BronteCapital

Sunday 9 October 2011

Client Letter for September 2011

The returns for this month were over 9 percentage points ahead of global indices. Despite this our USA reference account barely changed over the month thereby highlighting how grim September was for most investors. Our Australian account was up by over 9% in absolute terms as the "risk off" trade drove the Australian currency below US dollar parity.

This was a month where the performance was made possible by some minor miracles. We are roughly a third in Europe and we do not hedge the currency. We do not have many shorts on European stocks.

It has been explained in previous letters that you should expect us to report positive numbers when the Euro is strong and less good numbers when Europe is weak.

Europe was a disaster area.

The European currency was weak too

Therefore – like the global indices which include a European exposure – we should have had a very poor month.

We did not.

The main reasons we did OK in a hostile environment were:

(a) Our shorts – particularly our put option position on Trina Solar – did well. Our option position on Trina Solar was explained on John's blog.

(b) We did not get whipsawed – we largely purchased stocks (either increasing positions or closing shorts) as the market went down. We have since found some new shorts (largely but not entirely in Asia) which we think are promising.

Don't be too excited though about the small positive return. As we write this, the markets – particularly European and Asian markets – are continuing to bleed and that small positive return has evaporated. We are a fairly safe against big losses – the portfolio is constructed to avoid big losses – but please expect volatility.

With European markets collapsing and the Euro weak we will be happy if we don't lose too much. As we have said repeatedly we are long investors with a very profitable short book on the side, we are not a short fund. Just this year our shorts are shooting the lights out.

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The remaining glaring risk in the portfolio

The portfolio at the moment contains one glaring risk: we are about 9 percent at risk on Trina Solar puts. This is a position that "started small" and got big the right way (that is we are making profits). We have been trimming our position as Trina falls. We could face a full 9 percentage points reversal in our fortunes if this position does not pan out. Against our purchase price we can't lose (we have been trimming continuously) but against current market levels we are taking a fair risk.

We also have the usual Simon-and-John take where John is inclined to let winning positions run and Simon wants to trim. We have trimmed several times but the position just gets bigger (because it is working). This is a "high quality problem" but it is still a problem and Simon and John are still arguing about how much profit to take.
Trina has been an important driver of returns for two straight months.

We would love to talk more about individual positions but most of the work we have been doing is on shorts and on most shorts we remain silent.

Our current batch of shorts have largely imploded – the stocks are down a long way. To offset this we must find numerous new positions – and that is taking most of our time. Largely we have succeeded in finding positions. Our view on our new positions is very negative indeed: the companies vary from rampant overstatements of earnings and balance sheet to outright frauds. These days it is easier to find gross overstatements than outright frauds – but both are available. As per usual we will limit our discussion of individual names.

Traveling, trading and fund raising

We are not a trading fund. We do not believe we can add value by "trading smart" or reacting to news. We have seen funds with banks of computers who do that faster than we can.

We have beaten the market – and think we will continue to beat the market – by intense due-diligence – and by really understanding our positions.

It does not matter what time of day we work – we can work at ten at night or three in the afternoon. It just matters that we generate "ideas" with theses that we can check and that those ideas are indicative of long term incorrect valuation of financial instruments. That requires many hours of work per day (reading mostly). Some of this work is intellectually intense (reading the accounts of a complicated insurance company) and some less intense (say reading a history of Boeing and Airbus). Our greatest profit comes from the intense stuff – and that can't be managed for more than two to three hours per day. Our concentration span is not that high. Sometimes the best work is done when we appear to be doing nothing – that is when two hours of work is interspersed with say a book and a trip to the beach.

We are on the road visiting prospective clients. We are happier with clients with genuine expertise in particular industries than with funds-of-funds. We find industry people more

knowledge of their own field of endeavor than with financial people - and they allow us to generate or corroborate or falsify ideas. For instance our current short on the solar stocks came from a discussion with a client who purchases solar panels. (He simply told us the price was falling fast – much faster than was advertised. This could not be good for the solar companies.) The Longtop idea did not come from a client – but a client with expertise in cloud computing helped us to corroborate the idea. Meeting clients is thus a good way to grow our expertise.

But being on the road is also grinding and it is not allowing us to do the intense work which produces some of our edge. John really wants to sit in a beach-house somewhere (almost anywhere) and do two hours surfing, three hours intense work and a lot of sleeping per day for a while. We think it will be productive.

