Salt Long Short Fund Fact Sheet – January 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 January 2020

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$112 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 January 2020

Application	1.5653
Redemption	1.5589

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 2020

Long positions	63
Short positions	38

Exposures at 31 January 2020

Long exposure	88.74%
Short exposure	-50.14%
Gross equity exposure	138.88%
Net equity exposure	38.61%

Largest Longs	Largest Shorts
Tower	Ryman Healthcare
Oceania Healthcare Limited	Commonwealth Bank of Australia
Kiwi Property Group	Seek Ltd
Marsden Maritime Holdings	JB Hi-Fi Ltd
360 Capital Digital Infrastructure Fund	Carsales.Com

Performance[1] at 31 January 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%												-2.01%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	0.56%	1.48%	5.48%
6 months	5.89%	2.98%	9.45%
1-year p.a.	19.19%	6.33%	28.38%
2-years p.a.	0.60%	6.54%	14.67%
3 years p.a.	2.34%	6.61%	15.09%
5 years p.a.	6.20%	7.00%	12.18%
Since inception p.a.	8.28%	7.16%	12.54%

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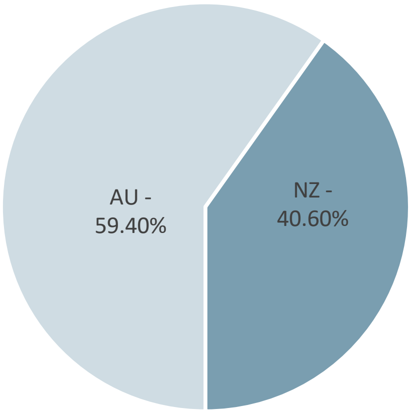
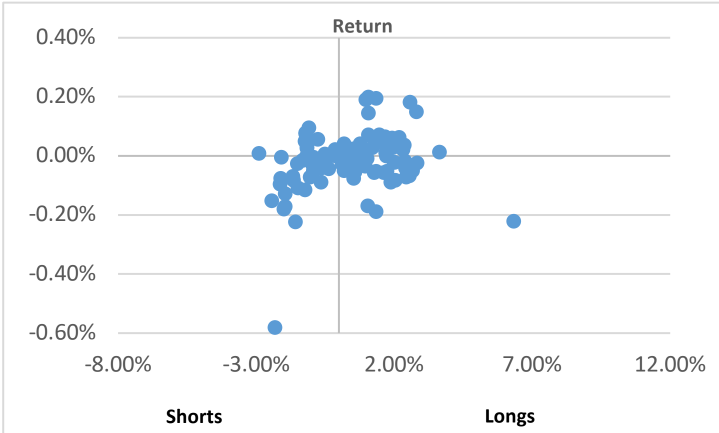
Country Allocation at 31 January 2020 (Gross Equity Exposure)



January 2020 Individual Stock Contribution



Fund Commentary

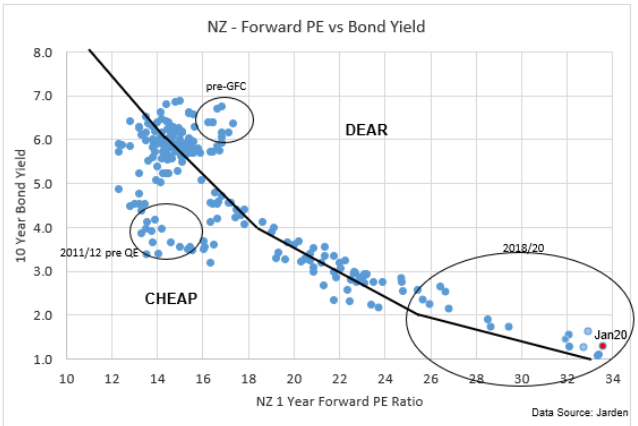
Dear Fellow Investor,

January was a somewhat difficult month for the Fund, with a return of -2.01% after all fees and expenses. Since inception, the Fund has returned +55.9% after all fees and expenses, which has seen us move back below the all-time high reached last month.

January saw a liquidity-driven surge in the Australian market, with their benchmark rising by +5.0% and having been up as much as +6.7% at one point. Even though there was no fundamental news, this placed considerable pressure on our short book, which is generally very high-multiple. This was added to by a mooted takeover bid for National Storage REIT, which we had been short given our assessment of it as the most expensive name in the Australian property universe. At the same time, our diverse set of longs had a quiet month, with nothing going particularly wrong or right for the most part.

