SALT

Salt Long Short Fund Fact Sheet – August 2024

Manager Profile

Salt Funds Management is a boutique investment management firm wholly owned by its employees which specialises in actively seeking to maximise returns while managing the risks of the investment.

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 31 August 2024

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$93 million
Inception Date	1 August 2014
Portfolio Manager	Matthew Goodson, CFA

Unit Price at 31 August 2024

Application	2.8291
Redemption	2.8177

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 31 August 2024

Long positions	54
Short positions	29

Exposures at 31 August 2024

Long exposure	94.81%
Short exposure	48.01%
Gross equity exposure	142.82%
Net equity exposure	46.80%

Investment Risk to 31 August 2024

Fund volatility[1]	6.56%
NZ50G / ASX200AI volatility[1]	13.47%
NZ50G / ASX200AI correlation	0.053

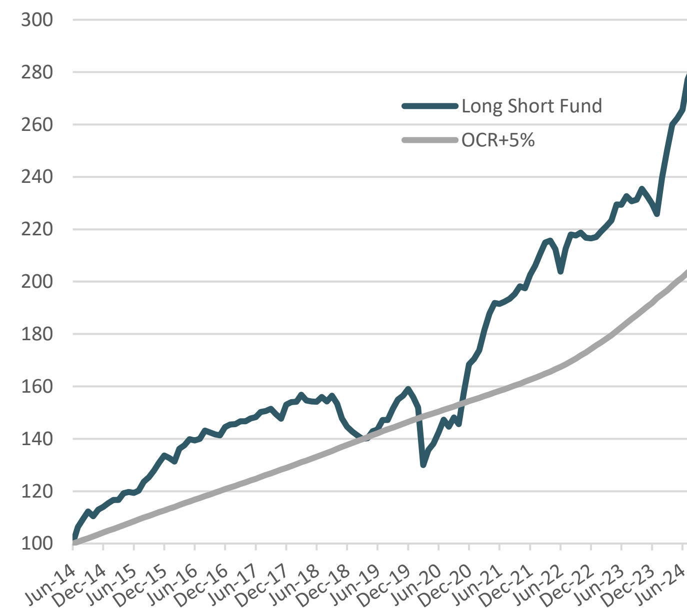
1. Annualised standard deviation since fund inception.

Fund Performance[2] to 31 August 2024

Period	Fund Return	OCR+5% Return	NZ50G/ASX 200AI Return[3]
1 month	1.63%	0.81%	0.40%
3 months	7.38%	2.50%	5.33%
6 months	17.62%	5.10%	6.51%
1-year p.a.	22.12%	10.43%	11.30%
2 years p.a.	13.70%	9.97%	7.56%
3 years p.a.	13.36%	8.70%	2.16%
5 years p.a.	13.87%	7.39%	6.27%
7 years p.a.	9.36%	7.19%	8.20%
10 years p.a.	9.93%	7.30%	8.68%
Inception p.a.	10.82%	7.38%	8.96%

2. Fund performance is after all fees and before PIE tax.
3. NZ50G/ASX200AI is a 50/50 blend of the S&P/NZ50 Gross Index and the S&P/ASX 200 Accumulation Index and is for comparison purposes only.

Cumulative Fund Performance to 31 August 2024



Fund performance has been rebased to 100 from inception.
Past performance is not a reliable indicator of future performance and no representation or warranty, express or implied, is made regarding future performance.

Largest Longs	Largest Shorts
Tower	Commonwealth Bank of Australia
GDI Property Group	Wesfarmers
Global Data Centre Group	Breville Group
Turners Automotive Group	Reece
Heartland Group	Scentre Group

