Salt Long Short Fund Fact Sheet – September 2021

Manager Profile

Salt Funds Management is a boutique investment management firm wholly owned by its employees which specialises in managing NZ/Australian equity and listed property mandates for wholesale and retail clients.

Investment Strategy

The Fund aims to deliver positive absolute returns in all market environments. In addition to holding "long-only" NZ and Australian securities, the Fund may, at our discretion, short sell shares, hold cash, lever its assets and utilise active currency management to generate returns (although generally the Fund's assets will be fully hedged).

Fund Facts at 30 September 2021

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$53.9 million
Inception Date	30 September 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 30 September 2021

Application	1.9604
Redemption	1.9525

Investment Limits

Gross equity exposure	0% - 400%
Net equity exposure	-30% - 60%
Unlisted securities	0% - 5%
Cash or cash equivalents	0% - 100%
Maximum position size	15%

Number of Positions at 30 September 2021

Long positions	55
Short positions	41

Exposures at 30 September 2021

Long exposure	105.49%
Short exposure	52.60%
Gross equity exposure	158.09%
Net equity exposure	52.88%

Largest Longs	Largest Shorts
Tower	Wisetech Global
Emeco Holdings	Arena REIT
Lynch Group Holdings	Auckland International Airport
Shaver Shop Group	Commonwealth Bank of Australia
Australian Vintage	Carsales.Com

Performance[1] at 30 September 2021

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2014							6.28%	2.85%	2.74%	-1.67%	2.27%	0.89%	**13.96%**
2015	1.28%	1.07%	0.04%	2.17%	0.38%	-0.28%	0.75%	2.84%	1.34%	2.04%	2.37%	2.04%	**17.21%**
2016	-0.67%	-1.08%	3.81%	0.92%	1.72%	-0.39%	0.50%	2.26%	-0.51%	-0.57%	-0.20%	2.19%	**8.14%**
2017	0.68%	0.12%	0.74%	-0.01%	0.80%	0.30%	1.32%	0.25%	0.58%	-1.36%	-1.18%	3.62%	**5.93%**
2018	0.67%	0.05%	1.74%	-1.40%	-0.21%	-0.11%	1.20%	-1.06%	1.37%	-1.88%	-3.71%	-2.16%	**-5.50%**
2019	-1.26%	-0.97%	-0.96%	0.14%	1.94%	0.42%	2.56%	-0.03%	2.93%	2.34%	0.90%	1.70%	**10.02%**
2020	-2.01%	-2.51%	-14.47%	4.35%	1.80%	3.18%	3.39%	-1.81%	2.41%	-1.67%	8.31%	6.76%	**5.88%**
2021	1.24%	1.90%	4.42%	3.52%	2.16%	-0.23%	0.48%	0.56%	0.93%				**15.92%**

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	1.98%	1.30%	6.64%
6 months	7.61%	2.59%	11.54%
1 year p.a.	31.82%	5.24%	21.31%
2 years p.a.	13.53%	5.41%	12.76%
3 years p.a.	7.67%	5.80%	12.41%
5 years p.a.	6.51%	6.19%	11.92%
Since inception p.a.	9.67%	6.73%	11.82%

[1] Performance is after all fees and before PIE tax.

[2] NZX 50 G/ASX 200 AI is a 50/50 blend of the S&P/NZX 50 Gross Index and the S&P/ASX 200 Accumulation Index and is for comparison purposes only.

