but of late the shorts (especially the larger positions described above) have driven our aggregate results. Whatever – we have soundly trounced that index and almost any other you might compare us to.

The stated goal we have is to (a) roughly keep up with rising equity markets, (b) sharply outperform falling markets – even though we will accept negative results - and (c) ensure that we avoid fat tail risks at all times.

Whilst our longer results are great, for six straight weeks (two weeks in June and four in July) we fell short of these goals. We have under-performed as some of our higher conviction shorts bounced. In one case a stock we were short more than tripled. The aggregate performance in June (a small gain) and in July (down 5 percent for our USA accounts) understates the pain. (We were down about 10 percent from top to bottom. And that result owes itself largely to the longs doing fairly well and persistent and painful risk cutting on the short book.)

In most cases the losses were of the form of returned gains rather than losses on new positions. We went through similar in 2010 and we explained then the losses were not existentially threatening even though unpleasant. The same applies now.

Quality of losses

We have always felt that not all quotation losses are created equal. In 2010 we had situations where our favorite (ultimately very safe) stocks were declining and our shorts were evaporating profitably. This meant we had a ready source of cash we were investing in longs at lower prices whilst we rotated our shorts.

Aggregate results were slightly negative but we were fairly happy because we owned more and more of our favorite longs at lower prices. The portfolio was spring-loaded for a bounce in our longs. These were high quality losses because they set the stage for profits.

This month unfortunately the losses are smaller than in 2010 (much smaller) but alas their quality is lower – there is no “spring loading” in the results. Sorry.

In small consolation this month so far has produced very high quality sideways results.

One lottery ticket position

Last month we described a single lottery-ticket position (put options over a listed company) which we thought had the chance of paying 40 to one and which was a reasonable bet. We debated as to how much of the portfolio to risk on this (John thinking 6 percent, Simon, usually more conservative, thinking lower).

As it turned out the price of the position moved as we were putting it on. We put about 3 percent out (now worth about 5% of the portfolio) and our maximum win is under 40 percent of the portfolio. We still think it is a worthwhile bet but we have no desire to chase it.

We still want to be coy as to the name because we might wish to buy more puts.

Our longs

Our shorts were horrible to us in July. Our longs were much better. Of particularly note was Google – a company which we have been buying with our short profits all year. We purchased quite a lot of Google (several percentage points) below $500. The company had good results largely for reasons we predicted and is trading above $600 now. Our fine gains on Google were a direct result of the spring-loading we described above. Our original purchase price on Google was above $600 – but hey – we spent the first five months of this year generating lots of cash and Google kept trading lower and lower...

The rest of our longs (except the banks and News Corp) did OK – but to be fair about it – there is less spring-loading currently embedded in the portfolio – and mostly portfolio management is about being back for the grind...

Forward

We are not averse to small negative carry positions – and we have a few on at the moment. Unless we get a few things right then we will continue to have non-descript performance. When (if?) we get a few things right we might produce good months. We have one position (described above) which could potentially produce a blindingly good period. We are hoping – and working - on getting things right.

We are fairly happy with the portfolio at the moment but to be frank we are not as happy as we were at the beginning of the year. 2010 was brutal – a year of hard work to get 9% annual returns (negative returns in Australian dollars) but it left us with a portfolio we saw as full of opportunities.

You make big money in financial markets when you are right and the consensus is wrong. The consensus is usually right so betting on the consensus makes money most of the time (and loses it in spades when everyone is wrong and rushes for the exits at the same time). But we love it when we think it's us "us-against-the-world".

Alas at the moment we have fewer "out-there" positions – and when we talk we sound more conventional. That bodes for lower returns in the future.

Still we know where we need to devote our research.

Portfolio Leverage

The aggregate length of the portfolio (sum of longs and shorts) has increased to 176.6% for our USA accounts. Our net length is 64.2%. Our Australian accounts are very similar.

This is somewhat misleading. Over 20 percent of the portfolio is in limited-loss positions – most commonly being short takeovers. We expect to lose on most of these positions – but we like the risk-reward ratio.

One example on which we are making a small profit is that we are “reversing” the takeover of Blackboard Inc (Nasdaq:BBBB). This is a company we could not get comfortable with from a long perspective – nothing seriously untoward but we did not much like the management and we did not entirely understand the accounts. We were hardly going to go long the stock – and we did not know enough about it to go short the stock. It was in the “too-hard basket”. (Most things are in the “too hard” basket.)

The company put itself up for sale – something which sometimes yields windfall profits to short-term holders and sometimes is the last refuge of rat-bag stock promoters before it all falls apart. Sometimes the rat-bag stock promoter actually finds a buyer (think Mattel buying The Learning Company).

