SALT
Funds Management

Salt Long Short Fund Fact Sheet – February 2019

Fund soft closed to new investors

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 28 February 2019

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$207.0 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 28 February 2019

Application	1.4196
Redemption	1.4138

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 28 February 2019

Long positions	69
Short positions	38

Exposures at 28 February 2019

Long exposure	76.90%
Short exposure	-43.87%
Gross equity exposure	120.77%
Net equity exposure	33.03%

Largest Longs	Largest Shorts
Centuria Metropolitan REIT	Auckland Intl Airport
Tower	BWP Trust
Investore Property	National Storage REIT
Pacific Current Group	Technology One
Turners Automotive Group	Invocare

Performance[1] at 28 February 2019

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%	1.76%	-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%											**-2.22%**

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	-4.33%	1.62%	7.25%
6 months	-8.37%	3.29%	-0.56%
1-year p.a.	-8.26%	6.75%	6.24%
2-years p.a.	-1.46%	6.75%	9.79%
3 years p.a.	2.51%	6.85%	12.67%
Since inception p.a.	7.70%	7.33%	9.99%

[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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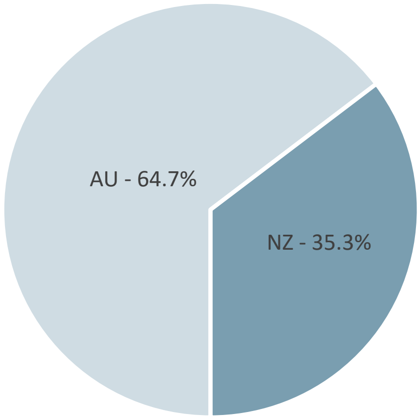
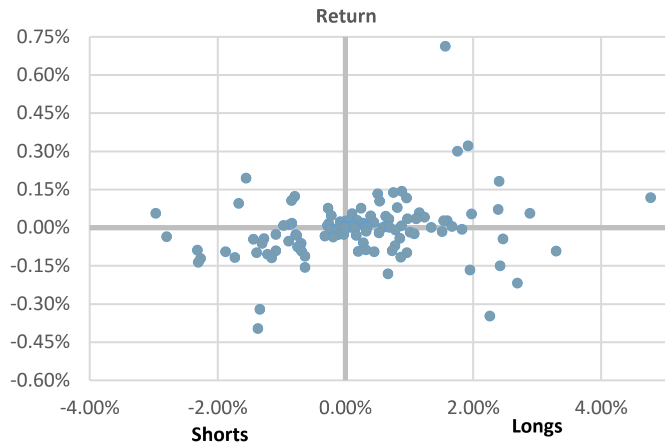
Country Allocation at 28 February 2019 (Gross Equity Exposure)



February 2019 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

February was another difficult month for the Fund, with a return of -0.97% after all fees and expenses. Equity markets were strong and we came under pressure from many of our extremely overpriced shorts becoming even more overpriced. Conversely, we did achieve some solid performance from many of our longs but their typically low beta, low valued nature saw them struggle to keep pace. Pleasingly, the Fund did bounce strongly from its lows late in the month as several of our key longs finally began to work.

Since inception on 30 June 2014, the Fund has now returned +41.38% after all fees and expenses, with thirty-four of the fifty-six months having had positive returns.

Following the sell-off in December, equity markets have returned to nose-bleed expensive levels. Using FNZC forecasts, the one-year forward PE for the NZ market (ex-property) has hit a new record high of 26.8x. While very low bond yields are clearly supportive, earnings forecasts are not. The year-ahead earnings forecast for the market is still 6% below the highs it hit back in April 2018. Normally this earnings index grows steadily over time due to inflation and as companies reinvest for growth but earnings downgrades have more than offset these drivers.

Forward indicators from business confidence surveys suggest a continuation of this weak earnings theme, whereas market pricing implies a return to normal growth. Just think of Japan or of Europe (where earnings have been flat for ten years) for why the implicit market view on earnings growth may be wrong. This theme is also evident elsewhere. The US experienced first quarter earnings that fell by 2.1% on last year and forecasts from here have faded to red. UBS analysis shows forecast Australian earnings for industrials ex-financials are -3.4% for the next year, having fallen from -0.6% going into earnings season.

