Wednesday 7 March 2012

Separately Managed Account Client Letter for February 2012

When the facts change, I change my mind. What do you do, sir?

John Maynard Keynes

The results for this month are adequate though not spectacular. We have started March well. One of our clients (correctly) suggested that we should put the results – at least monthly – at the back of our letter. We will do so from now. This discussion should be more about the idea generation and risk management than about results. Getting the risk management right is a non-negotiable first requirement for us and it is a requirement that mostly falls on Simon. If we do that we are always going to be in-the-game tomorrow.

Idea generation (and testing) naturally comes in spurts. It's mostly John's job.

The mix suits the personalities too. Simon is conservative and stable (and John says a touch boring). John is liberal (sometimes extremely so) has peripatetic flashes of brilliance (but he can be a touch distracted).

Anyway this is a month when our idea generation went awry. We have been working on one broad theme for a while and the facts changed.

When the facts change we change our mind.

The facts probably changed six months ago (but it took us a while to conclude this). Being wrong for six months has meant our results have been largely flat. That is a triumph of Simon (risk management) over John (idea generation).

Whilst the results this month are adequate it has not been an easy month and this is one of the harder monthly letters. It is a hard letter because we are telling you (a) how we were wrong and (b) why the portfolio is much less exciting than we thought.

Last year we made all of our money in the first half of the year – and the bulk of it over the audit season when many companies we were short collapsed. In some instances (notably with Longtop) we prompted the collapse by writing to the auditor or by discussing the company on John's blog.

Most of the collapses however were not like Longtop – they were penny-dreadful reverse mergers – and relatively simple frauds - that somehow the market had taken to believing (e.g. China Media Express). The Chinese establishment was barely involved. The crooks were upstart new-era Chinese businessmen involved in the time-honored game of fleecing Gweilos and old-fashioned American penny-stock promoters.

By the middle of last year the really obvious reverse-merger frauds had mostly collapsed (and we said so in our letter to you). There are a few reverse-merger scumbag companies left. Most of those

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have traded up over the follow eight months (and we lost money shorting them). But the thin pickings in complete frauds meant we went looking for more reputable companies to short. Most of these reputable companies had links to the Chinese establishment.

Most of those stocks went down. Then they went back up. As a result, since the middle of last year we have made essentially no returns. We have been up a little bit, down a little bit – but essentially flat. We also got whipsawed a little in January so it has not been a happy experience.

At no point have we risked substantial losses – but we have not earned our keep either.

That is sort of OK. We are going to go through periods where it does not work well – and as long as we don't take risks that can blow us up we will get by. No particular strategy works forever.

Our dashed hopes

We had big hopes for this audit season – indeed we wrote at the end of last year how we thought the portfolio was just fabulously positioned. This time though the target was not penny-dreadful reverse mergers but major Chinese companies with real businesses and fake accounts, where the business is associated with friends of the children of CPC Central Committee members. In other words we were going right after the mainstream Chinese business establishment. The blatant frauds in China had mostly collapsed but the kleptocracy that allowed them was alive and well and we wanted to short that as well.

During January and February our main most important specific bet was a real business with fake accounts which was deeply associated with the Chinese establishment. We purchased a large number of put options over audit date and hoped to repeat the Longtop experience. (We told you about our asymmetric bet last month and told you we would apologize if it did not work.)

Alas it did not work – the company received a clean audit statement. As per Longtop, banks probably verified fake cash balances. The company almost certainly got documentation from large State Owned Enterprises that verified huge receivables. In other words the fraud involved the establishment and is not going to go down quietly.

We lost about 3.5 percent of your funds on this asymmetric bet. It was a good bet – and whilst we regret taking it if we look back at what we knew and when we knew it we don't think we did the wrong thing. (It was not a silly bet but we are sorry for the outcome.)

But whilst we think it was a sensible bet given what we knew then we have no desire to repeat it.

Our view about China: the ruling establishment is a kleptocracy however the infrastructure of corruption is so pervasive that it no longer allows easy money to be made by short-sellers. If you want to understand China we recommend listening to John Garnaut – an Australian correspondent in Beijing who gave a talk to the US China Institute on the topic "Is China becoming a mafia state?" His conclusion: it probably already has.

