Sunday 12 February 2012

Separately Managed Account Client Letter for January 2012

Our USA reference account lost 6.34% and the Australian reference account 9.67% for the month in an environment where stock markets rose globally.

January was a poor month for us. There was no "major" disaster but a bunch of smaller problems (each costing 1-3 percent of the fund) that would normally pain us but go unnoticed by our clients. However we had several of these pile up on us – and the result is the worst month we have had in the last 18 (and our lowest quality month ever). Nothing here is threatening (we manage the portfolio so we live to fight another day). But nothing is pleasant either.

This monthly letter contains more than the usual dose of self flagellation. In it we analyze what went wrong so that we learn from the mistakes we made (the letter is written in part for us). However this run through of the errors we made will make clear the risks we take with your money.

But first we wish to explain how we see losses. Not all losses are born equal – some are higher or lower quality than others. Some are just bad news. Some – as we will explain – have a silver lining. Alas the losses this month were mostly "low quality losses". We wish to explain that in some detail because in the future we may have some "higher quality losses" - that is losses which we believe carry a silver lining. When we have higher quality losses we are going to say it to you – and tell you to trust us – and point back at this letter as part of the explanation.

The Warren Buffett way of thinking about the quality of losses

Both of the key people at Bronte started as dyed-in-the-wool value investors and students of the Warren Buffett style of investing. The short version of this is that you buy good businesses cheap and over time the value will out. Warren Buffett says you should not be comfortable buying *anything* unless you would be comfortable owning if if the market closed for five years.

The Buffett style requires that you can identify good businesses with honest management that you really can own for five years. (That is difficult. Think how many good businesses have imploded over the last thirty years. Newspapers anyone?) Then it requires that you can sit on large amounts of cash until the market throws up one of its legendary bad pitches (as per Wells Fargo at $9). Then you have to swing.

If the stock goes down in the Buffett view of the world the solution is simple. Buy more. After all if it was good value at $9 it should be better value at $5.

There are a few problems with the Buffett style particularly as they apply to us.

1. We think we can identify the good business (but we can be wrong).
2. We are not capable of sitting on large piles of cash year in year out. We are just too inclined to be activist – and too willing to swing at less than delectable value.
3. We think that the Buffett slogan "buy more if it goes down" is very dangerous. We have seen more than one value investor crucified on a single cheap stock. They purchased more as it went down. And then more. And then it imploded – the problem they had not identified

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showed itself. What started as a 5 percent position winds up costing them 15 percent or more of their funds.

Our investment style was chosen at least in part because we are not Warren Buffett. We are neither as skilled as him in identifying great businesses nor as patient as him in sitting on large piles of cash. Also we are very cognizant of the ways in which we can be wrong so whilst we are happy to buy more if it goes down we wish to limit that buying.

But we do think the Buffett way of thinking about investing has a lot to offer. In particular we think that his view that success is owning large and increasing piles of stock in businesses with real value and longevity is right irrespective of what that stock is currently quoted at. What he is concerned about is the underlying earnings power of the businesses he holds (and he wants to grow that earnings power) rather than the current quotation. We ascribe to this view.

We don't much care whether it is quoted in Euro, Yen or Special Drawing Rights. We care that it will earn a lot in the future and those earnings can be used by our clients for real things (like paying college tuition or buying cars or yachts if you are so inclined). We have no idea for instance what a US Dollar is going to be worth in twenty years so quotation in US dollars is not that interesting. Nor is quotation in Euro or anything else for that matter. What matters is the real goods and services the underlying earnings and assets can buy.

The Warren Buffett valuation is not able to be measured accurately (though Buffett claims to have a rough idea of the “intrinsic value” of Berkshire Hathaway). Warren Buffett quotes his performance in US dollars per share (which he can measure). It’s a reasonable approximation of “intrinsic value” but it is only an approximation. Buffett tells shareholders regularly whether book value grew faster or slower than intrinsic value. In his view a gain is a “high quality gain” if hard-to-measure “intrinsic value” grew faster than easy-to-measure book value. In the Buffett view of the world it is possible to have book value declining whilst intrinsic value rose. He would consider that “high quality losses”. The reverse is also possible and they would be low quality gains.

This month unfortunately we had low quality losses using a Buffett style measure.