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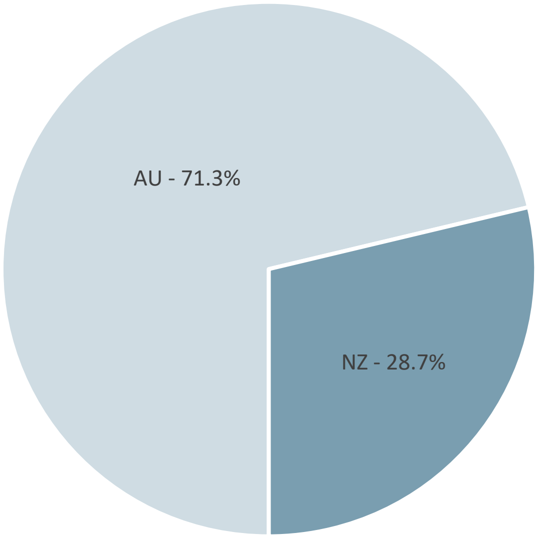
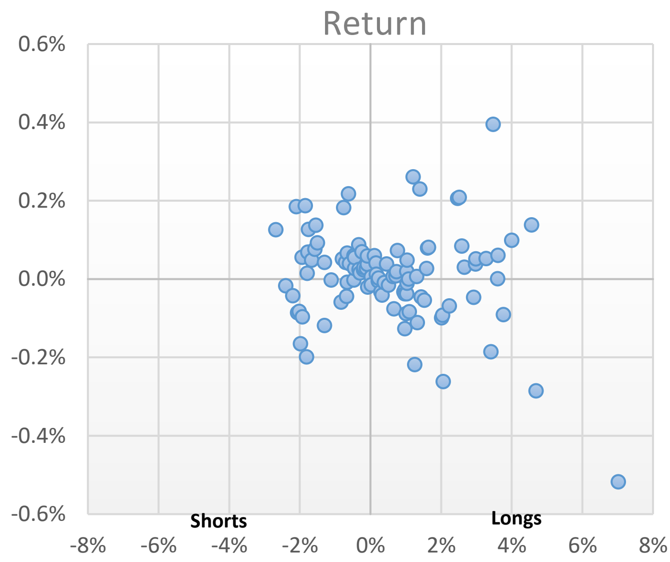
Country Allocation at 30 September 2021 (Gross Equity Exposure)



September 2021 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

Against a backdrop of volatile and generally weak long-only equity markets, the Fund delivered a solid performance in the month of September, with a return after all fees and taxes of +0.93%. While it would be an exaggeration to say that we sailed serenely through the increasingly turbulent equity market waters, the Fund was certainly far less volatile than the market and entirely uncorrelated to its movements. That is why this Fund exists.

The month saw a furious rally on the last trading day which saw the NZ index end +0.43%, while its Australian cousin still ended down -1.85%. These moves came in defiance of rising bond yields, with NZ 10-years moving from 1.72% to 1.97%. Australia and NZ far outperformed the MSCI World Index which fell -4.2%.

The Fund's net length rose slightly from 49.6% to 52.9%, while our gross remained relatively unchanged at a higher than normal 158%. Volatile markets generate more opportunities from both sides of the ledger.

Despite our net length, the Fund generally did well on negative days, which speaks to the style of our longs versus our shorts. There were eight negative days for the 50/50 index of Australia and NZ equities during the month. We were actually up on seven of those eight days and returned an average +0.07% versus the market's -0.69%.

Remember that being uncorrelated does not in any sense guarantee that we will be up when the market is down, but on average, this Fund does tend to do slightly better on down days than up days – even when we are running 50% net length.

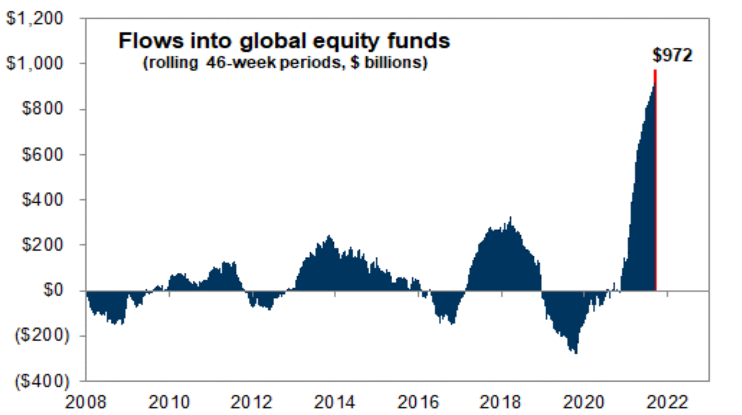
Several linked themes are currently driving our thinking. We see risks regarding extended valuations in some segments of the equity market accompanied by rampant inflows. This is against a backdrop of remarkably loose monetary policy. However, these policy settings are on the cusp of changing in some countries, including NZ. This change is occurring because evidence is mounting that inflation is picking up, and that while it has some transitory elements, there are components of a more lasting negative supply-side shock to it as well.

Finally, and tangentially to this, markets were rocked during the month by the travails of the mega Chinese property developer, Evergrande and fears that this might herald China's "Lehman moment". We doubt that but do see some significant investment implications.

