Salt Long Short Fund Fact Sheet – October 2020

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 October 2020

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$47.1 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 October 2020

Application	1.4624
Redemption	1.4565

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 October 2020

Long positions	51
Short positions	31

Exposures at 31 October 2020

Long exposure	105.31%
Short exposure	47.21%
Gross equity exposure	152.52%
Net equity exposure	58.09%

Largest Longs	Largest Shorts
Tower	Napier Port Holdings
Marsden Maritime Holdings	Premier Investments
Shaver Shop Group	Goodman Property Trust
Spark New Zealand	Technology One
Vitalharvest Freehold Trust	Wisetech Global

Performance[1] at 31 October 2020

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%			**-6.76%**

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	-1.13%	1.28%	2.21%
6 months	7.37%	2.59%	11.90%
1 year p.a.	-6.04%	5.51%	3.79%
2 years p.a.	-2.58%	6.01%	11.92%
3 years p.a.	-1.30%	6.46%	10.02%
5 years p.a.	2.64%	6.57%	10.82%
Since inception p.a.	6.12%	6.95%	10.05%

[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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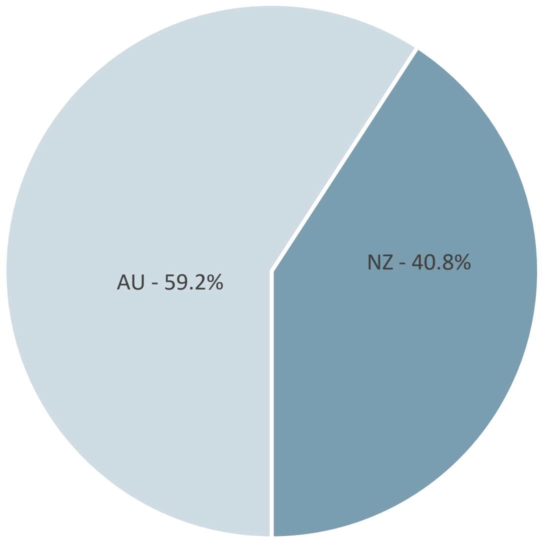
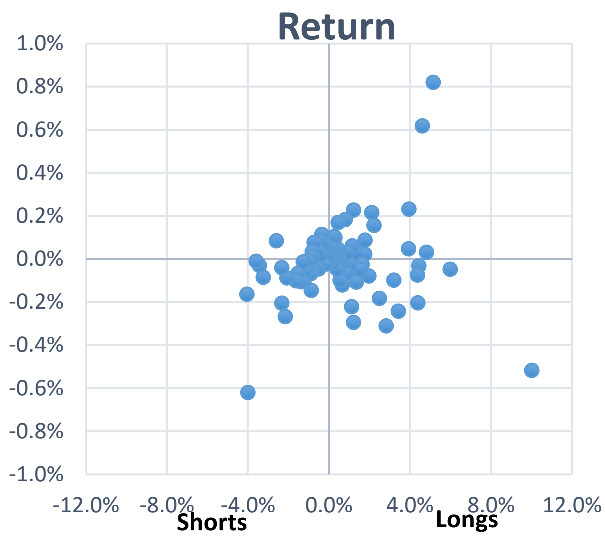
Country Allocation at 31 October 2020 (Gross Equity Exposure)