While our short book almost always struggles on major up days, what really matters is the Fund's ability to provide protection when the market falls, which is something it used to do occasionally back in olden times. We have done very well on those rare occasions in recent months but our record on the negative days in January was middling. There were 7 days where a combined ASX/NZX benchmark was negative, with an average move on those days of -0.38%. We were up on 2 of those days, outperformed on 6 of them and had an average return of -0.08%. In other words, we provided reasonable protection but did not quite deliver the positive returns in a downside environment that we had in previous months.

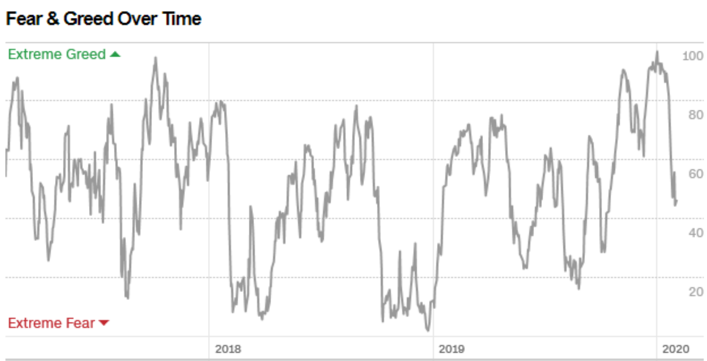
The NZ market rose by +2.0% in the month, which saw the forward PE ratio rise from 32.9x to 33.5x. Bond yields did at least fall from 1.65% to 1.30% which meant that relative valuations improved slightly although they remain very stretched. With bond yields being so low, our latest "fair value" PE estimate is 30.3x, which requires a 10% market decline for fair value to be restored.



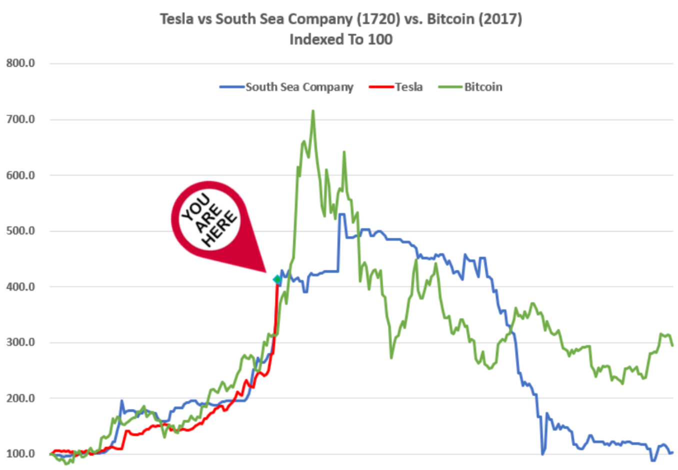
We have depicted the NZ PE ratio slightly differently this month in the chart above, which relates the forward PE multiple to the bond yield for each month for the last 17 years. Note how the fair value line flattens at very low bond yields. This shows how convexity sees a small move in yields at low levels have a large impact on the valuation of long duration assets such as equities. Even with this support, the market remains well to the right of the fair value line.

We would also highlight that the market tends to get "stuck" in a paradigm for an extended period before something exogenous jolts it into a new paradigm. Pre-GFC, bond yields were 6-7% and PE's were 17x and the market was expensive – then the GFC happened. We were extremely bullish back in 2011/12 (yes, it's true!) with the market on a PE of 13-14x and bond yields in the 3-4% region – then QE forever happened and the market took off. The point is that right now the market is expensive and one day the paradigm will shift. Longer term returns from here will be low.

Investor sentiment across global equity markets ran red-hot for much of January although they gave up some of their advances in the last couple of days (when our Fund not coincidentally did much better). A visual depiction of sentiment can be seen below in the CNN Fear & Greed chart, which almost touched 100 early in the month and ran at "extreme greed" levels above 90 for much of the month. Similarly, shorts as a percentage of the SPDR S&P500 ETF hit a low of 1.1% on 9 January, the same level they hit in January 2018 just prior to the sharp "quantageddon" meltdown in February.



Another way of looking at "animal spirits" is to look at the performance in January of some of the most notoriously speculative (and heavily shorted) go-go momentum names. Beyond Meat was +46%; Tesla +56%; Smile Direct +53%; Uber +23% et al. Tesla has gone hyperbolic since month-end and has more than doubled in 2020 as this piece is being written – surely we are in the blow-off stage of the bubble. The chart below puts this in its historical context, against the South Seas bubble and bitcoin. To be clear, we are not short Tesla.



