BronteCapital

Wednesday 13 June 2012

Separately Managed Account Client Letter for May 2012

Our USA account was down (3.8%) for the month. Whilst personally we are disappointed, dispassionately this was an adequate result. Adequate here is measured against the markets we faced and our global stock position. Our position is that against a poorly performing global equity market you can expect out-performance but not positive returns. We delivered that

Moreover the shorts generated considerable cash in May. We started May a little too long (in retrospect a mistake) so with limited exceptions we have not deployed this cash in more longs.

We are up with the market in the first part of June.

Europe – the place of our best performing and some of our worst performing longs

This letter is mostly about Europe – and so we should state up-front what our European positions look like.

Mostly we are long European consumer stocks that benefit from a weak euro. Our best performing long is a global German industrial glue and consumer goods company (Henkel). We are also long the French liquor companies which are more China longs than European longs. Liquor has historically been recession proof – but the French liquor companies now have more China risk than Europe risk. Their most profitable business is selling 3000 dollar a bottle cognac in karaoke bars in Shanghai where businessmen show off their new-found wealth to each other. They probably also show off their wealth to the female staff who will "entertain" them in exchange for the sales commission they get on high end liquor.

The end of the Chinese kleptocracy (see attached article) poses more risk to those French longs than the Euro crisis (although both risks are clearly present). Still we are short China in so many ways (fraudulent Chinese companies, promotional commodity companies) that honestly run Chinese longs (albeit ones based in France) are a sensible hedge.

We have small positions that face far more European currency crisis risk. These include a Dutch insurance company, some French regional banks and our well disclosed but small position in an Italian defence conglomerate. Every one of these positions has been a dog. Macroeconomic concerns have overwhelmed what were some nice stock specifics.

Despite those small (and unprofitable) positions Europe has been pretty nice to us.

At these prices we are going to continue to nibble (and only nibble) on the cheaper parts of Europe. But the bulk of our European exposure is quality German and French companies with global businesses. Or British. We have a lot of British exposure – we think the Pound is structurally cheap and the stocks are inexpensive.

That said – Europe has been nice to us in general – and our main European exposure is to Northern Europe and Europe based globals as opposed to Portugal, Ireland, Italy, Spain and Greece.

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We also have considerable European exposure through our American longs. Google makes a lot of revenue in Europe. We don't own Apple – but iPhones are cool in Germany and Spain too. If you own equities (other than predominantly domestic US equities like Target) then you have European exposure.

We are also both long and short commodity stocks. These are going to have big moves depending on what happens in Europe (or China).

Europe was the biggest driver of the markets and our results this month

Above we stated that (a) Europe has been good to us and (b) European exposure is everywhere but that (c) our specific-crisis-targeted European exposure is small. Despite that, Europe – and in particular the concerns about Spain – were the largest driver of global equity markets last month – and on a day-to-day basis our portfolio moved according to European concerns.

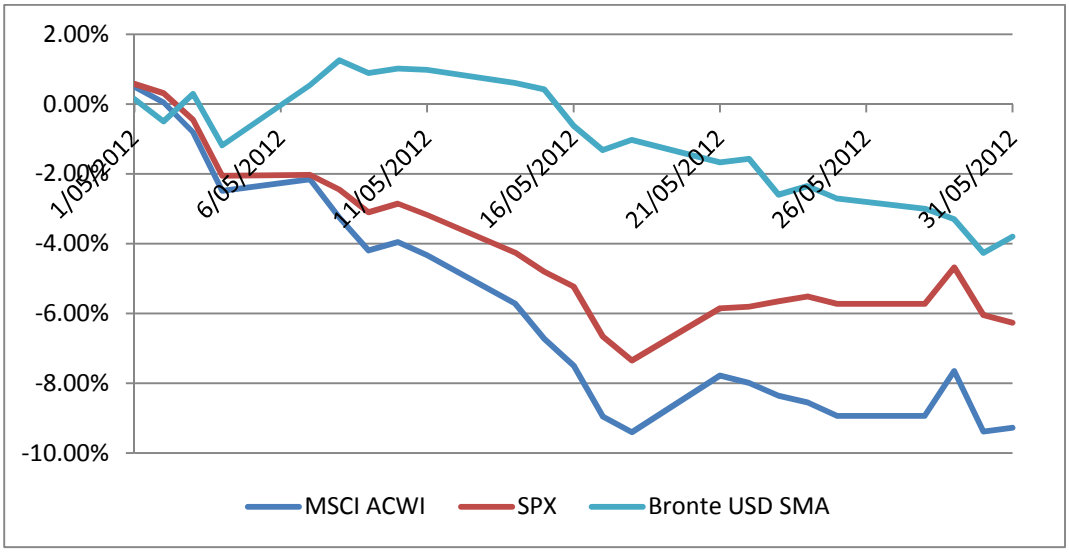
As stated many times we are long large cap global equities and short frauds, fads and stock promotes. [We short real companies for macro reasons or because of technological obsolescence but those shorts are rarer.]

