14 March 2013

Separately Managed Account Client Letter for February 2013

The numbers were sort-of acceptable in February – nothing to be proud of – but no disaster. We outperformed our internal benchmark (global equity indices) and underperformed the S&P – but the differences were well within the noise-factor of our portfolio.

Whilst the numbers were sort of okay, the process by which we got there was not. We made the worst stock picking mistakes we have made since January 2012 – mistakes we consider amateurish. [If you go back and read the January 2012 letter we drew a distinction between high-quality and low-quality losses – and confessed that month to low-quality losses. This month was a low-quality break-even...]

We are into self-flagellation at Bronte believing if we can't analyze our mistakes properly we will keep making them - and we aim to be better than that. So in this letter we will describe one of our mistakes in some detail.

But before that we should give a top-down look at portfolio management

The portfolio is becoming more levered

The aggregate portfolio as enumerated below is becoming more levered. Part of this is illusion. We have some arbitrages on – which mean we have offsetting longs and shorts in which the total possible loss is limited. We also have a few debt shorts on (though less now). Being short debt is loss-limited in that the value of debt cannot appreciate ad-infinitum. We do not consider loss-limited positions as adding substantially to (downside) leverage.

But part of the portfolio becoming more levered is real – and is a natural part of running a long-short book – and we need to reduce position sizes.

It is best to explain why by example:

Imagine for instance a hypothetical portfolio that looks a little like ours. The portfolio starts 125 percent long, but the longs have a beta of 0.9 meaning that in a market up-draft they go up about 90 percent of the market.

The same portfolio starts about 40 percent short – but the shorts are the wildest range of scummy, high-volatility, rat-bag companies imaginable. They have a beta of 1.5 – meaning they will move about 150 percent as much as market.

This is the starting position:

Bronte Capital Management Pty Ltd (AFS License: 334325)
Suite 2101B Tower 1, 520 Oxford Street, Bondi Junction, Australia.
Phone: +61 2 9389 3293 • Email: simon@brontecapital.com

Position	Actual (percent exposure)
Longs	125
Shorts	-40
Net exposure	85
Gross exposure	165

Now imagine the market goes up ten percent relatively fast (which is roughly what has happened).

The new portfolio will look like this:

Position	Actual (percent exposure)	Change
Longs	136.3	
Shorts	-46.0	
Net exposure	90.3	6.2%
Gross exposure	182.3	10.5%

A 10% market move has only increased net exposure by 6.1% But gross exposures increase by 10.5 percent.

We thus – without doing anything – become sharply more levered. But because beta adjusted net exposure has not moved very much and the portfolio has been profitable (as we were net beta long) there is not very much pressure to reduce gross leverage. But higher gross exposures do mean higher risks – and they constrain our capacity to put good new ideas on – so we are forced – over time – to reduce our gross exposures.

We are doing that at the moment – but it is hard. Firstly we have to trim off our shorts a little (and that is turning what we think are temporary losses into permanent ones) and we have to sell our longs in quantity. That is very hard because we like our longs a great deal (which is why we are long them).

As we write this letter we have gone through a fairly major portfolio review. We started with the assumption that we needed to pull ten percent out of the portfolio to get it back into balance. We found six and a half percent to remove – we will come back next week to find a few more longs to throw out. We only rebalance when it is a long way out of kilter (we are not people who desire to trade every day).

Our bad trade

As stated above we made some mistakes this month. The main mistake was a single bad trade. It cost us less than two percent of funds under management but it could have cost us three to four percent. We were short the equity of American Airlines in default.

There were two problems with this trade: our analysis (which was very faulty) and the size of our position (which was about two to three times too large).

The sizing was the more serious problem. We will make mistakes fairly regularly. Everyone does. We are well aware of this which means that our risk management is sophisticated. However this was a case where if we were right we gain X and if we were wrong we might lose 5X. Even if winning is extremely likely it is wrong to have a substantial position in such a bet because the consequences of loss are severe.

And when your analysis was as flimsy as ours it is wrong to have any more than a position of about one half of one percent. Our position was several times that – and whilst we only lost a low single digit percent of your money it could have been worse. Dumb luck played its part.

The analysis mistake

We watched the behavior of US Airways in bankruptcy and in particular the behavior of the CEO, Mr Tom Horton. CEO's in bankruptcy most often have a simple agenda: compromise as many liabilities as possible and emerge from bankruptcy as a stand-alone airline with as few liabilities as possible. Then (of course) award oneself equity in this business and compete on the basis of a better balance sheet and cost structure.

This is a strategy of getting rich at the expense of the creditors in bankruptcy. With creditors taking large haircuts there is no recovery for equity.

