Salt Long Short Fund Fact Sheet – August 2021

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 August 2021

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$53.5 million
Inception Date	31 August 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 August 2021

Application	1.9424
Redemption	1.9345

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 2021

Long positions	53
Short positions	36

Exposures at 31 August 2021

Long exposure	101.98%
Short exposure	52.11%
Gross equity exposure	154.09%
Net equity exposure	49.87%

Largest Longs	Largest Shorts
Tower	Goodman Property Trust
Dalrymple Bay Infrastructure	Mercury NZ
Shaver Shop Group	Xero
Emeco Holdings	Carsales.Com
Intega Group	Arena REIT

Performance[1] at 31 August 2021

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%					14.85%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	0.81%	1.30%	6.64%
6 months	11.33%	2.64%	11.54%
1 year p.a.	33.75%	5.24%	21.31%
2 years p.a.	14.65%	5.45%	12.76%
3 years p.a.	7.83%	5.85%	12.41%
5 years p.a.	6.20%	6.22%	11.92%
Since inception p.a.	9.64%	6.75%	11.82%

[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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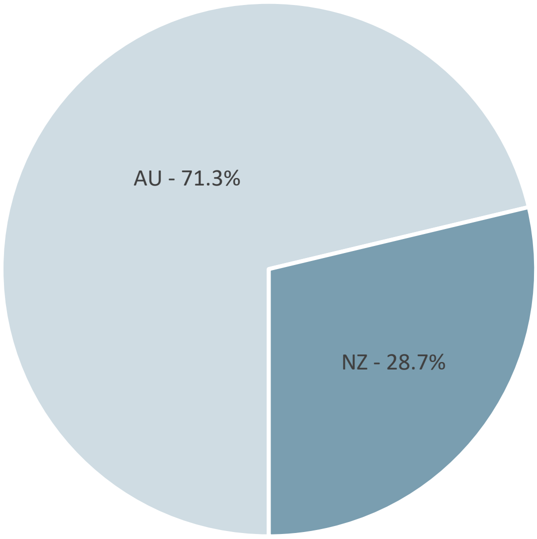
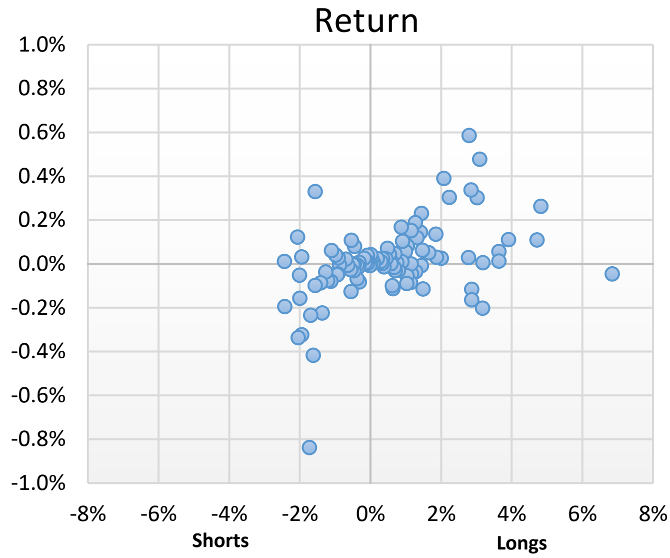
Country Allocation at 31 August 2021 (Gross Equity Exposure)



August 2021 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

The month of August ended up with a similar outcome to July, with the Fund delivering a satisfactory albeit far from stellar return of +0.56%. Beneath the surface, this was comprised of several quite significant positives and negatives, with result season seeing typical elevated volatility amongst individual holdings. In a strong month for markets, our long book performed extremely well but as one might expect we were held back by our short book.

August was a strange month for long-only equities. The NZ benchmark rose by +5.0% despite a largely in-line result season with mixed outlooks that saw year-ahead earnings downgrades in the order of -4% across the market. At the same time, NZ 10-year bond yields rose from 1.51% to 1.74% as signs of economy-wide price pressure abounded. In short, NZ equities became more expensive on weaker earnings and a higher discount rate.

Within this strong equity performance, we saw a return to strong outperformance by the barbell of GAAP (growth at any price) and TINA (there is no alternative) stocks. This was perhaps a response to lockdowns but didn't square with the rise in bond yields and we naturally took advantage of opportunities where they presented themselves.

