BronteCapital
Amalthea Fund

31 July 2014

Investors' Letter for June 2014 and End of Financial Year Update

Dear Amalthea investor,

This letter, in addition to providing our usual monthly commentary, also updates you on the end of financial year fund distribution calculation determined by the fund's accountants – Moore Stephens.

End of Financial Year

Firstly, the distribution calculation has determined that, although the accounting return for the fund is a 15.2% net gain, the fund is in an overall tax loss position and so no distribution will occur. This is the same situation that applied in the 2013 financial year and is not unexpected due to our investment process. The fund incurs borrowing charges on many of the stocks it shorts thereby incurring a realized expense. Similarly it makes payments in lieu of dividends for stocks that it is short, and has other additional realized expenses (brokerage, fees etc.). On the other hand much of the fund's gains remain unrealized and therefore do not contribute to any distribution assessment.

This is in keeping with our strategy of holding deep value longs for a considerable time - with the additional benefit of achieving discounted capital gains treatment upon their sale. In this respect we are pleased to advise that the fund achieved "Managed Investment Trust" status at the end of its first full year and therefore will be able to distribute tax advantaged discounted capital gains to its investors in future. Given that the fund is presently only 14 months old, realized discounted capital gains are expected to be modest in its early years and more significant in future years.

June Commentary

It wasn't a good month – and we scored a couple of percent less return than we should be getting with this sort of market. The Aussie dollar was a head-wind too. As with most of this year, we were hurt by our short portfolio – with the most fraudulent and stupid stocks causing abnormal pain.

There was an FT story[1] about how hedge fund short exposure has shrunk to its lowest level since the crisis. We can understand why: being short in this market produces a pain response similar to banging your head against a wall.

[1] http://www.ft.com/intl/cms/s/0/b5445190-069c-11e4-8c0e-00144feab7de.html?siteedition=uk#axzz36yJcuu2p

Bronte Capital Management Pty Ltd (AFS License: 334325, IARD No. 151222)
Suite 2101B Tower 1, 520 Oxford Street, Bondi Junction, Australia.
Phone: +61 2 9389 3293 • Email: simon@brontecapital.com

But we want to disagree with the consensus move, and we don't think it is because we are too stupid to know when it makes sense to stop banging your head against a wall. This is a market where stock-frauds no more robust than the average penny-stock mailer wind up with market caps in the half-billion dollar range. Some wind up with multi-billion dollar market caps. The exposure of Gowex (a Spanish WiFi provider) by Gotham Research demonstrates that some stock market stars are grotesque frauds. The dross feels very toppy. Contra: it has felt toppy for a while – and then added fifty percent.

Despite this, we have maintained our short exposure as everyone else is cutting theirs.

Call us suckers for punishment.

The punishment over time has been muted because our long stock picks have been extremely good. What we lost last year on shorts we more than made up for with our longs.

This calendar year our longs simply haven't cut it. We just haven't made enough money for you, yet – and for that we are sorry. We are also trying to remedy that. [Though we suspect the remedy will come through our short-book.]

John and David (our new analyst) have just been to Europe mostly looking for longs. (We looked at some shorts too – and those were comical meetings with fantastic claims made by people lacking credibility.)

Almost everything we saw (on the long side) seemed 30 percent expensive – not diabolical for a decade long investment – but hardly encouraging.

A typical example was Unilever (the giant fast-moving consumer goods company). It still grows but the margins are lower than say Procter & Gamble or Reckitt Benckiser. [The margins for the three companies are sub 15 percent, and 19.6 and 26 percent respectively.]. Unilever is priced at 2.1 times sales, Procter at 2.9 times, and Reckitt at 3.8 times.

Unilever management are targeting fatter margins. Margins have fattened up a little over the past few years - but only a little. By comparison margins at Reckitt have risen from 16 percent a dozen years ago.

2.1 times sales for something with a 14.5 percent margin is not desperate. Here is the calculation: $100 in sales represents $210 in market capitalization and $14.50 in pre-tax profits. At a 28 percent tax rate that $14.50 in pre-tax profits winds up as $10.44 in post-tax earnings. Against $210 in market capitalization that gives an unlevered PE ratio of just over 20 times. [You can produce lower PE ratios by leverage – but then the earnings don't all belong to shareholders but must be used to repay debt.]

Twenty times earnings feels 30 percent expensive to us (at least versus a price where you stick the stock in the bottom drawer to hold forever). It certainly doesn't meet the Warren

Buffett "punch card" test.[2] But you could win on the stock... if margins were to increase to Procter & Gamble type levels the stock would appear cheap – especially if sales continued to grow. But there are plenty of things that could go wrong too. The company sells through a lot of what they call "traditional trade". This is street-shops in India and the like – small scale retail. The markets are moving – almost everywhere – to what they call "modern trade", meaning chains with superb in-house logistics and prices low enough to make traditional retail non-viable. Unilever seems to think the traditional retail is fatter margin (though if it is it becomes very difficult to explain the ultra-fat margins of the other fast-moving consumer goods companies).

