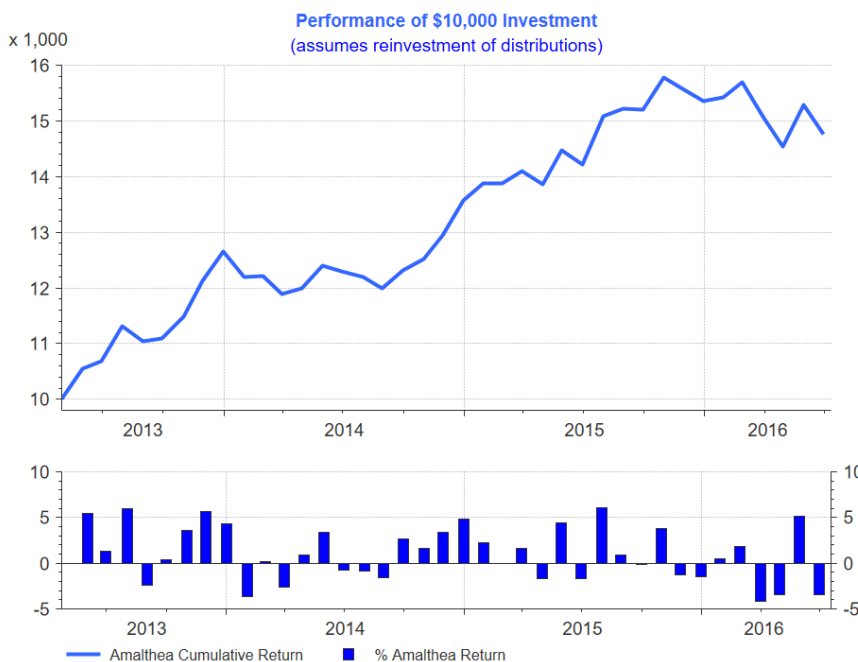


The Bronte Amalthea Fund is a global long/short fund targeting double digit returns over the long term, managed by a performance orientated firm with a process and portfolio that is genuinely different. Objectives include lowering the risk of permanent loss of capital and providing global diversification without the market/drawdown risks typical of long-only funds. A highly diversified short book substantially reduces risk and enables profits to be made in tough markets. The fund is an alternative to equity investing, and complement to most portfolios, and is typically an excellent diversifier which may lower overall portfolio risk.

	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	FYTD
FY13											5.4%	1.3%	6.8%
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%	15.2%
FY15	-0.9%	-1.6%	2.7%	1.7%	3.4%	4.9%	2.3%	-0.1%	1.7%	-1.7%	4.4%	-1.7%	15.6%
FY16	6.1%	0.9%	-0.2%	3.8%	-1.3%	-1.4%	0.5%	1.8%	-4.1%	-3.4%	5.1%	-3.4%	3.8%



During June the fund was adversely affected most particularly by its long position in Royal Bank of Scotland and more generally by its pound sterling positions and holdings outside of USA.

As we write this the S&P 500 (a broad measure of leading US listed stocks) is at 2129 – a hair's breadth from its all-time high. It's not like that everywhere else. The table on page 2 shows a few markets we invest in and their performance versus their all-time-high.)

This letter includes our regular monthly commentary but because it is the end of the Australian financial year we also describe the audit and distribution calculation process for the fund. As described below your statement for June will be sent out once the end of year distribution has been determined.

Fund Features		Portfolio Analytics	
Min. initial investment	\$100,000 (for qualifying investors)	Sharpe Ratio ¹	1.0
Min additional investment	\$50,000	Sortino Ratio	1.9
Applications/redemptions	Monthly	Annualised Standard Deviation	10.4%
Distribution	Annual	Largest Monthly Loss	-4.1%
Management fee	1.5%	Largest Drawdown	-7.8%
Performance allocation	20%	% Of Positive Months	60.5%
Administrator	Citco Fund services	Cumulative return ²	47.6%
Auditor	Ernst & Young	1 year annualised return	3.8%
Custodian/PB	Interactive Brokers LLC	3 year annualised return	11.4%
		Annual return since inception	13.1%

¹ Sharpe and Sortino ratios assume Australian risk free rate of 2.5%

² Returns are net of all fees

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a) Monthly Commentary (Continued from page 1)