Our portfolio positioning and what a low quality loss looks like

We aspire to Warren Buffett style portfolios on the long side of our book. Over time we want to own increasing piles of underlying earning capacity in high quality businesses and we are not particularly concerned about the quotation values of these (figuring if we are right about the businesses the quotation will look after itself). We are however a little less sure of ourselves as per which businesses are truly high quality and we solve this by having a little more diversification than Warren usually has.

There is a trade off here though because more diversification means we will compromise a little on the quality of the businesses in which we invest. In an idealised world we have said we would like to have fifteen positions of about 7 percent of the portfolio each adding up to about 100 percent of the portfolio.

On the short side however we actively seek anti-Buffett stocks and particularly focus on businesses without management integrity. We love frauds. We are not averse to stock promotes, slimebags and any other type of wretched villainy. John would say we short s—t but Simon is more genteel and says we short trash.

And the idea is that as the trash declines (as it usually seems to do) we use the cash freed up to buy good stocks – the ones that belong in a Warren Buffett portfolio. The slogan: we turn trash into treasure. We could have named Bronte “Nicolas Flamel capital” after the famous alchemist.

Moreover the trash mostly declines when the market is weak and the Warren Buffett stocks are fairly cheap. This means we swing at the Buffett style stocks when they have gone down. The short-selling is our solution to not having Buffett's amazing patience.

In an idealised world we are only about 30 percent short and the shorts are highly diversified.

Now imagine a situation where the market goes into free fall. Equities are down 50 percent with the high quality ones down a little less (say 40 percent) and the real trash down 80 percent. We would lose 40 percent on our longs (ouch). We would gain 24 percent on our shorts (80 percent of 30 percent) and we would be down a mere 16 percent.

But we would have cash which we would busily be using to buy more quality longs. We would be winning the Warren Buffett game of accumulating a large pile of future earnings potential. They would be “high quality losses”.

Likewise imagine a world where equity markets throw out high quality stocks to buy the most outrageous trash. This is <u>very</u> bad for us because we lose money on the longs, lose money on the shorts and need to sell the longs to pay for our losses on the shorts. We are losing the Warren Buffett game of accumulating future earnings potential. We could even have low quality gains if the market goes up enough with the trash really outperforming.

Alas January was – in part – a month of low quality losses. This (more than the poor headline number) pains us.

Things that went wrong this month- Google and Tesco

We had two long positions hurt us. These were Tesco (which declined 21 percent in the month) and Google (which declined 10 percent).

Tesco is the major grocery retailer in the UK and a big global company. What went wrong is that they lost their edge (particularly in food freshness) in the UK and their growth stopped. The management had a mea-culpa conference call in which they gave only the most vague future guidance and talked about required expenditure to fix the problems. The stock tanked.

John asked readers of his blog (and preferably shoppers outside London) to talk about Tesco and their experience. We wound up with a diverse collection of readers’ mothers and grandmothers (precisely the people we wanted) and their diagnosis matched Tesco managements. This was good because if the management diagnose the problem correctly they can probably fix it. It won't be easy though – Tesco for instance engages in sourcing some produce a long way from market because that makes it cheap. It also compromises freshness. An enormous infrastructure exists to make sure the right number of apples (not too many as to go stale) wind up on your supermarket shelf. This infrastructure is hard to fix. And if your apples are sourced in Kenya your supply chains can be very long. Fixing them is hard. Shortening them may cost more too.

The stock is cheap and it got cheaper – but more problematic. The most famous shareholder (Warren Buffett no less) roughly doubled his stake after the profit warning following his dictum if it gets cheaper just buy more. We would have, except that we couldn't. Our position is already big enough and risk management precludes much buying of bombed out stocks just because they are bombed out.

Google is a company that does not give guidance. This means that street expectations can be a long way from reality. The company published results that are quite good and somehow the market punished it. We went looking for the negative and there was one. The average click fee (amount of money Google makes per click on its website) declined a little. This is contrary to the anecdotal evidence we have seen (where businesses need to pay up more to get a good position on the Google search page). It was the subject of the bulk of the questions on the Google conference call.