Longs

We have added only one small new long (L'Oreal). This is not cheap and not a holding to which we are dramatically committed. It is another hair dye company. One of our largest holdings (Henkel) is (amongst other things) a hair dye company. Europe was in semi-crisis and we were generating cash so thought to buy something. L'Oreal is a stable company that should survive the crisis with minimal hurt.

This is a general theme. European markets fell dramatically in the month and our shorts were generating lots of cash. Our purchases of longs are in part dictated by when the shorts generate cash rather than by timing the longs as to when they are cheap. Generally this means we buy longs as the market goes down – simply because that is when the shorts generate cash – and to some extent we sell as the market goes up (as the shorts use our cash). We think that over time having a short book will make us better long investors and it is better still that our short book is profitable.

Thanks again for the trust you put in us.

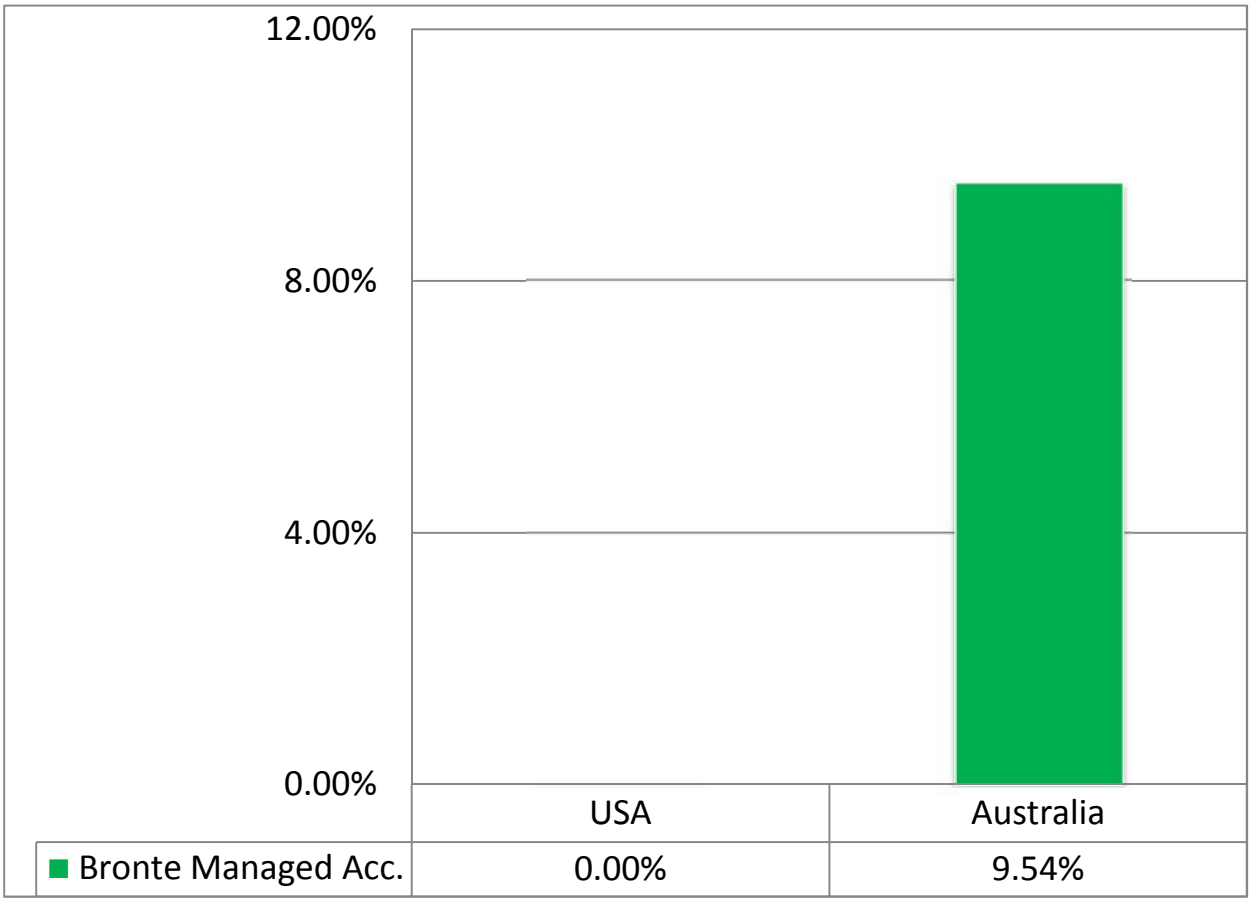
John
Simon

Portfolio Management

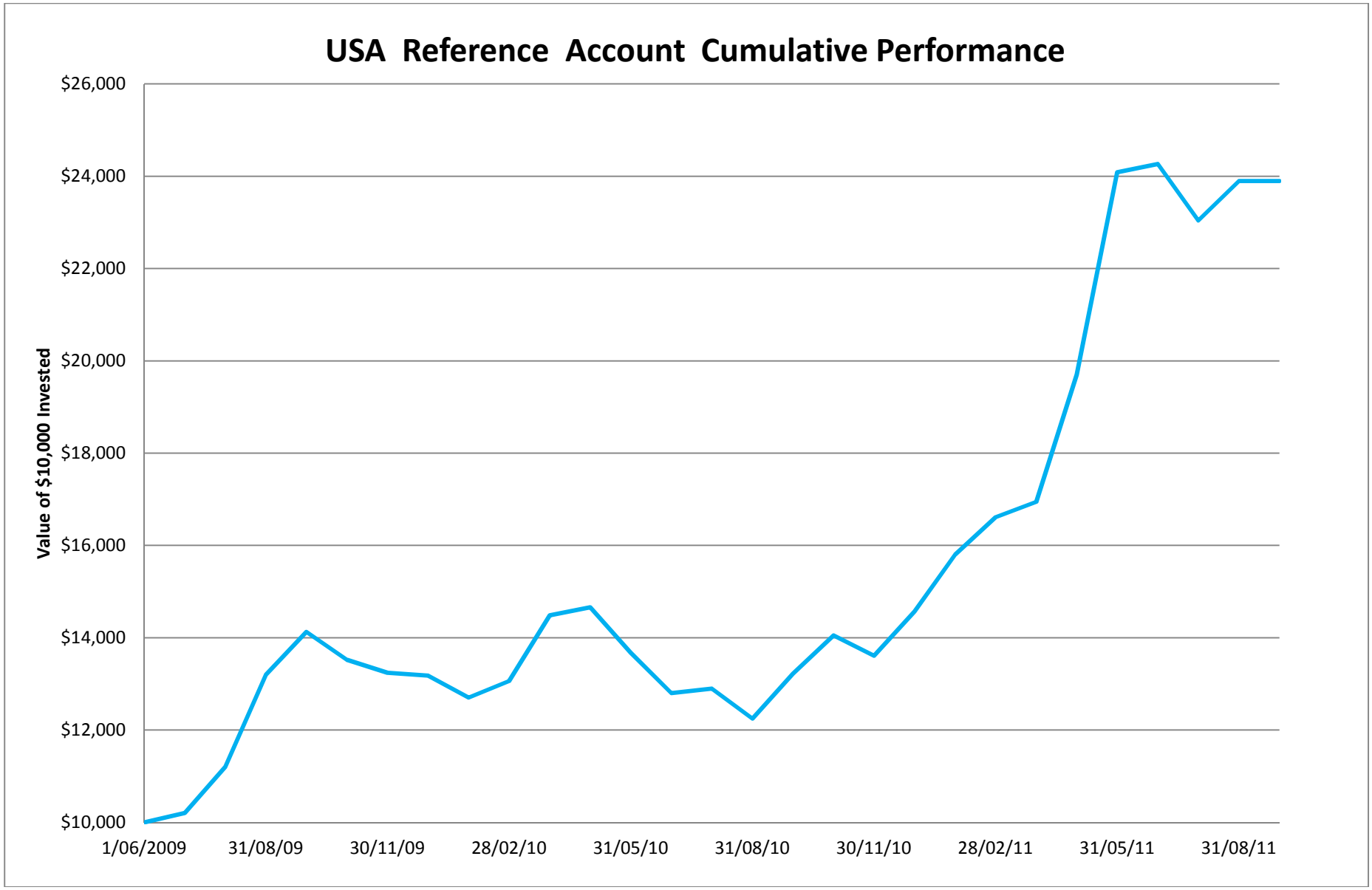
	Long%	Short%	Net Long%
USA Reference Account	109.83	57.38	52.45
Australian Reference Account	109.85	57.31	52.54

Performance Data [1]

Reference Account Monthly Performance



[1] All performance data is adjusted to allow for an accrual of the annual performance fee. All dividends received and earnings of the fund are retained and reinvested in the account. The volatility of the account may differ materially from comparable indices. The comparison index used by the advisor decreased by 9.4% in USD and 1.0% in AUD during the month and since inception of the account has increased by 16.3% in USD and decreased by 4.3% in AUD terms. Past results are not indicative of future returns.