Country	Index	8-Jul-16	all time high	% of all time high
USA	S&P 500	2129.90	2134.72	99.77%
United Kingdom	FTSE 100	6590.64	7122.74	92.53%
Germany	DAX	9629.66	12390.75	77.72%
France	CAC 40	4190.68	6944.77	60.34%
Japan	Nikkei 225	15106.98	38915.87	38.82%
Australia	ASX 200	5230.54	6851.50	76.34%

The bull market is an American phenomenon. Most markets are near bear market territory and worse if you measure them in US dollars. The US dollar has been very strong. Given the pound's decline post Brexit the UK market is also into bear-market territory measured in dollars.

We haven't listed the true disaster markets like Brazil, Greece, Italy or the like. Some of these are down over 80 percent.

The US market is highly priced versus history. The price-earnings ratio is not far outside the normal range but profit share is very high. [Wage share and tax share is low versus history.] Warren Buffett has regularly said that the market cap of the index relative to GDP is his favorite measure. (See various articles Mr. Buffett has [written in Fortune...](#)) The US market has only exceeded the current market-cap to GDP ratio twice. Both times ended in tears.

And so every value manager we know has tended to look outside the United States. Us included. By and large those markets (and especially those currencies) have performed poorly relative to the US market in recent weeks and pretty well every value manager we know has been making excuses.

The relative performance of the US – more than anything – accounts for our recent performance.

We have lots of shorts in the USA (and not much length in aggregate). We are long outside the USA and as the US has been the main strong market in the world this is – with the benefit of hindsight - poor macro-positioning.

And in the vein of value managers making excuses we will note that our stock picking has been okay – not brilliant – but okay. This has been offset by the macro positioning.

And this month was not great. Brexit turned what was an okay month into a not-so-good month. We are long in Europe and the UK. And that did not work very well.

The relative safety of the US

There is a reason the United States has performed better than anywhere else. The demographics are good for profits (in sharp contrast to say Japan and Italy). The politics are mostly pro-business. And the place is innovative. Both sides of politics are committed to free markets. [By global standards most Democrats are strongly pro-market and pro-business.]

By contrast Europe has a long list of problems. The Eurozone does not make sense as a currency block – and the pain inflicted on Greece (where the market is down 90 percent) is disproportionate to its economic sins. There are also emerging (and disquieting) nationalist political movements.

The US is relatively expensive because of a rosy (but possibly justified) consensus. Alas, as Warren Buffett and others have observed, you can pay a lot for a rosy consensus.

Brexit

We got Brexit wrong. We were not alone – but it turned a good month into a bad month. Bluntly we did not think there was any way that the UK would vote for it. Nobody had clearly enunciated just how the UK economy would look post Brexit – and people in the quiet of the polling booth don't normally vote to risk their livelihood.

But they did. There were towns in Wales where 6000 people worked for the Airbus consortium that voted marginally for Brexit.

We held long discussions internally about whether we should buy some option-protection over the Brexit poll but mistakenly understood the sad death of Jo Cox and the immediate polls thereafter to have stymied the Leave campaign.

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We have a fair-few UK positions but about half our loss was on a single position. We have an oversized holding in Royal Bank of Scotland (RBS). *UK banks and home-builders didn't take the decision very well.*

At the time of the global financial crisis RBS was a catastrophically run bank with global ambitions. Ever since it has been in a long retreat to its origins as a UK domestic bank. The stock is hated, and the UK Government is (by far) the largest shareholder.

Our case for owning British Banking is that we think that margins will expand over the next decade or so. To understand why you need to see where British banking has come from. So let's start with ancient history – 1998.

In 1998 Lloyds TSB was the thirty fifth biggest bank in the world by assets but the biggest bank in the world by market capitalization. Under the leadership of Sir Brian Pitman Lloyds had consolidated most of the building societies in the UK, cut costs and sold more and more product through the retail channel.

At the peak Lloyds earned a fawning article in The Economist. To quote:

In trying to broaden its business [beyond UK retail and small business banking], however, Lloyds TSB runs head-on into a problem that most other banks would envy:

it simply earns too much money. By some estimates the bank is sitting on £3 billion more than it needs. It would gladly use this for acquisitions. But short of buying another big British bank and closing down hundreds of branches, which would almost certainly be blocked on competition grounds, it is difficult to imagine an acquisition that would be as profitable as Lloyds TSB's current business.

