

12 July 2013

Separately Managed Account Client Letter for June 2013

Our USA reference SMA was down 4.3% and our Australian one was flat. We feel that this was a rather ordinary result following a good run. Many other funds would just go on. Some big funds we know of (9 billion dollars in one case) seem never to hold post-mortems.

That is not us. This letter is going to spell out the recent negatives. There are two:

- The perennially challenging part of our portfolio – our particularly scummy-company US shorts – did not perform as expected.
- Our US telecoms did not perform brilliantly although they did perform within our range of expectations.

The unsatisfactory US shorts

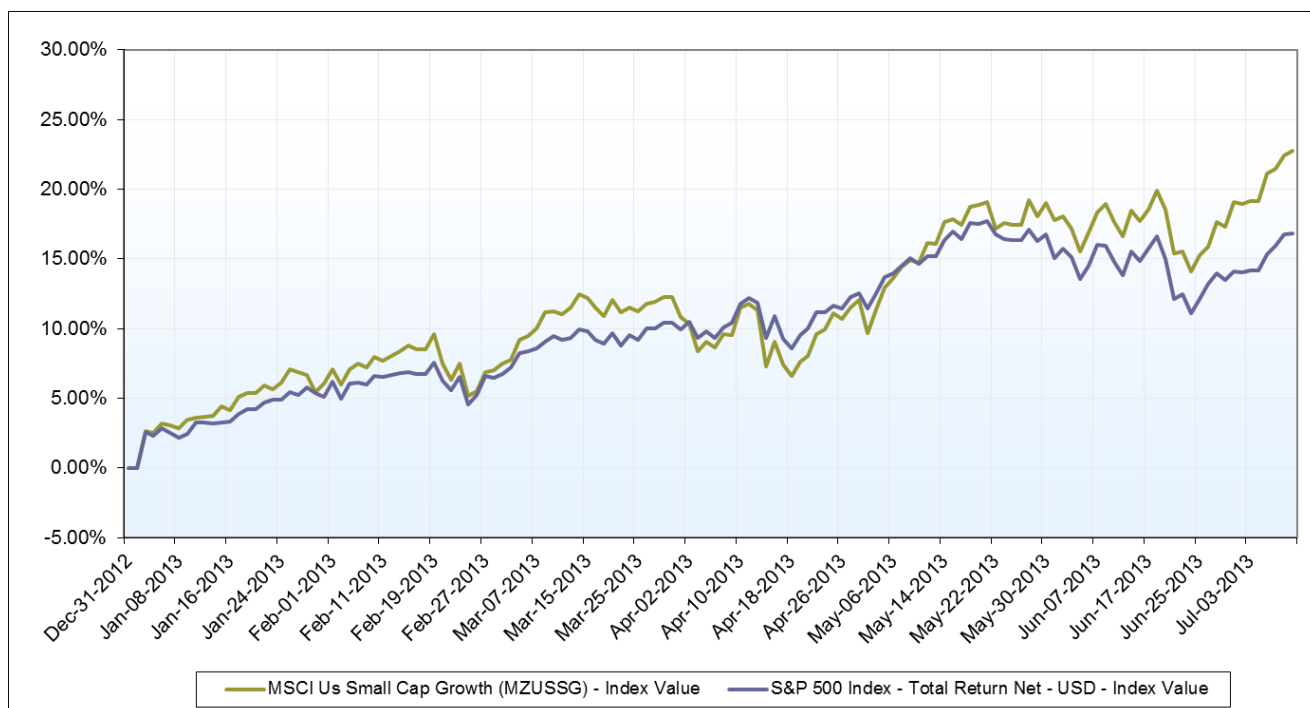
The US suspect-company short area can get crowded. Sometimes borrow costs go up. Sometimes the behavior of other hedge funds can drive these companies. To a large part (and especially post January 2012 – our only really bad month across our broader fund platform) we have diversified our shorts globally and avoided some, albeit not all, of these problems.

