SALT

Salt Long Short Fund Fact Sheet – July 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 July, 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 July 2024

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$91 million
Inception Date	1 July 2014
Portfolio Manager	Matthew Goodson, CFA

Unit Price at 31 July 2024

Application	2.7837
Redemption	2.7725

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 July 2024

Long positions	57
Short positions	36

Exposures at 31 July 2024

Long exposure	101.18%
Short exposure	61.18%
Gross equity exposure	162.35%
Net equity exposure	40.00%

Investment Risk to 31 July 2024

Fund volatility[1]	6.55%
NZ50G / ASX200AI volatility[1]	13.46%
NZ50G / ASX200AI correlation	0.055

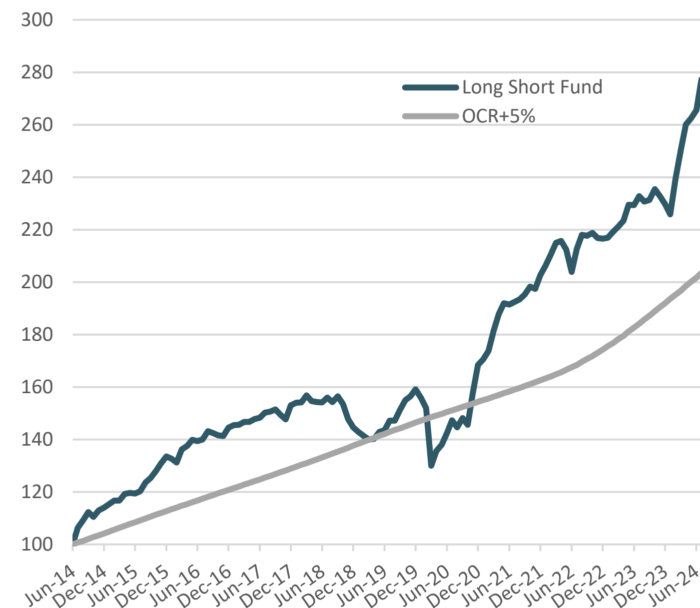
1. Annualised standard deviation since fund inception.

Fund Performance[2] to 31 July 2024

Period	Fund Return	OCR+5% Return	NZ50G/ASX 200AI Return[3]
1 month	4.40%	0.93%	5.03%
3 months	6.61%	2.54%	4.99%
6 months	22.76%	5.08%	5.92%
1-year p.a.	19.14%	10.47%	8.14%
2 years p.a.	14.17%	9.90%	7.91%
3 years p.a.	12.96%	8.57%	3.28%
5 years p.a.	13.50%	7.32%	5.84%
7 years p.a.	9.15%	7.15%	8.32%
10 years p.a.	10.06%	7.29%	8.73%
Inception p.a.	10.64%	7.30%	8.91%

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 July 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	Reece
Turners Automotive Group	Breville Group
Monash IVF Group	Scentre Group

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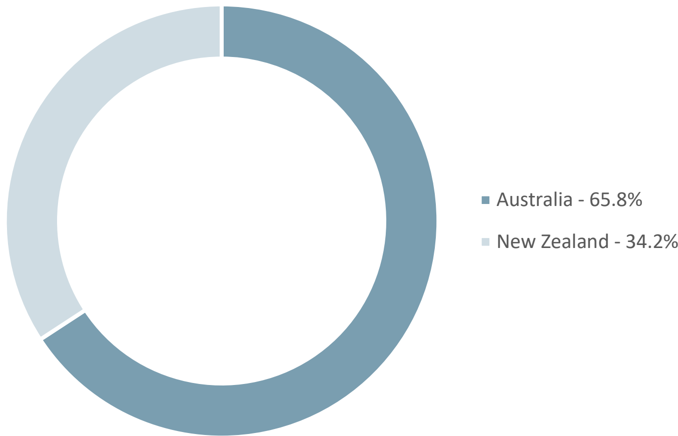
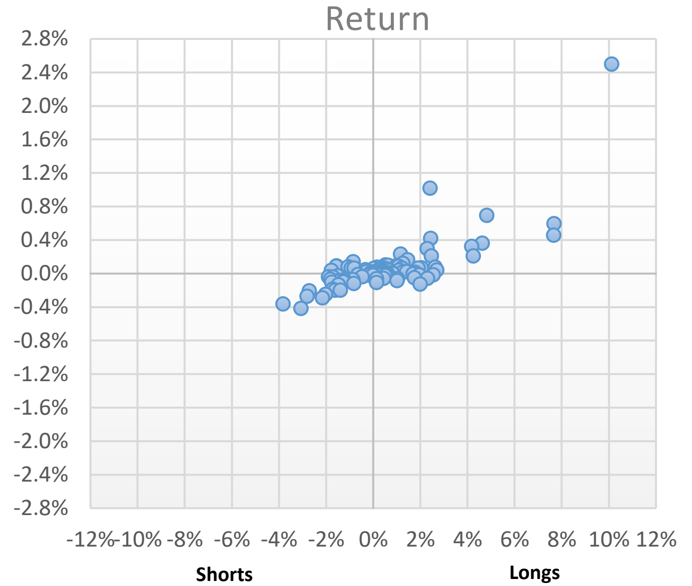
Country Allocation at 31 July 2024 (Gross Equity Exposure)



