BronteCapital

Monday 9 April 2012

Separately Managed Account Client Letter for March 2012

A short monthly letter this time. Results were more than adequate for the month – but not for the quarter.

There were two big events in the portfolio during the quarter. The first was a whip-saw loss in our high short-interest stocks in January. (They went up on the way to going down but in going up they left us no choice but to cover some.)

The second was that we essentially gave up our focus on the short-China-frauds game. We had a lay-down obvious fraud which we informed the auditor about. We bet about 3.5 percent of your money on the auditor not signing the statement (we purchased way-out-of-the-money puts). And we lost. This was a company deeply enmeshed with the Chinese establishment, but utterly criminal in nature. We decided the shorts would be harder to break. (We had a few smaller but similar losses during the quarter as well.)

This month has been spent diversifying shorts. We have much less China – and started shorting Australian and UK mining frauds amongst other things. Results have been satisfactory so far and the change in portfolio positioning led to an acceptable month. The recovery (especially post stress-test) in Bank of America stock (once our largest loser) also helped.

We added two asymmetric longs to our portfolio – both small positions. These are stocks on which we will either lose all of our money or (potentially) make many times our money. Without further ado they are Finmeccanica and Clearwire.

Finmeccanica is a real into-the-teeth-of-the-crisis long. The position is small – less than 3 percent. But the stock is unbelievably cheap with no earnings and awful macro circumstances. Before we discuss that though, we want to talk about awful stocks with no earnings.

> An aside: A really competent fund manager (call him Andrew) in 2002 was sitting around having drinks with a couple of less competent guys (including at the time John). We were talking about what the main growth stocks of that market were worth and whether they were cheap enough. Andrew in frustration said that he was sick of the low earnings growth low price earnings ratio versus high earnings growth high price earnings ratio argument. We had just gone through an amazing tech crash. The cheap stocks are the ones with no earnings.
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> He was buying Ericsson (which halved before it went up ten times). He also purchased Nortel (which went to zero) – though he was keener on Ericsson. That worked out OK even though the path was miserable.
>
> Andrew's argument was simple: is there a good chance that mobile phone tower capital expenditure was going to be higher in five years? Answer - yes. Was there a good chance that Ericsson was going to have a decent market share and get paid well for its kit? Answer - yes.

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Did he foresee the iPhone? No. But it wasn't a bad guess that capital expenditure volumes would recover.

Lesson: Capital equipment stocks which are by nature cyclical and with some intellectual property can be very cheap when they have no earnings. And you can still lose 100 percent of your money (see Nortel).

Finmeccanica is our attempt to buy an Ericsson into the teeth of a crisis. We may however have a Nortel. Finmeccanica is an Italian defense conglomerate with a focus on aviation. It is the second biggest industrial company (revenue, number of employees) in Italy (behind Fiat). The recent change of government in Italy from the colorful Berlusconi to the technocratic Monti was probably good for Italy. But it was tough for Finmeccanica. The Chairman was arrested for giving bribes.

This created the bottom in the stock (a bottom we should have purchased but were too slow). In what sense is an Italian defense conglomerate that pays bribes newsworthy?

There is plenty that is wrong with Finmeccanica – but there are some real lottery tickets in there. They have a division which makes carbon fibre parts for planes for instance. If the Boeing 787 is a big success this division could be very profitable. But even that one is difficult – Finmeccanica was responsible for some of the delay in the 787-Dreamliner project. Boeing is not particularly friendly and would like to bring some of the technology in-house. We think they are bluffing. Ultimately though we don't think there is any way to know.

What we are betting on is that the Italian Government gives just enough business to the company to keep it solvent. After that we hope something goes right.

The second asymmetric stock is Clearwire. Clearwire was the first fourth Generation mobile phone company in America – and they chose the wrong technology (think Betamax versus VHS). However in this case they chose WIMax rather than LTE. They built out a network and nobody came.

They own a lot of spectrum, however it is very high frequency which is good for capacity but suggests they can never be a phone company in their own right. They are now building out an LTE network on this frequency and hope to take excess demand from other carriers.

But even then it is not obvious – the high frequencies they own forced them into choosing “time division LTE” rather than “frequency division LTE”. You don't need to know the difference but alas the highest bandwidth using devices (notably the iPad3) use “frequency division” and their excess bandwidth consumption cannot yet be handed off onto the Clearwire network.