October 2020 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

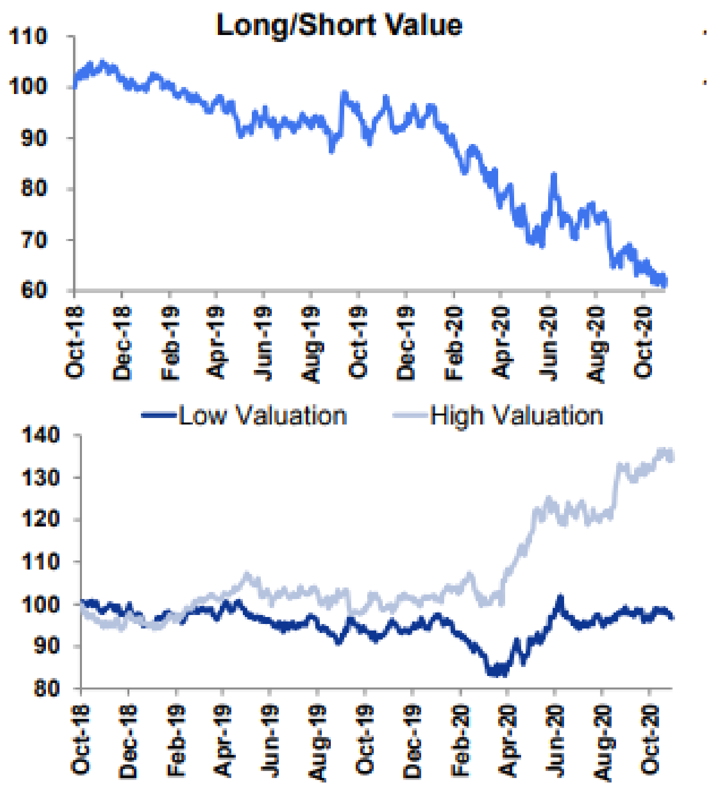
After a strong month of returns in September, the Fund retraced somewhat in October, with a performance of -1.67%. There was no single driver of any great note or concern but several of our key longs saw their share prices fall on moderate volumes and no news. We will discuss these in more detail shortly.

The Fund continued to deliver returns that are uncorrelated to equities. October saw only eight down-days for the 50/50 index of Australia and NZ, with an average return on those days of -0.63%. The Fund did its job by rising on six of the eight days, with an average return of +0.04%. Interestingly, it did this despite net length rising to a record 58.1% at month-end.

We are finding that the use of valuation as an investment rationale is throwing up a number of investment opportunities despite the Australian and especially NZ markets being driven by a seemingly endless bid in the TINA (there is no alternative) and GAAP (growth at any price) stocks. Several names which do not neatly fit into those buckets are being left behind. Given our investment style, 50% net long currently feels like what 30% used to be in terms of market exposure.

Some interesting research at month's end by the excellent Australian strategy team at GS illustrates just how sharply cheap stocks have under-performed expensive stocks in recent times.

Performance of individual factor portfolios shown relative to ASX 200



Source: FactSet, Goldman Sachs Global Investment Research

On their analysis, high PE stocks in Australia trade on an average forward PE of 43.2x which is 83% above the 20 year average, while low PE stocks are on an average forward PE of a mere 10.5x, which is just 15% above the 20 year average. Ultra-low interest rates and technological change provide partial explanations but this is a truly extraordinary divergence. Even worse, as can be seen in the second chart, the nominally high beta expensive stocks fell by far less when the market imploded in March.

In the US context, Wilson Advisory pointed out some data from Joel Greenblatt at Gotham AM, which noted that 261 US companies with a market cap above $1bn lost money in 2019 and that at end-September, they were up by an average of +65% this year.

The Fund is drawn like a moth to the flame when we can find companies in the cheap valuation group which also have solid prospects. To be clear though, we are valuation-conscious as opposed to being pure value investors – we own several high multiple growth names which appear on our analysis to have even stronger prospects than their share prices imply.

We would suggest that we are seeing a post-Covid bubble from retail investors and growth fund managers chasing the TINA and GAAP stocks. It has kept going for far longer than we ever dreamed it might, with the slashing of interest rates towards zero and the boom in Robinhood-style investors being key drivers. As this is written, the $34.5bn IPO of Ant Financial is reportedly 870x over-subscribed, with Chinese and Hong Kong banks providing up to 33x margin leverage.

This is not unique in financial history and on our twitter-feed we found a great quote from a book published in 1688 called *Confusion De Confusiones* which described a bubble in the shares of the Dutch East India Company, whose ships carried tulip bulbs:

> "*A high price of shares causes concern to many who are not accustomed to it. But reasonable men need not be disturbed about the matter, since every day the position of the Company becomes more splendid…and the revenue from investments at fixed interest becomes less….interest on ordinary loans amounts to only 3 per cent a year…. Therefore, even the wealthiest men are forced to buy stocks, and there are people who do not sell them, when the prices have fallen, in order to avoid a loss. But they do not sell at rising prices either…because they do not know a more secure investment for their capital.*"

In our view, equity markets globally have been driven by similar forces thanks to central bankers cutting rates to zero and below. NZ equities have been a stand-out in the extent of their outperformance. Year-to-date, we are +5.2% versus Australia being -7.2% and the MSCI World Accumulation Index being +0.7%.