When we hold stocks we generally hold the currency (unless we have funded the position via shorts in the same market). We purchased our French liquor stocks by converting money to Euro and we thus have a notional currency exposure. The stock, to some extent, is a natural hedge of that currency exposure – if the Euro goes down the profits of the French liquor companies measured in Euro should go up and over time we think their stock price goes up in whatever currency the French measure in.

That said – on a day when the Euro is particularly weak our funds go down in value. The natural hedge is there – but it is imperfect.

Our positioning

We are above 20 percent in European stocks (almost entirely French and German) and we mostly hold the currency. We are also short some French and German stocks (though not many). We are short stock promotes globally. When the global equity markets go down we should do well enough versus the MSCI. We did during this month. Very well as shown below:



But May was a month where Europe was plain ugly and we have very few shorts in Europe (and those we do have are in France and Germany, not in the periphery). So the shorts were not as well correlated with the European pain. Measured in USD the results were not fabulous (but were still considerably better than the S&P).

More generally: our USA positions were better than the American markets, our European positions better than the European markets. But we had European positions – and that is the cause of our negative result for the month.

What went right and wrong

On the plus side our shorts were mostly a hedge for our longs. On days when the market rocketed up we went up (albeit only a little). And we outperformed on the down days. The portfolio behaved much as expected.

On the minus side we did not add very much alpha – there was only one minor disaster (we got whipsawed on one short) and one or two minor successes. There was no reason to be pleased with ourselves and no reason for self flagellation.

These markets do not suit us

Whilst the portfolio is doing more or less as advertised (outperforming a falling MSCI by a fair bit) we don't think we are adding much if any alpha at least relative to the size of daily movements. This is not a stock-pickers market. The macro-situation determines stock movements on a day-to-day basis. We are “macro-aware” and know not to take too many “macro risks”. But we do not pretend to be a dedicated macro-fund. It’s unlikely we will ever make money or trade macro on any regular basis.

We pine for non-volatile sideways markets. Stockpicking works in that environment.

The macro call that matters most to us

Whilst the rest of the world is focused on Europe (and on a day-to-day basis Europe drives our results) we think the bigger story is China. We made a lot of money shorting Chinese frauds last year (and none since). We still think there is plenty left in the Chinese-fraud bank however the remaining frauds are much harder to crack. The degree to which these frauds are enmeshed in the Chinese establishment is staggering.

Last year – by writing letters to auditors and the odd blog post we could successfully expose and profit from the decline fraudulent stocks.

This does not work anymore. It took us a while (and some losses) to work out why – but we are not stupid and we worked it out. Most of the remaining frauds are deeply enmeshed with the Chinese establishment up to and including involving the families of senior members of the Central Committee.

Us writing letters to auditors or publicly agitating and hoping to profit from those frauds seemed quixotic. John and Simon from an office in Sydney versus the Chinese establishment is ludicrous.

We remain short small quantities of diversified Chinese frauds paying attention to stock borrow cost (this might take some time). We figure we get paid in the end but we are not deluded. The outcome

has nothing to do with us. And whilst time is on our side it might take a lot of time. We are patient and we hope our clients are too.

We are also short China more generally – particularly through commodity stock promotes. They should be profitable. However triggers are again hard to find.

Europe

If all goes to plan we should talk about the (very limited) stuff we are doing in Europe next month. We are however nibbling (and we mean low single-digit percentage nibbles) on more risky European fare as it gets cheaper. We are – at heart – value investors – and it's not our nature to avoid stocks at 2.5 times normalized earnings. But we are justifiably scared. These will always be small positions.