Worse than that though - Casino – a giant French retail and property chain – told us about their new-found ability to pressure their fatter-margin suppliers. They thought that three or four years ago the power lay with the P&Gs of this world – but less so now. If that is true then almost all of the giant consumer good companies will suffer either falling sales, falling margins or both – and the great march upward of Reckitt Benckiser and P&G stock will end.

That summarises how we feel about lots of longs. They might not kill you if you hold them for a decade but they have risks and they start pricey. We think that portfolios that are built purely with index like long stock positions – that is most peoples' portfolios - are unlikely to provide great long term returns from where we sit today.

The two surprising meetings

When we visit other countries wanting to see companies there are usually a list of "must-see" operations. Then we fit other companies in around the core objects of our trip. In this case the two most interesting companies were "extras" we did not originally plan to see. They were:

(a) Compass Group PLC – a global provider of food service at universities, hospitals, airport lounges, businesses, oil platforms and the like; and

(b) Rolls Royce – a maker of jet engines.

Neither were companies we thought we would be excited by.

Strangely the stocks are priced extremely similarly – Compass has a 7 percent EBIT margin and is priced at 1.1 times sales. Rolls Royce is slightly closer to an 8 percent EBIT margin and priced at 1.2 times sales.

You would think that making and maintaining jet engines was harder to do and fatter margin than serving food at an airport lounge. But it seems not.

Compass Group is vast. It has over half a million employees and has integrated itself with quality logistics companies in every market. Most vast-employee number companies doing

2 Warren Buffett says (correctly we think) that most investors would be better off if they thought of investing as having a twenty-hole punch card. After 20 punches you're all out – so you had best punch wisely.

simple things (e.g. laundry service outsourcing for hospitals and hotels) have low single digit margins and are ruthlessly competitive. Compass earns roughly double them. There is a trick here – a simple trick.

Food is emotional. And because it is emotional you get pricing power. If a University (say University of Pennsylvania) or a tech company (say Google) find the food service adequate they are not going to quibble with pricing over a stray 3-5 percent margin. *The same is not true of laundry services or cleaning services.* The result is that if the execution is good (and Compass has been good) then you can earn superior returns. [Both Penn and Google are clients. Indeed we believe that Compass is by-far the biggest supplier of Google's legendarily good in-house food-service.]

And the proof this is the trick: David acutely observed that Compass got out of the business of serving food in prisons. In prisons bad food is a feature, not a bug. Indeed it is part of the punishment. The ability to extract extra margin from our emotional attachment to food simply does not work in a prison environment.

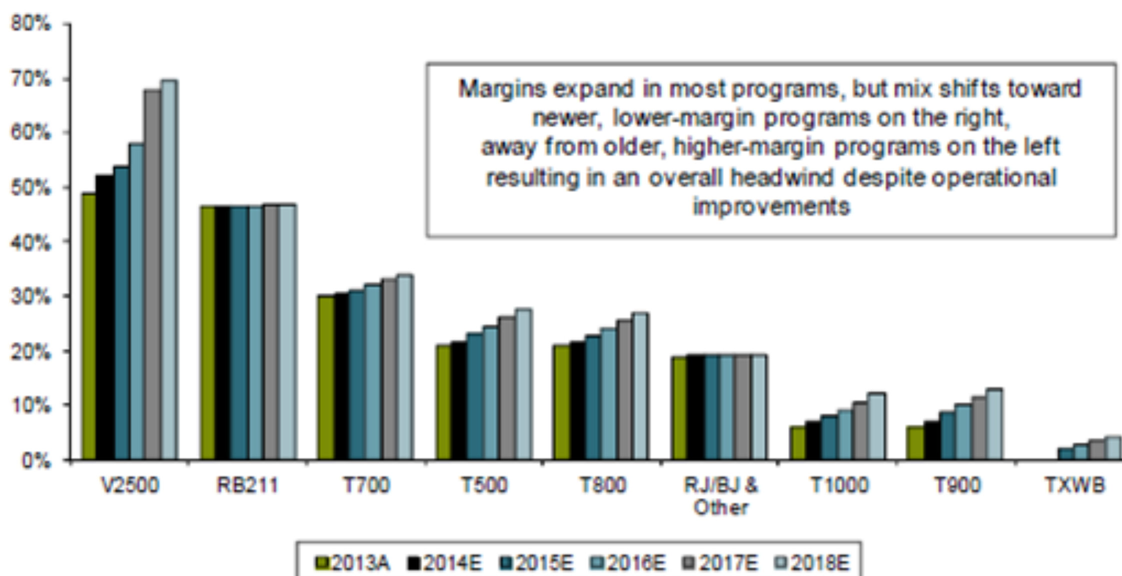
Compass say they can increase their margin even further. We don't disbelieve them (this trick looks awfully powerful) but the pricing of the stock requires a continuation. You could probably own this company but it is not cheap

For us, the lesson of Compass Group is that you can find genuine quality companies with superior economics in places you don't expect it. This business never ceases to be surprising.

