FRAZIS
CAPITAL PARTNERS

Monthly Investor Letter for December 2016

Dear investors,

Performance

The Fund was down 0.1% net of fees and costs for the month, behind both the S&P500 and ASX200.

	ASX 200	S&P500	Frazis Fund Net
30-Jun-16	-1.5%	1.0%	-2.5%
31-Jul-16	6.3%	3.6%	5.4%
31-Aug-16	-2.3%	-0.1%	0.8%
30-Sep-16	0.2%	-0.1%	6.1%
31-Oct-16	-2.2%	-1.9%	-2.5%
30-Nov-16	2.2%	3.4%	3.9%
31-Dec-16	2.3%	2.7%	-0.1%
Total	**4.7%**	**8.6%**	**11.4%**

Major gross contributions to the portfolio were approximately:

Contributors	
CVR Refining	0.7%
Valero Energy	0.6%
The Berkeley Group	0.6%
Santander	0.5%
Magnis Resources	0.4%

Detractors	
FX and Macro	-0.9%
Navios Shipping	-0.6%
Alibaba	-0.4%
Horizon Pharma	-0.3%
Deltic Timber (short)	-0.3%

Exposure

Country	**%**
USA	32%
Australia	26%
UK	17%
Europe	11%
South East Asia ex India	9%
India	4%
Total	**99%**

Investment Theme	**%**
Financials	16%
Energy and Refining	14%
Tech	14%
British Land Developers	12%
Blue Chip Mining	10%
Mining Development	8%

Biotech and Pharmaceuticals	8%
Autos	7%
Luxury	5%
Shipping	2%
Other	4%
Total	**99%**

Short Positions	%
Technology	-2%
Energy and Refining	-6%
Total	**-9%**

Hedge book	%
S&P500 - covered with calls	-24%
Net Front Month Volatility	3%
Total Equity Exposure with VIX at 4x	**54%**

Credit and Macro	%
Corporate Credit	5%
EuroBund 10y	-16%

Macro

The Fund made major changes to positioning this month, closing the remnants of our short volatility position and moving to a 3% net volatility, with a 24% covered hedge in S&P 500 futures. We are now in our most comfortable position: long equities and long vol.

Only very specific times reward short positions, so we always treat this part of the portfolio with respect. Our front month VIX position has a beta of about 4x. We would never allow our net exposure – including VIX at 4x – to fall below 0%. It is generally better to earn risk premia and hold your nerve in crises, rather than constantly make random bets on the view that markets are 'due for a crash'.

Even when these bets are successful they just encourage future risk-taking on the short side which is invariably damaging. There are many things to be scared of in this world of ours, but companies on average make profits every year, and this drives equity returns.

This was the first month that our shorts and FX positions really hurt. As I mentioned in the October letter, we hold a net short position in USD at all times, as we hold currency across USD, GBP and AUD. USD strength detracted nearly 1% of performance in December. Our long positions performed well, but our shorts rallied hard with the market.

Interestingly, our vol hedges actually made money this month, as we had covered our positions with cheap call options that finished well in the money. We rolled this position forward.

We implemented a new macro trade that bears some explanation. We are long US long rates and are short the German 10 year Bund (~16% of the portfolio) at a yield of 28bps. This trade reflects the view that eventually rates will normalise to a 2-3% range, involving a 20-30% depreciation from here, lifting the Fund by 2% to 3%. In the meantime, the carry is marginal and if the trade moves much against us it will become positive yielding.

A key risk is that the Eurozone breaks up – not under duress but by the ballot, which, as democracies, could happen in any Eurozone country with little warning.

FRAZIS
CAPITAL PARTNERS

In this scenario we'd expect a liquidation of peripheral debt and an immense flow into Bunds, as under most break up scenarios these would end up being denominated in a vastly more valuable currency.

What is the worst case? Well the duration of the Bund with rates close to zero is roughly 10. So a 1% move from 28bps to -72bps – which seems well past any realistic bottom – would cost the Fund 10% of 16%, or -1.6%.

If this occurred we could roll our bund short forward and get paid a yield of 0.72% to do so, until eventually rates normalised. Currency is also important, but as a USD fund, the USD would be expected to appreciate more than the Deutschmark, or whatever the new Bund currency was to be (most likely would remain the Euro), so that side is covered too.

