# SALT

## Salt Long Short Fund Fact Sheet – September 2022

### 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 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 30 September 2022

| | |
|---|---|
| Benchmark | RBNZ Official Cash Rate +5% p.a. |
| Fund Assets | $64.2 million |
| Inception Date | 31 October 2014 |
| Portfolio Manager | Matthew Goodson, CFA |

### Unit Price at 30 September 2022

| | |
|---|---|
| Application | 2.1849 |
| Redemption | 2.176 |

### 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 30 September 2022

| | |
|---|---|
| Long positions | 42 |
| Short positions | 34 |

### Exposures at 30 September 2022

| | |
|---|---|
| Long exposure | 86.56% |
| Short exposure | 36.98% |
| Gross equity exposure | 123.54% |
| Net equity exposure | 49.58% |

### Investment Risk to 30 September 2022

| | |
|---|---|
| Fund volatility[1] | 6.45% |
| NZ50G / ASX200AI volatility[1] | 14.00% |
| NZ50G / ASX200AI correlation | 0.087 |

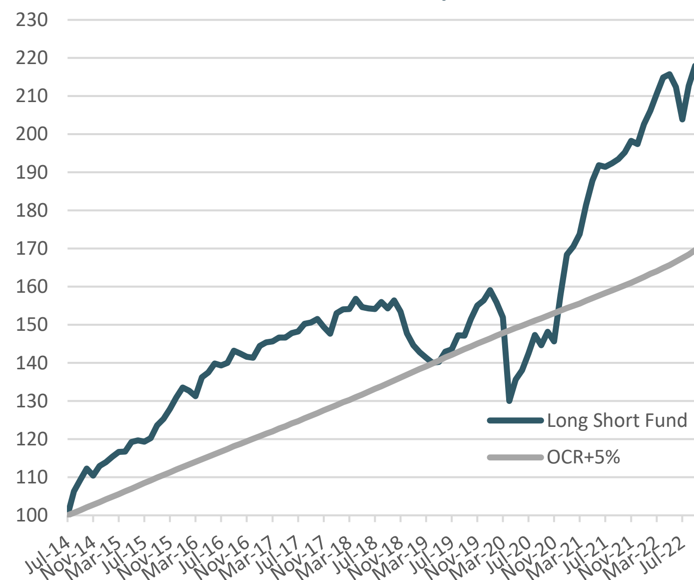
1. Annualised standard deviation since fund inception.

### Fund Performance[2] to 30 September 2022

| Period | Fund Return | OCR+5% Return | NZ50G/ASX 200AI Return[3] |
|---|---|---|---|
| 1 month | -0.17% | 0.63% | -5.39% |
| 3 months | 6.72% | 1.88% | 1.10% |
| 6 months | 1.25% | 3.52% | -10.06% |
| 1-year p.a. | 11.45% | 6.42% | -12.18% |
| 2 years p.a. | 21.21% | 5.83% | 4.23% |
| 3 years p.a. | 12.83% | 5.75% | 2.92% |
| 5 years p.a. | 7.51% | 6.12% | 7.11% |
| 7 years p.a. | 8.20% | 6.39% | 9.36% |
| Inception p.a. | 9.88% | 6.69% | 8.38% |

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 30 September 2022




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 | Ryman Healthcare |
| Monash IVF Group | Technology One |
| Lynch Group Holdings | BWP Trust |
| GDI Property Group | Fortescue Metals Group |
| Global Data Centre Group | NIB Holdings |