Google explained that the adverts that are displayed are the result of Google's optimizing algorithms. Some low click fee adverts that are clicked often are displayed along with high click fee adverts that are clicked infrequently. Google has said (several times I might add) that they have been tweaking the algorithms to make the adverts more “relevant”. Now they say that they “chose” to display more low-fee frequently clicked adverts and so the “average” click fee went down. Revenue they note was good (and rose quite nicely). If you believe this then Google (at the new lower price) is a particularly delicious bargain in the market now. John does believe Google managements' explanation and if the position were not so large he would buy more. Alas risk management precludes that.

We trimmed our holdings in both Google and Tesco before the stocks bombed out. We would like to say that was inspired genius but it wasn't. The positions were too big and we needed to sell some positions just for risk management purposes. If it was inspired genius we would have trimmed more than we did (and repurchased some later). But alas it was not to be.

If we were really clever we would have 25 base positions (not 15) and be good at rearranging them in response to price signals like this. Alas we can't find 15 good base long positions – so we are hardly going to find 25.

Things that went wrong this month: the generalized short-squeeze in North American highly shorted stocks

The second thing that went wrong in January was that highly shorted stocks (most particularly in North America) went up – sometimes by a large amount. It is easier to say this about stocks we are not short (because the ones we are short we are often short because we suspect fraud and we are not in a position to give names).

Lulu Lemon Athletica is a retailer of women gym gear and yoga clothing. It is very successful and a fair number of women like the stuff because they perceive that their posterior does not look fat in it. That is a pretty powerful marketing pitch.

It also has a market cap of almost USD10 billion (over 25 percent of well run giants like Target) and a PE ratio above 50. It trades at about ten times sales (retailers are typically at half sales). It is very richly valued. It has also stomped on the grave of some aggressive short-sellers. The stock was very strong in January:

Figure 1 lululemon inc Stock Chart

At least part of this was just that the short interest was too high.

We are diversified in our shorts with a partial aversion to being short hard-to-borrow names. A generalized squeeze like January would normally cost us a low-single-digit percentage of the fund. This January was no exception. Normally we would report this as a not-so-good month – but as a low-single-digit loss it would raise no eyebrows. Alas this loss came on top of our other losses this month.

We managed to duck the biggest potential short-squeeze in our portfolio. We are fairly convinced that Sears is going bankrupt and we increased our short position after the last results. Alas our conviction is widespread and the borrow cost on the short went above 80 percent. We are not *that convinced* – and we had enough hard-to-borrow stuff in our portfolio. We covered about $30. The stock is now trading above $48.00.

European stocks

We own quite a few European stocks and – as a rule – we do not hedge the currency. We would not generally know what the right currency hedge was. For instance we own French liquor stocks which have some debt in US dollars and many sales in Asian currencies that are de-facto pegged to the US dollar. The net currency sensitivity is hard to determine.

The reason we do not hedge the currency is mostly that an unhedged position can't be taken away from us by market movements. Our fear is that we might own say a good business in a particularly currency, hedge that currency back to US dollars and have currency hedging losses that force us to sell the good stock. That would be a way of losing the “Warren Buffett game” as described above.

We have a friend who runs a mathematical trading firm and he has some strong views on currency hedging. We are going to see what we can learn from him and our currency hedging stance is open for review. However we have thought a lot about this and it will take a very strong argument to shift us from our “own the stock, own the currency” default position.

That said – we got a little knotted on the Euro during the month. In the middle of the month the Euro was weak driving down the value of our longs (and hence raising our leverage levels). We responded by shrinking the position. Some of this was good (we trimmed Tesco and Google) but most was bad. The cost was not large – but there was a cost.

Why this was a "low quality month"

Bluntly our longs went down (Tesco, Google, a few other minor problems) and our shorts went up (just market plus the squeeze). Whilst we keep the positions small enough that being forced to cover for risk management is infrequent it is not impossible. We were whipsawed. We sold our "treasure" and had to buy back "trash". We spent the month slowly losing the "Warren Buffett game". It was our "anti-alchemy" month.

The minus 6.34 percent we report on our US reference account. Those losses are real. They are painful to us and should be to you too. The low quality result is that for each dollar you have invested with us the portfolio (and hence the opportunities for future profit) are just a little smaller.

Opportunities and risks

We said at the end of December that we thought our portfolio was well positioned. We still think that (but it is per-dollar invested just a little smaller now for the reasons described above). We think the portfolio should grind out nice profits over the next year (not like last year but adequate).

