SALT

Salt Long Short Fund Fact Sheet – January 2022

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 31 January 2022

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$56.6 million
Inception Date	31 October 2014
Portfolio Manager	Matthew Goodson, CFA

Unit Price at 31 January 2022

Application	2.0701
Redemption	2.0618

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 January 2022

Long positions	43
Short positions	31

Exposures at 31 January 2022

Long exposure	91.57%
Short exposure	38.02%
Gross equity exposure	129.59%
Net equity exposure	53.55%

Largest Longs	Largest Shorts
Tower	Goodman Property Trust
Dalrymple Bay Infrastructure	Breville Group
Lynch Group Holdings	Fortescue Metals Group
Monash IVF Group	Reece
Pepper Money	Commonwealth Bank of Australia

Performance[1] at 31 January 2022

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%	1.52%	-0.39%	2.62%	**20.29%**
2022	1.76%												**1.76%**

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	4.02%	1.43%	-6.78%
6 months	7.18%	2.75%	-4.68%
1 year p.a.	20.91%	5.40%	-0.27%
3 years p.a.	13.03%	5.68%	10.75%
5 years p.a.	7.23%	6.10%	10.04%
7 years p.a.	8.64%	6.53%	9.43%
Since inception p.a.	10.01%	6.68%	9.91%

[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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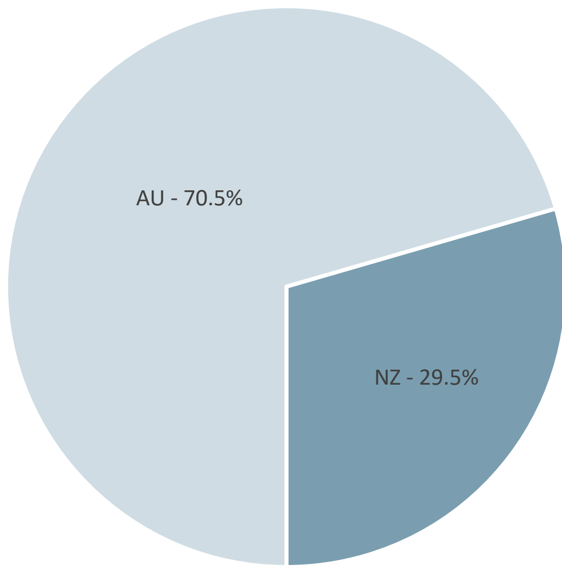
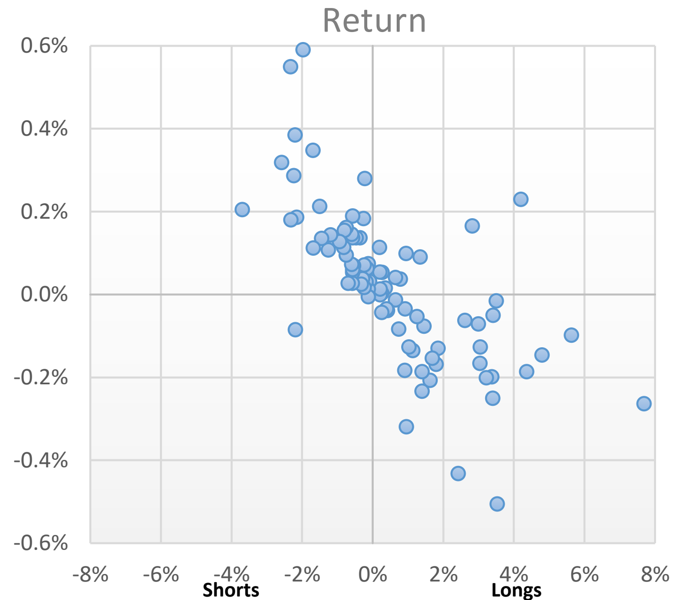
Country Allocation at 31 January 2022 (Gross Equity Exposure)



January 2022 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

January was the most turbulent month for equity markets since the dark days of March 2020, with NZ declining -8.0% and Australia -6.4%. Against this sombre backdrop, we are delighted to report that the Fund performed strongly, delivering a return after all fees and taxes of +1.76%. After being lulled by the seemingly endless bull market, it turns out that uncorrelated assets such as this Fund do have a place in a diversified portfolio after all.

The key question after last month's decimation is one posed by my children. Are we there yet? We think not. It is only natural to hark back to March 2020 when the NZ market plunged -13% and those courageous souls who bought near the lows did exceptionally well. However, there is one key difference. Then, central banks cut rates to zero and turned on the money printer. The value of financial assets soared in paper currency terms. Now comes the hangover.