When the company put itself up for sale the arbs jumped in. After all, a buyer usually means a premium and there are plenty of buyers these days (given just how desperate private equity funds are to find assets). We did not play.

The buyer eventually turned up – Providence Equity Partners – a reputable private equity shop. This was done at a small premium and it is likely no further buyers would turn up because there has already been a competitive bidding process.

Now we had reason to go short. The stock was trading above $44 and the bid price was $45. We shorted the stock (it’s a slightly larger than 2% position). If we are wrong we will lose the spread between $44 and $45 – just over 2% of the position - and the stock-borrow costs as well – taking total losses to near 6 basis points of the fund. If however the deal falls apart (because something is found) we could make $20 per share. The risk-reward ratio is right. We would make the position bigger (potentially much bigger) but there is also a small risk of an over-bid.

It’s likely nothing will be found on due diligence and the deal will close. Even if the company is scummy (something we are far from knowing) the deal will likely close because private equity shops tend to close most deals. They get deal fever. Thus it is likely we are going to lose money. We won't lose much money but it is likely we will lose it.

But BBBB made us uncomfortable – nothing more. This takeover has given us a way of expressing our discomfort at minimal risk and with a nice risk-reward ratio.

Over 20% of the portfolio has limited risk – but in most cases the loss-if-we-are-wrong is finite, but larger than the Blackboard example.

We like those positions but we also want to be long the market – so we got longer on lower-risk stocks (big caps like Target and Tesco) in part to offset the negative-beta we get from the shorts – and in part because we like the positions anyway.

Regulatory

Finally we are coming up against regulatory difficulties. For instance we cannot invest in Hong Kong listed warrants for US equity holders. We hoped to invest heavily in Hong Kong warrants as protection against shorts on Hong Kong stocks (manufacturing synthetic puts). These would be capped loss positions – but we can't take them because US regulators seem overly concerned to protect you – dear clients – against capped losses.

Here is a short explanation... read it and you will understand the insanity we deal with on your behalf.

http://www.futuresindustry.org/fi-magazine-home.asp?a=960

Strangely we are allowed to short Hong Kong stocks on behalf of Americans (accepting uncapped losses) but we are not allowed to buy puts (accepting capped losses). This is truly Kafkaesque.