Many global equity markets continue to be driven by a torrent of "there is no alternative" inflows. BAML data early in the month showed that their private client allocation to equities was a new record high of 65.2% versus a long-term average of 56%. Sensibly, bonds were at 18% versus a 27% average and cash was slightly below normal.

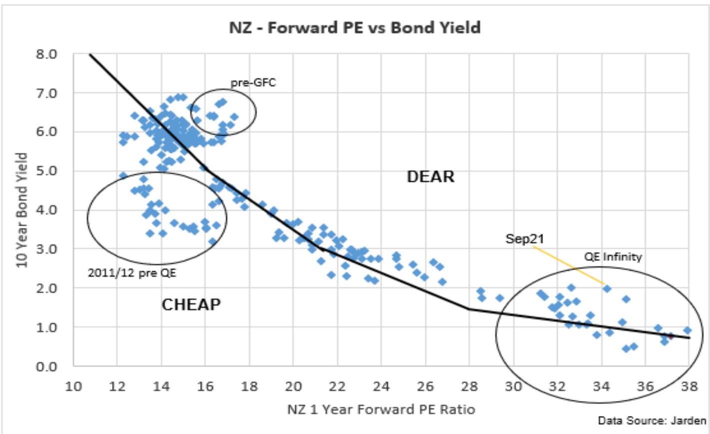
Similarly, JP Morgan positioning data from early in the month shows that all-strategy US hedge fund gross positioning of 250% was at its 92nd percentile in recent years, while net length of 75% was at its 100th percentile. Our Fund's 158% gross and 50% net length feels rather timid against this backdrop. It is also interesting that both retail investors and "smart money" hedge funds are record long.

Goldman Sachs data shows that in the 46 weeks since the Covid meltdown, global equity inflows have been $972bn. The chart below puts that number into its somewhat startling context. Combined with a continued move from active towards passive investing, it also explains why there has been a relentless bid for equities towards the end of most days.



Source: Goldman Sachs Investment Research Division, Cormac Conn

NZ has been subject to similar forces although we lack the hard data to pinpoint exactly the degree of equity inflows. Our market has continued to be strong even in the face of rising bond yields, with the chart below showing that it has left valuations very extended indeed. One can see the clear relationship between 10-year bond yields and the one year forward core PE ratio. Fair value at a 2.0% yield is some way below the current forward PE of more than 34.0x. We are a little wary that "fair value" is very sensitive to small changes in the risk-free rate (and the market risk premium) at such low bond yields but the picture is clear.



The chart also shows that over the last 20 years, the market tends to get "stuck" in certain paradigms where it is cheap or expensive. For example, as hard as it may be to believe, we were uber-bullish in 2011-12, when bond yields were 3-4% and the forward PE was in a 13-15x range. We were stuck there until Draghi's famous "whatever it takes" policy commitment and that eventually saw us transition to the current paradigm of "QE infinity". We think that evidence for a movement out of this current paradigm is building.

This bring us to our second and third themes, inflationary pressures are rising and they will force central banks to tighten monetary policy. This in turn may put a brake on the relentless inflows to equities, particularly those exposed to higher bond yields. We reiterate our view of looking to be long cyclicals and special situation stocks, while being short GAAP (growth at any price), TINA (there is no alternative) and Quality. The one proviso is whether we end up in an inflationary or stagflationary scenario, which will obviously impact the Cyclicals versus Quality decision.

Inflation pressures are evident everywhere. The US core PCE for August was 3.6% annualised, while the headline was +4.3%. Transitory used car inflation is becoming less of the story and stickier generalised pressures are becoming more of it. Surging rental inflation is still to come. Non-farm payrolls for August were weak but average hourly earnings were +4.3% in the year versus +3.9% expected. The New York Fed inflation expectations survey showed that they rose to new multi-decade highs of +5.2% in the short term and 4.0% in the medium term. In NZ, the latest ANZ Business Outlook Survey showed a near record net 58.1% of firms expect to lift prices over the next year.

While shipping costs have stopped rising, they are hovering at a plateau which may be in place for some time until capacity is expanded. Worse, the Economist magazine estimates that 60% of total goods are subject to contracted shipping rates and are yet to see any major increase. Offshoring and optimisation of supply chains has been thrown into a spaghetti jumble, partly due to Covid and partly due to increasing costs from China and a less certain political backdrop. Further fuel is being added by a boom in soft and hard commodity prices (we are long Oil Search and Graincorp).