Over the course of the last year or two, we have seen several vicious but ultimately short-lived rotations out of momentum stocks and into cyclical and value names. We think the stars may be aligning for another rotation, led out of the US.

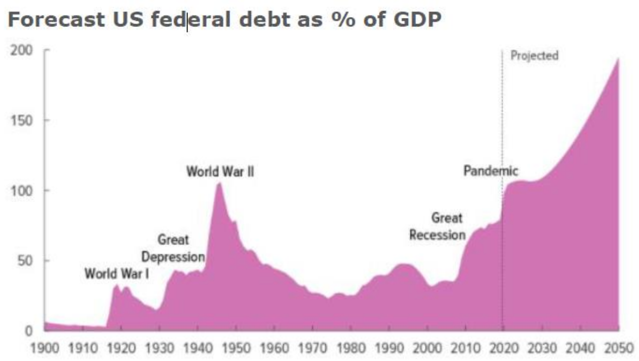
The US has already seen the beginnings of such a move, with 10-year bond yields rising from a low of 0.65% in September to 0.85% as this is written. This is a mix of perhaps pricing in a "blue wave" plus a degree of recovery beginning to become apparent in the US economy.

This letter is being written while we are in the final throes of the US election campaign. The best-case outcome for markets would be a Biden Presidency coupled with the Republicans clinging onto control of the Senate. This would see far greater predictability than the Trump years especially as regards trade policy, some degree of fiscal expansion and difficulty in enacting any of the more far-reaching Democratic polices.

A worst-case outcome for markets would be a relatively close election where the mid-West states of Pennsylvania, Michigan and Wisconsin are too close to call on the night. While polls suggest this is ultimately unlikely, these three states cannot begin counting their early votes until election day, so it could be quite some time before we have an outcome. It is generally viewed that the early and postal votes will heavily favour Democrats, meaning a superficially close result could occur on election night. There would be a massive effort from each side around counting these votes or preventing them being counted. Amidst cries of "fraud", the market could easily tank in this possible but somewhat unlikely scenario.

Parking this dire scenario, and at the risk of being utterly wrong, our expectation is we will see a "blue wave" of the Democrats winning the Presidency, possibly the Senate and definitely the House. Prediction markets lean moderately this way but the most important factor is that almost all non-partisan surveys in the last few weeks have pointed to this outcome with solid Democrat leads in the key swing states. The non-partisan statistical analysis site fivethirtyeight.com gives Trump only a 10% chance of victory. The "shy Trump" voter could perhaps be a factor but the pollsters have generally corrected for their under-sampling of lesser educated white voters compared to 2016 and the undecided voter segment is low. Turn-out also appears to be high in battle-ground states which would normally tend to favour the Democrats.

If this is the outcome, then expect a highly expansionary fiscal policy. This would give a boost to cyclical stocks and would likely see a continuation of the recent rise in bond yields due to both expectations of higher inflation and concerns regarding the sustainability of the vast and growing US debt impost. This might spark a rotation from TINA and GAAP stocks into cyclicals. We sourced the chart below from ANZ Bank and it shows just how dire the fiscal outlook is.



Source: Congressional Budget Office

While major fiscal stimulus may be good news for some companies' top lines, this will be more than offset by other impacts. A lift in the company tax rate from 21% to 28% and a doubling of the GILTI tax rate for US companies' low-taxed foreign subsidiaries would impact S&P500 earnings by approximately 10% according to various strategists' estimates. Further, a sharp lift in the capital gains tax rate for high income earners will see past winners sold prior to enactment. A far more vigorous anti-trust policy could also have implications for the likes of Amazon and Google. A mooted lift in the minimum wage would also impact profits.

Put this together and a sharp market reaction is quite possible. However, rather than selling everything in a panic, we would suggest beyond this initial response, the key question is whether it changes anything in the stance of central banks. They appear fixated on the continued aggressive use of QE, which is inflating equity and housing markets but doing little to help the real economy except via trickle-down wealth effects. Central banks are certainly creating inflation but the tools they are using mean it is confined to asset markets rather than the general price level.