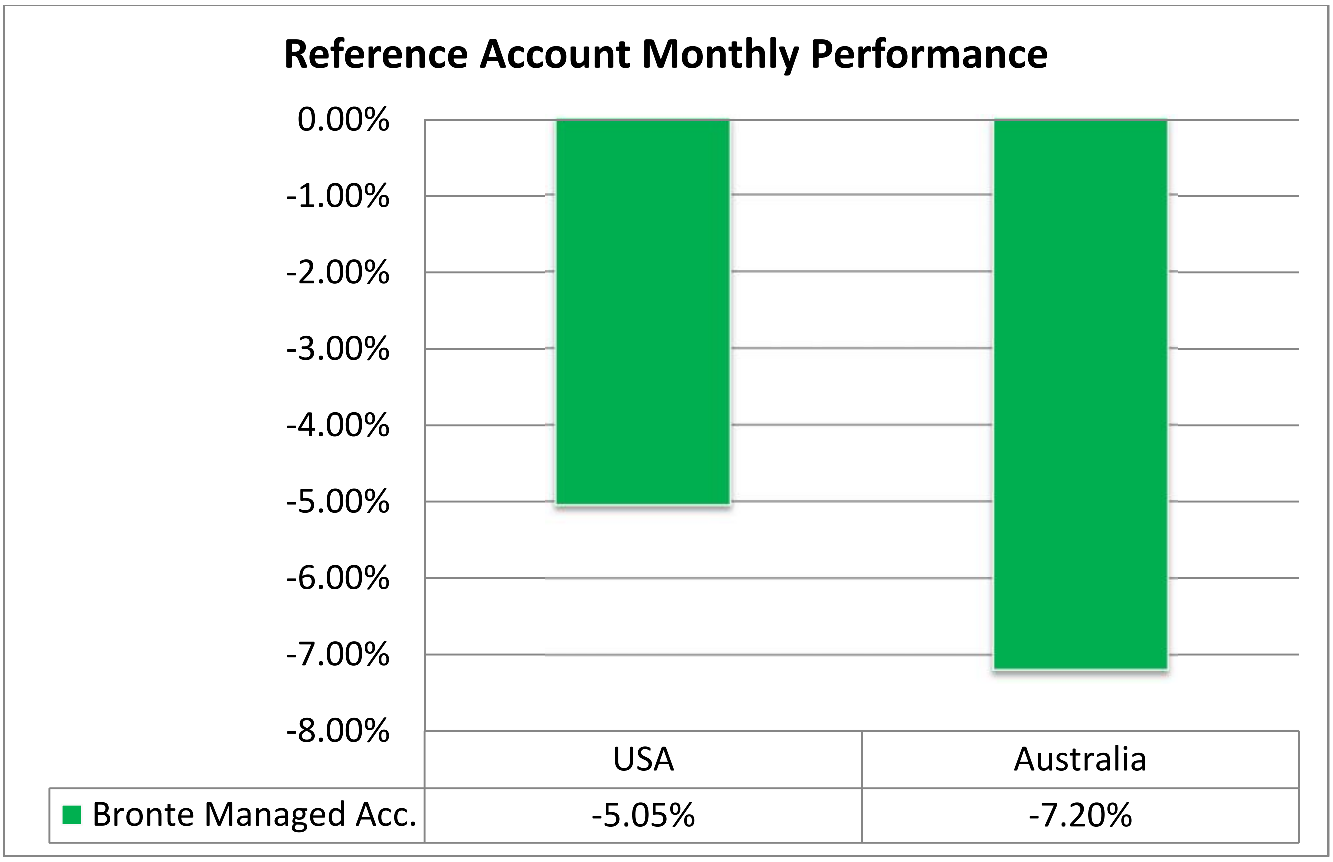
Thanks again

John
Simon

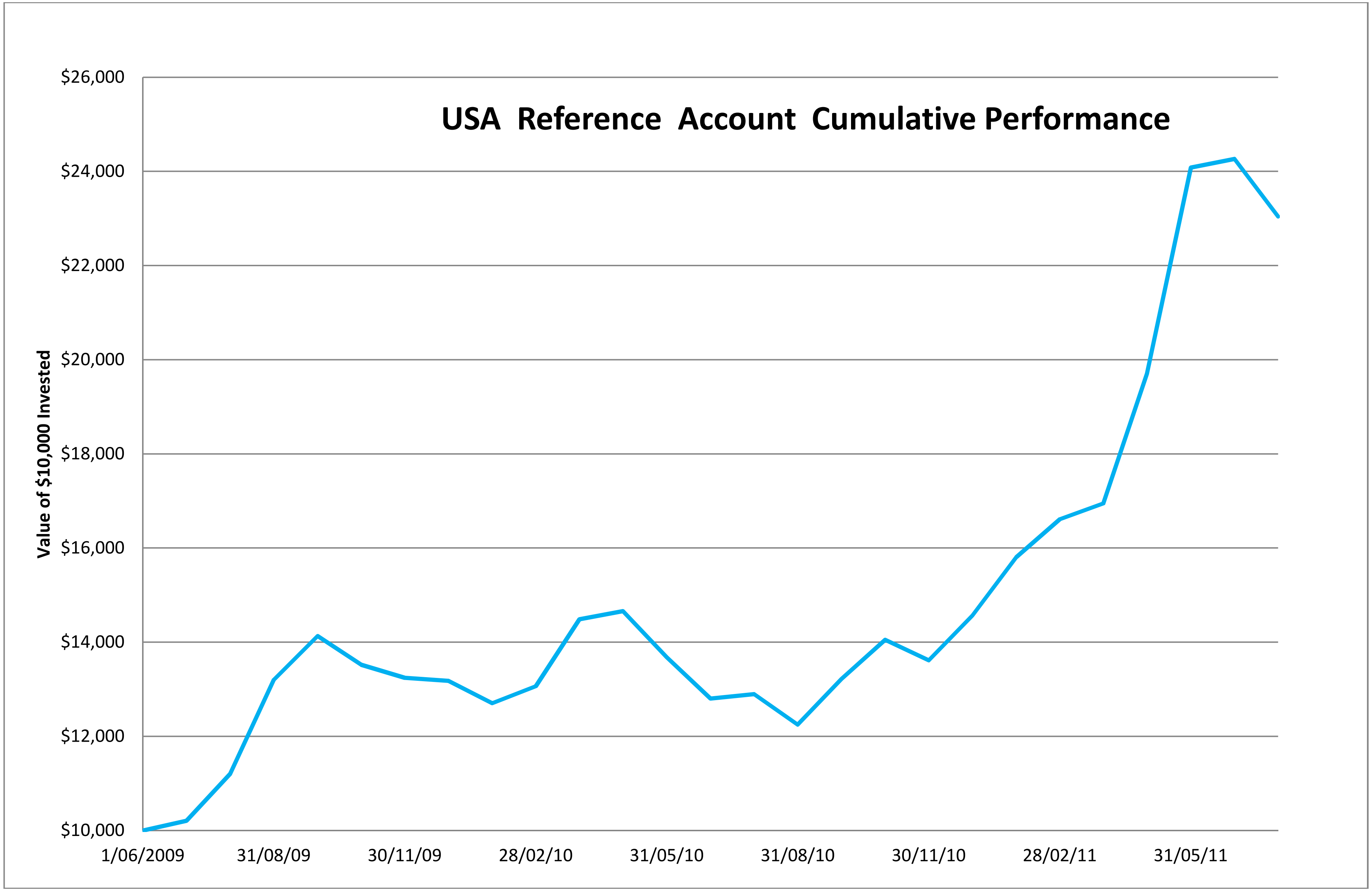
Portfolio Management

	Long%	Short%	Net Long%
USA Reference Account	120.4	56.2	64.2
Australian Reference Account	120.8	56.8	64.0