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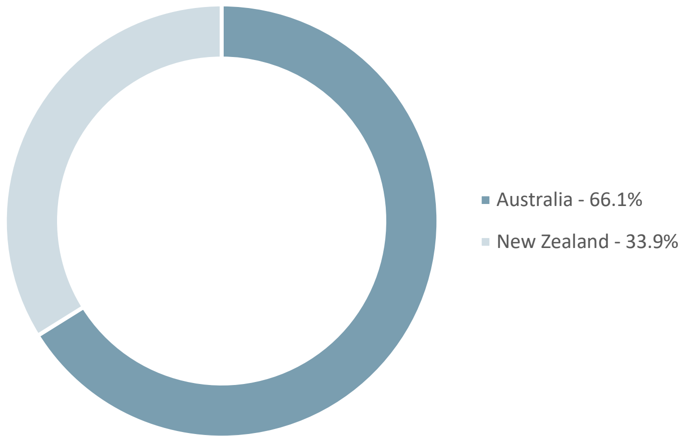
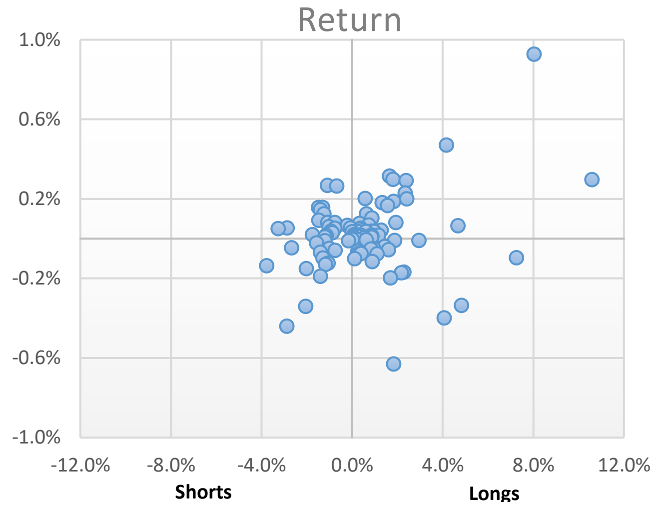
Country Allocation at 31 August 2024 (Gross Equity Exposure)



August 2024 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

We are pleased to report that the Fund delivered another strong month of performance in August, with a return after all fees and tax of +1.63%. At an overall level, long-only equity benchmarks delivered superficially muted outcomes, with NZ rising +0.3% and Australia advancing +0.5%. However, as is often the case in August result season, these muted aggregates concealed a seething mass of volatile winners and losers beneath the surface. We certainly experienced both sides of the ledger and will pick through the main movers shortly.

August was very much a month of change for macro indicators across the key Western markets that we focus on. You may recall that we ended July in a position of "extreme fear" on sentiment indicators as the Japanese-driven carry trade stumbled, fears of recession grew in the US (and NZ), and the first cracks began to appear in the AI story/bubble.

As shown above, mid-August onwards saw a change of script on the sentiment front. The CNN Fear & Greed indicator bounced hard off its brief flirtation with "extreme fear" below 25 and finished the month firmly in "greed" territory at 63. Two developments drove this. Firstly, the "carry trade" collapse had only a temporary impact and has perhaps been superseded in magnitude and importance by other market factors. Secondly, US macro data turned decidedly more supportive, with signs of recession fading somewhat but inflationary pressures clearly ebbing. While not yet positive enough to suggest that Goldilocks is definitely back, macro factors did move in that direction.

There were several pieces of helpful US inflation data in the month. CPI inflation for the month of July rose by an expected +0.2%, with shelter accounting for about 90% of the lift. The +2.9% level for the year was below the 3% mark for the first time since March 2021 and is now well below its brief peak of +9.1% back in June 2022.

After month-end, core PCE inflation for July was just +0.16% (+0.2% expected). The annual +2.6% rise was below the +2.7% expected. The Fed has a dual jobs and inflation mandate, so upcoming non-farm payrolls data will be critical in determining how aggressively they start to cut.

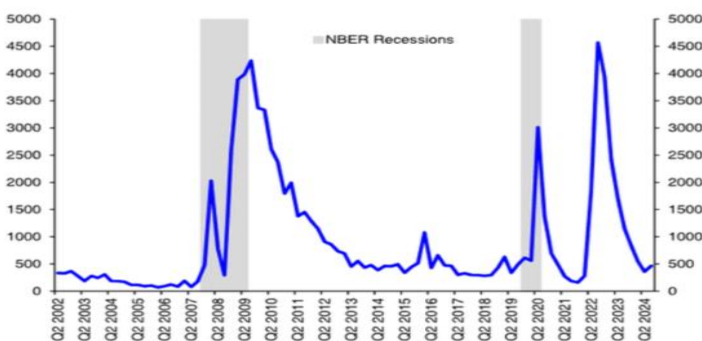
Governor Powell was clear at Jackson Hole that they are cutting but will be data dependent in how they do so: *"The*

time has come for policy to adjust. The direction of travel is clear, and the timing and pace of rate cuts will depend on incoming data, the evolving outlook and the balance of risks."