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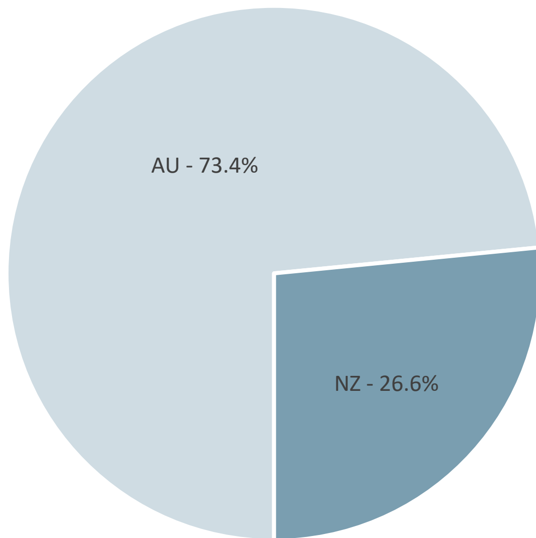
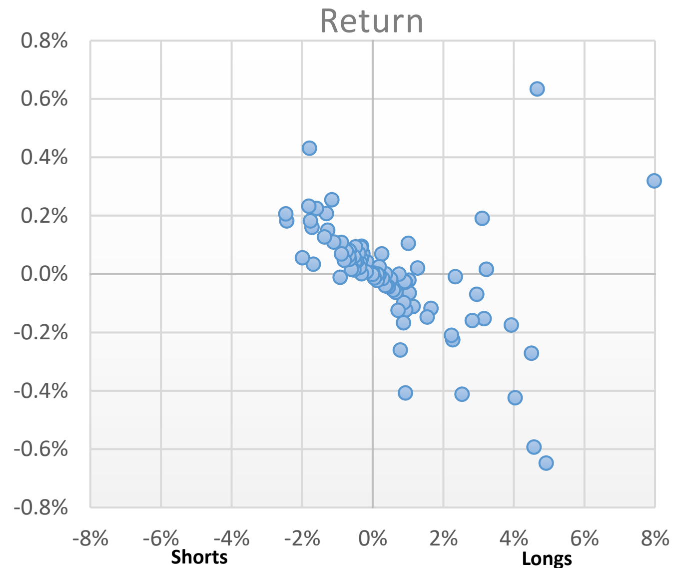
**Country Allocation at 30 September 2022 (Gross Equity Exposure)**




**September 2022 Individual Stock Contribution**




## Fund Commentary

Dear Fellow Investor,

September was a hideous month for most financial markets but the Fund did its job in shielding investors from the great bulk of the pain. We were slightly down for most of the month and could not quite get our head above water but the final return of -0.17% was highly satisfactory compared to the -4.6% decline in NZ equities and the -6.2% return from the higher beta Australian market.

This was a pleasing relative return and spoke to good relative stock selection given that our net length was typically in the mid-high 40% region over the period. In hindsight, we could have sat tight a little longer before engaging in our typical contrarian buying of stocks on weakness but when we see share prices at attractive levels, we find it hard to resist.

For the last 12 months, the Fund has now returned +11.5% compared to -7.7% for the Australian equity benchmark and -16.6% for NZ. In the face of gathering bear market clouds, the Fund will keep plugging away doing what it has always done – try to buy solid businesses when they are at deep discounts to their current profitability and growth outlooks and short-sell companies which are egregiously over-priced or at risk of earnings downgrades (or ideally both!)

The macro backdrop is becoming ever clearer, and unfortunately, markets do not like what they see. We have a good old-fashioned 1970's case of negative supply-side shocks (Covid and Ukraine) meeting economies whose finance ministers and central banks were slow to diagnose the illness. Printing money during Covid to bring forward demand has just made matters worse. Now comes the hangover of slowing activity and inflation which may be peaking but which will likely prove embedded. Stagflation has not historically been the equity market's friend.

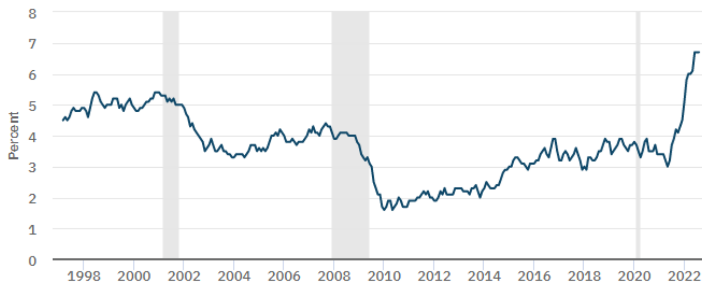
What markets need to find their feet again is hard evidence that inflation has peaked, that it will fall back to the levels targeted by central banks in a timely fashion, that central banks can then pivot to looser policy, and that actions taken so far won't cause significant financial market contagion which liquidates investors along the journey.

