

Thursday 8 December 2011

Separately Managed Account Client Letter for November 2011

Our USD reference account is up 59.4% for the year to date (net of all fees and charges) but it's been about two and half months since anything has gone particularly right for us at Bronte and it shows in our results which have been bland. It is annoying because we have worked very hard for these bland results and – when we look at the list of things that have gone wrong - we are pleased enough with results that are only bland.

The idealized positioning of our portfolio is 15 diversified value longs at 7 percent of the portfolio each adding up to about 100 percent – and 50 diversified shorts at about 0.6 percent of the portfolio each adding up to about 30 percent.

We are a little too short at the moment (but the opportunities are so good we are salivating). Truly – it is dead easy to find mid-cap frauds of the most egregious nature. And we are also a little too long simply as an offset to our excess short position. But the portfolio is not that far from our idealized position.

The key word here though is diversified. We have been wrong spectacularly on some positions (notably our US reflation plays) and our results are only bland because we are diversified. Diversification does not just mean having 20 stocks. Diversified means having positions in different industries, different currencies and different economic trends that are as close to uncorrelated as possible. Obviously a risk-on-risk off highly correlated world market does not help us in this goal. But we are sort of achieving our goals.

Below we illustrate by example. This is a genuine portfolio from a big-name fund manager with a fantastic reputation whom politeness (and bad karma) prevents us from naming.

American International Group	23.20%
AIA Group Ltd	9.70%
Sears Holdings Corp.	7.90%
Berkshire Hathaway	7.90%
Brookfield Asset Management	6.80%
Bank of America	6.10%
Citigroup	5.90%
CIT Group	5.40%
China Pacific Insurance (Group) Co.	5.30%
The St Joe Co.	3.80%

Total*

82.00%

The manager – up until this year – had an enviable record – but that record has gone-to-pot. What went wrong? The bets are essentially all correlated.

1. AIG is a bet on American reflation and global insurance.
2. AIA is a bet on Chinese life insurance (which is correlated with global growth).
3. Sears Holdings, which is a failing retailer with some property assets, is a bet on American reflation.
4. Berkshire Hathaway is a minor bet on American reflation and a big bet on global insurance (as well as Warren Buffett's mortality).
5. Brookfield is a manager of leveraged mostly North American investment funds – it is thus a bet on American reflation.
6. Bank of America is clearly a bet on American reflation.
7. CIT Group – a struggling post-bankruptcy finance company is a bet on American reflation.
8. China Pacific Insurance is a bet on American reflation.
9. St Joe is a property developer in a remote area of Florida and is hence a bet on American reflation.

Rhetorical question: do you sense a sameness – an internal correlation – to this portfolio?

If you get this bet right you are going to look like a massively successful fund manager. If you get it wrong then you are going to collapse in a screaming heap. The reason is that it is an undiversified bet. And you get no diversification benefit if the *economic trends behind the positions are not diversified*.

We were wrong too – we have consistently believed in American reflation and it has not happened.

We own and continue to own three stocks on this list (Bank of America, Citigroup and Berkshire Hathaway). But our positions are a little smaller and we have offsetting positions.

We hope readers see the point. We have not been right but we have not been crushed – and the reason we have not been crushed is that we have a fair degree of genuine diversification and we have some offsetting positions. We are a hedge fund – proudly stated as such – which means we like to have modestly hedged positions. It does not mean we won't lose money (we did this month). But if we get this right – and so far we have – we will keep the losses manageable. (And in the past when we have got our positions right the results have been very good.)

Opportunities in other people's failings

We don't mean to pick on the fund manager above (we hope our next ten years are as good as his first ten years) but his problems have offered us one opportunity. We have never much liked Sears Holdings. The retail business is truly dreadful and we are believers that we should own good retailers who accumulate some of their real estate (e.g. Tesco, Target) rather than bad retailers on a liquidation premise. But we have never really had a case to go short the stock either.

But Sears results have been particularly dreadful; its credit rating got downgraded to deep junk. Moreover, a short position in it is negatively correlated to our remaining reflation bets (Citigroup, BofA) and negatively correlated to our one US property owning retailer (Target).

This correlation is extremely strong through the balance sheet of the above-mentioned fund. They own 16.2 million Sears shares – and average trading volume is only about 650 thousand. If the reflation bets continues to fail then there is at least one huge forced seller of Sears stock. It would be very hard to liquidate a position so large. So our guess is that in that adverse scenario Sears stock would be hit very hard. So we shorted a little Sears (now about 1 percent of the portfolio).