This Chinese stock taught us something. The frauds of 2012 are going to be much harder to break than the frauds of 2011. The portfolio we thought was brilliantly positioned at year end is – well – not so brilliantly positioned – it was positioned short Chinese frauds that are not going to break.

We have cut back all of these positions to our benchmark 50-70bps. Until there is a change in China where the kleptocratic establishment is truly challenged we are not going to waste any more option premium.

This should make your returns lower than last year (though we still think adequate). However they will be a little more even than last year. We still think we are going to do well – just nowhere near as well as we hoped (but then we were hoping for 70 plus percent).

We have retreated much closer to our benchmark portfolio on the shorts – lots of names, 50-70bps each – diversified globally on which we hope to harvest small but fairly consistent gains.

The longs in our portfolio

We sound a little down about the short-side of our book. Our fabulous money-spinner is not going to be so fabulous in the future.

By contrast we are just thrilled about the long side of our book. The portfolio is full of things that should do very well in the medium term. Large cap equities are fairly well priced <u>and very well priced compared to most assets except some American residential real estate</u>. We think we will hum along making decent returns on that part of the book.

We have a (very) few small cap positions which should be profitable but we repeat that we are <u>not interested</u> in competing with Private Equity funds to buy small-cap listed companies. The PE funds have advantages over us – namely much better inside information and access to very cheap funds with which to buy businesses. We have met a few PE people along the way and some are profoundly inept. They however have huge advantages that offset their ineptitude and the lack of a transparent market means they can hide mistakes a long time. Trying to find cheap stocks against stupid people backed by seemingly limitless cheap funds and no market discipline does not seem like a good way to construct a value portfolio.

Some people might wonder why they are paying us hedge-fund fees (as opposed to index fund fees) to invest in large cap stocks on which we can add little value. We offer a modest defense:

(a) We do have some selective small-cap stocks which are likely to give us enough returns to pay the fees and then some. For a variety of reasons these are not attractive to PE funds.

(b) We still short small caps. *The extraordinary crowding into some of these names gives us good opportunities to short*.

(c) You will be here for the swing. When we no longer find nonsense frauds and promotes amongst $300-500 million companies with ease, we will turn around and go long small caps. At the moment it is so easy to sell nonsense that you know the small caps are nuts. One day we will be a small cap – fund. That day however is not today.

We think we can earn our keep and we think we will again find opportunities for out-sized returns albeit by making asymmetric bets.

Diversifying our shorts

Our main research is targeted at diversifying our shorts. The Short-China frauds game is no longer so easy. We have had a heavy weighting to China shorts for most of the past 18 months. We lost money initially, made it in bucket loads during the first half of 2011 and mostly lost money since. We are not going to give up on it. China is the most important kleptocracy in human history. But we can be patient too.

Meanwhile we find old mining fraudsters from Australia with multi-billion dollar market cap stocks in Canada, Canadian fraudsters playing the AIM stocks in the UK and many variants on that theme. The globalization of stock promotion suits us fine – it means that the people we short are outside the purview of any single regulator. It reduces our risk that this profit stream will be closed down. Diversity also reduces the risk in taking on scum-bags and villains. A lower Chinese concentration also reduces our risk.

How to think of our returns

Despite the focus of this letter (and our recent research efforts) on the short-side of our book it is right to think of us as primarily a long fund that shorts on the side. We do most of our original research though in that short book.

Our shorts do two things for us:

(a) they make money in their own right – most of what we short is true scum and will trade to zero at some indeterminate point in the future, and

(b) our shorts are negatively correlated to the longs and they allow us to hold more longs.

We are not adding much value on the long side at the moment. We have said this many times as we find ourselves drawn to large-cap high-quality stocks to which our analysis adds relatively little value. (We might argue that we are adding value by telling you that now is the time for those stocks... but that is a thin argument.)

On the short side we add a lot of value.

We think our longs are going to make the global index (MSCI) plus or minus a bit (hopefully plus a bit). You should make that return.

Our shorts (typically about 30 percent of our portfolio) go to zero over three to five years on average. It is safer to call it five years on average because the shorter dated stuff often has a high cost to borrow. So we should make about 6 percent a year on that book.

So at a first cut we should make about MSCI plus 6 percent a year on the portfolio.