July 2024 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

We are pleased to report that the Fund delivered an extremely strong month of performance in July, with a return after all fees and tax of +4.40%. Long-only equity benchmarks were also very strong in the month as they rapidly bought into the idea that central banks are on the cusp of reversing tight monetary policy settings. The NZ benchmark rose by an unusually strong +5.9%, while Australia advanced by +4.2%.

In the past, the Fund has at times been left behind when equity markets have surged but this month was different. Markets were driven by a steady drumbeat of evidence that central bank monetary policy medicine is finally beginning to work and that the patient may not die first after all. Rather than chocks-away momentum and growth fund euphoria, it was a case of markets anticipating lower rates and a future nadir in the economic and earnings cycles. Momentum lagged as a style, while cyclicals and valuation factors did well.

Our long book performed spectacularly well (+8.1%), with an understandable partial offset from our shorts (-3.0%). Importantly, the Fund has started August extremely well as volatility has soared in global equity markets. More on this shortly.

July was a month that was fully of directional changes and fascinating news for equity investors. We will do our best to summarise the key implications and how our Fund is positioned to take advantage of what lies ahead. We have been waiting a long time for a sea-change from darling momentum stocks and it may finally be upon us.

After fluctuating between greed and normal levels for most of July, investor sentiment turned sharply negative after month-end as shown below. The CNN Fear & Greed Index has dipped to 17 as this is written, comfortably below the "extreme fear" threshold of 25. This is rare, and in the past, this has been an excellent contrarian buying indicator but it has worked best when it has spent a few weeks around this level, with the December 2023 quarter being a good example. The reasons for the sentiment plunge have strong fundamental underpinnings, so we suspect that patience may pay off again.

The swan-dive in sentiment seems to be due to a confluence of three different events:

1. As we have warned from time to time in recent months, the multi-decade long carry trade based on Japan is running out of steam.
2. Cracks are beginning to show in the Artificial Intelligence story.
3. Fears are beginning to grow of a US recession, with a weak non-farm payrolls number in early August suddenly driving a switch to bad news being perceived as bad news.

Taking each of these in turn, Japan witnessed a sea-change during the month, with the Bank Of Japan being more hawkish than expected. They lifted the short-term policy rate from 0-0.1% to 0.25%, warned of potential further hikes and will halve their monthly bond buying to JPY 3trn. This is the end of an era.

Since July, the JPY has appreciated by over 13% against the USD, generating carnage for those carry trade investors who have huge leveraged bets on borrowing zero-yielding JPY to invest in much higher yielding international bonds and stocks. All those hedge fund pods and "sophisticated" investors that have looked good for years by picking up pennies in front of the steamroller are now being crushed by it. Their risk departments will be rather busy at present.

The scale of the carry trade unwind is enormous. Bank for International Settlements data suggests that cross-border yen borrowing has increased by $742bn since 2021 (from already high levels). In addition, Japanese investors have net international assets of US$3trn which are at risk of a degree of repatriation.

These carry trade pressures are an important factor behind the S&P500 Bank Index falling by -8.7% in the week ended 2 August and it suggests the unconscionably strong Australian banks are highly vulnerable as well. CBA and NAB have been painful shorts for us but they are finally starting to work and possibly have considerable further downside ahead of them.

Moving to the second of the key market drivers, the June quarter result season has been rather ugly so far for most members of the "Magnificent Seven" to the point where they are now perhaps better thought of as the "Seven Horsemen Of The Apocalypse".