If the American reflation bet succeeds we will lose money on the Sears position – but we do not think we lose a lot because the retailer is truly dreadful. It looks like a good natural hedge in the event that we continue to be wrong on the reflation bet. We like natural hedges – we collect them.

And that is why – even though we had a lot of things wrong in the last few months our performance has merely been bland.

In general we would rather be right than wrong – but we are well aware we will be wrong regularly – and we want to manage the portfolio so when things do go wrong we are still here next month (and hopefully to get a few things right). We succeeded in at least that in the last couple of months. We hope to do better in the future.

What excites us?

We are getting increasingly chirpy about the bulk of our portfolio. Some of our large-cap stocks are now very cheap (especially the reflation-bet stocks on which we have been so wrong¹). Even Marc Faber (Mr. Gloomy himself) has pronounced that US equities are “not terribly expensive”.

Despite that we are finding plenty of mid-cap frauds including frauds outside China². Alas – we are reluctant to name the frauds we are shorting for all the usual and obvious reason.

We have had particular fun finding really scummy oil-and-resource stocks in the \$1-2 billion range. John is thinking of a blog post about the Swiss Private Banker, the red-necked oil driller, the Southern Preacher and the Slime-bag accountant which sounds more like the start of a very good

¹ John would love to increase the reflation bets as the stocks decline. Simon is – as per usual – more cautious. Good money-after-bad etc. Those arguments are largely won by Simon.

² Frauds outside China are most appreciated – they are uncorrelated with our other shorts – and after a letter detailing the benefits of diversification we hope you understand why we are thrilled to diversify our fraud-short collection.

joke than a stock story. But believe us – it is a stock story – though still hilarious. (We will name this stock to any client who rings up...)

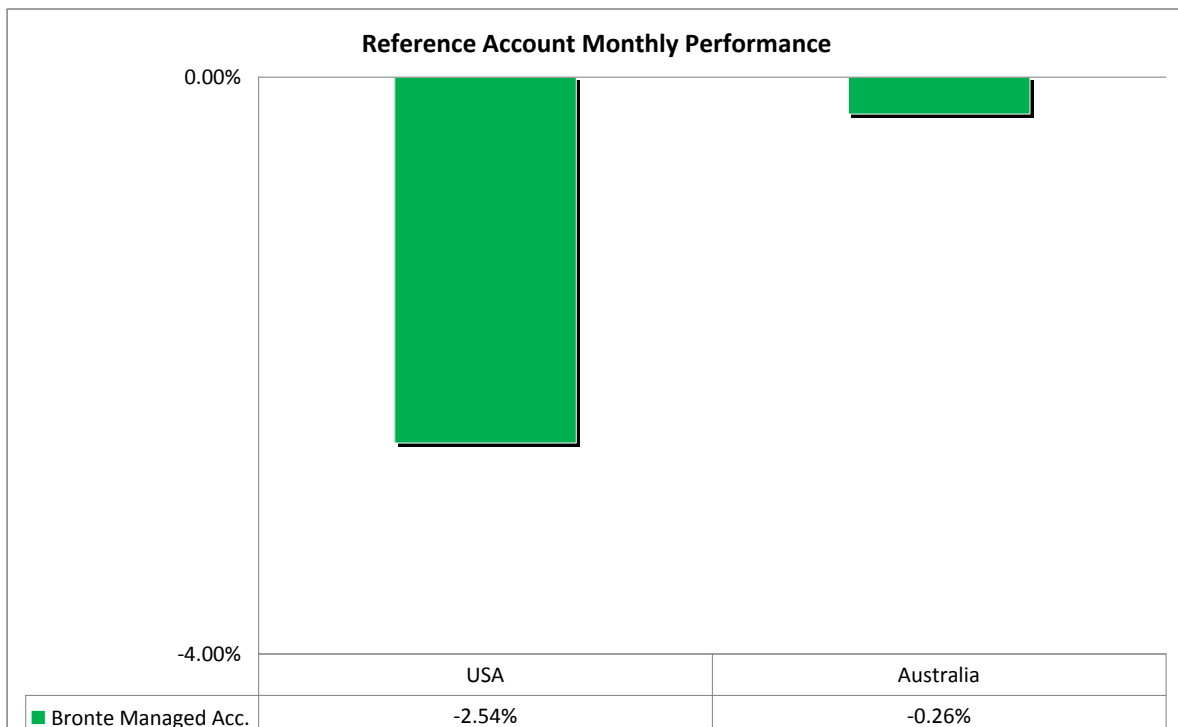
John
Simon

Portfolio Management

	Long%	Short%	Net Long%
USA Reference Account	122.6	40.6	82.0
Australian Reference Account	122.4	40.1	82.3