We also have a couple of our irregular asymmetric bets – bets where we can lose X dollars or make 8X dollars in short-order. These bets were responsible for about half our returns last year. One of these bets looks particularly good (we will describe it to clients on request but do not wish to publish it). That bet is about 3 percent of the portfolio (and that is after it declined a little in value in January). If it does not work our starting position in February/March will be minus 3 percent. If it works we could have an outrageously good month. Just warning you in advance that we are taking this risk – and if it does not work out we will produce more negative returns.

This is a pretty good bet. We said after the Longtop profits we should have made the bet three times larger (and reported a plus 50 percent month). We were going to size this position above 6 percent (as per where we think the Longtop position should have been) but the losses of January have rattled us a bit and we sized down. This is not entirely rational (surely we should be sizing about 6 percent of our newly shrunk portfolio). However there is emotion in this investing business and we have not quite banished it. We haven't liked reporting losses and we are acting (perhaps too conservatively) to reduce the chance of reporting more.

We will let you know in March how the asymmetric bets went. If it goes well (and we hope it does) then you can tell us to buck up next time and take our (appropriate) chances. If it does not go well we will come back to you and apologise for another small loss.

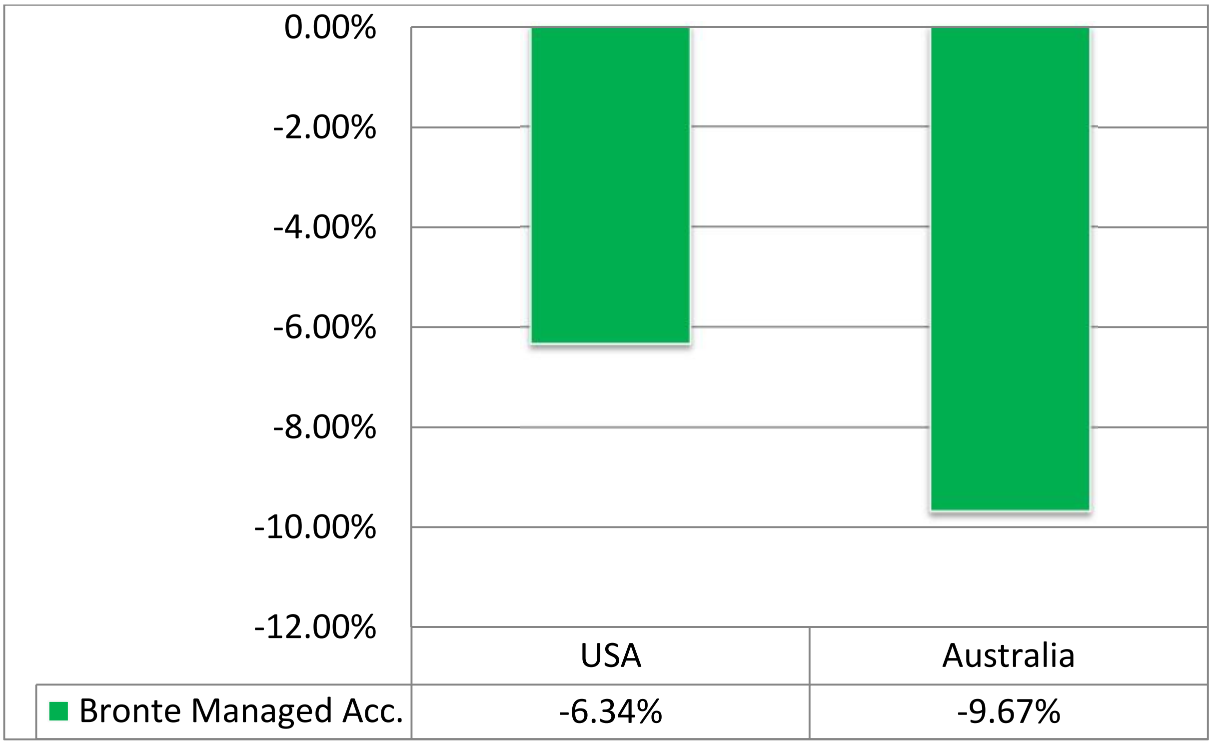
John
Simon

Portfolio Management

	Long%	Short%	Net Long%
USA Reference Account	135.00	51.47	83.53
Australian Reference Account	135.94	52.47	83.47