Overall, Australia's earnings season was stronger than NZ and year-ahead downgrades were only modest but the market didn't rise by as much. The performance divergence by sector was stark. The Technology sector rose by +17.0% despite being the second worst sector for earnings forecast changes, with year-ahead downgrades of circa -10%. Resource performance lagged badly at -8.8%, highlighting a clear shift away from cyclicality and value stocks in favour of growth dreams.

According to JP Morgan analysis, Australian growth outperformed value by a sharp 5.5% in the month. There is now a near record 12.5 PE point differential between growth and value stocks, which is more than 2.5 standard deviations away from long term averages.

Our observation is that this extreme valuation differential has been the case for most of the zero-rate era. We saw a fleeting shift back towards cyclicality and value in late 2020 and early 2021 but this has now taken a breather. It is no accident that a spell of extremely strong performance by this Fund coincided with that fleeting style shift. It is pleasing that we have eked out modest positive returns in the hostile (for our style) recent environment. We can see which way the wind is blowing but just cannot bring ourselves to own story stocks on 20x revenue.

So, the key question becomes when does the zero-rate era end and what ends it? The image of the merry money-printing central banker with a wheel-barrow full of billion-dollar notes is slowly starting to change.

The RBNZ was crystal clear that its path of no regrets now lies with lifting interest rates before inflation gets out of control and that it would have moved already but for the Delta outbreak. The RBA is somnolent but the Fed is glacially moving to withdrawing a degree of stimulus, likely beginning with a tapering of QE in the next month or two. Some Governors are calling for faster action and influential economist, Larry Summers has called for an immediate end to QE. Little surprise given that the Fed's favourite inflation measure, the PCE core deflator, has risen by +3.6% annually in both June and July, with the mix of inflation becoming less transitory to boot.

The Bank of Korea became the first developed market central bank to pull the trigger, unexpectedly moving their policy rate from 0.5% to 0.75% and signalling further moves in the future.

The RBNZ's current hiatus and the Fed's reticence make it clear that the key to near term rate decisions is not rising inflation, it is the emergence and impact of the delta strain of Covid. There is much debate about what vaccination rate constitutes herd immunity and at what rate countries can safely re-open. There are all sorts of unknowns, such as long-term vaccine effectiveness, whether good Covid treatments emerge, and whether progress might be overtaken by virulent new strains.

NZ has the advantage of the Tasman moat and is still targeting elimination in the short term and potentially re-opening in the medium term. Victoria and NSW appear to have given up on elimination, while as always, Singapore appears to be the gold standard in how to handle matters and they are targeting an 80% vaccination rate for significant re-opening.

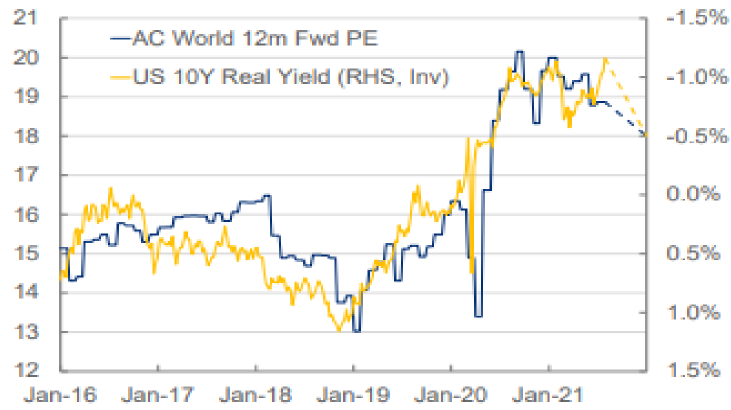
We do not know the answers and do not even know all the questions. However, one thing is clear. Re-opening will see central banks embark on an overdue tightening of monetary policy. This remains the positioning of the Fund, with performance tending to be very strong on those rare days when cyclicals and/or value do well relative to expensive GAAP, TINA and quality stocks.