We can think of four possible warning signs of a more fundamental change: 1) generalised inflation pressures do finally start to be generated and while central banks will hesitate to tighten, long bond yields would rise sharply; 2) one or two central banks give up on the folly that is QE and experiment with helicopter money which will actually make its way into the real economy and generalised inflation; 3) a robust vaccine is found; 4) current murmurings about the unfairness and risks of gathering asset market bubbles turn into outright political revulsion which drives change.

Summing this up, we think the most likely scenarios form the US election see markets weaken and a shift from TINA/GAAP into cyclicals. We are net short the former and net long the latter. However, aside from the style spill-overs, the direct effects on NZ and Australian companies will be more limited aside from higher taxes for those with large US divisions. Thereafter, does anything really change in terms of the central bank settings that are driving markets? Not yet.

Returning to our portfolio, this macro backdrop has seen us lift our net length over the last several months to about as long as we can get it at 58%. Relatively small shorts in the TINA and GAAP segments deliver an awful lot of bark for their size. On the other side of the coin, we are finding numerous attractive long opportunities which have been left behind and look attractive relative to current repressed discount rates. Key names include:

- Tower Limited (TWR) – we have talked about TWR ad infinitum and it is a large long which hasn't yet worked. They report on 25 November and we expect a good result relative to the conservative guidance they gave back in May. More importantly, the successful implementation of their industry-leading IT system has allowed significant job cuts, which will barely impact the Sept20 year but should have a major impact in Sept21. We forecast it as being on a forward PE of just 6.8x, assuming they utilise their entire reinsurance allowance (likely given the early hit from the Lake Ohau fires).
- Marsden Maritime (MMH) – another long-standing name which has worked very well from when we first bought it but which is now 18% below its pre-Covid peak. It is on an EV/EBITDA of circa 16x versus 32x for Port of Tauranga and has a strong growth profile from avocadoes, yellow kiwifruit, some cargo shifting from Auckland as transport linkages improve, major property development upside, and the naval dry-dock likely to move there. The latter could be a massive catalyst in the relatively near future.
- Spark (SPK) – we have built up a large long in SPK as our TINA play. We see their gross yield of 7.7% as relatively assured and this is far more attractive than

the 3-4% gross yields from NZ property stocks which are surely near their cyclical peaks.

- Vitalharvest (VTH) – they are the landlord for most of Costa Group's citrus groves and berry farms. They trade at $0.77 versus their $1.00 listing price as they come off a drought-affected season which hits them via a partially variable rental stream. This year is looking far better and they are on a forward cash dividend yield of 6.9% growing to 7.5%. Their fixed rental stream has a major upward reset in five year's time. We think it is in both Costa and VTH's interests to renegotiate the entire lease early, which could see a large dividend uplift.
- Shaver Shop (SSG) – their AGM late-month talked to a continuation of exceptional sales growth. Since then, the Victorian lockdown has helpfully been lifted. This has been an excellent albeit volatile investment for the Fund and we see far more upside to come as they are only on a PE (ex-non-cash amortisation) of circa 10x, have net cash and have strong continuing growth from their genuine omni-channel model as well as category expansion potential. The multiple looks low given the growth outlook.
- Graincorp (GNC) – we built a large long on weakness during the month as Australia is set for its third best season in history, while difficult global conditions are driving high grain prices. GNC's crop insurance arrangements take away some of the upside but we think they retain more than the market believes given the sheer size of the harvest. The share price appeared to fall due to rains which hurt some farmers but will help others. It is now 20% below recent highs.
- Emeco (EHL) – their equity raising dealt with any possible gearing questions and they are now on a forward PE of just 5.8x and are at 80% of NAV. Their coal segment is difficult but pricing has moved up a little off bottom. Base metals and gold are booming, with EHL busily refocusing its equipment away from coal.
- Tabcorp (TAH) – online gaming is booming and TAH should be benefitting via both their lotteries and wagering businesses. While TAH's wagering has lost share to competitors due to their enforced retail outlet closures, they should still be strongly up overall and the outlets have reopened in time for the all-important Spring Carnival. TAH has drifted 10% off recent post-Covid highs and is over 30% below pre-Covid levels. It is on a high single digit free cashflow yield.