Speculative ferment frothed over and some of the moves in the sexier "darling" stocks in Australia have to be viewed against this broader backdrop. Australia was notable for the Healthcare sector rising +12% and Technology +11% in the month despite both already having been the strongest sectors in 2019. Almost all of this move has been multiple expansion rather than earnings upgrades. In fact, as outlined last month, Technology has risen in the face of earnings downgrades.

As a final comment on the current froth in markets relative to the abysmal state of some of the key companies and entities that comprise them, we have a quiz question. Guess the identity of this entity. Its bonds are AAA-rated by 2 out of 3 agencies; it has lost money every year for the past 20 years; debt sits at 6x revenues; pension liabilities sit at a further 30x revenues; fixed costs are 60% of revenues and have grown 3-6x faster than revenues over the past 4 years; bankers recently cut its credit lines for the first time ever....the US Government.

Coronavirus is clearly the key focal point for financial markets as this piece is being written and is the culprit in "Fear & Greed" returning to neutral measures. Note that we remain a long way from any panic thresholds as investors try to work through what the implications might be. History is always a logical starting point. Goldman Sachs research looked at SARS and found that it peaked in May 2003 after the first infection was recorded five months earlier. Trend GDP growth in China had been running at 9.8% annualised and fell to 3.4% at the peak of the outbreak before rebounding.

The H1N1 virus in Mexico in 2009 peaked after only two months, while affecting far more people but with a much lower mortality rate. This dropped Mexico's trend growth rate from -1.7% to -5.4% after which it rebounded although the aftermath of the GFC complicates this somewhat.

This time around, everyone is still guessing at the key metrics. We are likely two months from the initial infection in China, which possibly points to a March/April peak. However, nCoV appears to be far more infectious than SARS and possibly has an asymptomatic period where it can be carried for as much as 2 weeks. Infections have only just begun outside China but stringent movement restrictions make a shorter period to the infection peak likely. A pandemic beyond China is the obvious tail-risk but does not appear likely at this stage.

As this is written, nCoV infections have reached over 20,000 and are still growing at an increasing rate although it is below exponential. The 426 deaths to date have surpassed SARS and the measures to shut down the movement of people and thence economic activity have been far stronger. This will end up being far larger than SARS and therefore the deviation from the trend growth path is almost certain to be larger.

That said, whatever the exact specifics end up being, the broad investment lesson from past episodes is that a return to trend growth rates does occur and that markets tend to bottom at about when the peak infection rate is reached. Some investors point to the exceptional move in China post-SARS as a possible template here but the size and timing of the move suggests it had more to do with China's accession to the WTO than a mere return to pre-epidemic growth rates.

This time around, nCoV has hit at a rather inconvenient time for the world economy, with growth having generally been slowing. The hope from some leading indicators had been that it might be starting to bottom out. Instead, we have a shock which will hit not only from the demand side (hard and soft commodities, tourism etc) but also from the supply side, with the impact on global supply chains bearing close watching. China's linkages to the world economy are far greater now than they were in 2003, so the impact may be correspondingly greater. Some simple examples are that China now accounts for 64% (was 21%) of the world's iron ore demand, 53% (was 18%) of copper and has 35% (was 7%) of the world's car sales.

Put all this together and our view is that economic growth and thence share prices will recover from nCoV but that the bottom will only be apparent in hindsight. Our approach is to buy names where the share price is being hard hit and they are trading at a clear discount to fair value. Conversely, we are selling/shorting names where the market appears to be underreacting in relative terms.

The Fund is positioned reasonably well for nCoV albeit not perfectly. On the plus side, we are short Fortescue, Rio Tinto, Orica, IDP Education, Auckland Airport and Seek which all have material China exposures and are expensive. Conversely, we are long the likes of Coronado Coal, Scales, Sanford and Millennium & Copthorne Hotels which may be hit hard in the short term but are already cheap. MCK particularly intrigues us given that it trades at half of an ungeared NTA and has a sizeable Auckland land development subsidiary which is rebounding strongly.

One final thought on the nCoV impact is that interest rates will stay even lower for even longer. Notwithstanding a couple of balancing shorts in the sector, we are heavily net long property stocks, we are long other yield plays such as Spark, we are short banks and we are short other plays that suffer from low rates such as Netwealth and Hub24.