Alas it is not so simple. A short that starts at 10 and goes to zero over five years does not make you 2 per year if the stock goes via 100. If the stock is that strong you <u>have to cover it as it rises</u>. You get "whipsawed" which is just another way of saying you lose money (even when you are ultimately right). The risk of being "whipsawed" (as per what happened to us in January) reduces our returns somewhat.

On the positive side having some shorts allows us to be over 100 percent long. Our longs (things like Google, Vodafone, Berkshire, Henkel) are low risk and as our shorts are negatively correlated there is no real problem from a risk management perspective being 110-120 percent long. This is outside our benchmark but as the longs are very low risk and our protection is so good we are comfortable being there. That adds to our returns a little.

But the core portfolio – just our core value longs and our diversified fraud shorts – we think should score about MSCI plus 6 percent per year. Less if we are whipsawed. More if we are clever. The shorts are by far the most profitable part of that – but we need to keep the positions small and diversified because otherwise we would get whipsawed more often. We manage a vast proportion of our book to reduce the whipsaw risk (or more precisely the cost of being whipsawed because the occasional whipsawing event is inevitable).

On top of that we will take selective asymmetric bets – bets of say 3 percent of the portfolio to make 24 percent of the portfolio. Those worked beautifully in the first half of last year (hence our great returns) and mostly have not worked since (hence our flat aggregate portfolio).

There are no major asymmetric bets at the moment – so think about the core portfolio as described above – and you will be thinking about our returns the same way as us. We will tell you how that plays out and if (and when) our positioning changes again. Whilst not thrilled, we are happy enough with how we are positioned now.

Thanks again....