Lloyds was astoundingly profitable. Although the article does not say this – revenue to risk weighted assets at Lloyds was about 8 percent.

Put that in perspective. To appreciate how unreal a number this is, we need a bit of international perspective. In Japan and Germany, revenue to risk

weighted assets is typically well under 2 percent. In the US 4-5% is typical, (with Wells Fargo being a profitable outlier. In Canada (which is an oligopoly) revenue to risk weighted assets is about 6 percent. In the best banking oligopoly of them all (Australia) revenue to risk weighted assets approaches 7 percent.

Lloyds at its peak was considerably more profitable (against assets) than the Australian banks at their peak.

Merely a decade after this article was written Lloyds collapsed and became (mostly) Government property. How the mighty fall.

The reason was competition. The most visible and aggressive competitor was Northern Rock, which never saw a mortgage it did not want to undercut. UK television was awash with advertisements to refinance your mortgage and reduce your monthly payment. Bank capital adequacy standards were cut to ribbons by the Thatcher Government, which believed that the market was a good enough policeman of risky behavior and inadequate capital.

So the banks levered up further by writing more and more loans atop a sliver of equity capital. (with Northern Rock's leverage going over 60 times its equity at one stage). But Northern Rock was small beer. By far the biggest of the aggressive competitors was Royal Bank of Scotland run by the (then) Sir Fred Goodwin. To observers like ourselves, Goodwin never saw an asset (a loan, remember, in the banking context) that he did not want to put on his balance sheet.

The epitome of this was RBS setting up a stand with Formula 1 simulators in Circular Quay Sydney trying to drum up business amongst leverage buyout operators in Australia. You have to be overly keen for growth when what you are soliciting is adrenalin junky LBO customers on the other side of the planet. This marketing was designed to produce fast growth and bad business loans.

The end came spectacularly and RBS stock dropped 99 percent. Old shareholders were diluted by a seemingly endless stream of capital raisings, many of which were sold to the UK Government, the only barely-willing buyer. The bank was Hamstrung by large credit losses and low margins (and hence low

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profits) so it could not easily replenish the lost capital [to write new loans].

For the next five years the bank was sorting out one of the uglier balance sheets in the world. Credit losses were large and ate up all the profits.

These days credit losses are not that large – but litigation losses are. The company is being sued every-way- to-Sunday for a host of misdemeanors, real and imagined, for behavior in the crisis. There is enough real there for a few more years of profits to disappear.

The litigation losses also damage future profits. If you get sued for selling products with opaque disclosure of risks and pricing you will inevitably become more transparent in the future. That will decrease profitability.

So why do we own it?

Well revenue to risk weighted assets got as low as 2 percent. And the UK is now a pretty good oligopoly with the hyper-aggressive competitors washed out in bankruptcy and reconstruction. Every year the revenue to risk-weighted assets rises. We think this is a thirty-year trend (just as it was in Australia after the disaster of 1992). If this is true, then RBS (and the other UK banks) are sort of like buying Westpac (an Australian bank) at \$5 on the way up from its 1992 debacle. (Westpac bottomed at about \$2.50 in November 1992, presently trades at close to \$30, and has cumulatively paid almost \$23 in tax advantaged dividends since March 1993.) If the story repeats these stocks wind up being ludicrously cheap.

We are very keen on the story. But the stock has been a mixed bag since we bought it. First the positives:

- Margins have continued to grow, slower than they grew in Australia – but the trend is in place. It is however slower than we originally guessed. In the 1990s Australian banks did not see how profitable their business would be and went on a binge of cost-cutting and branch closing. That ended when their margins increased enough. The UK banks are still in cost-cutting mode – but the pattern is the same.

- The CEO – Ross McEwan – is in our opinion an absolutely first-rate guy. He is a Kiwi – and he worked at Auckland Savings Bank in New Zealand at the same time John was at ANZ bank. John knew him (a little) and admired him a great deal. He – and his then boss – were the best retail bankers John has ever known. Many years later McEwan was passed over for CEO of Commonwealth Bank in Australia (a decision Commonwealth will one day regret) and went to run the retail bank at RBS in the aftermath of the crisis. He became CEO. The ASB/Commonwealth experience is telling. McEwan knows how to run a retail bank with fattening margins and he will exploit it.

