SALT

Salt Long Short Fund Fact Sheet – July 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 July 2020

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$77.6 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 July 2020

Application	1.4791
Redemption	1.4731

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 2020

Long positions	54
Short positions	39

Exposures at 31 July 2020

Long exposure	97.61%
Short exposure	56.06%
Gross equity exposure	153.68%
Net equity exposure	41.55%

Largest Longs	Largest Shorts
Tower	Netwealth Group
Pacific Edge	Port of Tauranga
Marsden Maritime Holdings	Fortescue Metals Group
Vitalharvest Freehold Trust	Napier Port Holdings
GDI Property Group	Domino's Pizza Enterprises

Performance[1] at 31 July 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%						-7.40%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	8.60%	1.30%	9.48%
6 months	-5.50%	2.66%	-7.22%
1-year p.a.	0.06%	5.72%	0.76%
2-years p.a.	-2.81%	6.21%	8.52%
3 years p.a.	-0.65%	6.39%	9.90%
5 years p.a.	4.15%	6.71%	9.71%
Since inception p.a.	6.57%	7.02%	10.09%

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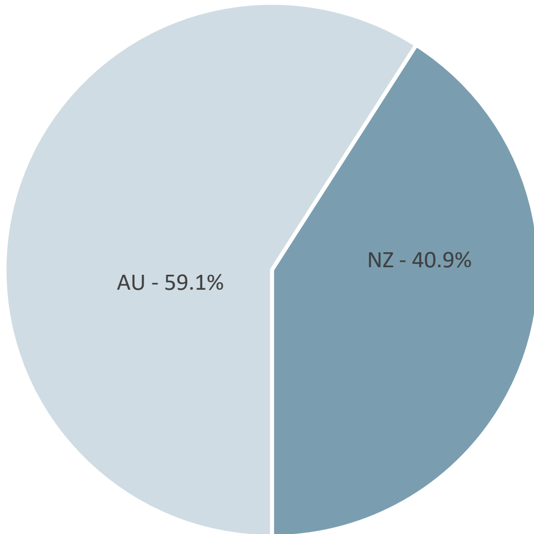
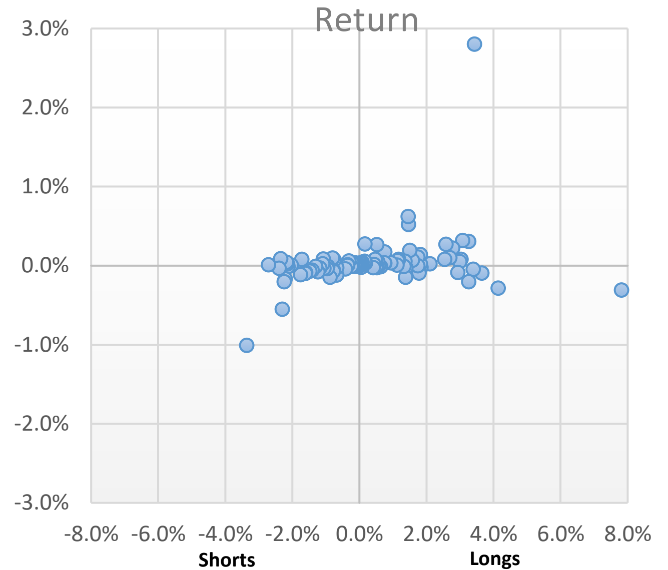
Country Allocation at 31 July 2020 (Gross Equity Exposure)



July 2020 Individual Stock Contribution



Fund Commentary

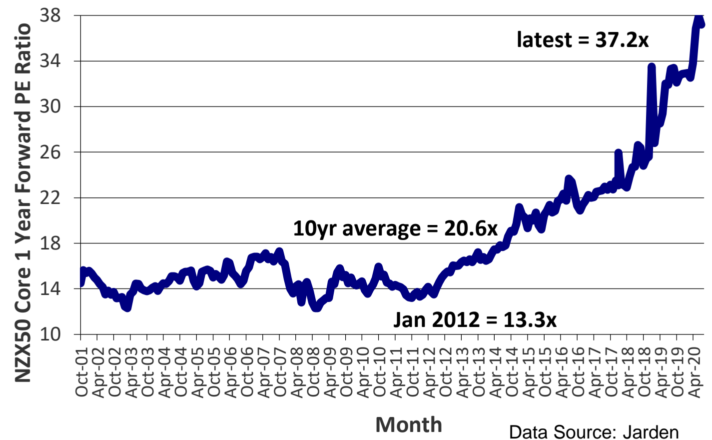
Dear Fellow Investor,

Against a backdrop of positive but somewhat choppy equity markets, the Fund experienced another very strong month in July with a return of +3.39%. As was the case in June, this reflected a combination of generally good resilience on the negative days and several of our long-standing (and long-suffering) pieces of stock selection finally coming good.