One other theme to be wary of in a rising rate environment is the great NZ housing bubble. A press release from the RBNZ titled "House Prices Above Sustainable Levels" gives a subtle hint as to their thinking, even if it was their actions that partly caused the situation in the first place. In case one thinks there is little leverage in the system and that the need for a 20% house deposit will act against distress, you can simply go to squirrel.co.nz and borrow 15% of that 20% although in their words, you do at least need to have, "a 5% genuine saved deposit (includes KiwiSaver)."

We are wary of shorting the NZ retirement sector stocks too early as they are experiencing record conditions. They are clearly seeing a lift in penetration rates as elderly residents recoil from the loneliness of lockdowns. We are moderately long Arvida and short Ryman but there will be a time in the next few quarters to go far harder.

How will equity markets react to eventual tighter policy? We are trying hard to guard against being too bearish because even as policy tightens, real interest rates are so deeply negative and markets are so awash with liquidity that we may need to see extended rate hikes before they are greatly impacted. US$1-1.5trn is still routinely parked in the Fed's overnight repo facility as there is nowhere else to put it. That said, the chart below shows there can be little doubt about what has driven positive equity markets since the onset of Covid – deeply negative real rates.

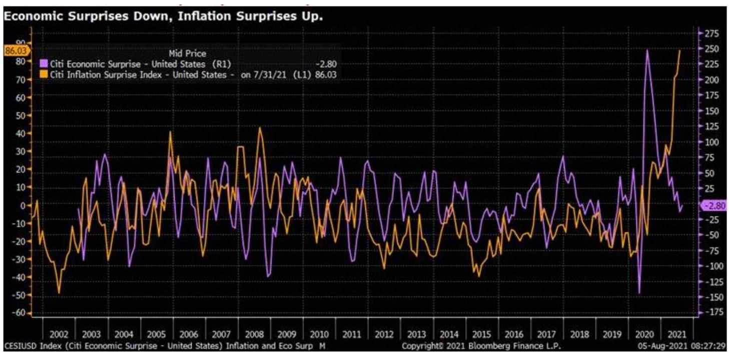
Figure 2. MSCI AC World 12m fwd PE & US Real Yield



Source: Citi Research, DataStream, MSCI

A further note of caution is that stagflation and bull markets have historically been mutually exclusive concepts and some evidence is beginning to emerge of stagflationary pressures. Covid is a negative supply-side shock which is very different to the deflationary impact of the GFC. In this light, the chart below provided to us early in the month is rather concerning. The US is seeing fewer positive economic surprises but a surge in inflation surprises. NZ feels similar.

As ex-Italian PM, Mario Monti put it on CNBC as this piece is being written, "the huge mass of accommodative monetary policy by central banks may well fire more inflation…at the same time, there are a number of constraints on the flexibility of production to increase."



A final theme of note during the month has been index changes, with NZ particularly impacted. Stride and Argosy have been very strong due to their impending inclusion in the FTSE-EPRA NAREIT Index. Vital Healthcare Property fell by over 5% when it wasn't included. Mainfreight has been very strong partly due to its fundamental business performance but also due to its pending addition to the FTSE-Russell Global index. The irony here is that it fell out of this index last year in the high $20 region and will now go back in at about the $100 region. The tail is well and truly wagging the dog.

Returning to the performance of the Fund in August, our return of circa +0.70% (pre fees and tax) was driven by highly divergent returns from our long book (+3.58%) and short book (-2.65%), with a small amount of attribution error in-between. Our overall "winners to losers" ratio was a solid 61%, with there being equally large contributors on each side of the ledger.

The Fund did not perform quite as well as normal on negative days for the 50/50 index of Australia and NZ. There were eight down days with an average return on them of -0.34%. We were actually down on six of those eight days, with an average return of -0.02%. We would put this down to there being some large positives and negatives in result season and it was just a case of which day they happened to occur on.

The largest headwind came from a mid-sized short in Wisetech (WTC, +57%) which soared on an in-line result but considerably better forward guidance than expected. WTC had already risen sharply going into the result and we had used this strength to implement our position. It is fair to say that we were surprised by the magnitude of the reaction. WTC is a SaaS darling stock but we have always been somewhat wary of the closed loop rather than open API nature of their system, the mixed feedback from customers and the cascade of small acquisitions on very low sales multiples. WTC now has a $16bn market cap for which you get F22 sales of $623m and NPAT of $161m. We were light-footed in reacting to the announcement but will continue to have a small position in what is the epitome of growth-at-any-price stocks.