The one concern left on the inflation front is that lagging drivers such as shelter and wage inflation may linger. However, lead indicators for rental inflation are slowing quickly and as shown below in the chart sourced from Goldman Sachs, a variety of indicators linked to wage inflation are also heading in the right direction.

So, everything is starting to come together for Fed rate cuts but the question is how many and when. The market is pricing four rate cuts in the rest of 2024 and 250bp over the next 18 months. This does feel rather excessive, particularly with the US election in November possibly creating a hiatus in the short term and potentially a renewal of inflationary risks in the medium term. Moreover, the Fed has never cut more than 75bp outside of a recession.

In July, a variety of US data points had convinced the market that recession was imminent. While the data is still far from uniform, equity markets began to lean more in the direction of Goldilocks in August – we can have our rate cuts but keep eating continued economic growth too.



One interesting take on the recession question is the chart above sourced from @SoberLook. If there is a recession going on in the US, then someone forget to tell all the companies in the August reporting season. The number of times that the word "recession" was mentioned harked back to the halcyon periods pre-Covid and pre-GFC. The Fed has hiked 500bp from its (previously absurd) lows but the toll exacted on the economy to defeat inflation has seemingly not been large. There are a couple of interesting explanations.

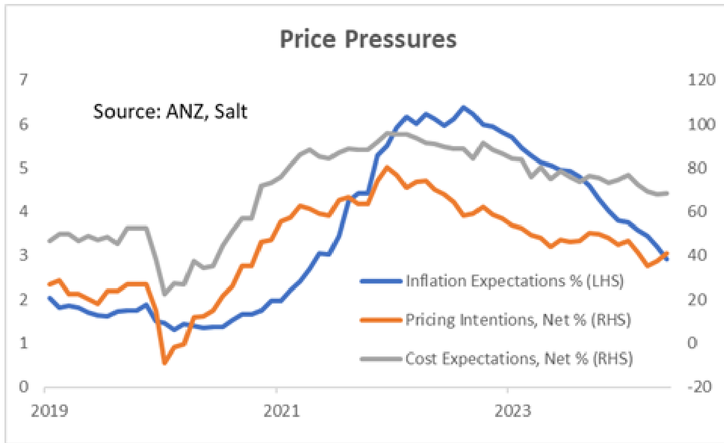
One is that the "natural" interest rate has risen because the US has been running large fiscal deficits. Therefore, while the Fed has hiked, monetary policy is not actually as tight as it might seem. If this is the case, then the market has hopelessly over-egged its very optimistic expectations for 250bp of future cuts.

The second explanation is an argument being pushed by Dr Doom, Nouriel Roubini. He believes that Janet Yellen's Treasury Dept has engaged in backdoor stimulus via an excessive reliance on short term debt in its debt issuance strategy. Usually, the Treasury aims for 15-20% of debt to be in short term bills but suddenly 70% of all new debt in the last year has been issued there, pushing the ratio to well over 20%. This reduces the supply of long-term bonds, taking the pressure off yields and having a QE-like impact. Roubini estimates that the impact is equivalent to 100bp of Fed policy rate easing. No wonder there are no concrete signs of a recession.

In contrast to the Goldilocks-tinged US economy and market, the NZ economy has been experiencing a far more traditional recession, with our ship of state having been steered onto the rocks by the somewhat wayward Captain Orr. One worries that the RBNZ is now gyrating like a data-dependent forex dealer rather than a considered central bank with a robust fundamental process.

That said, there was little disagreement when they abruptly reversed course in the month and cut the OCR target by 25bp to 5.25%. Their new projected OCR path has it declining to 4.92% by the end of this year, 3.95% by the end of 2025 and an ultimate base of around 3.0%. These were significant cuts to the prior path by around 1%-1.5%, especially through 2025 and 2026.