The performance of the Fund in October saw an estimated return of -1.42% (pre tax and fees). This was composed of +0.39% from the long book and -1.81% from the short side. Our overall winners-to-losers ratio was weaker than it had been for some time at a disappointing 48%, which reflected that far fewer of our longs working than we would have hoped in the period.

The biggest headwind was our large, long-held position in Tower (TWR, -5%) which fell for no fundamental reason that we could pin-point. The Lake Ohau fires were unhelpful in removing potential upside from the Sept21 year but everyone models it as hitting their reinsurance limit in any case. In this world it is rare to find a business on a forward PE of 6.8x, which has growth thereafter and which is through its investment hump. We will keep the faith.

The second key detractor was our short in Netwealth Group (NWL, +13.8%), which thankfully closed well off its intra-month highs and allowed us to cover off some of what had been an increasingly large position. The catalyst we saw had been falling short term interest rates leading to earnings downgrades but it has become apparent that those buying it simply don't care about that or its valuation and are far more focused on it being a long term "winner" in the platform space.

Smaller headwinds were led by the aforementioned Emeco Holdings (EHL, -9.5%). We had thought that their equity raising several months ago removed any balance sheet questions and would open the way to a solid rally. Instead, it has been lumped in as suffering from the structural travails of coal. This is true but overlooks that coal appears to have reached a cyclical bottom post-Covid, that EHL is growing rapidly in gold and base metals and that the share price has fallen from an issue adjusted pre-Covid high of $2.75 to just $0.75.

Other laggards included our premature long in Coronado Coal (CRN, -22%) which we built up during the month as coking coal inventories are falling with prices lifting off bottom. The market is tightening right up but the soft Chinese ban on Australian coal is clearly a short-term issue although as a commodity it is fungible into other markets. Kina Securities (KSL, -6.9%), Aurizon Holdings (AZJ, -11.3%) and Spark NZ (SPK, -4.5%) also weighed on returns.

Our largest winner by some distance was Pacific Edge Biotechnology (PEB, +14.3%) which predictably surged on its entry into the S&P/NZX50 Index. We did sell some into this strength but have already repurchased a portion as we still see it as having large potential fundamental upside. They are a small company playing in a huge market. PEB's success is a reminder of the value of patience as we held it for several fallow years prior to them making it. Potential near-term catalysts include analyst initiations and entry into further indices in coming months.

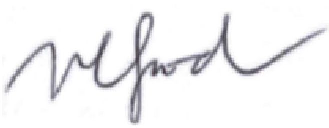
The second stand-out was the earlier mentioned Shaver Shop (SSG, +14.1%) which continues to print enormous sale growth metrics off a cheap valuation base. It actually closed 13% below its intra-month high. They are a truly omni-channel retailer, with 30% of sales now online and growing rapidly.

Other winners were longs in Turners (TRA, +6.0%) where used car sales and margins appear to be very strong; Oceania Healthcare (OCA, +18.4%) which is now our only position from either side of the ledger in the NZ retirement sector; and Infratil (IFT, +8.6%), whose investor day saw analysts upgrade the longer term growth outlook for their data centres business.

Thank you for your ongoing support of the Fund. We continue to operate in remarkable times with a major global pandemic, interest rates at zero or negative in many countries, booming equity and housing markets thanks to central bank largesse, an increasingly assertive rising global power in China and a fraught US election which may be decided by the time you read this.

Our strong view is that central banks have created a bubble and that this is particularly concentrated in the TINA and GAAP stocks, with an accompanying retail investor frenzy. Our response has been to carefully short those names which are the most egregiously overpriced, while running greater net length than normal in a wide selection of cheaper names that have been left behind.

We repeat last month's comment that we are remaining focused on core valuation disciplines. We are seeking to short sell expensive names with identifiable catalysts or weak business models and be long companies that are cheap, either on current multiples or relative to the growth opportunities that they have in front of them. The US election outcome will create volatility but our reaction will be governed by the major catalyst for changing the current paradigm being a change in monetary policy settings. That still appears some way away.



Matthew Goodson, CFA