17 March 2014

Investors' Letter for February 2014

This wasn't a bad month like January, but it wasn't a good month either. We were marginally up – but we did not do as well as we would expect given the size of the market movements. Adverse movement of the Australian dollar was a headwind but is not a sufficient justification of the small return.

Bluntly we underperformed our expectations but not by an amount that worries us (nor an amount that should worry you).

The bigger problem is that we no longer know how you outperform in this current market.

Things that should work are not working. The market is simply ignoring obvious frauds even when competently exposed. Shorting promotes and outright frauds – which is the bread-and-butter of our short-book – just doesn't work right now.

The most shocking thing about January – a month where we underperformed a falling market – was that when the market turned down we lost money on our shorts. This is not meant to happen – and we have been trying to work out how to stop it happening again. We have no real solutions except continuous diversification of the short-book so that it gets – at least in the short-term – more correlated with the market.

Valuation shorts on good, but expensive companies look even worse than our high-beta-frauds/promotes. The market is bidding popular stocks up to levels that discount the hereafter. We, for instance, are not short Tesla – and we think it is possible that Tesla earns its valuation – but at this price almost everything needs to go right for Tesla to be a good investment over ten years. When the market is discounting five years of good news in a well-managed, albeit speculative, business model we are not interested (long or short). We don't think you should play in these stocks either.

Facebook is just as extreme. We owned the stock in the 20s. At that time the business was about half a dozen times forward revenue and that revenue was growing fairly fast. To make money on the stock all you needed was for things not to go dramatically wrong.

Facebook now trades at 14 times forward revenue (on our estimation). To make money on the stock you need things to go continuously right for some time. It's possible. It is a very well-managed company.

We think we are rational when we say it is not a bet we want to take.

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Bluntly though, this outlines our problem. This market is not rewarding rationality. At least it is not rewarding our sort of rationality.

But we are not prepared to give up being rational. We think being rational will give you very respectable returns over the longer haul. It has been lousy now for a few months.

So we are struggling. If we add value at the moment – and we think we are despite the year-to-date results – it is because the portfolio is well positioned for large inflexion. We hope at least to tread water until the inflexion comes.

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We have one largish potential shift in the long book. We are committed (intellectually and financially) to the view that average revenue per user for cell phones in the US and other high use markets (Seoul, Istanbul and other markets) will be considerably higher in five years.

This thesis is dependent on the technical problems of scaling up data capacity indefinitely. We figure if the carriers cannot raise the capacity they will have to raise prices. Rising prices (or even mildly falling prices) will, given the massive increase in demand, be a very big win for the carriers.

The thesis was challenged by of all things the Superbowl. In an Australian football stadium your cell phone simply does not work with 70 thousand people in the stadium. There is not enough network capacity. The Superbowl (sponsored by Verizon) demonstrated that 70 thousand high use people could be accommodated in an open arena and could still get decent coverage. There were roughly 1000 towers hidden in that arena and these were often not small transmitters. The signal-noise ratio issues seems to have been solved with enormous numbers of transmitters. If this solution can be taken cheaply and efficiently to the streets of Seoul and New York then our thesis is wrong.

John is spending some time in the US trying to work out how this was done. There are large investment themes that hang off this. We intend not to miss them.

<u>The future</u>

Longer term we are as bullish about Bronte as can be. Our competitors in the short space are being carted away and our risk management has meant that we are not. A world without competitors in the short selling space should be very profitable indeed.

And we think rationality will work on the long side too.

We just need to work hard, keep our discipline intact and we (meaning you) will get there. The difficulties here are emotional rather than intellectual. It's hard when you see bozo idiots getting rich – and besides – as they get rich they don't look like bozo idiots. [Wealth tends to make people look smarter and more physically attractive. Wealth from inheritance or irrational speculation has the same properties.]