Rolls Royce is an altogether different story. Rolls has entirely ceded the market for narrow-body regional jets. These jets have lots of take-off and landing cycles which means lots of strain on the engine and lots and lots of fat-margin maintenance revenue.

Instead they have focused on (or retreated to) wide-bodied planes. The margin has been coming down for a long time to the current anemic number.

Sanford Bernstein argue a bear-case for Rolls by observing that the fleet of Rolls Royce engines in circulation is shifting towards lower margin product.



And it is true too.

The V2500 was attached to a narrow-body A320 and over 4000 of them were made. The RB211 went on the Tristar and wound up on Boeing 747s. These were massively successful planes on which lots of copies were made.

Later engines went on much less successful planes including the infamous A340. [The A340 was a four-engine wide-bodied plane so fuel inefficient that the second hand price has collapsed to about $10 million if they can be sold at all. They only built a few hundred. Economically this plane is a dog with wings.]

Rolls also provided engines for the A380 – the double-deckered super-jumbo. However the A380 also appears to be a flop with only 11 delivered last year. We know a long-haul jet pilot who tells us that on a passenger adjusted basis the A380 burns about 60 tonnes more fuel to cross the Pacific than the Boeing 777. The A380 is substantially fuel inefficient compared to the (now ancient) 747.

Our pilot is pretty sure that the 777 will remain the best “bird in the sky” for a long time. General Electric (whose engine business is very profitable) is the main provider to the 777.

And therein lies the problem with Rolls - it has not attached its engines to a truly great jet in a very long time.

On paper that looks set to change. The Airbus A350 has flown about with a bunch of journalists on board but has not made *any* commercial deliveries. Specification wise it is a great plane – the equal of the Boeing Dreamliner. Moreover there are forward orders for over 800 of them, and Rolls Royce is the sole engine provider. If they deliver this many and

they have adequately priced the maintenance contracts Rolls Royce's margin should rise into the twenties. Our slogan: sales double, margins double and a half. This could be a very good stock indeed.

But the bull case is on paper. The proof will be in safety (critical) and fuel consumption (also critical) of the A350. All planes are great planes on paper. The A380 was a great plane on paper. Even the infamous A340 was a great plane on paper. Whether the A350 lives up to the hype is yet to be seen.

If the plane burns too much fuel then the huge order book will evaporate like ice-cubes under the Dubai sun. And Rolls Royce's margins will similarly disappear.

We will know soon enough whether the A350 is a great plane in the air. Depending on validation of our thesis it could become a more substantial position or we could sell the entire holding.

A quick summary

Our long book looks okay but, as the market has risen, it no longer fills us with joy. There are some things like Rolls Royce on which we could make a lot of money – but they have some risk. There are very few things where we think good returns are a lock.

Our short book is pregnant with profit – a situation made more delicious by the retreat of hedge funds from shorting.

But shorting has been a bad game for long enough now that it is hurting. We think we will make you money shorting – lots of money. But we need good long exposure to offset the losses whilst we wait – and they are difficult to find.

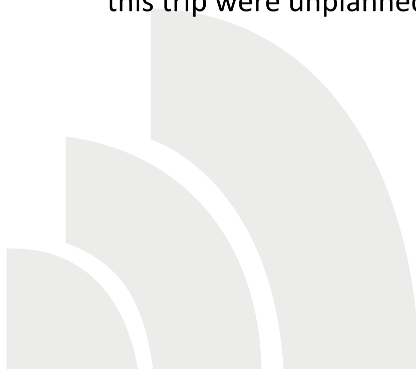
We don't know when the market will turn our way – but in the meanwhile we should expect some modest fluctuations.

We aim to make good money again. We think we will. We are just not quite sure when.

Thanks again...

Post script

It's a joy to do some work travel for the purposes of finding investments rather than clients. We want to develop new contacts and new ideas. This should be a more regular thing. Alas some of the travel will be less glamorous (Korea, not Paris or New York). The best meetings this trip were unplanned. That is often the way of the world.



Performance

Current financial year return	15.2%
Last 12 months return	15.2%
Return since inception (annualized)	19.4%

	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
FY13											5.4%	1.3%
FY14	6.0%	-2.5%	0.4%	3.6%	5.7%	4.3%	-3.7%	0.2%	-2.6%	0.9%	3.4%	-0.8%