There are helpful signs that supply chains are easing and that commodity prices may have seen their highs but actual inflation evidence is still problematic. The Fed's favourite indicator is the US Core PCE Deflator and this came in at +4.9% for August versus the +4.7% that was expected. The chart below puts this in context – goldilocks is long gone.

The US Core PCE Deflator actually tends to be at the lower end of inflation measures, with core goods CPI inflation for August being +7.1% y/y and core services inflation being +6.1% y/y. Headline CPI inflation was +8.3%. We are quoting US data because there is so much of it and it is so timely but the situation is similar everywhere. In NZ for example, firms' selling price intentions in the ANZ Business Outlook for September only retraced very slightly to a high +68.0 from +70.1 previously – less bad but glacially so.

On the bright side for inflation, shipping rates are plunging, some Covid-driven price explosions such as used cars are starting to reverse and many retailers are reporting excess inventories. Even the mighty Nike share price fell -12% last week after reporting a 60% lift in inventories.

The concern is that while inflation has likely peaked and will decline, it may not decline far enough. It has become embedded, with the chart below being the US wage growth tracker that is published by the Atlanta Fed. A 1970's style wage-price spiral is underway.




Sources: Current Population Survey, Bureau of Labor Statistics and author's calculations

Markets are see-sawing as they try to tease out the reaction function for central banks in the US and elsewhere. September saw a degree of despair that the Fed won't be able to pivot because they simply have to keep going to break the wage-price spiral that the chart above depicts. This is why the Fed hiked by 75bp during the month and why 12/19 FOMC members now expect a Fed funds rate of 4.5%-5.0% by end-23. It is currently 3.0-3.25%. Numerous speeches were given by Fed Governors to reinforce this view.

September also marked the Fed going full Monty on QT, stepping it up to $95bn per month. On Sept 15, the Fed stopped buying mortgage-backed securities for the first time since 2008. So much for the land of free markets! However, we suspect the impact of QT may take some time to impact financial markets as US banks have over $2trn of reverse repos parked at the Fed – this is excess liquidity sloshing around the system that banks have not lent out.

Another issue for markets is the incoherent policy being followed by the Bank Of Japan. For years now, they have been printing money to buy bonds and suppress yields to near 0%. This has had the unsurprising impact that capital has fled in search of higher yields elsewhere, causing the JPY to weaken dramatically, which in turn is finally driving their long-sought return to positive inflation. However, rather than declare success, they have now decided that the JPY has weakened too much and they have therefore intervened by selling foreign assets such as US bonds to buy the very JPY that they have been so assiduously printing. Aside from high inflation readings, this was another reason for bond yields rising across almost all markets over the month.

As the monetary policy tourniquet is being twisted in most countries, September also saw a change in narrative for markets. We have moved from "inflation is peaking" to "when will we see peak central bank hawkishness" and now we have proceeded to "beware of financial contagion". The question is becoming which overly levered market participants will be carried out on stretchers.

On September 13, a brutal US market sell-off saw the Nasdaq decline -5.16% and every single stock in the index fell for the first time since the Covid-19 panic in March 2020. Diversification provides little benefit at the time you need it most.

The prior few quarters had seen significant activity by private equity funds taking advantage of cheap funding to embark on a takeover binge globally. The rug has now been pulled out from under this game. It was a factor in KKR abandoning their bid for Ramsay in Australia and the indicative bids for Infomedia and Pushpay have never quite been consummated. Late month, we saw Bank Of America and Barclays pull a US$3.9bn bond issue to fund the Brightspeed LBO by Apollo Global. They are now stuck with the debt and we suspect there could be a fair bit more of that out there.

Another sign of contagion has been the plethora of rumours surrounding Credit Suisse in the last few days and a sharp rise in their credit default swap spreads. We have no unique insight into this situation but the nerves seem to be on the basis of their exposure to levered loans.

The most spectacular piece of financial contagion so far has been the drama surrounding defined benefit UK pension funds. Normally, one would expect rising bond yields to be a strong positive as they reduce the NPV of the future pension liabilities. However, many of the funds chose to duration match their liabilities and they did so with so-called Liability Driven Investment funds (LDIs).