Bonus Article

Recently John published on his blog[1] an article, which was commented on, amongst others, by Paul Krugman. We (meaning Simon) regard it as a significant body of work that is important in its own right but one that has also informed Bronte's investment approach in respect of Chinese positions and the effect of China on the wider world. So with John's permission we have included in this letter John's piece on *The Macroeconomics of Chinese kleptocracy*.

Thanks again

John and Simon

And here is John's article – followed by the performance charts.

[1] The Bronte Capital blog at http://brontecapital.blogspot.com.au is separately written and operated by John Hempton

The Macroeconomics of Chinese kleptocracy

By John Hempton (http://brontecapital.blogspot.com.au)

China is a kleptocracy of a scale never seen before in human history. This post aims to explain how this wave of theft is financed, what makes it sustainable and what will make it fail. There are several China experts I have chatted with – and many of the ideas are not original. The synthesis however is mine. Some sources do not want to be quoted.

The macroeconomic effects of the Chinese kleptocracy and the massive fixed-currency crisis in Europe are the dominant macroeconomic drivers of the global economy. As I am trying a comprehensive explanation for much of the world's economy in less that two thousand words I expect some kick-back.

China is a kleptocracy. Get used to it.

I start this analysis with China being a kleptocracy – a country ruled by thieves. That is a bold assertion – but I am going to have to assert it. People I know deep in the weeds (that is people who have to deal with the PRC and the children of the PRC elite) accept it. My personal experience is more limited but includes the following:

(a). The children and relatives of CPC Central Committee members are amongst the beneficiaries of the wave of stock fraud in the US,

(b). The response to the wave of stock fraud in the US and Hong Kong has not been to crack down on the perpetrators of the stock fraud (so to make markets work better). It has been to make Chinese statutory accounts less available to make it harder to detect stock fraud.

(c). When given direct evidence of fraudulent accounts in the US filed by a large company with CPC family members as beneficiaries or management a big 4 audit firm will (possibly at the risk to their global franchise) sign the accounts knowing full well that they are fraudulent. The auditors (including and arguably especially the big four) are co-opted for the benefit of Chinese kleptocrats.

This however is only the beginning of Chinese fraud. China is a mafia state – and Bo Xilai is just a recent public manifestation. If you want a good guide to the Chinese kleptocracy – including the crimes of Bo Xilai well before they made the international press look at this speech by John Garnaut to the US China Institute.

China has huge underlying economic growth from moving peasants into the modern economy

Every economy that has moved peasants to an export-orientated manufacturing economy has had rapid economic growth. Great Britain industrialized at about 1 percent per annum. It was slow because all the technology needed to be invented for the first time. During the 19th Century US economic growth – once started – ran about twice the rate of the UK. They copied the technology which was faster than inventing it. Later economies (eg Japan, Malaysia, Thailand, Korea) went later and faster. As a general rule the later you industrialized the faster you went – as the ease of copying went up. In the globalized internet age copying foreign manufacturing techniques and seeking global markets is easier than ever – so China is growing faster than any prior economy.

This fast economic growth – which would happen in a more open economy – is creating the fuel for the Chinese kleptocracy.

The one-child policy drives massive savings rates

The other key fuel for kleptocracy is a copious supply of domestic savings to loot. The reason Chinese savings levels are so high is the one-child policy.

In most developing countries the way that people save is they have multiple children hopefully to generate a gaggle of grandchildren all of whom are trained to respect their elders. Given most people did not live to old age if you did you became a treasured (and well cared for) family member.

This does not work in China. Longevity in China is increasing rapidly and the one-child policy results in a grandchild potentially having four grandparents to look after. The "four grandparent policy" means the elderly cannot expect to be looked after in old age. Four grandparents, one grand-kid makes abandoning the old-folk looks easy and near certain.

Nor can the elderly rely on a welfare state to look after them. There is no welfare state.

So the Chinese save. Unless they save they will starve in old age. This has driven savings levels sometimes north of fifty percent of GDP. Asian savings rates have been high through all the key industrializations (Japan, Korea, Singapore etc). However Chinese savings rates are over double other Asian savings rates – this is the highest savings rate in history and the main cause is the one-child policy.