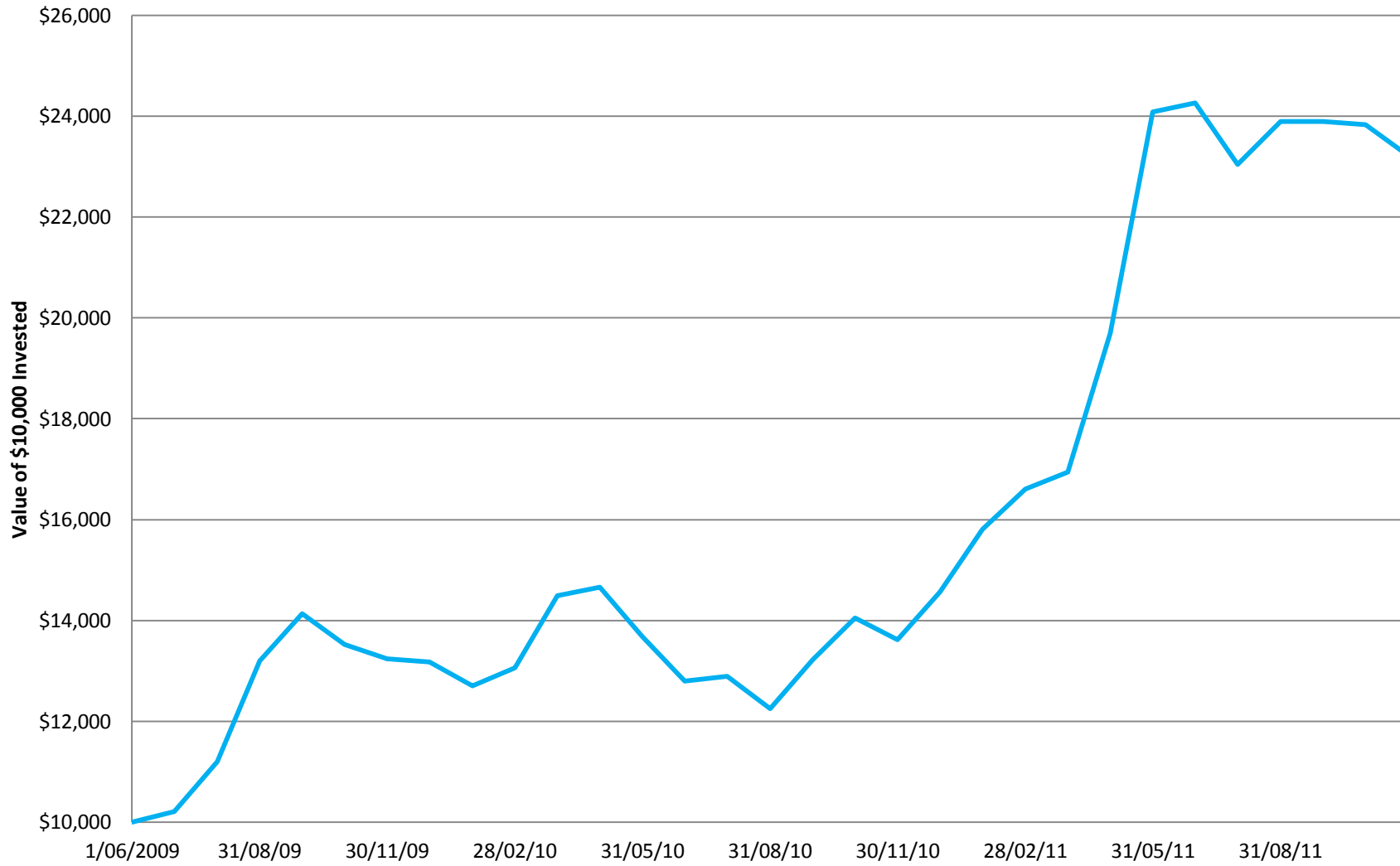
Performance Data ³

Reference Account Monthly Performance



³ 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 3.0% in USD and increased by 1.7% in AUD during the month and since inception of the account has increased by 24.9% in USD and 0.4% in AUD terms. Past results are not indicative of future returns.

USA Reference Account Cumulative Performance



Australian Reference Account Cumulative Performance