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
30/11/09
28/02/10
31/05/10
31/08/10
30/11/10
28/02/11
31/05/11
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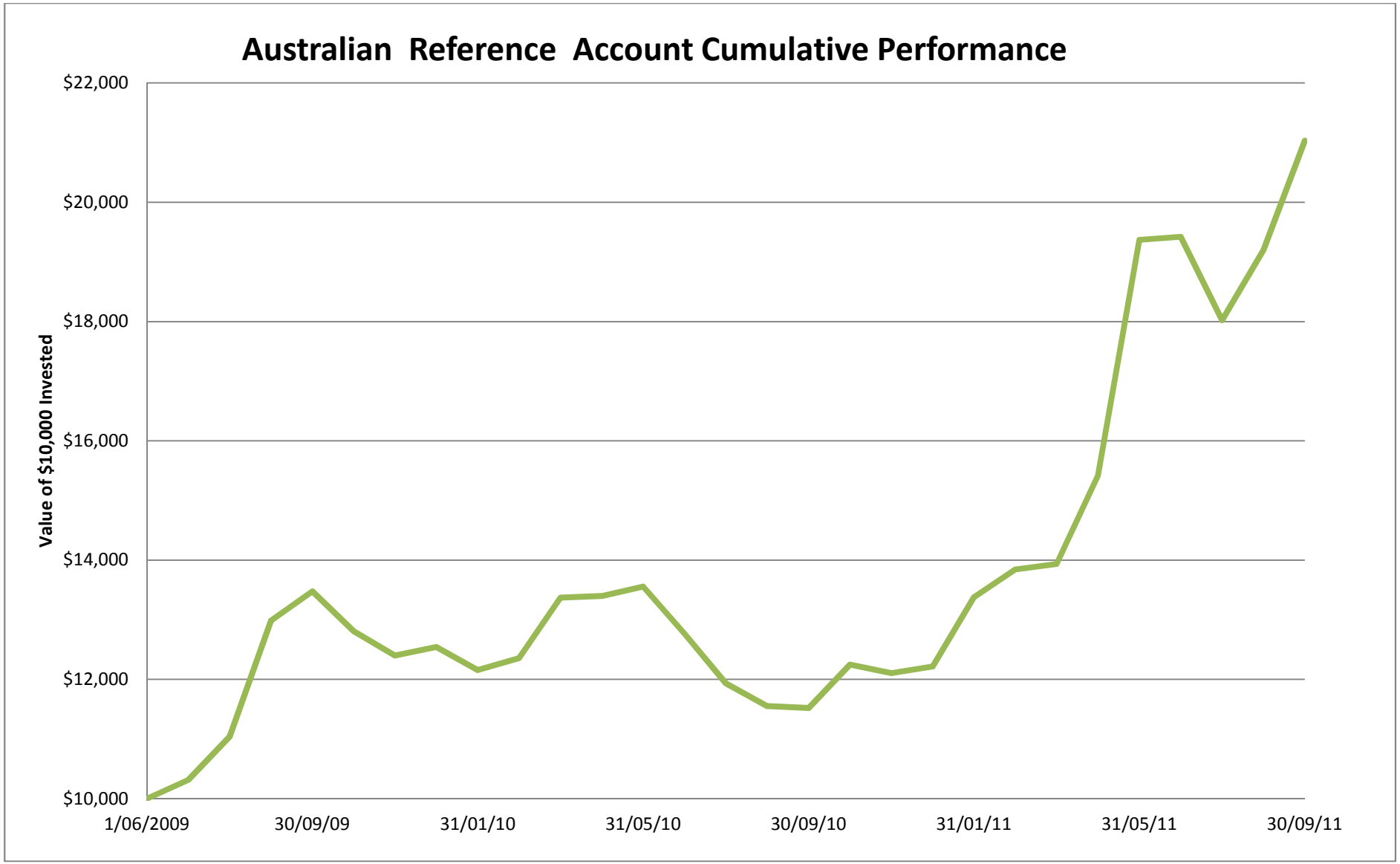
Australian Reference Account Cumulative Performance
Value of $10,000 Invested
$22,000
$20,000
$18,000
$16,000
$14,000
$12,000
$10,000
1/06/2009
30/09/09
31/01/10
31/05/10
30/09/10
31/01/11
31/05/11
30/09/11