June 2013 (and the period into July) would – if we had not learned the lesson of January 2012 – also have been fairly ugly. Instead it was only ugly within a small (but important) part of the portfolio.

To recap, our basic positioning is long high quality companies run by people who you would be pleased to have marry your daughter. Good companies mostly within the mega-caps. We are very selective in this space and invest where we believe we have an edge versus the market at large. Against this we are short the widest range of stock promotes and highly questionable groups you can imagine.

Most of these stock promotes are sold on “growth prospects” and most are not large cap. We are long a subset of mega-cap quality and short a subset of small cap (but phony) growth.

Below is a graph of the MSCI small cap US growth index vs. the S&P 500 over this calendar year. These roughly level pegged until mid-May. Long one, short the other was a good hedge. Then they diverged by more than 5 percent. Our basic positioning lost money and our stock picking did not offset it.



As markets go up our longs go up and our shorts go up. We become more levered. We also had the above divergence which made us more levered still. We had to have a “risk management discussion”. A “risk management discussion” is something that happens when positions move far enough against you that you need to reduce them. That is, they are a confession that you are losing money – and it is better to bite hard, swallow the losses and move on.

And we did. We performed – mid month – the biggest risk cut we have done since founding Bronte. Fortunately too because the market kept moving away from us. Still as we have said many times most of our shorts collapse eventually. We lose money in the interim on them only if they go up too far on their way to collapse that they force us to cut positions. Offsetting this, our non-US shorts did alright for most of the year and do not cause us pain now. For instance we remain profitable on UK and Canadian shorts despite what has obviously been a bull market.

The recent losses from this have been small. Our discipline remains intact. We quite like the portfolio’s prospects at the moment. Simon is inclined to describe the underwater shorts as “latent profit” and maybe that will occur - but John is never quite that optimistic. We are still (as always) vulnerable to a period where the market races ahead and the small speculative-growth stocks (of which the frauds and promotes are a subset) tend to race away. In this case the problem will be underperformance, not substantial losses.

The US Telecoms

We have a radically different view of the mainstream US telco-carriers than the market. We think they will have increasing pricing power over the next five years – and that they should be treated as growth stocks with dramatically improving economics. We believe that the market is (falsely) extrapolating the long history of these companies being highly

competitive and having ordinary profits, and hence fails to understand the real change in business prospects that is taking place.

The market mostly treats them as grandma stocks – as alternatives to bonds. The yield on AT&T (five percent) or Vodafone (over seven percent) is the reason most people hold them.

When the bond markets turned ugly in the middle of the month these stocks misbehaved a little. That is not surprising – the market sees them as bond alternatives. We are very long telecommunications stocks and that hindered this month's returns.

On the ground evidence suggests that our bull-case is largely intact. AT&T for instance just increased to 24 months the time between phone upgrades in their contractual terms. [They followed Verizon on this policy.] Make no mistake; lower handset subsidies are a de facto price rise and are good for shareholders. There are many similar policy changes happening currently.

Observations

This letter sounds like bad news – but don't be misled. We are optimistic about the portfolio and we think we will continue to do better-than-adequately. We are obsessive about risk management and that makes us sound like we are pessimistic Cassandras. We are not.

Still risk management means that sometimes we have to trim what are likely to be long-run winning positions. It is not pleasant and it is not natural but it is necessary for managing your money prudently.

China

On the ground data from China suggests that the lending market remains very tight. Corporates pay mostly with bank acceptances. They deposit a large fraction of the bank acceptance in the bank, and are then issued bank bills. Banks used to discount those bills very readily. They are not now – and they are forcing more and more of the trade finance onto the acceptance system.

This is the sign of a bank system desperate for liquidity and unwilling to make real loans.

We have several short positions that should work if the slowdown in China is as big as we expect it to be. These include the Australian dollar and some large-cap mining stocks. We are not short the obvious Australian mining companies.