Low and middle income Chinese have very limited savings options

The Chinese lower income and middle class people have extremely limited savings options. There are capital controls and they cannot take their money out of the country. So they can't invest in any foreign assets.

Their local share market is unbelievably corrupt. I have looked at many Chinese stocks listed in Shanghai and corruption levels are similar to Chinese stocks listed in New York. Expect fraud.

What Chinese are left with is bank deposits, life insurance accounts and (maybe) apartments.

Bank deposits and life insurance as a savings mechanism in China

Bank deposits rates are regulated. You can't get much different from 1 percent in a bank deposit. Life insurance contracts (a huge savings mechanism) are just rebadged bank deposits – attractive because the regulated rate is slightly higher.

This is a lousy savings mechanism because inflation has been between 6 and 8 percent (but is now lower than that and is falling fast). At almost all times (except during the height of the GFC) the inflation rate has been higher – often substantially higher – than the regulated bank deposit (or life insurance contract) rate.

In other words real returns for bank accounts are consistently negative – sometimes sharply negative.

You might ask why people save with sharply negative returns. But then you are not facing starvation in your old age because of the "four grandparent policy". Moreover because of the underlying economic growth (moving peasants into a manufacturing economy) there are increasing quantities

of these savings every year. This is the critical point – the negative return to copious and increasing Chinese bank deposits drives a surprising amount of the global economy and makes sense of many things inside and outside China.

The Chinese property market as a savings mechanism

Chinese people have very few savings mechanisms. The major ones (bank deposits and their life-insurance contract twins) have sharp and consistently negative real returns.

Beyond that they have property.

Bank deposits have sometimes 5 percent negative returns. If you got 1 percent negative returns from property – well – you would be doing well. Buying an empty apartment and leaving it empty will do fine provided you can sell the property at some stage in the future.

It is commonplace amongst Western investors to view the see-through apartment buildings of China as insane. And they may be a poor use of capital. But from the perspective of the investors – well they look better than bank deposits.

Negative returns on bank deposits and the Chinese kleptocracy

Most Chinese savings however are not invested in see-through apartment buildings. Bank deposits still dominate. The Chinese banks are the finest deposit franchises in human history. They can borrow huge amounts at ex-ante negative real returns.

And those deposits are mostly lent to State Owned enterprises.

The SOEs are the center of the Chinese kleptocracy. If you manage your way up the Communist Party of China and you play your politics really well may wind up senior in some State Owned Enterprise. This is your opportunity to loot on a scale unprecedented in human history.

Us Westerners see the skimming arrangements. If you want to sell kit (say high-end railway control equipment) to the Chinese SOE you don't sell it to them. You sell it to an intermediate company who on-sell it in China. From the Western perspective you pay a few percent for access. From the Chinese perspective – this is just a gentle form of looting.

And it is not the only one. The SOEs are looted every way until Tuesday. The Business insider article on the spending at Harbin Pharmaceutical is just a start. The palace pictured in Business Insider would make Louis XIV of France (the Sun King) proud. This palace shows the scale (and maybe the lack of taste) of the Chinese kleptocracy.

A normal business – especially a State Owned dinosaur run by bureaucrats – would collapse under this scale of looting. But here is the key: the Chinese SOEs are financed at negative real rates.

A business – even a badly run business – can stand a lot of looting if it is (a) large and (b) funded at negative real rates.

Those negative real rates are only possibly because there are copious bank deposits available at negative real rates to State controlled banks.

The cost of funds in China and the willingness to hold foreign bonds

The Chinese Government (and the banks are part of the government even though they are listed) has access to seemingly unlimited bank deposits at negative real costs.

When you have copious funds at a negative cost a lot of investments that look stupid under some circumstances suddenly look sensible. US Treasuries look just fine. Don't think the Chinese are going to stop holding Treasuries. The Treasuries yield far more than they pay the peasants. The Chinese make a positive arbitrage on holding low rate US bonds.

Monetary threats to the Chinese establishment

The Chinese kleptocracy – and indeed several major trends in the global economy – depend on copious quantities of savings at negative expected rates of return by middle and lower income Chinese.

There are two core threats to this system – one widely discussed – one undiscussed.

Inflation (widely discussed) is known to produce riots and demonstrations in China – and is considered by Westerners to be bad news for the Chinese establishment. And there are good reasons why the Chinese riot with inflation – the poor who save because they are going to starve – get their savings taken away from them.