We have argued for many months that inflation pressures are building, that they are only partly transitory and that central banks are hopelessly behind the curve. Central banks are now finally beginning to swallow a couple of painkillers and awaken from their stupor. As this is written, the NZ unemployment rate came in at 3.2% and wage inflation hit +4.2% and rising.

Money is about to become significantly tighter and this is not an environment in which many risky asset classes will prosper.

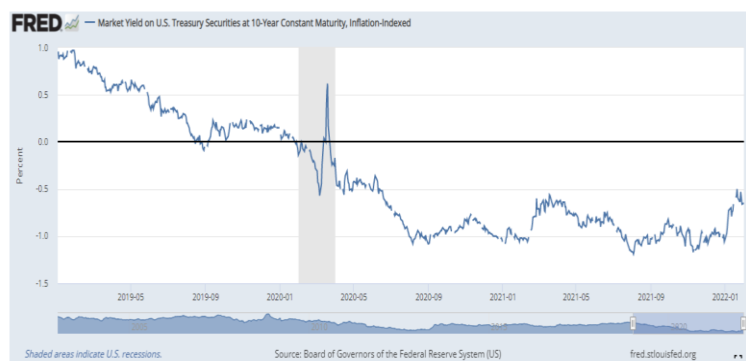
Some segments of the equity market (hopefully our longs) will do just fine. What matters is having pricing power, so that the positive impact of nominal earnings growth exceeds the negative impact of a higher discount rate. Be very cautious of two stock groups in particular; i) over-priced yield plays that are full of tourists from the term deposit department; ii) growth-at-any-price companies, whose discount rate is rising and where a more nuanced view of their true growth potential will be applied – when the tide goes out, a lot of vapourware companies will be seen to be swimming naked.

How are we managing the Fund in response to the sharp rise in volatility? Firstly, we have taken the gross leverage down from 145% to 130%. This was partly an active bottom-up decision as stocks hit our target levels and partly a top-down view that less overall leverage dampens outcomes in a highly volatile environment. Secondly, with markets selling off sharply, we naturally took the opportunity to buy and cover some names that were on sale. This lifted our net exposure from 41% to 53% - although 3% of this comes from companies subject to takeover; it's funny how often our cheap longs get bid for. We are positioned to sell into the trading bounce which has occurred so far this month and our positioning

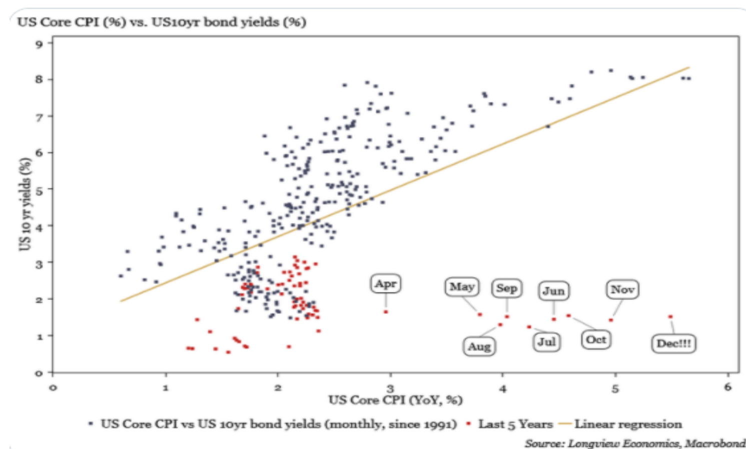
means we have plenty of firepower to take advantage of the wonderful volatility that lies ahead.

According to Macquarie research, Australian value stocks crushed Australian growth stocks by a remarkable 8.5% margin in the month of January. This comes after years of underperformance and was a global phenomenon that was driven by rising nominal and real bond yields. The move was perhaps exaggerated in Australia by the extent to which profit-less technology companies had earlier outperformed.

The charts below show how the US 10-year TIPS yield rose from around -1.1% to around -0.6% in January (at a time when the nominal 10-year yield went from 1.52% to 1.78%). Like clockwork, this impacted the valuation of long duration assets such as technology stocks. Notice however that having negative real yields is far from normal and has only been the case since the dramatic monetary response to Covid in March 2020. A full return to normality would see real and nominal yields rise a lot further yet.