It was clear from a plethora of data that the NZ economy has been in recession, so there is little doubt that this initial cut was the right move and avoided doubling down on earlier hawkish errors. However, remember that the RBNZ has a sole inflation target of 1%-3% and the actual evidence in the last few weeks has been mixed.



A real curveball came at month-end from the ANZ Business Outlook survey, which showed a surge in firms' own activity expectations and general business confidence rose to 10-year highs. However, we interpret this as things improving from 3 standard deviations bad to merely 2. Unhelpfully, pricing intentions rose a little from 37.6 to 41.0 and as shown above, price pressure evidence is still well above pre-Covid levels. A rate cut or two makes sense but suddenly projecting a 3% terminal OCR path could be setting us up for another future RBNZ reversal.

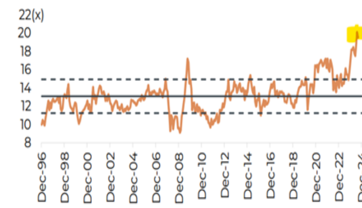
Australia is the odd country out at present. In contrast to NZ and the US, the RBA spent much of August vainly trying to jaw-bone markets that they have no intention of easing and could even raise again. We counted five separate occasions where they made public speeches that were crystal-clear in their stance and we may have missed some. They made comments such as: "explicitly considered a rate hike", "extended period at current cash rate of 4.35%", "tolerance for pushing CPI timeframe out further is limited" et al.

On top of this, we saw strong July employment data of +58k (versus 20k expected) and a number of strong July updates by listed retailers as tax cuts are starting to be spent. However, the market does not want to listen. Market-implied pricing for the cash rate is for -0.18% to 4.18% in Dec24, a sharp -0.75% cut to 3.6% in Jun25 and -102bp to 3.33% in Dec25.

Unsurprisingly, these aggressive rate-cut expectations have spilled over into nose-bleed equity valuations. According to JPM research, the S&P/ASX200 Index has seen a PE multiple expansion of 2.0 points so far in 2024, while the mid cap index has expanded by 3.4 points. Contrastingly, the 10-year bond yield has been flat over this time period. Worse, according to JPM, Jun25 year earnings growth forecasts have receded from +4.2% to +1.9% post results season. So, we have a case of multiple expansion that is not supported by lower discount rates or higher future growth.

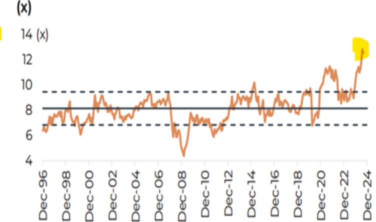
This multiple expansion is particularly evident in the Australian banking sector, which is unsurprisingly where some of our larger shorts are currently placed. The charts below from Barrenjoey put this in context. The valuations are absurd and much of the blame can perhaps be laid at the door of ever-increasing passive flows.

Figure 77 - Banking Sector Price to Earnings (x)



Source: Company data, FactSet, Barrenjoey Research

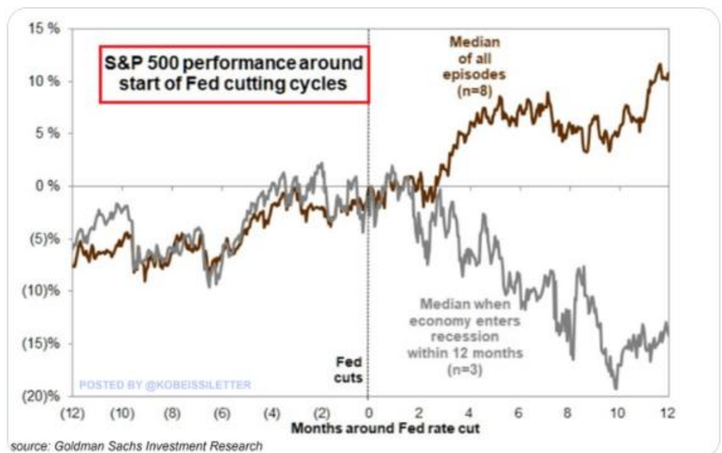
Figure 78 - Banking Sector Price to Pre-Provision Profit (x)



Source: Company data, FactSet, Barrenjoey Research

Put all this together and what should equity investors do? NZ has started the rate cut party and the US looks set to shortly join us. However, markets are pricing in magnitudes of future rate reduction which seem unlikely to occur absent a sharp economic contraction. We would be careful and sell/short those stocks that have priced such rate cuts in.