The second largest detractor was another mid-sized short in a growth darling in the form of Lovisa (LOV, +25.3%). We thought their result was a touch light but bulls decided to aggressively extrapolate their number of global store openings in the years ahead to justify a PE that now sits at 50x Jun22 and 35x Jun23, which is clearly a more normalised post-Covid environment. The bull thesis is that LOV's costume jewellery and trinkets have exceptionally high gross margins and very high sales per square metre of shop space. Throw in low set-up costs and you can get huge valuations on the assumption of global domination. We would observe that entry barriers are low and that the global roll-out has by no means been an uninterrupted success.

A third headwind from the short side came from the patent attorney business IPH Limited (IPH, +16.6%). Several "growth analysts" decided that they liked it despite IPH delivering little growth in recent years and being on a forward PE of 24x for a business where your earnings go home in the elevator each day. We will stick with our long in the competitor, Qantm IP (QIP) which is on a PE of 11x, has a higher quality global client base and is winning market share in Australia from IPH.

Other headwinds came from shorts in Ryman (RYM, +17.5%) which was only partially offset by other longs in the retirement sector; Carsales.com (CAR, +14.7%) which has moved to record share price and multiple highs despite an outlook which is more mixed than previously; and Arena REIT (ARF, +17.8%) where we were caught out by its inclusion in a global property index.

The strongest positive came from our large holding in Graincorp (GNC, +21.0%) which delivered a sharp lift in earnings guidance for 2021. They are experiencing an outstanding growing season and this is coinciding with difficult conditions elsewhere in the world, leading to high prices. Carryover stocks and continued good weather suggest that forecasts for next year may also need to rise. While we would normally go against the flow and sell into temporary cyclical strength, we view the GNC share price as still having fundamental upside. We are also wary of past corporate interest in GNC and how the network nature of their asset base could have appeal in the current mania for all things infrastructure.

Our second major tailwind came from our large holding in Monash IVF (MVF, +15.0%). They delivered as good a result as we could have hoped for and are a real beneficiary of Covid. We think this is partly a catch-up effect but also potentially something a little more durable as a focus on having children moves to the foreground. In hindsight, MVF need not have raised at the height of the uncertainty in 2020. They are now on a forward PE of 15.5x, with have a debt-free balance giving them a huge opportunity to grow via internal capex and external acquisitions. We note the improvement in industry structure following the acquisition by their competitor, Virtus of the low-cost IVF business owned by Healius.

Our third notable winner was a mid-sized long in the litigation funder, Omni Bridgeway (OBL, +18.9%). OBL has transformed its business from being an unforecastable contingency fee-based player towards being a far more predictable fund manager, earning fees on funds they have set up with outside investors to fund litigation in Australia, the USA and elsewhere. Our investment was a straight valuation call as OBL was sold off for reasons that remain obscure and has since bounced somewhat. It is still only on forward PE's of 5-6x – too low for a fund manager.

Other stand-outs came from longs in Genworth Mortgage (GMA, +8.8%) which is a major beneficiary of strength in Australian housing and which we think is at an earlier stage of the cycle than NZ; Pacific Edge Biotechnology (PEB, +14.5%); Australian Vintage (AVG, +9.0%) which delivered a strong result, is at the forefront of highly profitable zero/low alcohol wine trends, is generating far more free cashflow than any other wine company we have seen and yet is still only on a PE of 11x with a strong growth outlook; Redcape Hotels (RDC, +17.2%) which received a somewhat complex takeover and delisting bid from its manager, Moelis; and shorts in Fortescue Metals (FMG, -15.7%) with iron ore prices finally cracking; and Reece Group (REH, -11.2%) where a PE of 45x was too much after all for a plumbing retailer near the top of the cycle.

Thank you for your continued support of the Fund. The nature of what has worked in markets in recent months has not been quite so attuned to our style as in late 2020/early 2021. We are not blind to this and have adapted to some degree, allowing modest positive returns to still be generated. Looking forward, we see monetary policy tightening once economies re-open as vaccination rates hit threshold levels. This will once again change what is working in markets. We believe the Fund is well positioned for both this potential style shift and also the possibility that bull markets may falter as real interest rates rise.

Matthew Goodson