But ultimately the Chinese establishment like inflation – it is what enables their thievery to be financed.

The more serious threat is deflation – or even inflation at rates of 1-3 percent. If inflation is too low then the SOEs – the center of the Chinese kleptocratic establishment will not generate enough real profit to sustain the level of looting. These businesses can be looted at a negative real funding rate of 5 percent. A positive real funding rate - well that is a completely different story.

The real threat to the Chinese establishment is that the inflation rate is falling - getting very near to the 1-3 percent range.

Low Chinese inflation rates will mean reasonable returns on savings for Chinese lower and middle income savers. Good news for peasants perhaps.

But that changing division of the spoils of economic progress will destroy the Chinese establishment (an establishment that relies on a peculiar and arguably unfair division of the spoils). The SOEs will not be able to pay positive real returns to support that new division of spoils. The peasants can only receive positive real returns if the SOEs can pay them - and paying them is inconsistent with looting.

If the SOEs cannot pay then the banks are in deep trouble too.

All because the inflation rate is dropping. Maybe they can stop it dropping. The Chinese establishment has a vested interest in getting the inflation rate up in China. Because if they don't all hell will break loose.

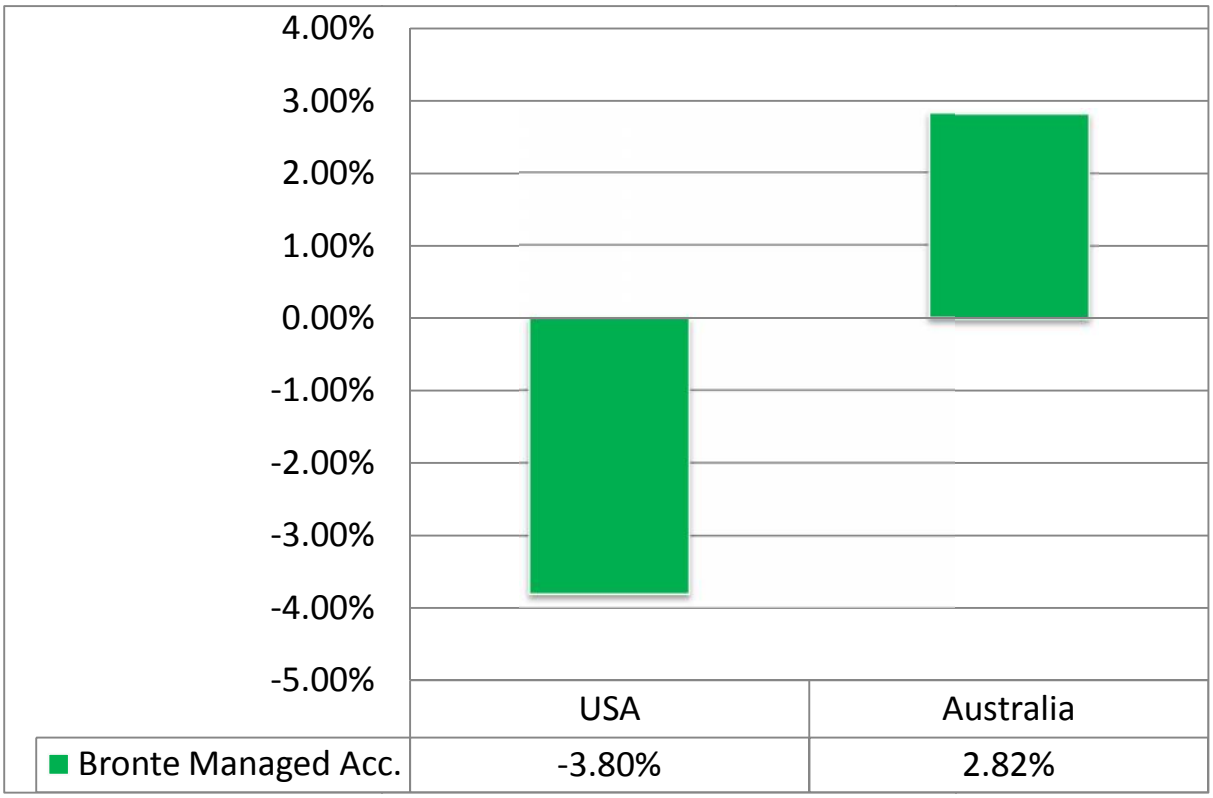
Unless the Chinese can get the inflation rate up expect a revolution.