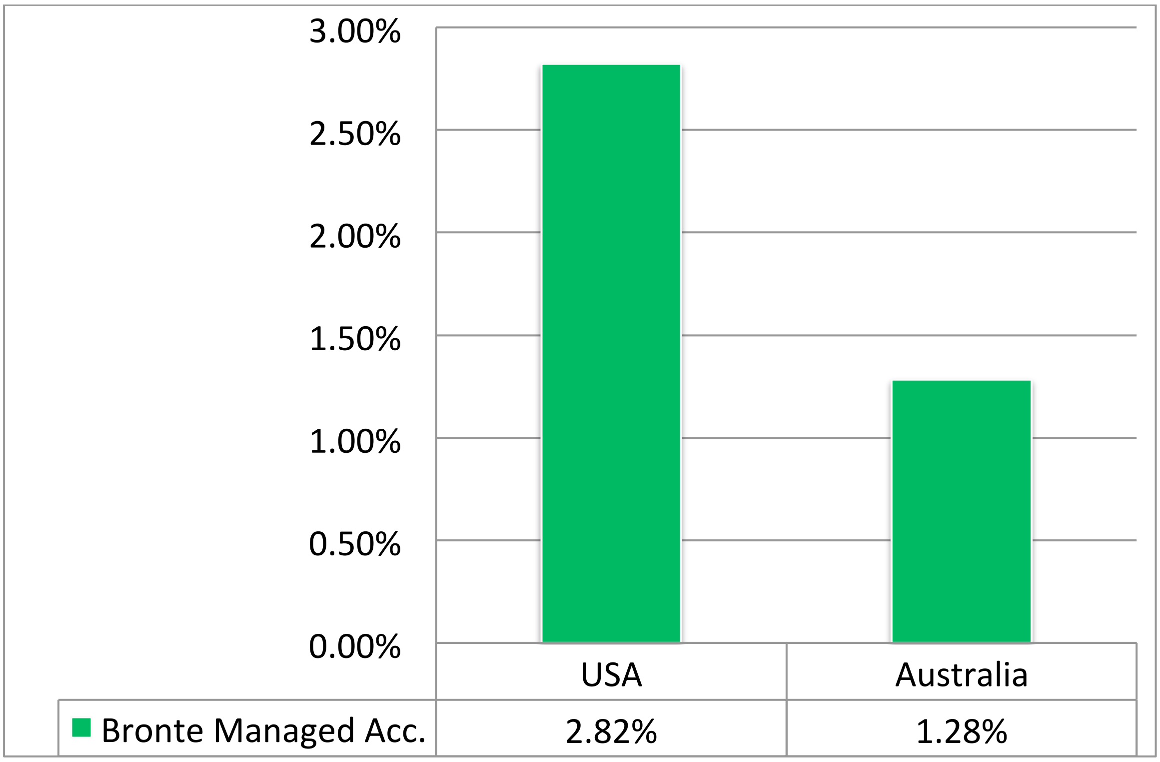
Being in Australia and at Bondi Junction is an advantage. The siren-song of the momentum crowd is far away. Discipline is easier to keep because emotions are hosed down a little. But it is still tough. There isn't a day we don't remind ourselves to maintain our rationality.

Thanks again

John and Simon

Performance Data[1]

Reference Account Monthly Performance



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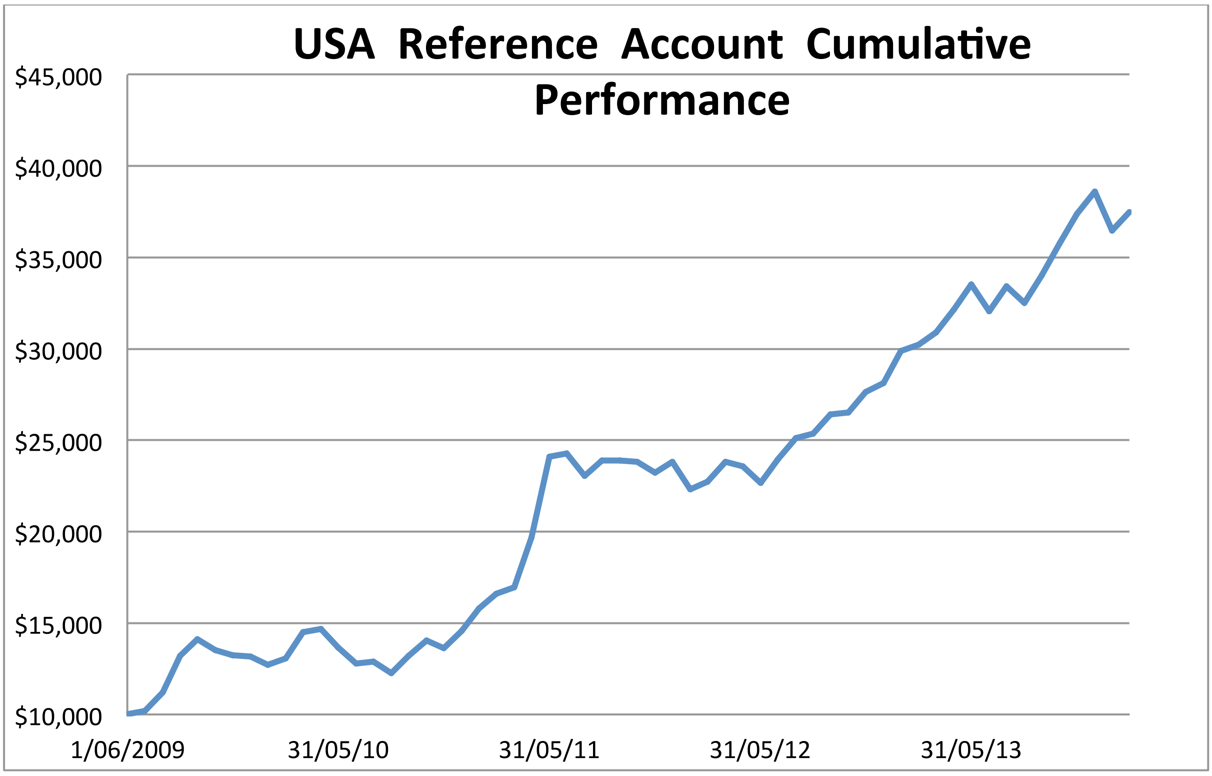
[1] All performance data is adjusted to allow for an accrual of the annual performance fee. All dividends received and earnings are retained and reinvested in the account. The volatility of the account may differ materially from comparable indices. The comparison index used by the advisor increased by 4.8% in USD and by 2.7% in AUD during the month and since inception of the account has increased by 79% in USD and 61% in AUD. Past results are not indicative of future returns. Fees charged on the separately managed accounts are 1.5% management fee and 15% annual performance allocation (with no high water mark) and differ from the standard terms for Bronte pooled funds which are 1.5% management fee and 20% annual performance allocation (with a high water mark). Moreover the separately managed accounts do not have incoming or outgoing flows which would incur trading costs.