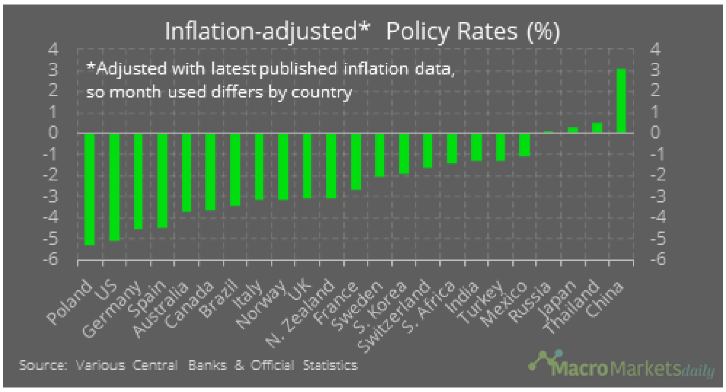
Even the renowned equity market perma-bull, Jeremy Siegel is quoted on CNBC.com as this piece is being written saying, "inflation in general is going to be a much bigger problem than the Fed believes…. there's going to be pressure on the Fed to accelerate its taper process…. there will be a challenge for long duration stocks…. the tilt will be towards value stocks."

Nouriel Roubini wrote a piece late-month in Project Syndicate which really resonated entitled "Goldilocks Is Dying". He argued that the economic recovery in the first half of 2021 has given way to a surge in inflation due to supply-side bottlenecks. Equities have only fallen a little on hopes that the stagflation tendency is mild and temporary.

He sees four possible scenarios: 1) inflation pressures prove temporary and normal service resumes; 2) economies over-heat with persistent above-target inflation, with the market impact depending on how central banks respond; 3) a stagflation trap due to persistent negative supply shocks, with central banks struggling to normalise rates due to very high public and private debt ratios, driving a sharp rise in long term bond yields; 4) a growth slowdown, with weaker demand exceeding supply shocks, leading to lower inflation and a continuation of very low bond yields.

There are no prizes for guessing the scenarios he is plumping for. For our part, it is perhaps wise to stay relatively flexible as to how the future states of the world may play out but it is critical to understand that they do not all line up with the optimistic view embodied by current markets.

It is very easy to get used to current interest rates as being normal rather than uniquely low across millennia of financial history. When I was teenager, I remember getting 20% for my $50 term deposit. I suspect many of the current generation of go-go growth fund managers barely remember the GFC let alone the Nasdaq crash or 1987. The chart below came from Forsyth Barr and shows how remarkably negative targeted policy rates are once adjusted for inflation. Better hope that the inflationary evidence all around us does prove transitory or we will live in some interesting times as rates begin to rise.



Finally, an obvious reason for market volatility during the month was the difficulty experienced by China Evergrande. What does the likely bankruptcy of China's largest property developer mean? In the short term, financial contagion seems somewhat unlikely, with exposure well spread across contractors, apartment buyers, wealth management product owners, bond owners, equity holders and the lucky depositors at Evergrande's own bank. Major mark-to-markets have already occurred and some form of government intervention seems more likely than not.

Longer term, it could portend the end of the great China property bubble which has been such an essential component of their economic growth, especially when it was super-charged post-GFC. Famed historian, Niall Ferguson pointed out on Bloomberg that housing accounts for 30% of GDP in China versus 19% in the US, that 25% of all apartments are vacant and that housing is 78% of Chinese financial assets versus 35% in the US.

Political policies have now turned against the sector, with the view from the top that, "housing is for living not speculation." Demographics are also looking ugly. JP Morgan analysis is that housing demand peaked at 20.2m units in 2017, it fell to 16.4m in 2020 and will be just 12.7m by 2030. Engineering a soft landing against this backdrop may prove challenging to put it mildly but as can be seen in the earlier chart, China does have at least have major monetary policy room and high deposit requirements are another buffer. However, it may be some years if ever before an iron ore boom returns.

Returning to the performance of the Fund in September, our return of circa +0.98% (pre fees and tax) was comprised of a modest loss from our long book (-0.32%) that was more than offset by strong gains from the short book (+1.32%) which did well from the weak and volatile Australian market. Our overall "winners to losers" ratio was again a solid 61%, with this being particularly pleasing given that we have more longs than shorts and the market declined.