Returning to the performance of the Fund during the month of January, the return of -1.81% pre fees and tax saw our shorts detract -1.93% while our longs added a mere +0.12%. This latter outcome was disappointing in such a strong up-month but it reflects how the highest multiple stocks caught a strong bid and many other stocks were left behind. Our "winners to losers" ratio was a mediocre +52%, with the magnitude of our losers being much greater than that of our winners.

A number of companies delivered warnings in the January confession season and we managed to miss all of them from both the long and the short sides. Stand-outs included Gentrack (GTK, -47%), Nufarm (NUF, -4%), our old friend Cimic (CIM, -12%), Downer (DOW, -9%), NIB Holdings (NHF, -14%) Insurance Australia (IAG, -8%) and Treasury Wine (TWE, -11%).

The major problem-child was a large short in National Storage REIT (NSR, +17%) which received a takeover bid from a credible party at a price that is yet to be disclosed. The market assumes this is around the $2.20 region. This compares to a NTA of $1.63 and would place NSR on an EV/EBITDA ratio of a mere 33x. They have a track record of consistently downgrading underlying earnings over the last several years. In our hitherto highly successful property screening model, it stood out as being egregiously expensive but there is no way to reckon with an aggressive buyer in a world of zero interest rates. This is a classic example of why we will never bet the Fund on one stock.

The second headwind came from our large long in Tower (TWR, -3.5%) which fell on light volume for no discernible reason. For now, we appear to be very lonely in seeing the merits of this stock but TWR is a throw-back to the opportunities of yester-year. It is on an underlying PE of 11x and has strong underlying double-digit earnings growth for years to come from both internal cost-out and top-line growth. In terms of variability on the claims side, the hurricane season in the South Pacific has not been a problem and no Cyclone Bola type events have made their way down to NZ, so current South Island floods are the only query. These aside, the March half result should be good.

Other laggards of note were our mid-sized short in Charter Hall (CHC, +16%) which is on a very high multiple of recurrent earnings relative to other property fund managers that we are long; a moderate long in NZ Refining (NZR, -13%) where our approach to buying a straw hat in winter ahead of the new shipping oil requirements has walked into a short term buzz-saw; and a short in Wesfarmers (WES, +9%) which is on an extraordinary 26x PE multiple in a difficult retail environment.

Our positive contributors were relatively small compared to the laggards, with the stand-out being a mid-sized long in Saracen Minerals (SAR, +19.3%). As highlighted in last month's commentary, we see a relatively bullish year ahead for the gold price for a range of reasons: the US$ may weaken under the pressure of election year and huge fiscal deficits; central banks have turned into major net buyers; a sharp slowdown in past exploration will weigh on production growth; and the opportunity cost of holding gold is a net positive in a negative rate world. We took some profits but recycled that into Resolute Mining (RSG, -3%) which has been an undue laggard and has now carried out a placement to de-risk its rather geared balance sheet.

Our second largest tail-wind was a moderate long in Graincorp (GNC, +10.8%). We have range-traded this name on a number of occasions over the last several years and we have some sympathy with the thesis that is worth more than the current $8.50 share price in a break-up scenario, where it separates its world-class malting business from its highly volatile grain business. GNC rallied as Pitt St farmers bought it on the appearance of significant rainfall and this rain looks set to continue in coming days. We also have significant exposure to this theme through Vitalharvest (VTH, -0.7%) so we exited GNC post month-end. We would look to re-enter on any undue weakness.

We did not have a single short that made a positive contribution of any note but a number of our other longs did do relatively well. Next DC (NXT, +15.4%) has been viewed suspiciously by many in the market for its lack of major contract announcements but this view clearly softened in the month and a mooted bid for a key competitor also assisted; our large long in Spark (SPK, +7.6%) did well as bond yields fell and Contact Energy (CEN, +4.4%) was in a similar boat. The key upcoming event for CEN is a decision on the Bluff smelter and we retain a clear view that the economics favour continued operation but that it is entirely rational for Rio Tinto to put forward a credible threat of leaving. Finally, a mid-sized holding in the leading insurance software business Fineos (FCL, +7.6%) reported a solid quarterly and signed a major new client post month-end.

Thank you for your ongoing support of the Fund. January was clearly a small hiccup relative to the strong last three quarters of 2019. From time to time, a confluence of circumstances sees our shorts fly and our longs remain moribund and January was one of those months. There were no single stock disasters aside from an unlucky takeover. The Fund will continue to stick to its aim of providing equity-like returns but with far less volatility than equities and no correlation to them. We believe there is value in having this as part of a diversified portfolio and this will shine through when the music eventually stops.

Matthew Goodson, CFA