There is a growing realisation that the colossal AI investment boom may not be the era-defining change that was heralded by the advent of the internet. Goldman Sachs wrote a much-cited piece in conjunction with a MIT professor entitled, "Gen AI: too much spend, too little benefit". The crux of their argument is that 18 months after the introduction of Gen AI to the world, not one truly transformative, let alone cost-effective, application has been found. As they say, Gen AI is starting to feel like the technology hype cycles associated with blockchain, virtual reality and the metaverse.

In a similar vein, the storied venture capital firm, Sequoia Capital published a piece called, "AI's $600B Question", which argued that the AI bubble (their words) is reaching a tipping point. Their argument is that given the AI investment we have seen to date, the industry is short $600bn of revenue that is required to make a reasonable return. They also point out that the GPU chip shortage is largely over. They argue that the main pushback they receive is that "GPU capex is like building railroads" but that this misses key differences. The market is being flooded with AI clouds unlike the old monopoly constituted by a physical railroad; railroads themselves incinerated vast amounts of capital in their speculative investment phase; the depreciation rate for AI equipment will be fierce as technology improves; and it is really hard to pick who the ultimate winners will actually be (if there are any).

One of the largest holdings in the Fund has been our very successful position in Global Data Centres (GDC, +5.4%). Their last remaining asset is a sliver of Air Trunk which is due to sell in a highly public auction process by month-end. Press leaks point to strong interest and we are crossing all our fingers and toes that this transaction will complete and perhaps mark the top.

Separate to the sharp cracks that appeared in the AI bubble at month's end, July had earlier seen a massive style reversal in equity markets driven by a sudden quest for small cap and cyclical stocks after years of underperformance. This had been slowly brewing for a little while but exploded into life on July 12, when we saw a huge reversal day due to a weaker than expected US CPI inflation reading. As shown in the chart below, there was fertile soil for such a reversal, with the momentum factor being at its most extended level of excess returns since 1999/2000.

Exhibit 3: Momentum Was also Historically Extended in the S&P 500

Source: S&P Dow Jones Indices LLC. Data as of June 28, 2024. Index performance based on total return in USD. The S&P 500 Momentum Index was launched Nov. 18, 2014. All data prior to index launch date is back-tested hypothetical data. Past performance is no guarantee of

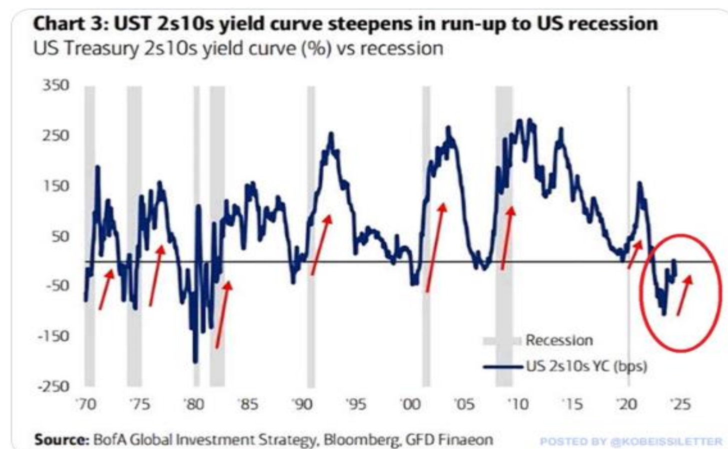
The Russell 2000 Index outperformed the Nasdaq 100 Index by more than 5.0% in a day for only the second time ever.

According to Bespoke Investment Group, the furious purchasing of small caps saw the Russell 2000 Index close more than 4.4 standard deviations above its 50-day moving average – the most extended any major US index has ever been on this measure.

US data since this historic move has continued to broadly be supportive of the idea that the US economy is slowing sharply and that the Fed will need to start easing in September. While US core PCE inflation was as expected at +2.6% YoY, it continues to gradually slow at a pace that should allow Fed easing. Post month-end, July non-farm payrolls were far weaker than expected at just 114k (versus 175k), the unemployment rate rose to +4.3% (4.1% expected) and average hourly earnings growth slowed to +3.6% YoY (+3.7% expected).