We continue to run this Fund in a truly uncorrelated fashion to long-only equities to provide a rare alternative in a world where many assets seem to be in an unending central bank-driven bull market. Our net length has been relatively steady in the mid 30% to the low 40% region and we closed the month at +41% net long. It has been a harsh environment for the last year or two running a combination of being long cheap companies and short a mix of ultra-expensive and low-quality names. Markets do however once again seem to be beginning to change.

The 50/50 index of NZ and Australia was more volatile in July and experienced twelve down days. Our Fund was up on nine of those twelve days and delivered an average return on them of +0.24% versus -0.52% for the market. This Fund does not provide an infallible backstop when markets fall but on average it is working relatively well. We repeat last month's comment that the alternative provided by this Fund may not seem very valuable when markets only seem to rise but this won't be the case forever.

The one year forward PE actually declined from 37.9x to a mere 37.2x as year-ahead earnings upgrades more than offset the market's advance. These upgrades appear to reflect both the passage of time and the impact of Covid-19 being less bad than initially expected for a number of companies. The median PE is hovering around 19.0x, pointing to a number of attractive opportunities that still surprisingly exist from the long side.



With 10-year bond yields finishing the month at just 0.77% (from 0.91%) the market is now only moderately expensive if yields were to stay at this level forever and the equity risk premium stayed constant. There really is no alternative and

the TINA trade to buy equities is alive and well. With core inflation still running at 1.8%, savers are being punished in term deposits. All over the western world, it is savers who will pay the price for the Covid-19 response.

However, if 10-year yields were to rise to a mere 2.0%, which is also the RBNZ's inflation target, our modelling suggests the fair value for equities would lie a gut-wrenching 30% lower at a constant equity risk premium. This is unlikely to happen in the near future but several mainstream strategists are starting to focus on a future lift in inflation and bond yields as a potential risk that is lurking around the corner. With the global money supply expanding at an unprecedented pace, the merest of recoveries in the velocity at which that money circulates could cause mayhem.

Moreover, there could be a period of cost-push inflation as deglobalisation becomes more prevalent. This really matters as NZ tradable sector inflation has been flat to negative in recent years which has offset non-tradable inflation of circa 3%.

We repeat last month's observation that investors are heavily long the TINA trade of "safe" yield stocks and/or the "FOMO" trade of ultra-expensive growth stocks. Investors are not positioned for a surprise lift in bond yields at some future point, which would spark a charge into cyclicals from expensive low risk names and ultra-expensive tech stocks. The hard part is when this happens. The call feels early but we have already seen one vicious rotation into value/cyclical stocks in the last few months and we may see it again. A Covid-19 vaccine being successful in Phase 3 trials is one obvious catalyst. We are gradually taking profits from some of our TINA longs and carefully adding to our FOMO shorts on big up-days.

As an investor who has experienced the meltdowns in 1987, 1997, 2000 and 2008, the dominant feature of today's market is **uncertainty** - uncertainty regarding the future path of Covid-19; uncertainty regarding the future economic path given the surprisingly resilient performance to date; and uncertainty whether the remarkable valuation expansion across markets is sustainable.

Equity markets have regained their former highs and retail sales and housing markets in NZ and Australia are strong but no one knows what will happen when wage subsidies/Jobkeeper come to an end and when mortgage holidays are over. In some ways it feels like the "phoney war" period in 2008 when markets rallied after the failure of Bear Stearns on the view that the problems were dealt with but then along came Lehmans.

As a colleague put it, we are playing a game of rugby and we know that the referee is changing the rules but we're not entirely sure how. Clothes-hanger tackles are now apparently being allowed but you know that the minute you try doing one yourself, the rules will have secretly changed again and the big red card will come out. Translated, we are not chasing hype stocks.

