3 September 2011

Client Letter for August 2011

Our performance was reasonable for the month. We are up in a down month, a long way ahead of index (by approximately 11%) and avoided the pitfalls that caused many hedge funds blistering losses.

We finished July overweight – we were about 120 long and in retrospect (and the retrospectascope is a harsh microscope) that was wrong. When the market swooned we would normally want to buy more but because we were too long we had to seriously limit our buying – and so our portfolio shifts in the early part of the month were smaller than we would like. The excessive position going into the month probably cost you a percent or two in performance and it cost us more stress than we should have had.

John wrote a blog post about the four toughest days of the month (FOUR DAYS AND ROUGHLY FLAT) and it described just how rough that period was. What alarmed us most is that during the period of most market stress our longs (generally safer blue-chip stocks) performed worse than our shorts – it was a period of generalized liquidation and people were liquidating the most liquid stocks. This proved we were taking slightly more risk than we thought. We have adjusted accordingly. We should repeat that we were never threatened (at most we were down about 5 percent) but it did make us think more clearly. Still, at Bronte we are a learning machine. We will make mistakes. We will try to keep them small (and they were small) and we will try not to repeat them.

Again our out-performance came at least in part from the short-side. We had a position in Sino Forest – a company mired in controversy since a short-seller (Carson Block) alleged they were fraudulent. Lots of prominent people disagreed with Carson but we did some thorough analysis and concluded he was correct. We also had a put position in Trina Solar that added a couple of percent to our performance.

We wince a little about our mistakes (and there have been a few) but we should probably celebrate our successes a little. We have developed a very good and still improving eye for fraud-shorts. These are very profitable.

The fraud-shorting business is complicated. We think that (by far) the hardest part of it is risk management. It is easy to identify frauds but it is very hard to work out what breaks them. We have often been short a fraud and had it double, even triple on its way to zero. We have a few still in the portfolio trading at over twice what we put the initial position on at.

We have lots of tricks to limiting losses (put options, shorting the debt rather than the equity , small position size) but these tricks often limit our gains too and we need to get better at working out when to press on a fraud (increasing our position as the stock goes down) and when to keep out of the way. After all, a company with fraudulent earnings can

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double those earnings with the stroke of a pen which makes short selling particularly dangerous. A real company can only double earnings by dint of hard work.

On fraud-shorts we are obsessive about risk management and it has worked well for us. The most common question we get asked about fraud-shorting is how come the regulators can't find these things? How is it that two guys sitting in Sydney can do this and regulators cannot? It comes down to many things – there is a range of regulator competence (just as there is a range of fund manager competence) and places with less competent regulators are a good place to look for shorts. But the main differences are things like the required standard of proof. A regulator needs very high evidential levels to suspend a stock and to charge executives with crime. We operate with a lower standard of proof. Three leads (often appearing quite circumstantial) are enough for us to be fairly sure we have a fraud. We tend to be right too and the evidence we have is sufficient to make money but would not stand up in a court of law. In other words our job is easier than the regulators. Notwithstanding that, we like under-resourced regulators and we find them in most jurisdictions. An improvement in regulatory standards would be good for the world but would decrease our profits.

To that end we suspect Mary Schapiro (at the US SEC) is better than her predecessor. For the world that is a good thing. For our portfolio – not so much.

Alas we think the amount of fraud out there is so high, and the standards required of regulators so demanding, that the job of head of a regulatory agency is nigh impossible. And that suits us – and so we celebrate our relatively good returns as we celebrate (unavoidable) regulatory failure.

White collar crime is a major drain on modern society – usually vastly under-estimated. We have seen many investments which were written off as "investment losses" that were in fact frauds. Indeed it is a recurring theme (and much to our personal embarrassment we have sometimes paid our dues too though generally we recognize what has happened). We at Bronte however benefit from this Mephistophelian world. Whilst we do not like criminals our (fairly detailed) understanding means their crime pays us – and that makes us happy.