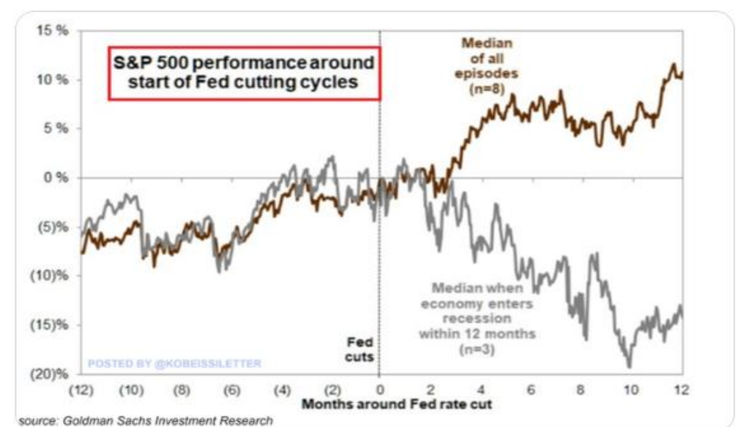
The market is now pricing more than a 100% chance of a Fed rate cut in September and at least three cuts this year. At current levels of growth and inflation, the Taylor Rule for monetary policy settings points to a 3.7% Fed Funds rate rather than the current 5.3%. This is quite the change from the post-Covid period, when this Rule pointed to rates being far too loose for far too long.

After being around 100bp inverted, the US yield curve is now almost flat from 2 to 10 years. As shown in the chart overleaf, the yield curve turning positive after a period of inversion has been a strong indicator of an impending recession. Despite the excitement of the weak payrolls data, the evidence is still somewhat ambiguous, with the US services sector actually expanding in July, with the ISM Services Index being 51.4 (48.8 prior) and Prices Paid being an unhelpfully high 57.0 (55.1 expected and 56.3 prior).



All this suggests we are in a very tricky period for equity markets. In the US, we have suddenly moved away from a paradigm of bad economic news being good news because it will herald Fed rate cuts and Goldilocks. Now, bad news is being seen as bad news because Fed rate cuts won't be enough to rescue the market from a difficult earnings outlook due to impending recession.

What is the answer? <u>Should one sell equities due to the market entering a period that will likely be dominated by earnings downgrades or buy equities as the market enjoys a period of Fed rate cuts?</u> The chart below shows that in the last eight episodes of monetary policy easing, the S&P500 is up on average around +10% one year after the first rate cut. However, this comes with an enormous caveat. On the three occasions that the US economy entered recession, the average return was around -15%.



This analysis very much pertains to the US equity market but it certainly has significant implications for NZ and Australia.

The NZ economic situation feels several quarters ahead of the US, with a plethora of data suggesting we have already entered recession. The main problem is that our leaden-footed central bank is waiting too long to ease, albeit they did at least turn turtle and post a dovish outlook in July. We just hope they move this month rather than wait until November.

The data suggests that should get moving now. The ANZ truckometer was very weak in June, with heavy traffic falling -5.2% m/m on top of a sharp decline in May; the BNZ manufacturing PMI for June was just 41.1, the third lowest reading ever for a non-Covid month; the BNZ Services PMI was similarly dreadful; REINZ data showed sales are down -26% YoY and prices fell -0.7% MoM to be only +1.6% YoY; and the ANZ Business Outlook survey showed firms' own activity expectations bumping along bottom at +16.3, while inflation expectations fell from 3.46% to 3.20%. There is the odd stagflationary undertone that is still present but the bulk of evidence is now point to a classic recession that is driving inflation down and will generate monetary policy easing.

The key question is whether the RBNZ comes to the party this month or whether it errs and waits for November. If it does move this month, then we are further through the difficult

recession/easing process than most other markets and our positioning in the Fund to be long quality cyclical stocks will continue to be the correct one. We shall see.

Australia is some distance behind from NZ and the USA in its economic cycle. It did appear all set for one last rate hike in August as generally weak economic data was still being accompanied by uncomfortably high inflation pressures. For example, the NAB Business Survey for June saw business conditions ebb from +6 to +4, the lowest level since early 2022. However, the Q2 CPI reading near month-end saw trimmed mean core inflation come in at +0.8% versus consensus of +0.9% and the 1.0% that many thought would trigger a hike. With the RBA cash rate target only being at 4.35%, they have far less room to ease than most and may be on hold for some time.

Given this decoupling of economic cycles, we are balancing our longs in NZ cyclicals with shorts in a number of Australian counterparts. In particular, we are short a selection of Australian retailers as their valuation multiples are at all-time historic highs; retail sales volumes are actually falling when you adjust the sales data for inflation; the impact of Amazon and Temu is starting to become a factor; and the impact of new AI devices on the likes of JB Hi-Fi will be marginal in our view.