The risk on the US Treasury side is more straightforward – in the current rate-rising environment this position will lose capital value until another shock causes a flight to quality. However, 3.2% is a tidy yield, and we can expect a 10-20% appreciation (0.5%-1% uplift in the Fund) if markets are wrong about what happens next in the bond market. This wouldn't be the first time!

Ofcourse the positive yield and negative correlation is the real value of the Treasury position, and the yield amply covers the carrying cost of our short Bund, so long term investors in the Fund should be rewarded. At circa 4.5% of the Fund, so nothing to lose sleep over either.

Core investment portfolio

We added to our British homebuilders, building up stakes in Berkeley and Crest Nicholson, as well as Beach Energy. We also added to Santander and KKR in Financials, which is our highest theme exposure.

Apart from that the portfolio was broadly stable.

We are sitting on decent profits in Glencore, CVR Refining and Valero Refining. We may consider trimming these positions in the coming weeks, though the current commodity investment trough suggests there are multiple years of gains ahead. We will also take a look at moving up the risk curve on commodities into higher return opportunities.

Tactical short positions

GoPro slumped, but unfortunately we took profits in October! We continue to hold small short positions in Deltic Timber, Pandora Media, and have slightly increased our short in the US Oil Fund. So far, we have held back from opening short positions in Australian retailers, but are watching closely.

The case in Australia is clear: Amazon has gutted the low end of fast moving consumer goods in the US, and we expect this slow motion train wreck to hit physical retail in Australia as well, particular in the discount and consumer electronic space.

Assuming Amazon takes at least some market share in Australia, as no doubt it will, the sales will have to come from the revenue lines of someone.

The clear short positions would be Target and Coles on the cost-conscious side, but unfortunately the corporate parent is Wesfarmers, which is a weird Australian conglomerate of coal and consumer retail.

At first glance JB Hi-Fi and Harvey Norman also seem attractive as shorts.

Harvey Norman has had a lot of air time in the hedge fund world recently. There's some shady accounting in which the listed head co provides support to its franchisees in the form of loans, which are quite likely non-recoverable.

While exciting for the analyst who teased this out, a total write-off would barely knock 10% of the firm's capital base. This is within the stock's annual volatility so is a bit of a red herring. The Harvey Norman franchise model is also a good one – weak franchisees have to perform very poorly before Harvey Norman takes a serious hit.

FRAZIS
CAPITAL PARTNERS

I've always had a soft spot for JB Hi-Fi as it's the first stock I made money on. But the firm appears to be running out of growth run-way, and while it has demonstrated decent pricing power – while maintaining its reputation as a discount store – this was in a benign competitive environment. At a sub 10x EV EBITDA ratio and basically no debt, the downside is limited here as well. Not enough juice to justify the risks of shorting.

Myers also lacks the debt heavy capital structure that would favour a strong short, but with anemic growth is highly exposed to competition.

The perfect candidate would be an overleveraged discount retailer where a 25% sales hit would cause the value of the firm to fall below the debt stack. If we find one we will let you know.

If only Booktopia.com.au and its grossly overpriced wares was listed! I would certainly welcome some tough Amazon love in the Aussie online book market.

Outlook and positioning

I'm of the view that markets won't tip until rate rises start in earnest. We seem to be in a goldilocks moment for stocks: impending infrastructure announcements, impending tax cut announcements, and US and global rates well below their natural level.

The most likely time for a serious shift will be when Yellen's replacement looms. We can be assured Trump will appoint a fiscal hawk, quite possibly a crazy one, who will almost certainly be of that strange belief that higher interest rates are a moral good.

Perhaps markets rally further from here as tax cuts and spending programs are announced, but we doubt they will survive a fiscal hawk. This is broadly our view on timing for the next few months.

It's too easy to chin-wag over when the next crash is coming and what will cause it, but such speculation tends to lead to losses and missed opportunities. So despite our timing view above, we remain intensely focussed on finding two way bets and building as much convexity as we can safely manage into the portfolio.

Warmest regards
Michael Frazis