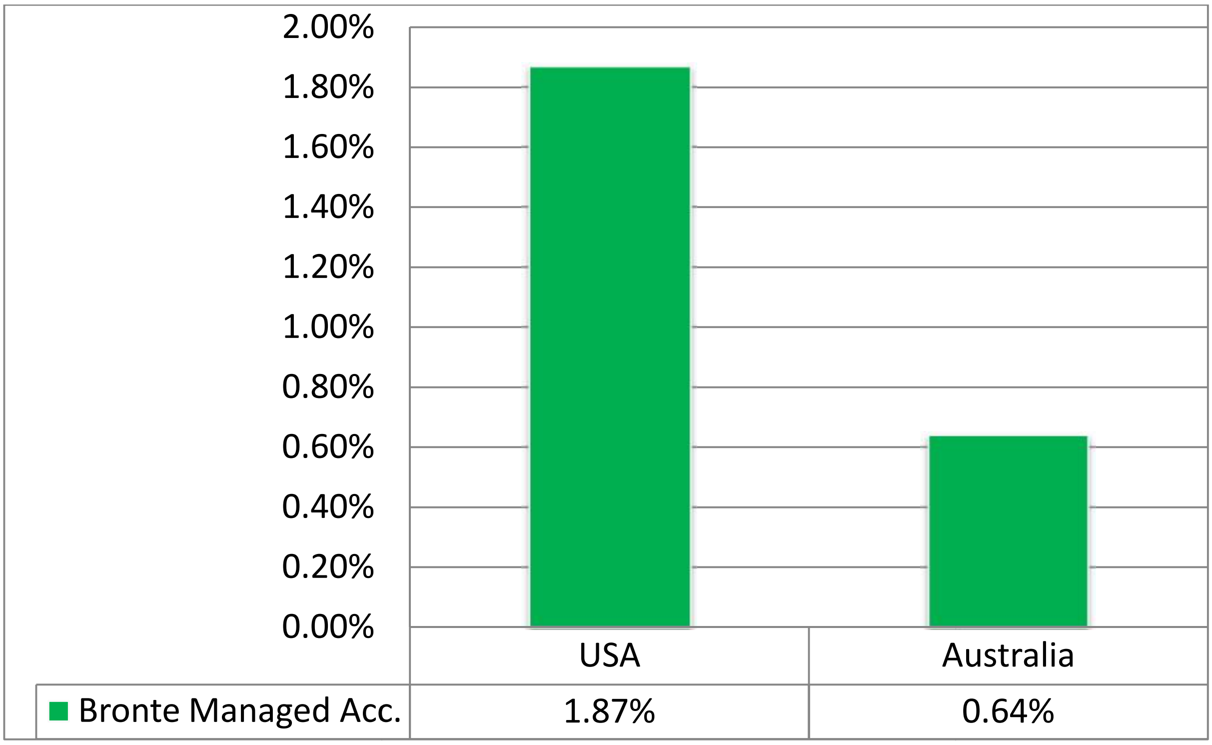
John
Simon

Portfolio Management

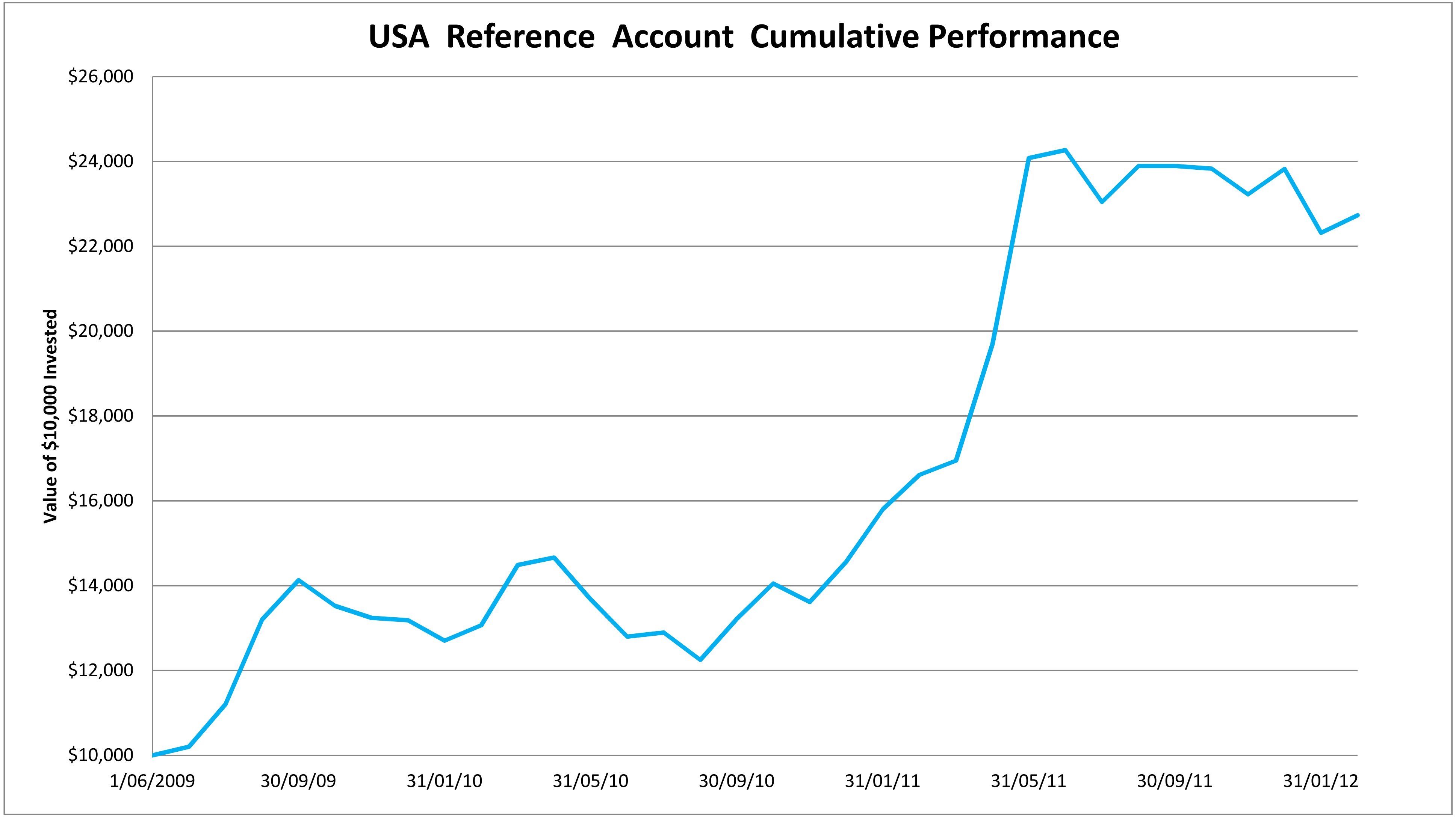
	Long%	Short%	Net Long%
USA Reference Account	130.03	45.12	84.90
Australian Reference Account	130.49	46.40	84.09