Performance Data [2]

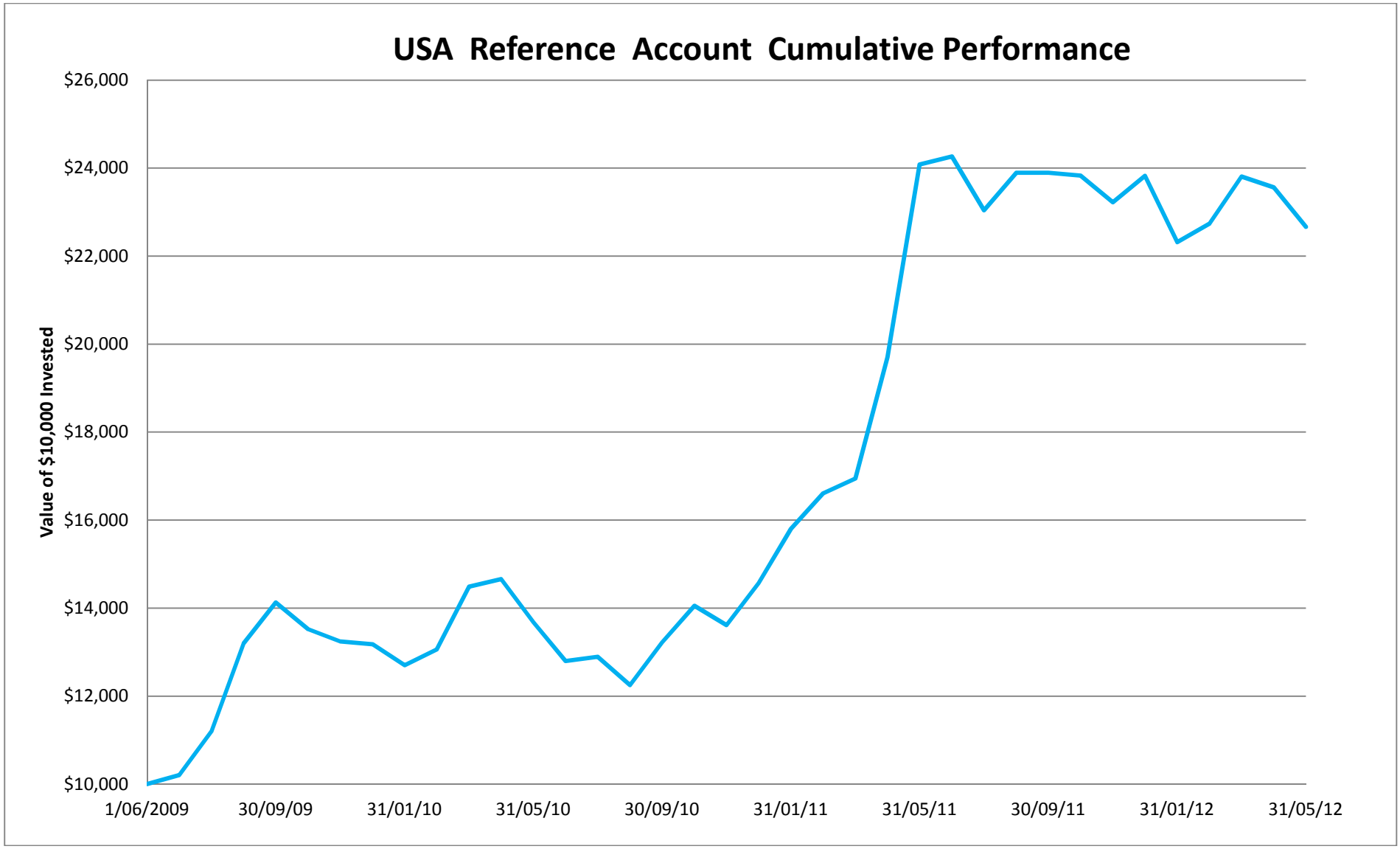
Portfolio Management

	Long%	Short%	Net Long%
USA Reference Account	122.98%	-56.58%	66.40%
Australian Reference Account	122.97%	-57.22%	65.75%