Still that does not look like being a permanent impediment. China Mobile is going to use “time division LTE” and it is inevitable that Apple will introduce time division product (as will all other manufacturers). They would – we presume – like to introduce products with a dual-mode chip so they can tune into either time division or frequency division LTE and allowing hand-off between all US carriers. There are such chips on the drawing board for dual mode wireless (and they will happen) but power consumption might be an issue.

To put it mildly Clearwire is in a difficult situation. But one where if they get past the difficult next few years the stock could be fabulous. Bandwidth use goes up and up and up (think more and more apps and phones and pads that link to the cloud). Bandwidth is a limited resource. Old rule of investing – find a boom and invest in the scarce factor. That scarce factor is bandwidth. We can envisage ways that Clearwire is a thirty-bagger. Alas it could be a zero too.

Still we mention these stocks because they are out of the ordinary. Our portfolio has been consciously shifted towards our benchmark – boring, cheap, global diversified longs and the wildest collection of diversified shorts that we can possibly organize.

Thanks again....

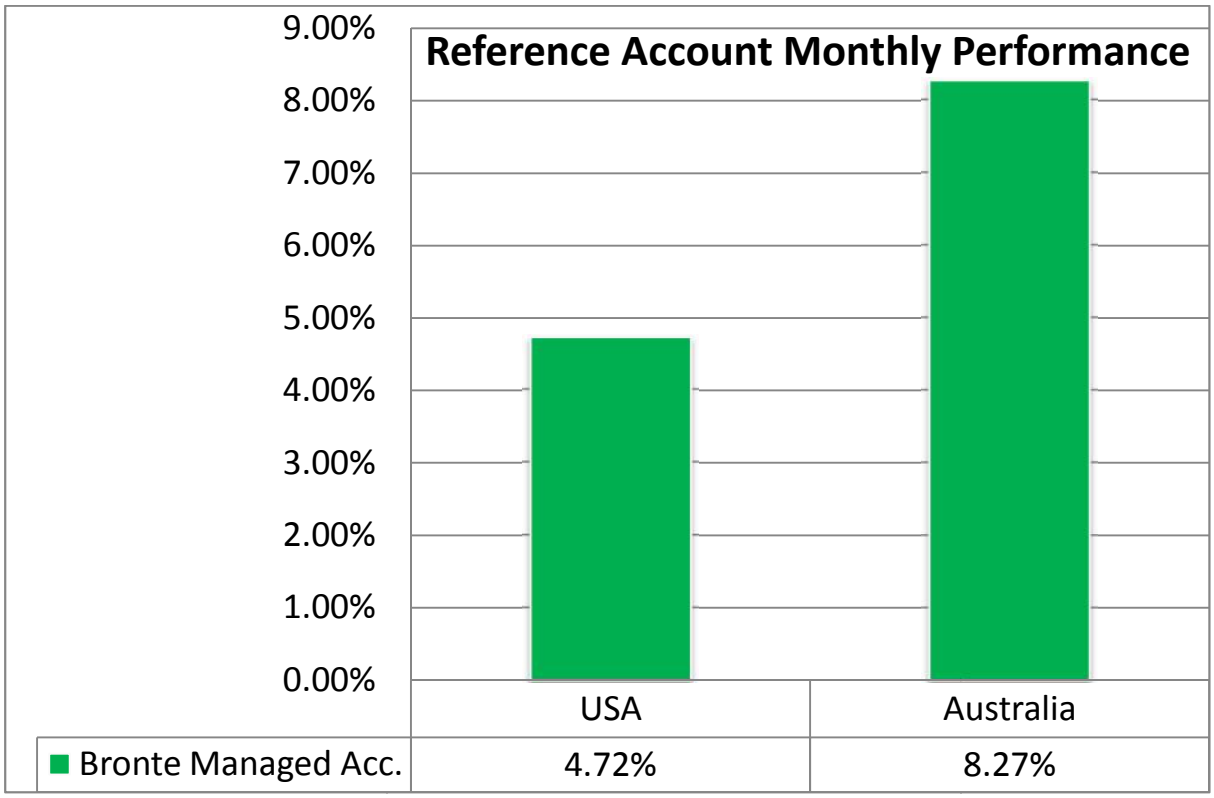
John and Simon

Portfolio Management

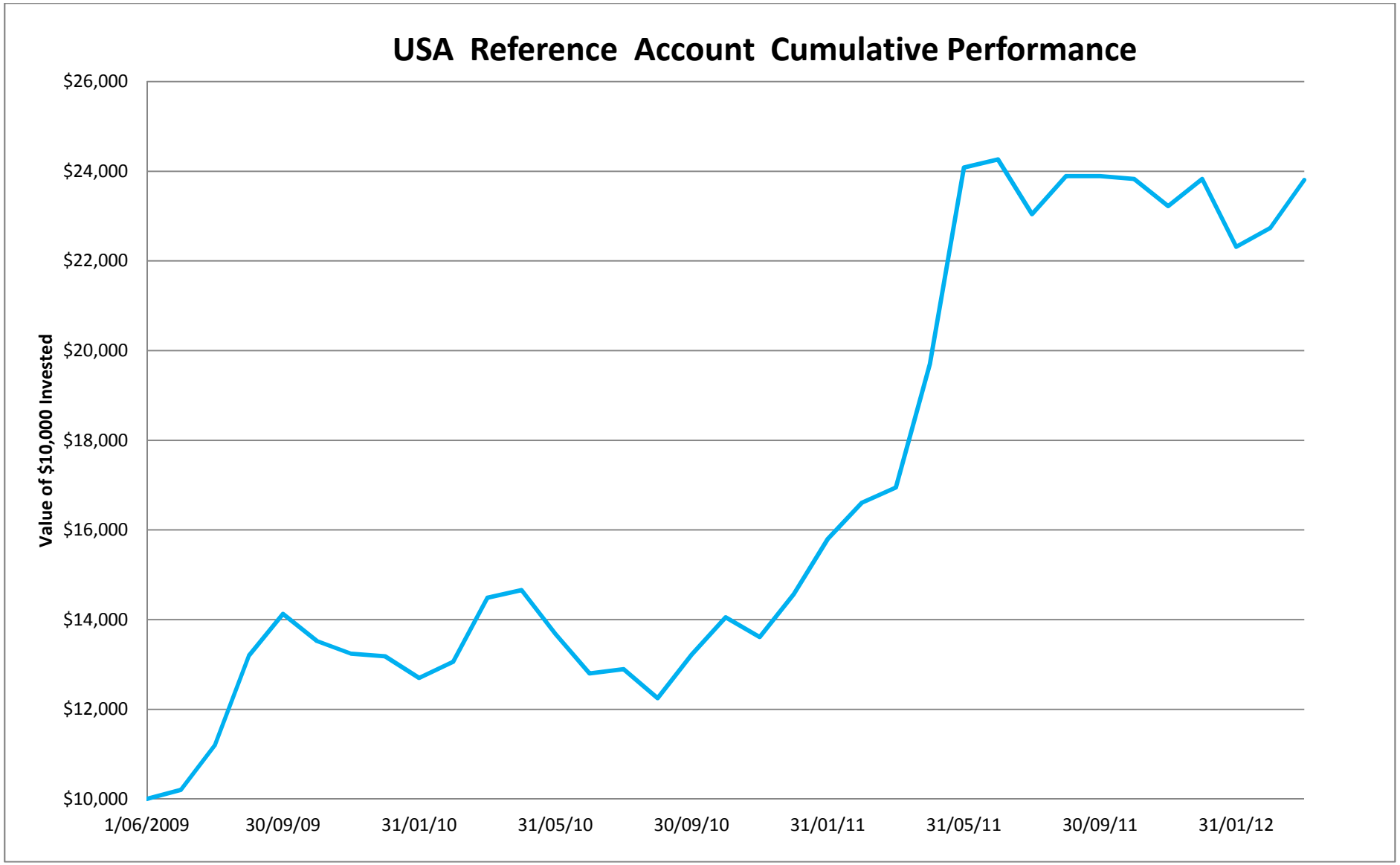
	Long%	Short%	Net Long%
USA Reference Account	132.7	44.4	88.3
Australian Reference Account	132.6	44.2	88.4

Performance Data [1]

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 increased by 0.7% in USD and 4.7% in AUD during the month and since inception of the account has increased by 39.5% in USD and 7.9% in AUD terms. Past results are not indicative of future returns.