LDIs seem to have been like swaps, which the pension fund used to match off its exposure to bond yield movements but which only required an initial margin to be posted. So magically, the pension fund had matched off its duration risk and had funds left over to invest in all sorts of other asset classes. The problem came when a general backdrop of rising bond yields was added to by the shockingly reckless Budget from the new UK government. Bond yields spiked, margin calls were needed, so the funds had to sell bonds and other assets, which drive yields up further and so on. This was only stopped by the Bank of England putting its QT plans to one side and engaging in an emergency bout of "whatever it takes" QE at the long end of the curve.

One could conclude from this sorry episode that markets forced the first central bank pivot but it was strictly limited to this specific situation and combating inflation risks is still the bigger picture game for central banks. One also wonders if this situation has been entirely dealt with. For example, as this is being written, the AFR is reporting that UK pension funds are holding auctions to sell large chunks of Australian mortgage-backed securities that they are lucky enough to own.

Summing up all of the foregoing, our view remains that inflation has peaked but that a portion has become embedded and this will require an extended period of tighter monetary policy. Markets and central banks may gyrate in their views on this as varying data emerges but this is the central backdrop.

Tighter policy will create instances of contagion, where leverage pops out in various unexpected places such as UK pension funds. One theme underpinning our positioning is being very sensitive to balance sheet risks and we have looked to short some names who may perhaps be getting themselves over-extended.

We also came across an interesting WSJ article by Jason Zweig looking at how stocks did overall and which types of stocks outperformed during the stagflationary 1970's. The article reprised a study by Robeco International that examined stagflationary episodes from 1875 through 2021. They found that stocks lost almost 17% annually during these periods but that it was often hard to recognise whether you were in a stagflationary period at the time. By the time the data made it official, financial markets had already moved. So, beware the stagflation that we see around us and don't want for the lagged and much-revised official data to say it was so. One might argue that NZ equities have already reacted in exactly this manner.

Further, a big theme across markets at present is to look for stocks with pricing power, on the basis that they can recover their cost pressures. The article looked at the best US performers from early 1966 to late 1982 and two quite disparate themes became apparent. The major outperformers were stocks that were i) very cheap; or ii) had secular growth drivers completely unrelated to the stagnant economy. This had nothing to do with pricing power, it was all about being too cheap or having growth irrespective of the backdrop. When we examine our long book, many of our names do seem to fit into one of these two buckets.

**Fund Performance in September**

Returning to the Fund's performance in the month of September, the overall return of circa -0.12% pre fees and tax was the net outcome of two very diverse contributions from our long book (-4.0%) and our short book (+3.9%). The determining factor in a marginally negative overall outcome was simply our net length, which finished the month at 49.6%. Stock selection was sound, with a "winners to losers" ratio of 60%.

While we lifted our net length from 47% to 49.6%, we did this on the weak days when tempting buying opportunities presented themselves. Our gross positioning continues to be at the bottom end of our historical levels, at just 123.5%. Current volatility is providing quite enough risk exposure without running our gross at 170-180%.

The natural contrarian ebb and flow of the Fund sees net length tend to rise after a few down-days and conversely fall as we sell/short into strength after a few up-days. While our overall view remains "don't fight the Fed", this means we still tend to perform during the occasional face-ripping short-covering rallies, which is exactly what we are experiencing as this is being written. The rise in our shorts is painful but is offset by our longs.

Looking at the 50/50 index of Australia and NZ during September, it had a high number of ten down-days, with an average return on them of a deeply negative -0.99%. The Fund was pleasingly up on five of those ten days and had a flat return on them of -0.01% on average. Despite our net length flirting with the 50% level, this Fund has remained uncorrelated – irrespective of whether the market is up, down or flat, we may be up, down or flat.

The largest positive contributor was once again our large long in Lynch Group (LGL, +12.4%), which defied market weakness and continued to recover from heavily oversold levels. That said, it remains well below its IPO price. If consensus forecasts

are accurate, it is on downgraded PE multiples of 11.6x Jun23, 9.0x Jun24 and 8.1x Jun25 earnings. Just our sort of company, providing deep value with decent organic growth and plenty of opportunity to reinvest at solid returns.

LGL is the dominant flower grower and distributor in China and Australia. The headwinds they have faced in three key areas appear to be close to peaking. Chinese lockdowns seem to be easing slightly and may ease further post the Party Congress; extortionate airfreight prices and lack of capacity should soon improve; and labour shortages in Australia due to Covid exposures should now be easing. There has been lightly sourced speculation in the AFR that LGL may be a takeover target but we would actually prefer to play a longer game here.