And this appears to have been Tom Horton's strategy. That was the sum-total of our correct analysis.

We have a strategy of taking positions based on behavioral traits. Mostly we find repeat offenders at the promotional end of the investment spectrum and short their latest re-incarnation – and mostly it works. Bankruptcy proceedings threaten careers and create opportunities for untold wealth. Human behavior, here as well, is somewhat predictable.

There were plenty of mistakes.

The first and most important mistake was to underestimate the success of the creditors' committee in side-lining Tom Horton. The American Airlines management lost control of their bankruptcy process. The most significant place where Horton lost control was in his negotiations with labor. Horton overplayed his hand.

With union support the creditor committee took control of the process. At this point we were not shorting Tom Horton (something we would happily do) but shorting the work of a very competent creditors' committee. This was dumb. Beyond that there were some flat-out amateurish mistakes. For instance American Airlines consistently overestimated the amount of debt subject to compromise. However we took seriously the estimate of debt-subject to compromise and we thus overestimated the amount of debt that was senior to the equity.

Further we had an amateurish – even embarrassing – misunderstanding of the position of single-dip and double-dip creditors in this bankruptcy. (I know – it is technical – but understanding this stuff is what you pay us for).

Finally we underestimated the determination that Doug Parker (who runs US Airways) had to consolidate the US Airline industry and to control it. This consolidation (not necessarily to the benefit of his own shareholders) is what animates Doug Parker. We believe he overpaid.

In summary we were shorting the wrong thing on wrong analysis. We thought we were shorting Tom Horton. But Tom Horton was mostly irrelevant. We were in fact shorting competent people and the determination of the airline industry to get big at any cost.

Current portfolio considerations

Our portfolio is causing us some angst at the moment – but mostly for high-quality reasons. For the reasons described above we have become increasingly levered and we need to reduce positions. We are doing so.

However we are awash with good ideas – particularly on the short side. We do not have a shortage of things to invest in – and there is a little portfolio rebalancing going on to increase the quality of our portfolio. Our problem is not finding things to trade (we have ideas). The problem is finding the best things to trade.

Thanks again

John and Simon

Performance Data [1]