Performance Data [1]

Reference Account Monthly Performance



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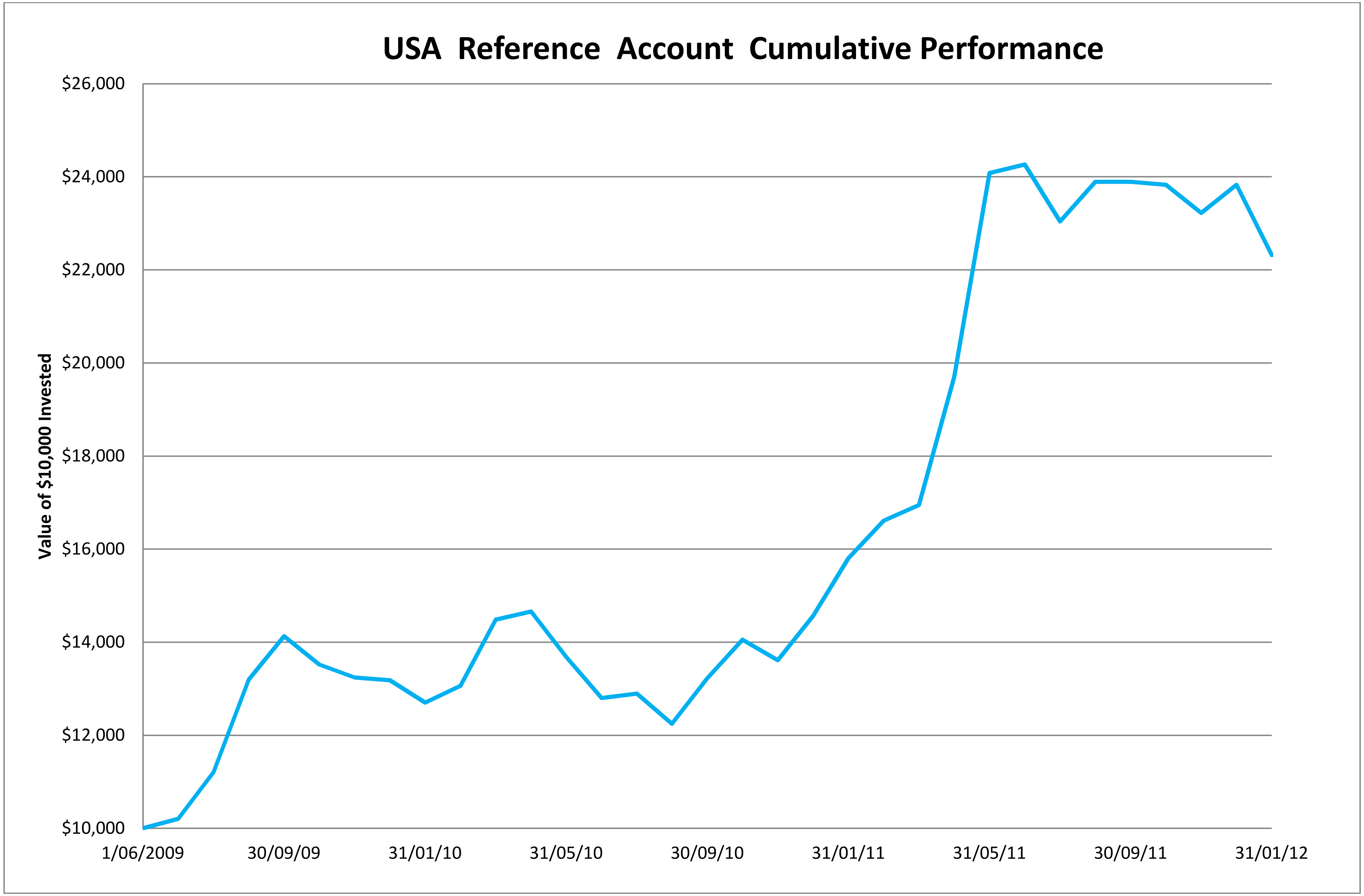
[1] All performance data is adjusted to allow for an accrual of the annual performance fee. All dividends received and earnings are retained and reinvested in the account. The volatility of the account may differ materially from comparable indices. The comparison index used by the advisor increased by 5.8% in USD and 1.0% in