Reference Account Monthly Performance



[2] 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 decreased by 8.97% in USD and 2.17% in AUD during the month and since inception of the account has increased by 25.5% in USD and 3.9% 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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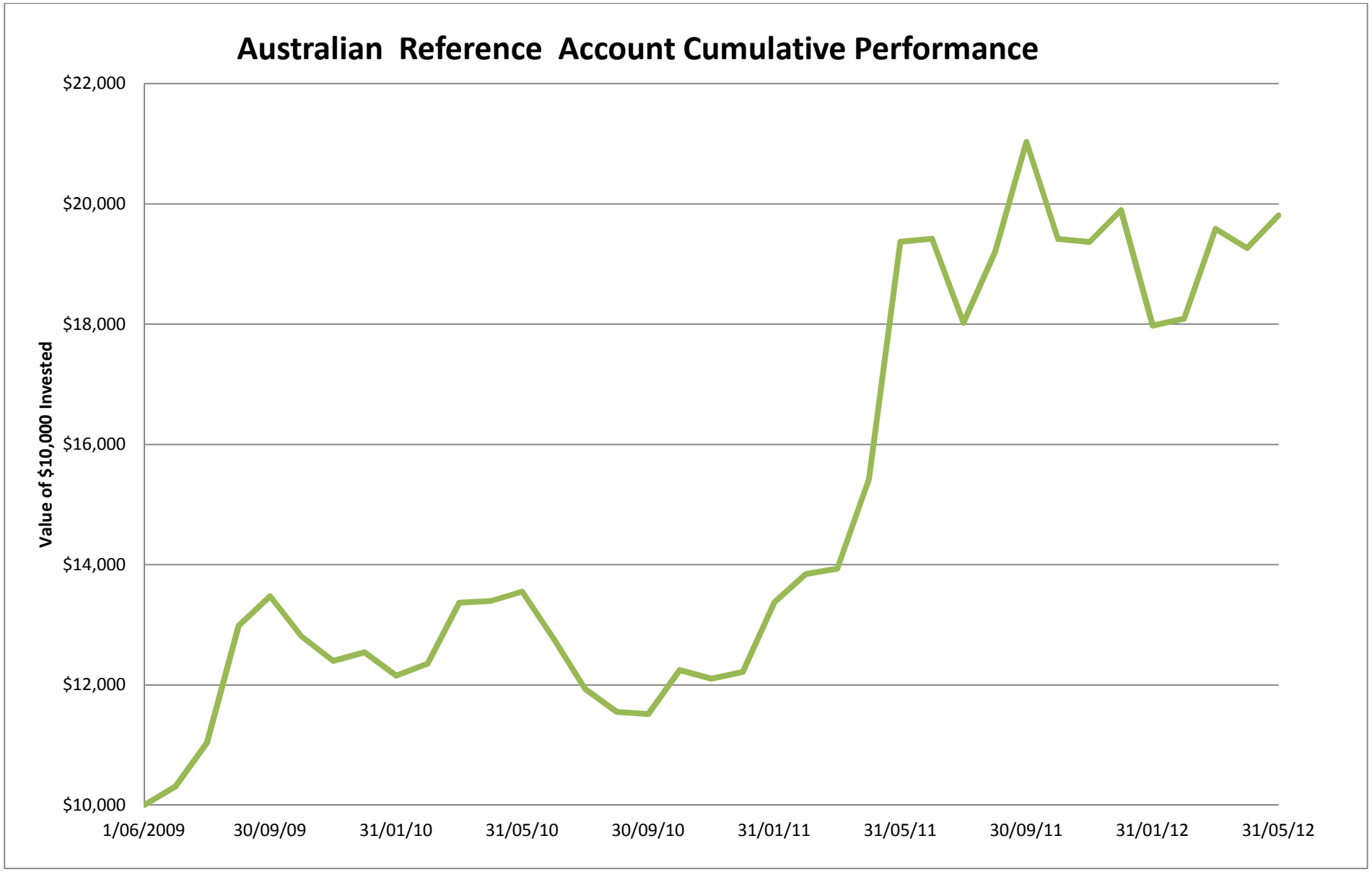
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