The second major tailwind came from our short in Breville Group (BRG, -17.7%). Australian mo-mo darling-stock investors seem to get all weak-kneed and giddy at the very mention of "global growth company" but even post its sharp recent weakness, BRG is on a forward PE multiple of 22.5x. We also suspect that a degree of earnings were pulled forward during Covid lockdowns as there are only so many coffee machines, kettles and juicers that a household need. We did cover some of the position into the pull-back but we will re-short into any renewed strength.

The third winner was our largest long in the form of Tower (TWR, +4.1%), which is a rare beneficiary of rising interest rates as they invest their insurance float of circa $250m in 3–4-month duration fixed interest securities. At month's end, they announced their reinsurance programme for F23 which was less bad than it could have been and in line with our forecasts. Reinsurance markets have hardened (just like end insurance markets) and TWR placed its catastrophe reinsurance at acceptable pricing. They didn't renew their aggregate cover, which cost about $6m for coverage of the $20m slice between $20m and $40m of large events. The last two years have been shockers for large claims but even so will amount to about $25m and $22m respectively, so this decision makes sense. TWR's potential earnings power in a light claims year is huge and the market conservatively forecasts that there will never be a light or even an average claims year again.

Other positives came from a group of our high multiple shorts which fell harder than the market. Stand-outs included Carsales (CAR, -15.7%) where we are wary of the market's assumption of success in their major US acquisition just as the used car market slows sharply; Wisetech (WTC, -11.4%); Technology One (TNE, -10.7%); Homeco (HMC, -9.3%) and Bunnings Warehouse Property (BWP, -7.0%), with the latter two being high-priced hedges against our cheap property sector longs.

The negative side of the ledger was headed by our high-conviction long in Monash IVF (MVF, -11.3%) which has frequently appeared in these pages. We view them as a secular growth business that is on value stock PE multiples of 14.9x, 13.0x and 11.4x for the next three years. Their balance sheet is strong to fund further organic and inorganic growth, and while IVF numbers will wax and wane, the reality is that this is around a growth trend as more women have babies later. Their main competitor, Virtus was acquired by private equity (at much profit to this Fund). Funding conditions perhaps preclude a repeat with MVF in the short term but there is also market gossip that MVF is picking up specialists from Virtus.

The second key headwind was another high conviction long in GDI Property (GDI, -11.1%). Rising bond yields don't help but Perth is re-opening and we expect leasing news to act as a catalyst to drive the share price. While there are lies, damned lies and property company NTA's, we believe GDI's NTA of $1.27 (58% above share price) is more real than most as they do not have a hungry external manager to feed. A recent major sale by Mirvac in the Perth CBD also lends support. GDI also has a number of syndicates with sizeable embedded performance fees. Directors have been buying and a buyback has been active.

The third key detractor was another long-held, high conviction position in Australian Vintage Group (AVG, -9.0%). They have been performing exceptionally well as a business, which continues to move up the value curve away from bulk wine, which is the world's leading producer of low/no-alcohol wine, and which has launched what should be a very high returning spirits business using the free alcohol that is generated from this process. The forward PE path of 8.2x, 7.4x and 6.7x is right in our wheelhouse so we have continued to nibble away on weakness. UK events do not help sentiment but the dovishness of the RBA managed to outweigh the budgetary foolishness of the new UK Government in recent days so that the AUDGBP forex rate has actually moved in AVG's favour.

Thank you for your continued support of the Fund. September was an interesting month to put it mildly and we are pleased to have emerged with a near-flat result. We used the weakness to add to our net length on what we believe to be favourable terms, which leaves us well placed to benefit from the current rally as this is written. We would be surprised if

this rally lasts as we are yet to see any evidence for a wage/price spiral being averted which would allow central banks to ease the tourniquet. The Fed appears set on further moves, while the RBA is so all over the show that it's anyone's guess as to how they will react next. Overall, our view remains not to fight the Fed as liquidity conditions tighten further in global markets. We will strive to continue delivering equity-like returns over the long run, with far less volatility than equities and no correlation to them.

Matthew Goodson, CFA

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