Investors everywhere have simply been applying a bigger PE multiple to flat or falling earnings. Lower bond yields have forced investors to pay record prices for equities. However, our regression analysis suggests that even at very low current bond yields, NZ equities are 18% overpriced, with their fair value PE being a “mere” 22.1x. This is at a time when real bond yields are around zero. Move them out to a still very low 1% real/3% nominal and our market would be 25% overpriced. We are very conscious that this analysis is like a broken clock, except that for the last year or two, it hasn’t even been correct twice a day.

When we examine NZ market valuations over the last 15-20 years, there have been three distinct paradigms, encompassing two of extended overvaluation and one of undervaluation. The market is rarely “normal”. The first was pre-GFC, when bond yields were in the 6-7% region and PE ratios were far too high at 16-17x. The GFC fixed that. Then there was 2011-12, when PE’s were 11-15x and bond yields were 3%-4.5%. We were actually very bullish back then and that period was ended by QE, Draghi’s “whatever it takes” stance which ended the Eurozone crisis and by a moderate economic/earnings recovery. We suspect the current period of sharp overvaluation will also be ended by some sort of unforecastable structural change. The trick will be to recognise it quickly when it happens.

A fascinating global strategy piece at month’s end from BAML ties in with this thought process by examining various arguments as to what may come next for equity markets. They argue that hot money could drive a short-lived mini-bubble but this will then be ended by either a debt deflation trap or an outbreak of inflation.

Our own leanings remain very much to the latter given numerous signs of wage inflation picking up in labour markets and a lift in the populist vote share across many countries, which will increasingly affect government policies. Just one example in terms of wage inflation comes from the Atlanta Fed Wage Growth Tracker, which looks at the annual change in the median wage of a large group of individuals. This has picked up from 3.0% to 3.7% over the last year and compares to a post-GFC low of 1.6%. With labour being 70% of the cost of everything, this will inevitably lead to price inflation.

Along similar lines to the above, Morgan Stanley points out that inflation rates are already near their 25-year average in the US, UK, France, Germany and Japan yet unemployment is at 20 to 50-year lows depending on country. Central bank policies and current bond yields seem bizarre against this historical context and this combination also makes a return of the 2016-18 “Goldilocks” paradigm of steady earnings growth and falling bond yields very unlikely – there is simply not the spare capacity to allow growth without inflationary pressures.

We have been net short the inflation/bond yields theme for some time and it has been very painful for the Fund as 10-year bond yields and thence bond-proxy stocks have rallied sharply but we will stick to it. It is somewhat galling that it hasn’t worked when core CPI in the US has picked up to 2.2% and when US 10-year bond yields bottomed at 2.55% on Jan 3 and are now 2.75%. In NZ, you actually need to get out to 8 year plus bond maturities before you can find a yield that is above the current 1.9% core inflation rate.

Low bond yields have led to staggering prices in commercial property markets. To illustrate how extended valuations are at present, GPT plans to sell its stake in the rather aged MLC Building in Sydney but analysts are not concerned at potential earnings decretion because the likely cap rate they get will be close to their marginal cost of debt – and this is at current incredibly low bond yields! This degree of animal spirits feels very 2008.

An alarming chart within the BAML piece looked at US private financial assets as a % of GDP. From 1950-1995 this measure fluctuated between 250% and 370%. It then exploded to a peak of 470% at the height of the Nasdaq bubble before easing to 400% in the bust. It reached 500% in 2008 before falling back to 450% in 2009. It is now a staggering 575%. As BAML puts it, Wall Street is too big to fail – no wonder Fed Governor Powell staged a rapid reversal from hiking and Quantitative Tightening (QT) being on auto-pilot. With leverage being at these levels, our fear is what happens when something goes wrong?

There appears a certain irony in the comments of Ben Bernanke back when he instigated QE that, “*Clearly this is a temporary measure which is intended to provide support for the economy in this extraordinary period of crisis and when the economy is back on the road to recovery, we will no longer need to have those measures.”* Unfortunately, the market addict is now utterly hooked and the consequences of going cold turkey are too frightful to consider.