We have high conviction that the current mass-market retail investor frenzy will end in a bloodbath but we have low conviction on when the rules will return to normal again. Meanwhile, taking the bubble on from the short-side has proven difficult to put it mildly. We have been cautious in this regard. The euphoria can extend far further and far longer than one can possibly imagine.

The retail boom is continuing, with some remarkable examples in the US market during the month. Tesla rose by 32% following a result which some analysts saw as rather aggressive in terms of its accounting but that mattered little. According to Robintrack, 10,000 day-traders per hour were buying it on Robinhood at the peak of the frenzy on 13 July. To show the degree of knowledge behind the Tesla boom, Tiziana Life Sciences Plc rose by 172% in the month of July, with this following a 138% surge in May. The ticker for their Nasdaq listed ADR's is TSLA…

However, perhaps one tiny sign of a crack in the growth-at-any-price tech company edifice came from Nikola, the product-free electric truck company. In June, they rose from $25 to a peak of $79. In July however, they have fallen from $67 to $30. It may be a stretch but perhaps we are entering a phase where extraordinary multiples will still be paid for real businesses (such as the FANG's) but more nascent business models could receive more scrutiny.

One potential warning sign of a sea-change came on 13 July, when the Nasdaq staged a negative intra-day reversal of almost 4%. It has only ever done this twice before, with those days being 24 Jan and 7 Mar 2000 – hmm. At the same time, retail investor confidence measures surged to new highs.

When we examine the retail turnover and net buying of NZ retail brokers, there is little sign that the mass market frenzy is abating as yet. That said, it does appear to have at least peaked in terms of its second derivative, with the net buying and value traded by those brokers in the key darling stocks being similar in July to that in June.

One market where a frenzy hit "all systems go" was China, following an article early in July in a State newspaper calling for a "healthy bull market". This drove the Shanghai

Composite Index up +11%, with Australian proxies such as iron ore companies enjoying a very strong month.

Not long after the press article, the CSRC blacklisted 258 brokerage firms that offered illegal margin accounts of up to ten times leverage. The stock move that perhaps best encapsulates the zeitgeist there was the IPO of QuantumCTek on 10 July which had a 924% day one pop to a US$4.3bn market cap. They produce "quantum information products, including "quantum key distribution products, quantum key management products" et al.

On top of uncertainty regarding the economic outlook and the longevity of booming equity market valuations, we are moving into a period of increasing political uncertainty.

In NZ, this abated a little in July, with Labour displaying sufficient relative strength that governing alone is a very real possibility. That said, a week is a long time in politics and their poll ratings above 50% contain numerous voters who have never voted for them before and may prove somewhat soft. A Labour/ Greens coalition cannot be ruled out. It could either happen as a mathematical necessity or Labour could choose to do this even if they don't need to in order to have a stalking horse for more radical policies. NZ investors have grown used to benign political outcomes but there is some risk of this changing.

In the US, the Democrats look to have an increasingly strong grip on Presidential polls. In this context, recent quotes from Joe Biden are worth noting, *"ending the era of shareholder capitalism is overdue…. it's time that corporate America paid their fair share of taxes."* Now this may just be red meat to his political base but a massive increase in the disparity of wealth in recent decades is a fact, with the greatest returns accruing to the owners of capital. Against this backdrop, the outcome of the Senate elections is critical, Predictit.org have had the Democrats in a remarkably steady range in the 62-64% region for the last several weeks. The next couple of months are going to be wonderful for political junkies!

Returning to the performance of the Fund during July, the return of +3.59% (pre-tax and fees) was again helped by a strong "winners to losers" ratio of 62%. Our longs contributed an exceptional +5.97% although this was partly offset by some mixed stock selection in the short book, which detracted -2.38%. This is not an easy market to short when the names running hardest are a mixture of overpriced glamour stocks and highly challenged "trash" – the two areas where we have historically done well from the short side.

The largest positive contributor by a considerable distance was again our holding in Pacific Edge Biotechnology (PEB, +173%). Critically, it received a positive Local Coverage Decision from CMS early in July which will allow it to be paid for both carrying out its tests from now onwards and also receive a negotiated reimbursement for unpaid past tests. We believe the details of last month's Kaiser Permanente deal mean that PEB will rapidly achieve scale as their test/s are carried out in the Kaiser system as a matter of course rather than PEB having to fund numerous sales people to try to persuade Kaiser's urologist base. Finally, PEB carried out a $22m share issue at a 14% price premium which takes any risk of an equity raising off the table.