The largest headwind came from an "old friend" in the form of Tower (TWR, -7.1%). Notwithstanding the benefit for their automotive book from lockdowns, they issued another modest earnings downgrade from a continuation of an unusually high number of house fires. To paraphrase Oscar Wilde, to have one house burn down may be regarded as a misfortune, to have ninety burn down looks like carelessness. On a more serious note, the main issue they are facing is an explosion in claims cost inflation. This is being faced by all players but it takes time to re-price policies as they only gradually come up for renewal. Looking forward a year, our thesis of a very cheap business with a sustainable edge in the cost of doing business versus its competitors, strong growth and a plump balance sheet remains unchanged. TWR remains a frustrating waiting game which we were clearly too early to the party on.

The second largest headwind came from our large position in Emeco Holdings (EHL, -7.1%) which fell for reasons that we could not discern. A key concern around EHL has been the exposure of its equipment rental business to the coal sector. However, both thermal and coking coal prices have gone vertical in the last few weeks. In our view, this will give EHL time to continue its transition to other commodities. EHL's balance sheet is now robust and it is on a Jun22 PE of 7.2x going to 6.4x in Jun23.

The third detractor of note was our mid-sized long in Omni Bridgeway (OBL, -14.9%) which fell when it surprisingly lost an appeal regarding a portion of its earlier win from the Wivenhoe dam disaster. While frustrating, OBL continues to transition to being a fund manager where investors bear these risks rather than having on-balance sheet exposures themselves.

Other laggards were our Wisetech (WTC, +11.0%) short which is now on a forward price/sales ratio of 28x, and yes, they do have costs and they do have competition; a moderate long in the gold miner, Regis Resources (RRL, -18.6%); and our large long in the cheap and strongly growing wine company, Australian Vintage (AVG, -5.3%), which took a rare breather.

Our positive contributors were relatively widespread rather than being hugely concentrated. That said, the largest tailwind came from our long-held position in the small cap infrastructure services business, Intega Group (ITG, +10.2%) which bounced from what appears to have been a purely flow driven sell-off. As this piece is written, ITG has received a takeover bid at a premium of nearly 60% and this will contribute nearly 1.5% to Fund performance in October. When we originally bought ITG, it was on a cash PE sub 5x with a strong growth outlook – sometimes there is something to be said for old-fashioned investing rather than following the latest hot, hot thing.

Our second notable winner was a moderate holding in Coronado Coal (CRN, +16.2%) which continued to run on the back of surging coking coal prices. It is an interesting reminder of how cyclical such companies can be as it was only a few months ago that it raised equity to shore up its balance sheet. At current spot prices, it is on a PE of less than 2x – not that spot prices are likely to hold forever. This is not a long-term holding.

Counter-balancing the CRN long was our short in Fortescue Metals (FMG, -18.7%), where we had steadfastly ignored near-unanimous Australian broker bullishness. Several commodity analysts had forecast the market to move into over-supply late-year and we surmised that share prices might anticipate this. Add a dose of luck from unforeseen Chinese electricity shortages and construction reductions and this turned into a strong contributor. We covered near the lows.

Other winners were our long in Oil Search (OSH, +17.4%), with LNG price strength looking to have structural elements to it as investment is curtailed on ESG pressures. We find this intriguing given that LNG is the natural transition fuel to get rid of coal-fired power plants across Asia. Qantm IP (QIP, +7.2%) rallied as some large overhangs cleared and some investors are perhaps noticing that it is on half the multiples of its peer, IPH; and Pacific Edge Biotechnology (PEB, +7.8%) rose following a large share issue which introduced major new global investors to the register and which will be used to turbo-charge growth. Finally, our short in the very expensive Breville (BRG, -9.5%) worked as investors perhaps began to ponder what growth looks like post-re-opening and whether a forward PE of nearly 40x is appropriate.

Thank you for your continued support of the Fund. We were pleased to deliver a solid result in the month even though style factors were mixed and our individual stock selection was not flawless. We have been banging the drum for some time about the risks posed by rising inflationary pressures and the growing requirement for tighter monetary policies. This is now upon us and we may about to enter an interesting and volatile period. October has started very well for the Fund and we continue to believe we are well positioned for what lies ahead.

Matthew Goodson

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