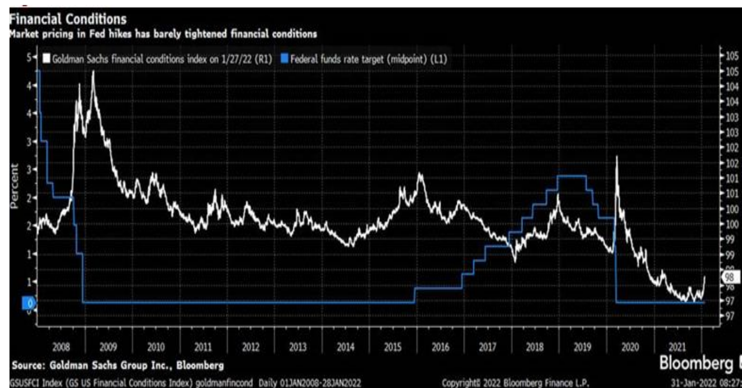
The second chart below is another way of showing just how unusual current bond yields are relative to current inflation rates. It suggests that both real and nominal yields could still have a lot further to rise unless inflation proves entirely transitory. The catalysts may be continued high inflation readings and the end of QE which has surely been a key reason for normal relationships breaking down.



Our argument is that growth and pure income stocks sold off in January because real/nominal discount rates finally started to rise. However, it's not over and these yields are still very low given the inflation outlook. Releases during the month saw Australian Q4 CPI inflation up by 3.5% YoY and still rising; NZ Q4 inflation was +5.9% YoY and underlying inflation was +5.4%; US Q4 inflation was +7.0% YoY and +5.5% underlying.

So, unless these inflation readings are entirely transitory, yields will need to rise further and what we saw in January may repeat rather than be a flash in the pan. We reiterate our view that while there are some transitory elements to current inflation, tradeable inflation is not returning to anything like its 0% level of the last decade and that leakage into wage inflation will see higher inflation become embedded.

The catalyst for the sea-change in markets in January was the volte face by the Federal Reserve to end QE and signal that higher federal funds rates lie ahead. The debates now are whether QE morphs into QT, if so when, and whether there will be any number from 3 to 7 rate hikes this year. Amidst all of this, the chart below of the Goldman Sachs Financial Conditions Index shows just how spoilt markets have been by central banks. As we highlighted last month, the Taylor Rule would have the Fed Funds rate at over 5% - that's 19-plus tightenings! Don't fight the Fed.



All of this is consistent with the argument we made throughout 2021 to own value/cyclicals and be short GAAP (growth-at-any-price) and the TINA term-deposit proxy stocks. This is now playing out. However, as it is doing so, we are becoming less comfortable with the arguments in favour of cyclicals. The shape of the yield curve often tells a tale and it has flattened dramatically across many markets. In NZ for example, the 2-to-10-year spread has gone from 97bp at end-Sept to 83bp at end-Dec and flattened to just 48bp at end-Jan.

What the market appears to be saying is that central banks will have to act to quash inflation and that tighter policy will see slower economic growth. We reiterate our view that 2022 will see "flation" but we just don't know yet if that's

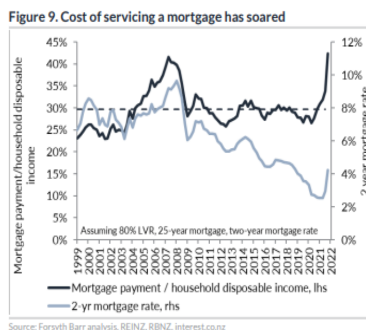
stagflation or healthier inflationary growth. The market appears to be tilting towards the former and that is consistent with quite weak business confidence surveys. This points to owning defensives, insurers, infrastructure and special situations rather than the pure cyclicals that did so well last year.

This brings us to NZ housing, a segment we have assiduously avoided discussing for a couple of years. The charts below from Forsyth Barr show what we all know but have perhaps grown overly familiar with and contemptuous of – NZ house prices are nuts! However, they have gone up forever and will therefore never fall. This feels like Ireland and Spain in 2007 or maybe 2008…

Mortgage rates are rising; a wave of cheap fixed rate mortgages will roll off over the next few months; we are consenting 47k residential builds versus a long-term average of 25k and a likely need in the low 20k region given how people squeeze up as prices rise; and net migration has turned slightly negative.