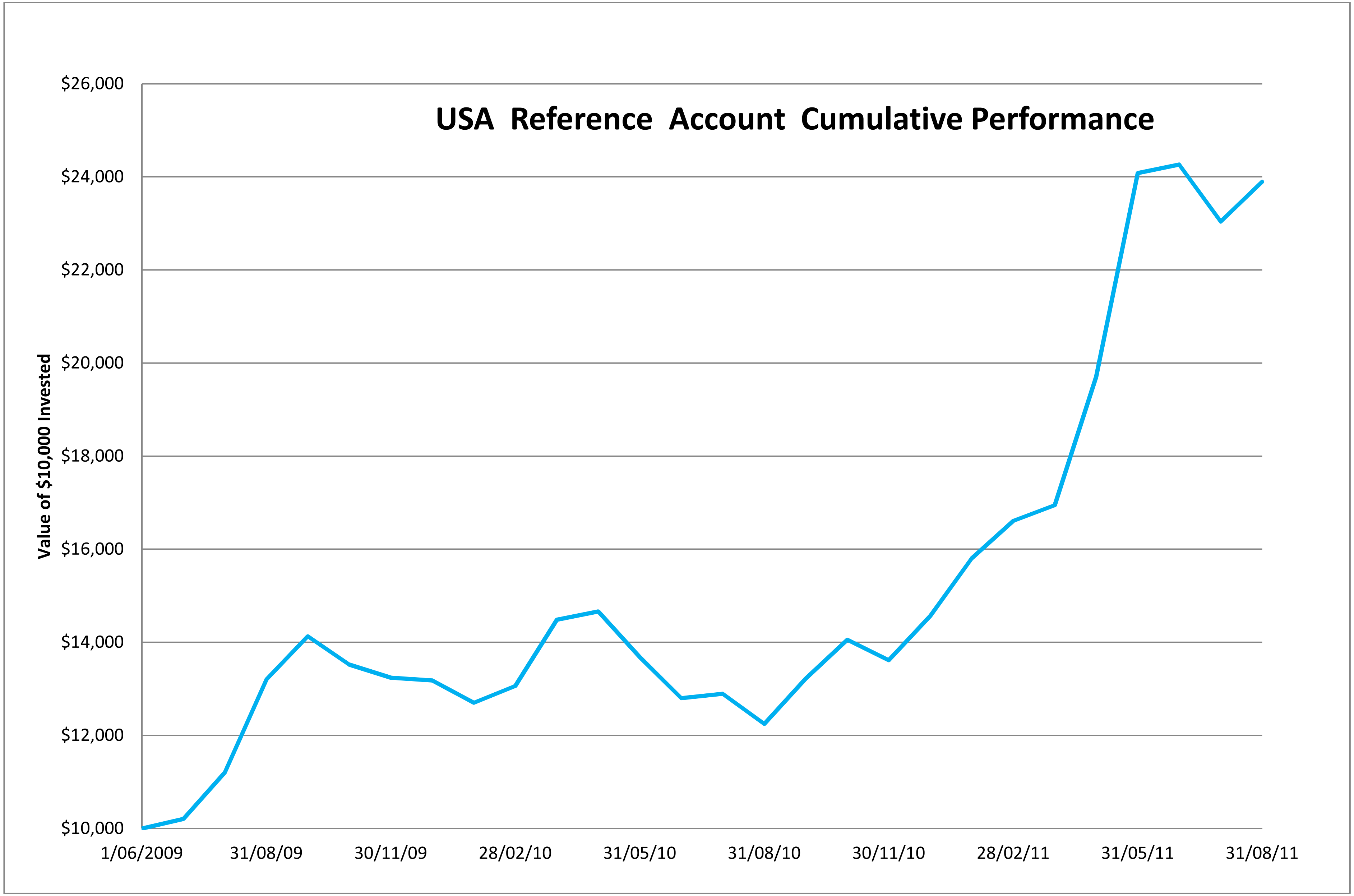
John and Simon

Portfolio Management

	Long%	Short%	Net Long%
USA Reference Account	113.90	47.44	66.46
Australian Reference Account	113.89	48.18	65.71