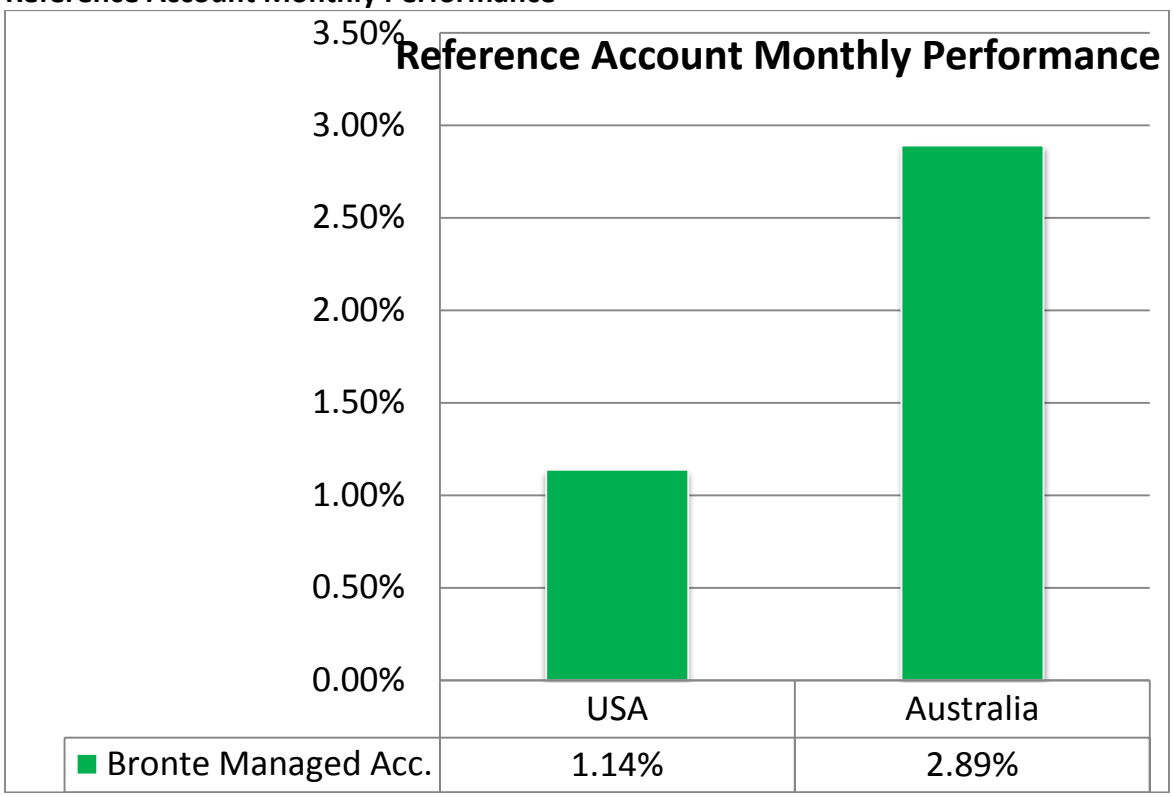
Portfolio Management

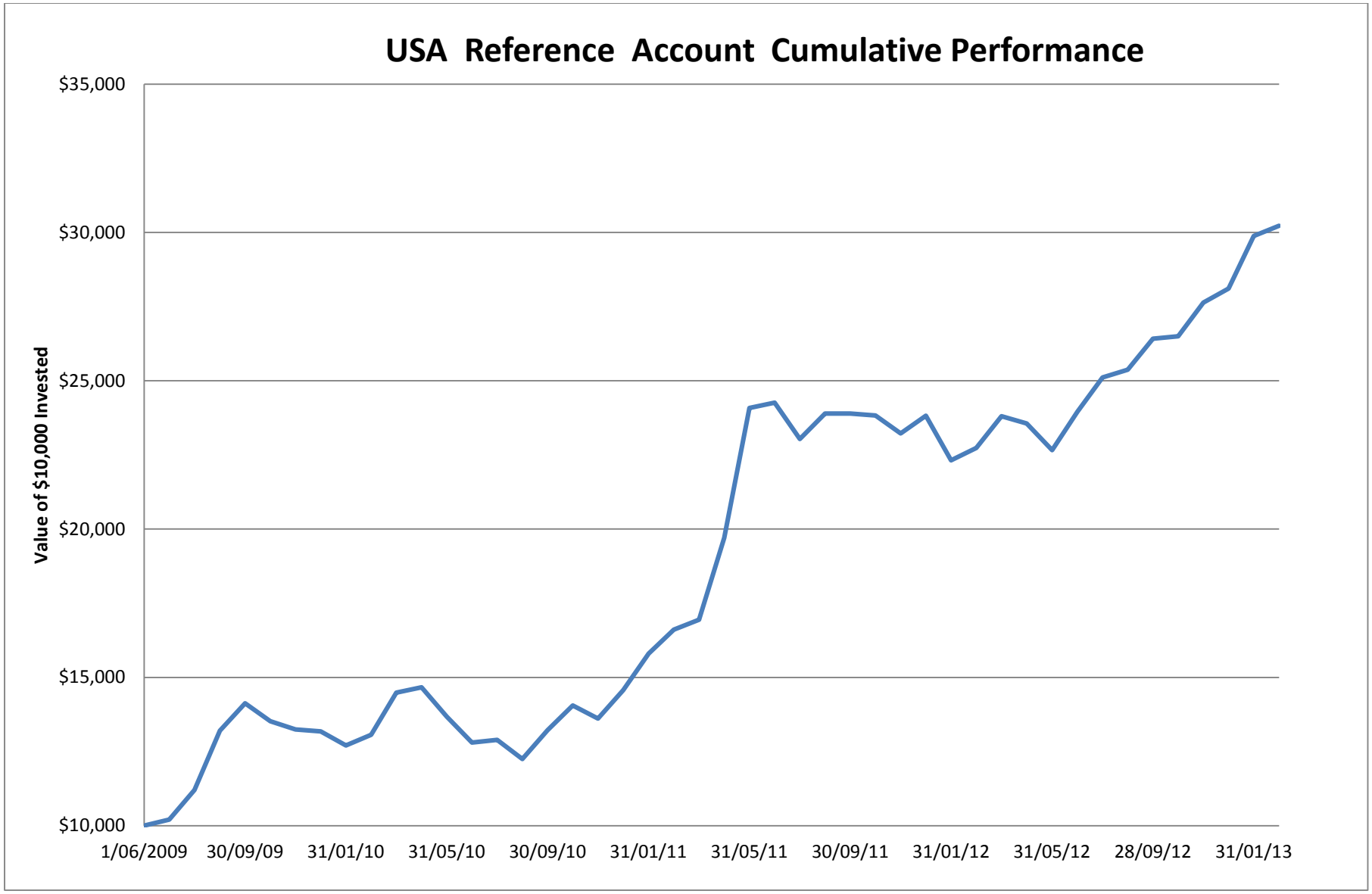
	Long%	Short%	Net Long%
USA Reference Account	150.70%	-60.99%	89.71%
Australian Reference Account	152.51%	-66.48%	86.03%