Performance Data [1]



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


USA Reference Account Cumulative Performance
Value of $10,000 Invested
$26,000
$24,000
$22,000
$20,000
$18,000
$16,000
$14,000
$12,000
$10,000
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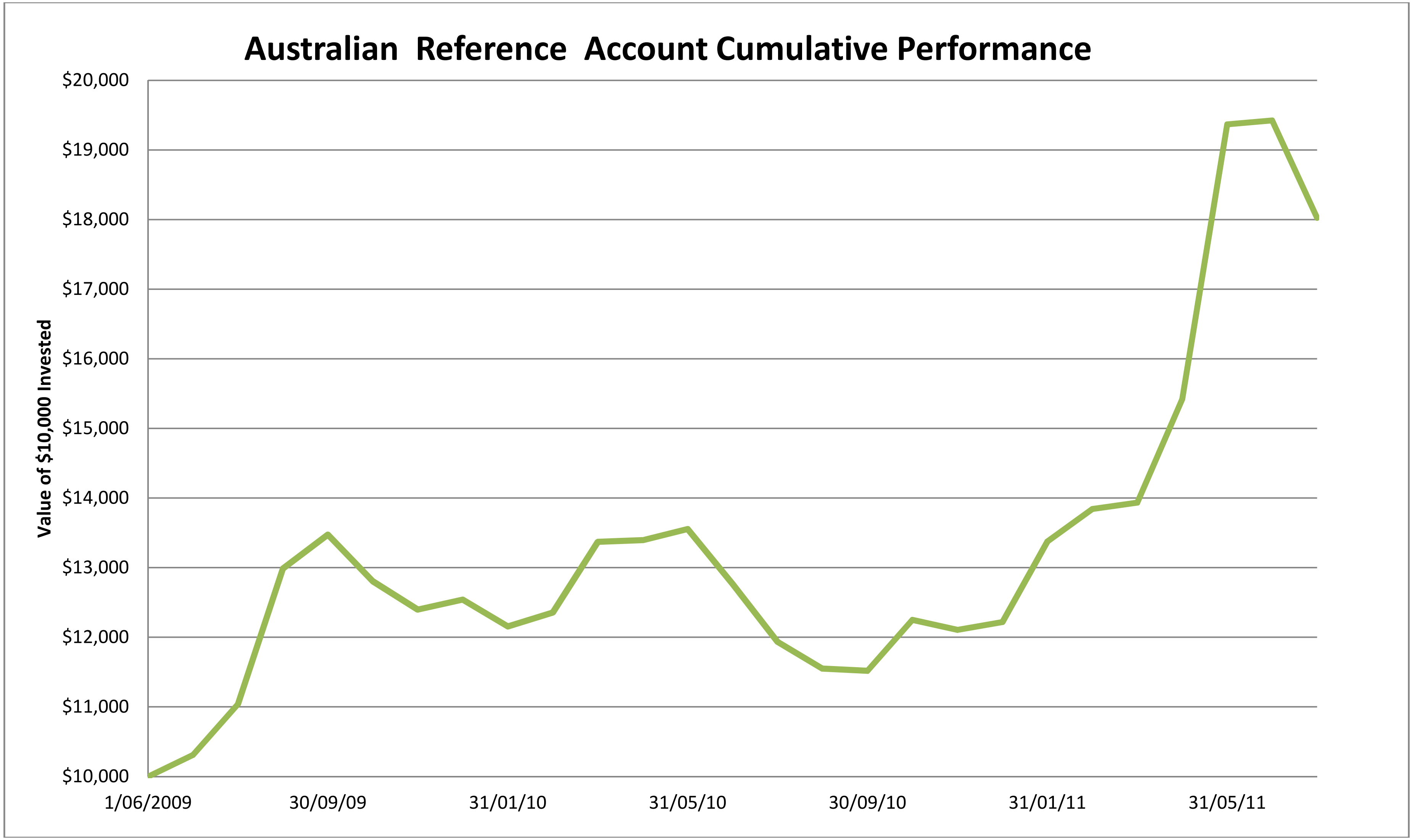
28/02/11
31/05/11


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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1/06/2009
30/09/09
31/01/10
31/05/10
30/09/10
31/01/11
31/05/11