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
1/06/2009
31/08/09
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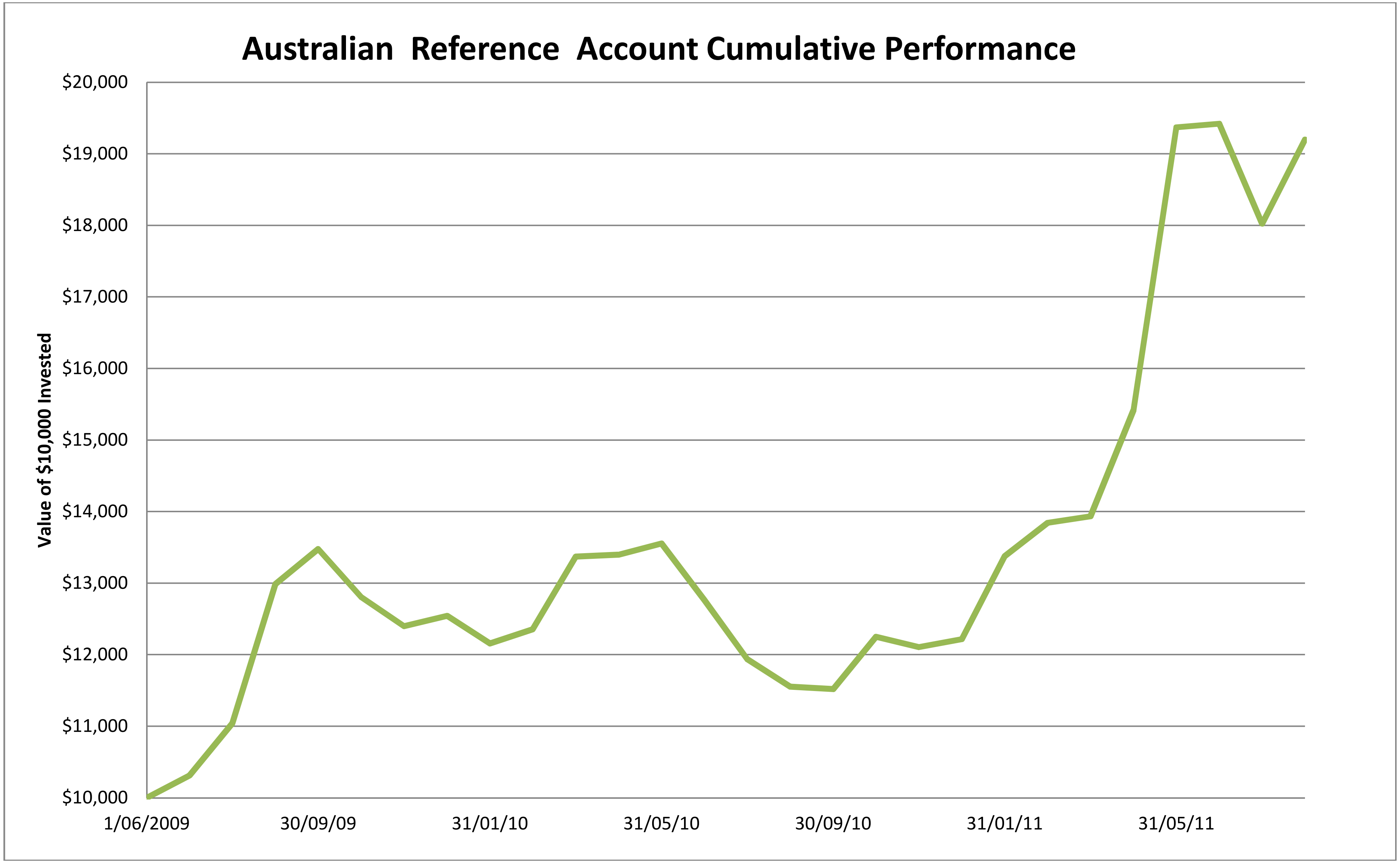
31/05/11
31/08/11



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
$10,000
1/06/2009
30/09/09
31/01/10
31/05/10
30/09/10
31/01/11
31/05/11