AUD during the month and since inception of the account has increased by 31.9% in USD and decreased by 0.17% 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
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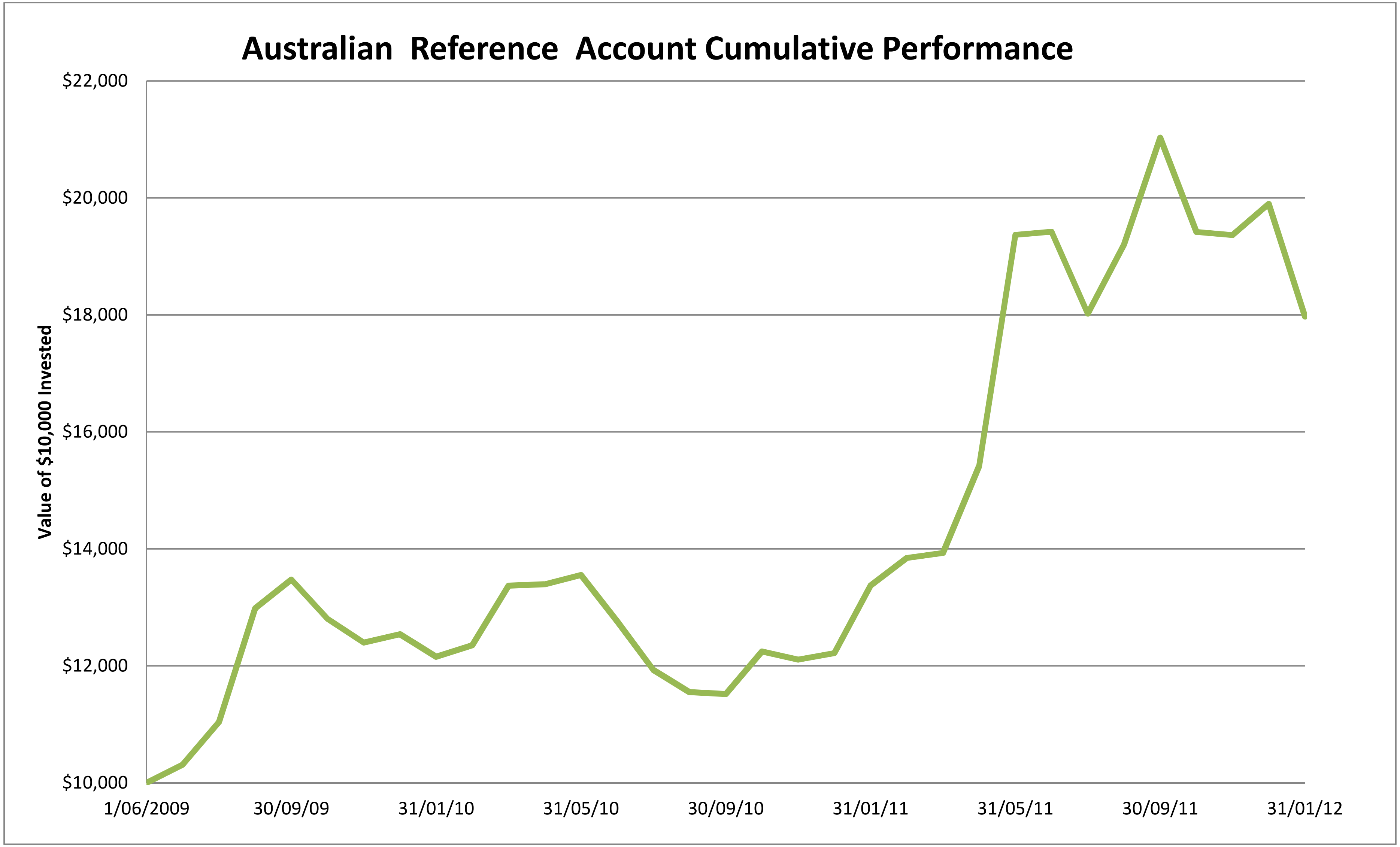

Australian Reference Account Cumulative Performance
Value of $10,000 Invested
$22,000
$20,000
$18,000
$16,000
$14,000
$12,000
$10,000
1/06/2009
30/09/09
31/01/10
31/05/10
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