On the negative side:

- The legal/litigation expense of RBS has been greater than we originally guessed. Just when you thought a billion pounds was a big fine or /settlement, the numbers expand. These days it seems to be a billion here, five billion there – and it is never ending. The politics of banking isn't bad. It is awful.
- The UK government has for some time wanted to exit its majority position, which some investors fear creates an "overhang" of sell orders and thereby keeps the share price depressed. To the extent that the share price decline slows the government's eventual exit, such fears could persist.

And then there is Brexit. Brexit is almost certainly going to be a proximate trigger of a UK recession – and that will drive up credit losses (again). This is hardly encouraging. But RBS is not a money-center bank any more. It is retreating from its investment banking business, which Brexit will accelerate. But Brexit might also reduce competition (and reduce the markets' willingness to fund the competitors). Depending on the balance of these facts, this might accelerate the margin expansion we think will come.

We still own RBS. It has returned to global financial crisis lows. The only justification for the current stock price is that you believe UK banking is

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hopeless forever. We doubt that. In 1998 UK banking was wonderful beyond belief. It took a decade for the world to change beyond recognition. Come back in a decade and we think it will have changed again – maybe by a similar amount.

UK Industrial stocks

We also own a bunch of very high quality UK industrial stocks – some of these are amongst the best industrial businesses we have ever seen. Most of them sell globally, and the stocks have risen (measured in pounds) since the Brexit decision. Measured in dollars we are still losers – they have declined, but these are relatively small losses compared to RBS.

We should however think what Brexit means because we think that politics is generally a threat to the consensus in many markets. It takes a lot of anger for a town populated by Airbus workers to vote against being in the European Union.

So here goes for a general observation.

Ever since Margaret Thatcher there has been a consensus that deregulation and free trade is the right way to run an economy. There is a left-wing of that consensus that wants a healthy economy so you can afford a welfare state, socialized health, and strong environmental protections but even left-of-center parties have been pro-market. (For example Bill Clinton in the USA, Blair in the UK, Hawke-Keating in Australia were all pro-market governments from the left.)

We would argue this consensus has mostly worked. *Empirically pro-market policies have produced strong productive economies.*

However, it is almost trite to observe than liberalization has worked better for some people than others. *Income inequality has increased* and better communications and travel mean that increase is more visible to more people.

What the Brexit vote is, is a backlash against that. It is not a well-thought-through backlash. *Brexit is not going to make the Welsh aerospace workers better off.* But it is a backlash nonetheless.

Major political parties are having a hard time keeping leadership within the consensus. In the UK

a non-consensus politician (Jeremy Corbyn) won the Labour leadership. In the US Donald Trump has wrested leadership of his party. Bernie Sanders was close.

The pro-market consensus that has run the World for over thirty years may be breaking.

And we are nervous. Some of the rejections of the consensus are plain ugly. The Finn Party for instance combines (and these are the words of Wikipedia) left-wing economic policies with conservative social values, socio-cultural authoritarianism, and ethnic nationalism. You might think this combination utterly unelectable – but they get 20 percent of the vote in what has been a civilized (and non-authoritarian) Scandinavian country.

We suspect that politics is a threat to valuations generally. If you are not nervous you should be. *We should have been before the Brexit vote and we won't be fooled again...*

b) End of Financial Year

The fund's accountant, Ernst & Young, will be calculating the distribution the fund will make. The distribution is based on realized gains that are generally taxable whereas the gains that are reported to you each month include unrealized gains. Although the fund is up for the year there may or may not be a distribution depending on E&Y's calculations.

In the event that there is a distribution you will receive (we anticipate in early August):

1. An annual tax statement;
2. A distribution statement; and
3. If you have elected to re-invest, a contract note detailing the number of additional units issued in the fund

If a cash distribution is determined and you have elected not to re-invest in the fund, then the payment will be made to your previously nominated bank account within approximately 2 business days of these documents being issued.

Once the distribution is determined the fund will also issue its monthly holding statement to you,

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which will be “ex-dividend” i.e. it will show your holdings at 30 June 2016 after allowing for the distribution from the fund.

Till then, thanks for the trust you have placed in us.

The Bronte Capital team

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