USA Reference Account Cumulative Performance
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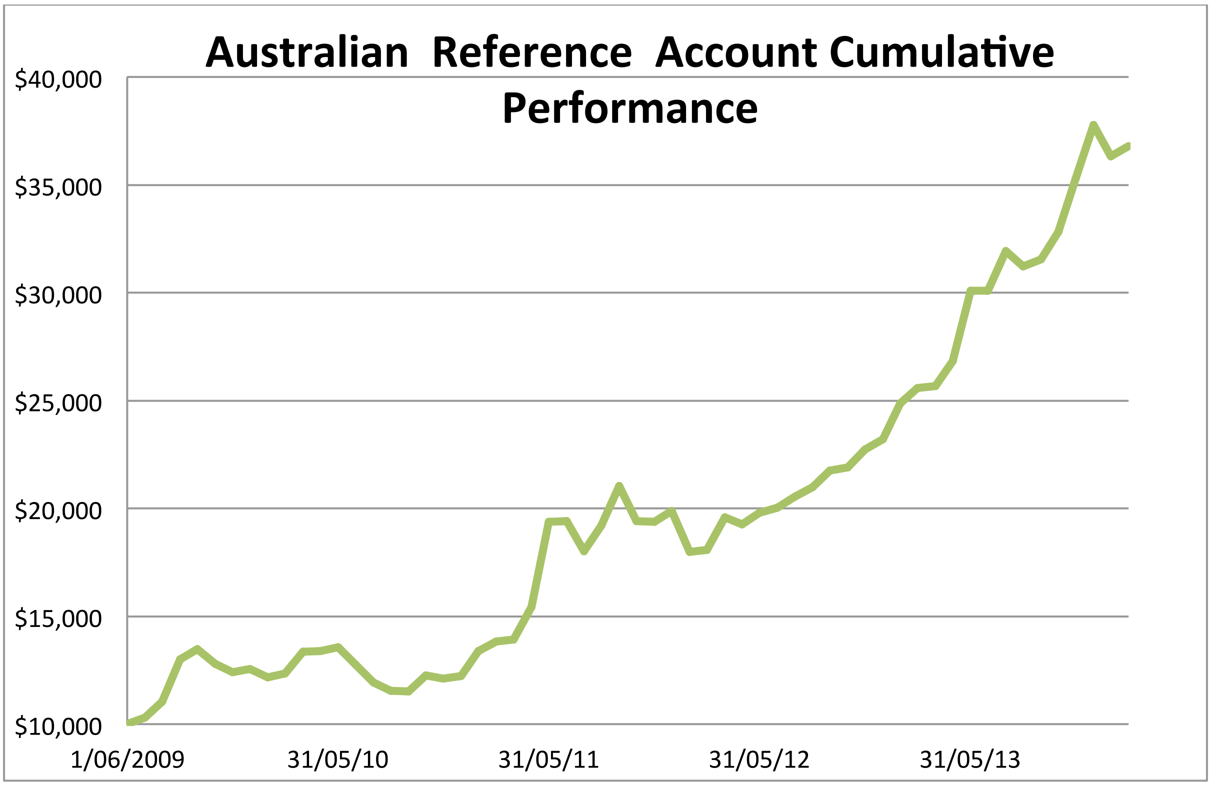
$40,000
$35,000
$30,000
$25,000
$20,000
$15,000
$10,000
1/06/2009
31/05/10
31/05/11
31/05/12
31/05/13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31/05/13