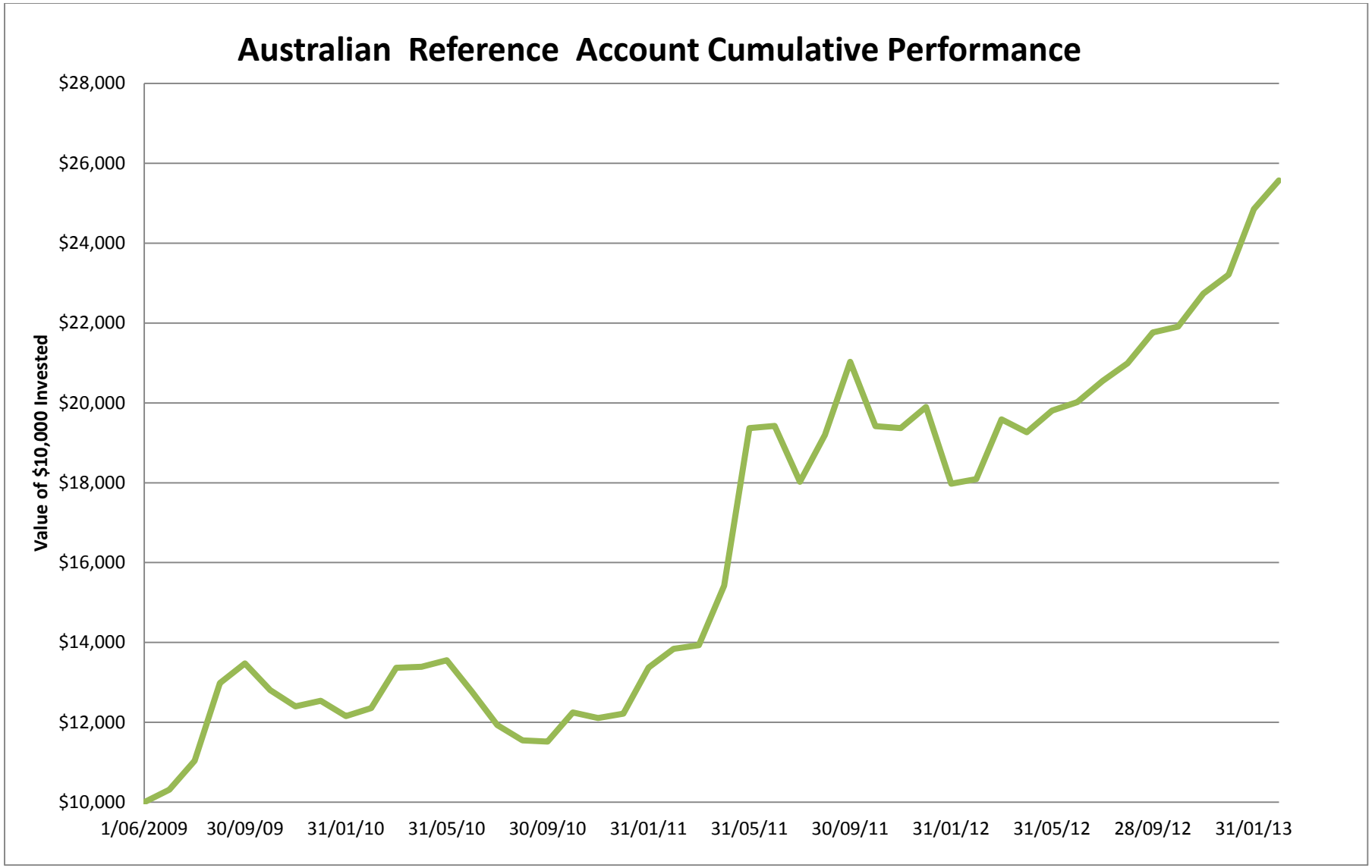
(Note: The USA Account short position includes 5.82% arbitrage and risk limited longs and (14.77%) arbitrage and risk limited shorts. The Australian short position includes 5.88% arbitrage and risk limited longs and (19.98%) arbitrage and risk limited shorts. Bronte may exceed its risk limits when the risk is itself limited (e.g. by shorting bonds or holding put options instead of shorting common stock)

[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 decreased by 0.02% in USD and increased by 1.14% in AUD during the month and since inception of the account has increased by 51.43% in USD and 18.63% in AUD terms. Past results are not indicative of future returns.

Reference Account Monthly Performance




USA Reference Account Cumulative Performance
Value of $10,000 Invested
$35,000
$30,000
$25,000
$20,000
$15,000
$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
31/05/12
28/09/12
31/01/13


Australian Reference Account Cumulative Performance
Value of $10,000 Invested
$28,000
$26,000
$24,000
$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
31/05/12
28/09/12
31/01/13