Our normal style would be to lower risk when PEB has run as hard as it has. However, we actually bought slightly more at lower levels as we still see significant potential valuation upside on reasonable valuation assumptions. There should be a steady stream of positive news flow in coming months as we expect PEB to sign up further clients, for more granularity to emerge on both CMS and Kaiser, and for PEB to enter various passive indices, sparking forced buying from a tight shareholding base.

Our second and third largest tailwinds were the close cousins Cardno Group (CDD, +35.4%) and their spin-out Intega Group (ITG, +34.8%). The engineering consultancy, Cardno was once upon a time a darling stock on the Australian bourse but expanded overly eagerly and fell into a state of disrepair with debt levels that were formerly worrisome. The private equity player Crescent Capital owns 49% of CDD and spun out ITG for reasons that aren't obvious but we surmise may be intended to put one or the other in play. In the short term, all it achieved was to see both names dumped out of several indices including the S&P/ASX300. We bought aggressively at deeply depressed prices off the forced passive sellers. Subsequently, they both upgraded guidance slightly despite the impact of Covid-19. CDD is still only on a forward PE 7.6x and ITG is on 15.2x with strong forecast growth thereafter. They both have favorable exposure to a strong outlook for global infrastructure expenditure and ITG has particularly strong growth prospects from its environmental engineering and testing services.

Other positives of note came from our long in Turners (TRA, +10.4%), with car sales data indicating a sizeable rebound in recent weeks; 360 Capital Digital Infrastructure (TDI, +8.4%) as it continues to recuperate from its undue Covid-19 sell-off; and our old friend Shaver Shop (SSG, +8.6%) which has more than tripled from its recent lows and is very well place with its online centric model.

The largest headwind by a considerable distance was our poorly pitched short in Netwealth (NWL, +33.9%) which took a one-way train to the heavens on an earnings update which delivered a slight upgrade due to better than expected earnings on their clients' cash holdings, solid platform inflows and high levels of transactional activity. We had previously moved in and out of this position very well but were caught out on this occasion. Our short position is predicated on ever rising fee competition and a sizeable headwind from ultra-low interest rates being rather incongruent with the forward PE ratio of 62x.

The second key laggard was our stubborn and to date incorrect short in Fortescue Metals (FMG, +25.7%), which soared on iron ore prices appearing to reach a permanently high plateau. Chinese steel production is surprisingly strong but we see four issues for iron ore companies at their current lofty levels: valuations are very extended on any NPV that uses mid-cycle prices; CVRD has experienced major supply issues but appears to be starting to get their production act back into gear; China's ban on scrap steel imports may be lifted shortly; and while China is dependent on Australian iron ore for now, the massive high grade Simandou project in Guinea appears to be moving forward, which in turn will spark a supply response from CVRD.

Other headwinds were more modest in size and more random in nature. Our large Tower long (TWR, -4.0%) slipped back on no news; likewise Marsden Maritime (MMH, -6.8%) drifted back as port studies sponsored by other interested parties did not back it as a future location for Auckland port; Elanor Commercial Property (ECF, -3.6%) is not exposed to the Sydney and Melbourne office markets but fell anyway; and our short in Breville Group (BRG +13.9%) weighed although we offset the worst of the impact with some successful trade timing.

Thank you for your ongoing support of the Fund. We are pleased to have delivered several strong months of performance despite being heavily hampered by our diversified group of overbought, overwrought shorts. These have at least provided good protection on the volatile down days. The returns have come from several idiosyncratic pieces of stock selection which is very much in line with the way we have always run this Fund. We are seeking uncorrelated alpha rather than chasing beta by simply jumping on board the latest trendy darling stock.

This is an extremely uncertain time for investors. Few would have predicted the stellar rebound of the last several months. From here, it is hard to have a strong view on whether economies keep performing well even as fiscal and monetary supports ease; whether markets may start to fear a future rise in inflation on rampant money-printing; what the outlook is for the spread of Covid-19; and what the NZ and US election outcomes will be.

Against this backdrop, the Fund will continue to follow the same strategy and carry sizeable protection from the short-side, while continuing to aggressively position in longs that we feel have solid outlooks and have been left behind in this most bullish of bull markets.

Matthew Goodson, CFA

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