More generally, we repeat last month's analysis that <u>the results of buying equities post the first rate cut depend on whether an economy enters a recession or not</u>. Equity returns are solid in the year after the first rate cut if the economy holds together but sharply negative if it doesn't, as shown in the chart below.



After being +5.9% in July and +0.3% in August, NZ equities may already be through this negative recessionary impact and starting to look across the abyss to the other side. While our market appears to be on very high multiples on an overall basis, the median stock PE of 15-16x of potentially depressed earnings strikes us as being perfectly investable at 4.5% bond yields.

In contrast, the "lucky country" Australia has outperformed NZ for three years but may face tougher times ahead. Its

multiple expansion has been extreme, and by not tightening monetary policy enough, they will have to keep tighter monetary policy for longer. We are finding it far easier to find short ideas in Australia and long ideas in NZ. Along with the monetary policy cycles being misaligned, this may provide a tell of which market will perform best over the next year.

Fund Performance in August

Returning to the Fund's performance in the month of August, our overall return of circa +1.8% pre fees and tax was driven by a strong contribution from our long book (+1.9%) but a mediocre return from our short book (-0.1%). Our overall "winners to losers" ratio was a very pleasing 61%, with a slight skew to larger winners than losers.

Our gross exposure fell quite sharply from 162% to 143% as a number of names on both sides of the ledger reached our targets. Our net exposure rose from 40% to 47%, mainly from using extreme weakness in the early part of the month. This worked well and mid-high 40% net positioning is still relatively "market neutral" given our style.

The month of August saw nine negative days for the 50/50 index of Australia and NZ and the average return for the market on those days was -0.67%. The Fund was up on five of those days and had an average return on all of them of +0.20%. Much of that came from two major negative days early in the month. On August 2, the Fund was +117bp versus the 50/50 Index being -120bp and on August 5, the Fund was +5bp versus the Index being -261bp. We are comfortable that the Fund continues to be "market neutral" and have no correlation with the somewhat fevered swings of long-only equity markets.

Our largest positive by some distance was our sizeable, long-held position in GDI Property (GDI, +10.7%), which finally started to work for us. It actually hasn't been too bad a long in the context of overall property stock performance but our view that the Perth office property market is performing well finally began to be recognised when they reported a solid result near month-end. GDI rose from 60.5cps to 67cps over the month but still sits far below its NTA of $1.19. Their gearing is reasonable at 33% and the cap rate for the NTA appears realistic at 6.6%. On top of this, they have hidden potential value in some of the syndicates they manage. There is a small risk they fall out of the S&P/ASX300 Index but they look likely to stay.

The second winner of note was what has become a relatively large holding in Servcorp (SRV, +10.5%), which has been a very strong performer for us over the last couple of years. They delivered another excellent result, with their global serviced office business continuing to do well in an era of firms desiring greater flexibility in their office provision. Even though SRV's share price is up around 50% over the last year, they are still on a high-teen free cashflow yield, have a solid growth outlook and have $115m net cash within a market cap of $450m. They have a possible catalyst coming up in early 2025, with the potential float of their Middle Eastern business at likely multiples far above those that SRV is trading at.

We had a number of other notable tailwinds from our long book. Our old friend Superloop (SLC, +15.5%) did well yet again following a result which demonstrates their continued share gains in the Australian telco market. Our major Tower (TWR, +2.8%) position ground a little higher and if there are no calamities by end-September, they will pocket a cool $32m post-tax from what they would have otherwise paid in reinsurance deductibles. The market doesn't value this due to the lack of certainty but cold, hard cash is most certainly worth its face value. A trading position that we took in Channel Infrastructure (CHI, +14.2%) did well after we gave it a few weeks of patience.