Fund Performance in July

Returning to the Fund's performance in the month of July, our overall return of circa +5.1% pre fees and tax was unsurprisingly driven by very different contributions from our long book (+8.1%) and our short book (-3.0%). Our overall "winners to losers" ratio was a solid 57% and the magnitude of our winners was significantly larger than that of our losers.

Our gross exposure rose slightly from 160% to 162% but our net exposure fell sharply from 48% to 40% as we took advantage of undue market strength to lighten some longs and lift some shorts. This has left us well positioned so far in August and we are taking the opportunity of current sharp weakness and volatility to return our net to the mid 40% region.

In a very strong month for equities, there were only five negative days for the 50/50 index of Australia and NZ in June and the average return for the market on those days was -0.44%. The Fund was actually up on all five of those days and had an average return on them of +0.35%. The high-beta nature of many of our shorts continues to mean that we tend to do better on negative days than positive ones and that a net in the mid-high 40% region is actually market neutral.

Our largest positive by a very long way was again our large, long-held position in Tower (TWR, +27.3%). There was not actually any new news behind this sharp move but there appeared to be a broader based recognition by investors of our long-held thesis that they are very cheap, that their guidance is potentially conservative and that they have windfall potential upside from their large events allowance. If there are no major calamities before end-September, NPAT will lift by a further $32m – very large in the context of their market cap which has grown to $410m. In our view, the market continues to materially mis-forecast TWR as having to eat their full large events allowance every year, when history suggests it is far less frequent than this. TWR appears to be certain to enter the S&P/NZX50 Index in either September or December.

The second stand-out was yet another repeat appearance by our mid-sized holding in Intelligent Monitoring Group (IMB, +50.0%), which staged a staggering 50% advance. There was no new news of any great note but the company did present at several conferences and the market finally began to catch up with just how cheap IMB was. We now view it as merely being attractive on a low-teen PE with a solid growth outlook and have lightened a little given the sheer velocity of the share price advance.

A third key winner was a good-sized holding in one of our quality cyclical names in the form of Turners (TRA, +15.3%). While there was no new news, it was very much part of the group of stocks that did very well during the month on hopes of future RBNZ rate cuts. Aside from the general impact on their business, they are a very rapid beneficiary as half of their finance book is funded via floating rates. We had been concerned as to whether their market share gains would be sufficient to offset broader market weakness but a convincing piece of web-scraped data from one of the key NZ brokers suggests that this is indeed the case. One final positive has been the sudden sharp reversal of the NZDJPY, which will lift the cost for competitors to import used Japanese cars.

A fourth sizeable tailwind came from our large, long-held position in GDI Property (GDI, +8.0%) which outperformed a solid bounce in the wider Australian property index. There had been some concern that they may fall out of the S&P/ASX300 Index in the September review but several broker analyses suggest this is unlikely. The attributes attracting us to GDI remain unchanged. It is at a fraction of its relatively solid $1.20 NTA which is based off reasonably realistic 6.6% cap rates; they have some windfall potential upside from several syndicates they manage, which also lifts any NAV estimate above their NTA; and the Perth office

market outlook is far superior to the muted Sydney and dire Melbourne outlooks.

There were a number of other strong contributions which would normally merit more than cursory mentions. These were led by our large and well-discussed long in Global Data Centres (GDC, +5.4%) on continued Airtrunk sale speculation. Our long in the quality cyclical, Freightways (FRW, +18.2%) rose strongly; similarly our long in the lesser quality but highly cyclical Heartland Group (HGH, +8.1%) did well; the flexible office provider Servcorp (SRV, +6.9%) continued to be a great investment and our long in NZME (NZM, +14.1%) was another of our cyclical winners.

There were no notable laggards from the long book, which is perhaps unsurprising in such a strong month for equities. Indeed, the largest headwinds tended to come from a series of large cap shorts which we view as somewhere between very overpriced and egregiously overpriced. Names that stood out were Commonwealth Bank (CBA, +7.9%), Wesfarmers (WES, +13.0%), JB Hi-Fi (JBH, +13.8%), Reece Limited (REH, ++9.8%) and Scentre Group (SCG, +11.2%). These have all reversed and are working solidly for us so far in August.

Thank you for your continued support and interest in the Fund. We are delighted to have produced such a strong month in July. Importantly, we did it despite being a long-short fund. We most certainly did not get long and ride the momentum train. Indeed, we lowered our net length as opportunities presented themselves and this has seen the Fund perform pleasingly amidst the carnage afflicting markets in early August as this piece is written. We are continuing to be very flexible in these rapidly changing circumstances and we remain single-mindedly focused on doing 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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