USA Reference Account Cumulative Performance
Value of $10,000 Invested
$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
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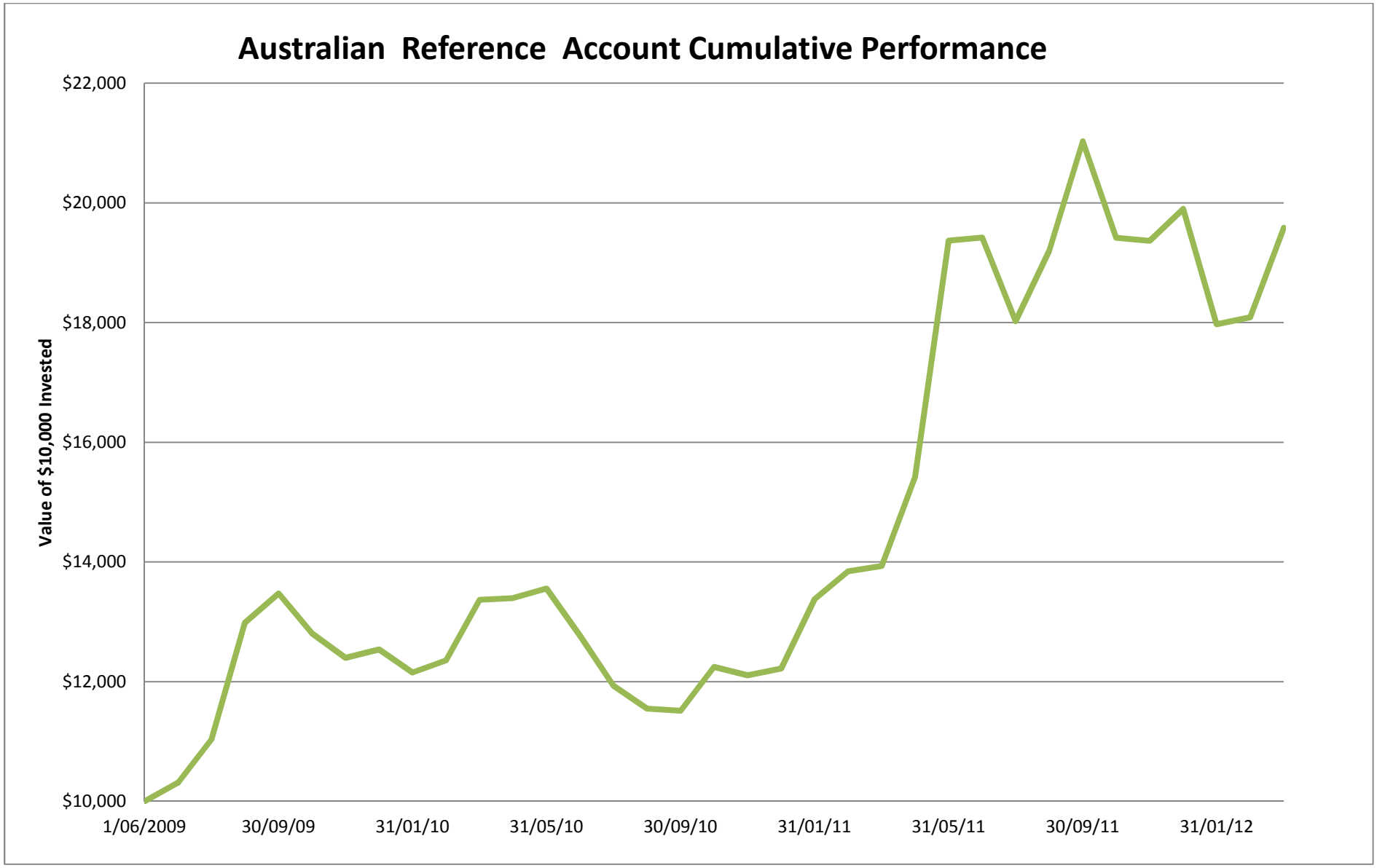
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$10,000
1/06/2009
30/09/09
31/01/10
31/05/10
30/09/10
31/01/11
31/05/11
30/09/11
31/01/12