DUG Technology (DUG, +14%) had a sound result and the market is beginning to focus on their growth potential across several key areas. They appear to have an edge in seismic processing technology which is now being recognised by their customers, their liquid cooling technology for data centres is early days and has huge growth potential, and they may have a very interesting product in modular data centre developments which could be well suited to "edge" roll-outs.

Notable winners from the short-side were led by Cochlear (COH, -12.9%). COH is a wonderful company but we had felt the multiple of well over 50x PE was just too high especially when competitors have their own product launch cycles ahead. We were a bit lucky when their result and guidance were below expectations. The previously painful short in A2 Milk (ATM, -23.3%) came right in one fell swoop when their weak year-ahead guidance reflected the harsh realities of China's difficult infant formula market – something that we felt the "growth" and "momentum" investors who had been aggressively pushing the name were overlooking.

The largest negative came from our moderate position in Elanor Investors (ENN, -6.8%) which is looking increasingly like a mistake. The stock was in suspense at month-end and we took a further -20% mark against the closing price. We established a position in ENN last year when they did what we thought was an outstanding deal to buy the Challenger property platform in return for Challenger taking a 13.7%

stake in ENN via new shares. Associated with this, ENN also became the manager for the massive Abu Dhabi Investment Authority (ADIA) in Australia and also picked up mandates from other blue-chip institutions. We had seen this as moving past their history of being good value-add managers of moderate quality properties across a range of structures which often had too much leverage in them. This leverage is non-recourse and not cross-collateralised. What we didn't expect was the moderate leverage at the parent company level to become an issue. However, some private debt that they have issued appears to be problematic in terms of finding liquidity to repay it. This should be solvable but we will know more in coming days.

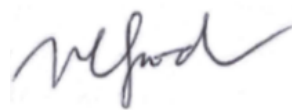
The second notable headwind was our large and formerly very successful holding in Monash IVF (MVF, -11.1%). We had earlier lightened a little into strength but were still caught by the sell-off. Their result was a touch light versus expectations but the main surprise was the settlement of a long-standing class action regarding a poor-performing genetic screening technology that they had used some years ago. Our expectation was that they were fully insured but they took a partial hit amounting to A$32.6m post-tax, which is just over 8cps. They are suing their insurer for this balance but the market immediately wiped it off the MVF share price and then some. We still see their forward PE of 14.9x as being very cheap considering their structural long-term growth from their leading position in Australia and growing position in Asia.

Other long-book laggards were our large holding in Turners (TRA, -6.8%) which fell on no news and a pull-back in the skyrocket that has been Intelligent Monitoring Group (IMB, -9.3%).

A couple of names in our short book were painful. The most frustrating was our relatively large position in Breville Group (BRG, +14.5%), whose result was a touch ahead of expectations if you gave them the benefit of the doubt around their ever-growing capitalisation of costs. While the bulls view this as wonderful evidence of reinvestment for growth, cynics see it as earnings management that results in an ever-increasing amortisation cost until one day there is a below-the-line write-off that no one pays much attention to. There is little doubt that BRG is a quality appliance-maker but the sector is competitive, it is cyclical and it should not be on a forward PE of 36x.

The second headwind was an error from a moderate short in JB Hi-Fi (JBH, +14.2%). Their result was solid and their July trading comments were upbeat. We keep looking for a cycle and a return to pre-Covid trading patterns but they keep managing to defy this. Their store roll-out is now mature, they are in what has historically been a notoriously cyclical sector and there is ever-increasing competition as Amazon gets its act together in Australia. The forward PE of 20x looks far too aggressive but we have been wrong so far.

Thank you for your continued support and interest in the Fund. We are pleased to have again produced a solid month of positive returns in August. September has started in a rather rocky manner for long-only equities but we have begun relatively well – albeit it is early days. Interesting times lie ahead as central banks enter divergent easing paths and expectations evolve regarding the state of the NZ and Australian economies. We are certainly finding the large cap Australian market to be very expensive but plenty of long opportunities lie elsewhere. We will continue to do our level best to extend the Fund's long-term track record of delivering equity-like returns, with far less volatility and no correlation to long-only equity markets.



Matthew Goodson, CFA

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