Thanks again

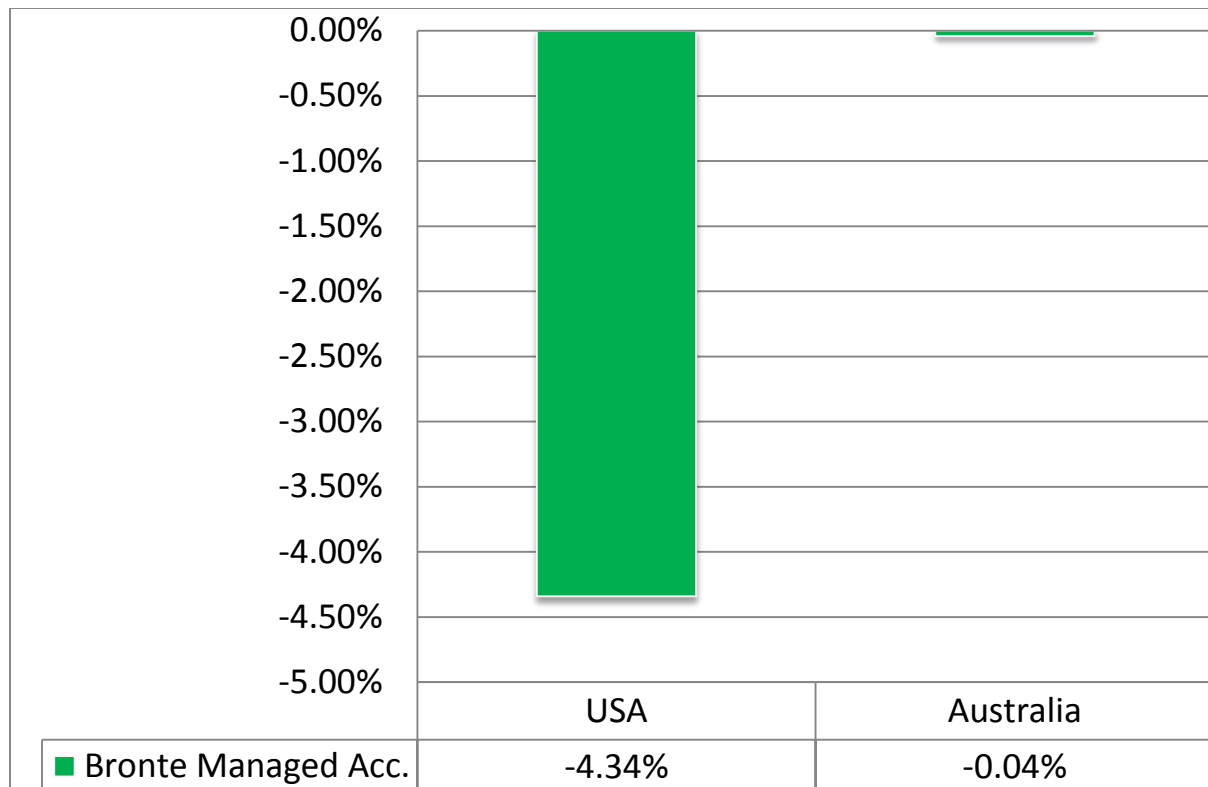
John and Simon

Performance Data¹

Portfolio Management

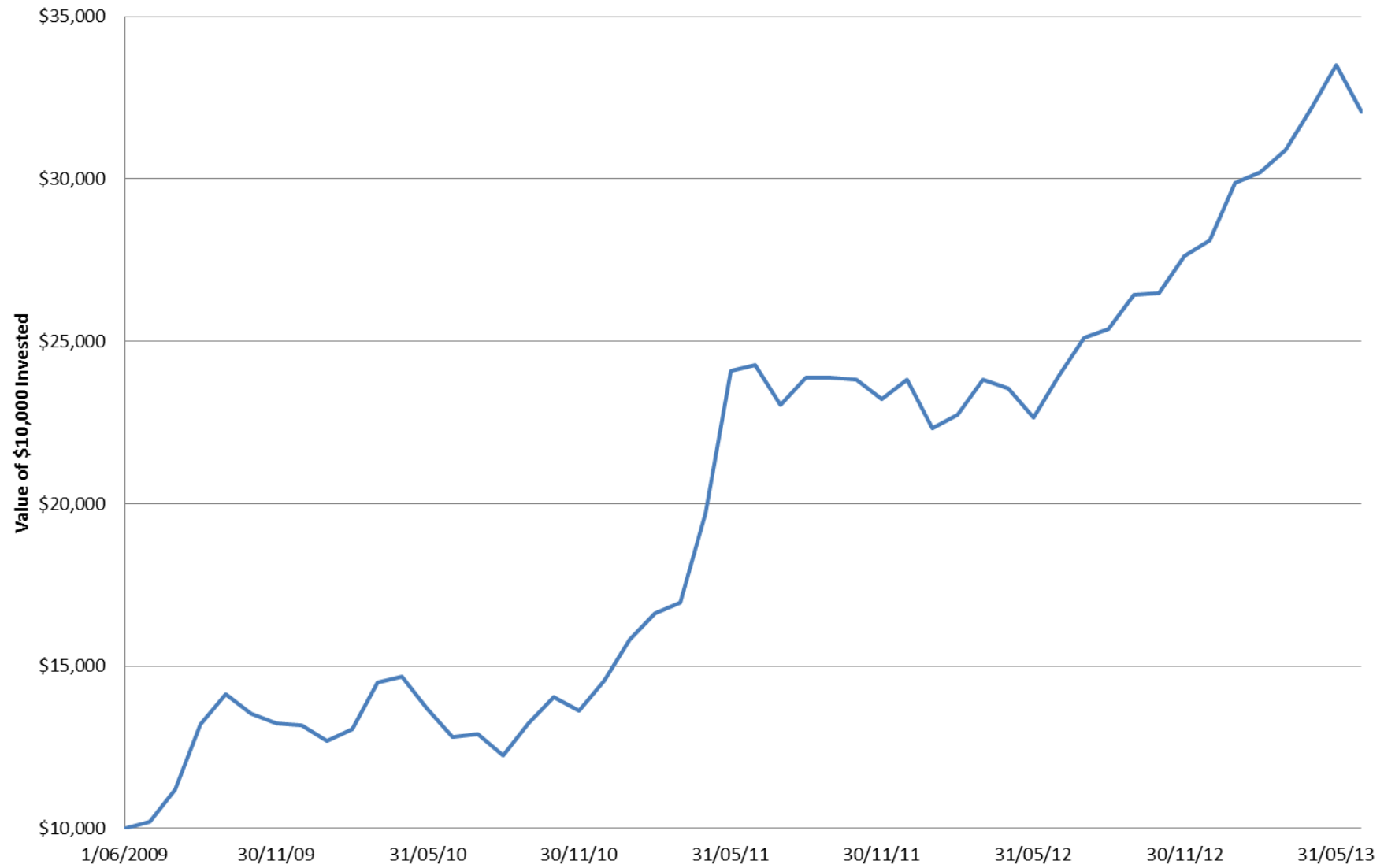
| | Long% | Short% | Net Long% |
|------------------------------|---------|---------|-----------|
| USA Reference Account | 145.61% | -54.79% | 90.82% |
| Australian Reference Account | 145.19% | -55.05% | 90.14% |

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 decreased by 2.93% in USD and increased by 0.99% in AUD during the month and since inception of the account has increased by 55.5% in USD and 33.2% in AUD terms. Past results are not indicative of future returns.

USA Reference Account Cumulative Performance



Australian Reference Account Cumulative Performance