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 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 5.0% in USD and 3.3% in AUD during the month and since inception of the account has increased by 38.6% in USD and 3.1% 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
30/09/09
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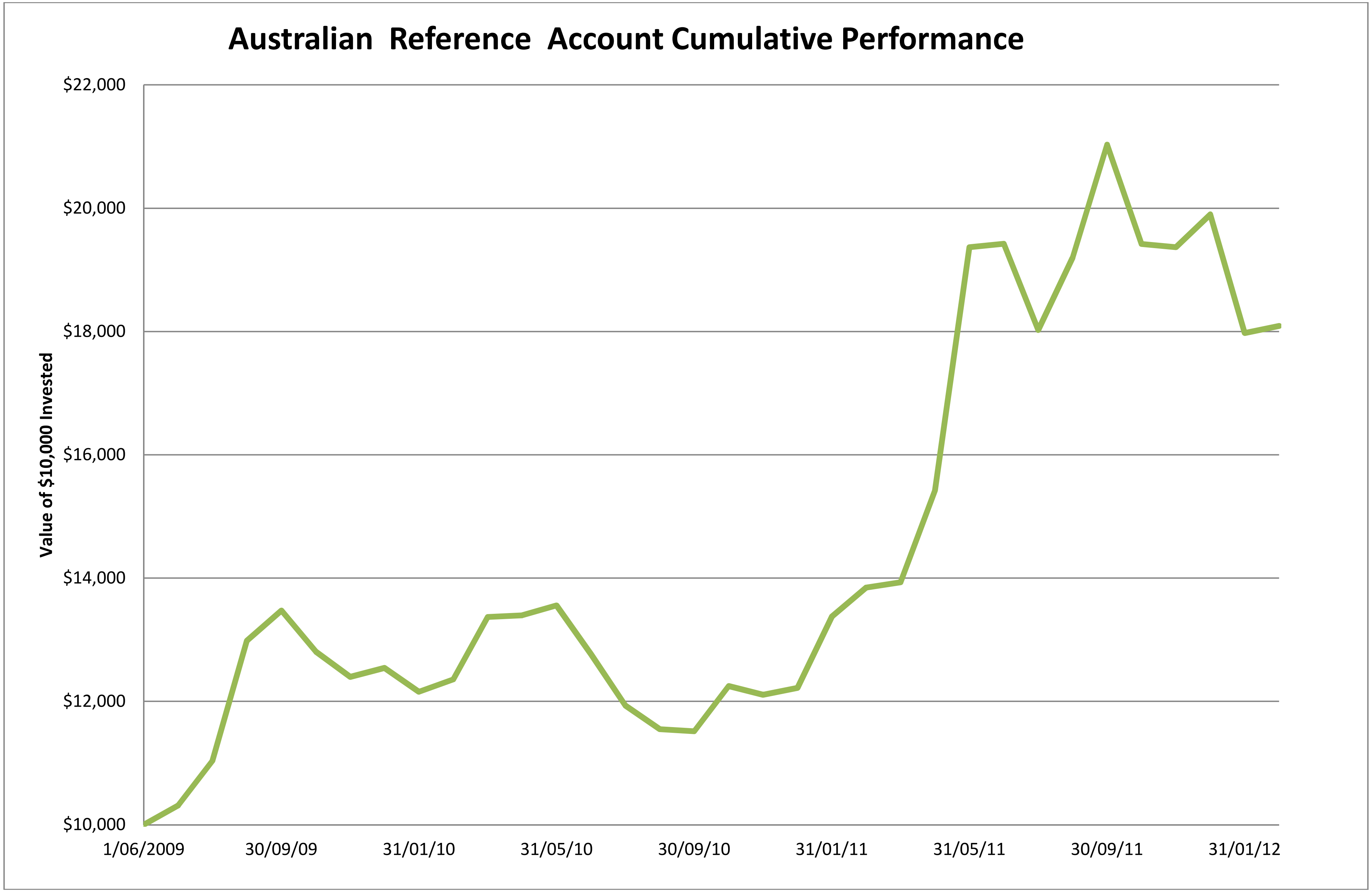
30/09/11
31/01/12



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
31/01/12