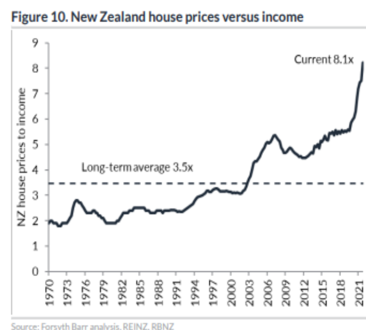
Our Ryman short has proven very rewarding and we are trying very hard to not be tempted into prematurely covering too much of it. The retirement companies have all built up a buffer by not lifting their prices as quickly as house prices but the problem with the NZ retirement village model is that the equity is just the tip of the iceberg that you see above the water. What lies below is the bank debt and the vast occupier advances – better hope the units can be sold to repay these advances when they pass away, or all this leverage will start working in reverse.

Figure 9. Cost of servicing a mortgage has soared



Source: Forsyth Barr analysis, REINZ, RBNZ, interest.co.nz

Figure 10. New Zealand house prices versus income



Source: Forsyth Barr analysis, REINZ, RBNZ

Fund Performance in January

Returning to the Fund's performance in the month of January, the overall return of c1.9% pre fees and tax was comprised of -4.1% from the long book and +6.2% from the short book. This is exactly what one would expect in such a negative month. A pleasing 13 of our 46 longs actually added value, while an unsurprising 41 out of 43 shorts worked (2 iron ore names rose slightly). Our overall winners to losers ratio was a solid 61%.

The performance from our longs was particularly pleasing because many of them tend to be in the small to mid-cap segment of the market versus our generally large cap shorts. This created a headwind due to the ASX Small Caps Index falling -9.0% versus a -6.1% fall for the ASX100 Index. It is safe to say that our longs are generally at the lower multiple end of the spectrum and this outweighed the impact of the small cap sell-off.

We did lift the Fund's net length to 53% over the month but are now trimming that again into the bounce in early February. This net length remains comfortable in terms of the Fund's performance and correlation to equities. There were 11 down-days in the month for the 50/50 index of Australia and NZ, with the average loss for the market being -0.99% on those days. The Fund was up on 9 of those 11 days and delivered an average return on them of +0.07%.

The largest contributors all came from our short book and all had a familiar story of being egregiously high multiple "darlings" that suddenly fell from favour.

The way was led by our old friend, Wisetech Global (WTC, -22.7%), with others of note being Reece (REH, -19.6%), Johns Lyng (JLG, -15.6%) and Breville Group (BRG, -10.1%). There were no particular stock stories to tell, just a case of their multiples derating sharply. Ryman Healthcare (RYM, -19.2%) is our play on a faltering NZ housing market and also plunged. Aside from a more difficult outlook, there is some risk that it may now fall out of the MSCI World Index.

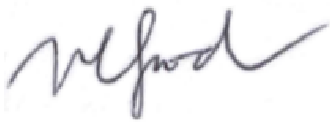
The largest headwinds came from our longs, with there being several interesting movements. Australian Vintage (AVG, -12.8%) fell as fears grew around new UK excise taxes which would hurt high alcohol Australian wines and offset the benefit from a recently concluded free trade deal. This will be a modest negative but AVG is on a PE of 10x and has strong growth regardless and is also the industry leader in low and zero alcohol wine (ghastly thought).

The second notable headwind was our long in Global Data Centres (GDC, -15.2%) which fell in sympathy with the sector globally. We view it as a cheap diversified play that may ultimately be of appeal to a fund manager looking to set up in the space.

A third standout was one of our disappointing quartet of small gold holdings, Resolute Mining (RSG, -26.9%). They have an outstanding mine in Senegal and a large underground mine in Mali that they have been struggling to get to operate to their original plans. They are slowly getting there but the market is concerned at their debt load on the journey. What we see is a 350koz mid-cost producer on a market cap of just $320m whose problems do not appear intractable.

Other modest headwinds came from our large Tower (TWR, -3.4%) holding but their AGM update this month was very promising; our large long in the cheap, high yielding GDI Property (GDI, -6.8%) for whom the Perth office outlook continues to improve; and from what is now only a modest holding in Pacific Edge Biotechnology (PEB, -18.8%), which we had earlier down-weighted considerably due to the pressure that the sector is under globally.

Thank you for your continued support of the Fund. We are delighted to have delivered a solid, positive return in January when all other asset classes were under immense pressure. The reasons for this pressure appear to be fundamental, with central banks starting to remove the punch bowl with which they have so copiously juiced markets in recent years. We will continue to focus on achieving our benchmark of OCR+5% and doing so in a manner that is both uncorrelated to long-only equities and is far less volatile than them. These properties may be very valuable in 2022.



Matthew Goodson

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