Returning to the performance of the Fund in February, the return of -0.90% (before fees and expenses) was comprised of +1.08% from our longs and -1.98% from our shorts. Our “winners to losers” ratio staged a welcome and overdue improvement to 53% but the negative performance for the month was driven by the number of mid-sized detractors outnumbering mid-sized contributors.

The largest headwind was our medium-sized short in IDP Education (IEL, +31%) which reported a moderately better than forecast result that sparked a furious share price surge. While IEL had a degree of weakness from the Chinese student market, this was more than made up for with strength elsewhere. As a measure of how valuation is irrelevant at present, they are now on a forward PE of 56x – all that matters is that you make or beat your number.

We had earlier made strong returns from an IEL short when they had a slight miss six months previously. The market seems attracted to the idea that IEL has structural growth from their student placement and English language testing businesses. We would observe that while they have grown strongly in recent years, it has been far from a straight line and they are subject to both the viscitudes of immigration and foreign student policies and there are also potential risks to the ownership of their IELTS English language testing programme.

The second key detractor was our large overweight in Bingo Industries (BIN, -20%) in what can only be described as an action-packed month. They had a 49% one-day decline in mid-February when they delivered an earnings warning on a mix of one-off factors and their collections business slowing with the residential market weakness. We remain hugely attracted to their post-collections assets in landfills and recycling. These continue to perform well but clearly both we and many analysts had underestimated the cyclicality of the smaller less valuable collections side, where small operators price for cash to survive in a downturn.

Our losses in BIN were ameliorated to a degree by lightening our holding somewhat prior to their earnings warning and re-purchasing near the lows. This paid off at month’s end when the ACCC approved the crucial Dial-A-Dump acquisition, with BIN only required to divest one recycling facility. This industry changing acquisition will deliver strong growth and we see BIN being on a sub 10x PE within two years, which is consistent with our DCF valuation being far ahead of the month-end share price of $1.67. As the dust settles from the excitement of the last few weeks, we see major re-rating potential. As the CEO of the Australian Landfill Owners Association put it, *“in terms of waste management assets in the Sydney metropolitan area, they are absolutely jewels in the crown."*

A third notable loser was our mid-sized short in Invocare (IVC, +22%) which had formerly produced very strong returns but which we erred in putting on again ahead of their result. The result itself was merely in-line to a touch behind expectations but we mis-read sentiment in the short term given that it was enough to spark a strong rally. The bull thesis is that death rates have been temporarily depressed and that there is sizeable structural growth forever after. This is true but what we see are a forward PE of 28x, a stretched balance sheet, a major market shift towards lower cost funerals and cremations, increased price transparency from the internet, and doubtful returns from a major capex programme in an industry where it is notoriously hard to move market share.

While a number of ultra-high multiple stocks hurt us during the month, a satisfying albeit modest win came from our short in Wisetech Global (WTC, -5%). While it only fell 5%, it did decline 20% post-result from its intra-month high. Its market cap of $5.9bn is 17x forecast revenue and is supported by forecast NPAT of just $51m. Even worse, a good portion of the revenue growth comes from small software companies that WTC is purchasing at multiples massively below their own. Just how bubbly the views are is shown by one experienced analyst's piece: *"$21.09 target price, we use a target EV/sales multiple of 19.0x….we also run a DCF model as a cross-check. Our DCF valuation ($7.78)…."* It seems that everyone has become a price momentum investor and has to make up ever more ludicrous reasons to justify it.

Our stand-out winner was a medium sized long in the Australian rural services company, Ruralco (RHL, +48%) which has long sat in the Fund as a slow-burning value name with apparently little interest. We had viewed its PE of 10x as being too low given steady earnings growth and saw fears of its exposure to the Australian drought as being overblown given their particular geographies and also given their countervailing investments in the water segment. Consolidation of the sector has long been spruiked as a left field possibility but the timing was in the lap of the gods and just happened to occur this month via a bid from global giant Nutrigen.

The second key positive was a large holding in Monash IVF (MVF, +16%), which delivered a solid result that was much better than some had feared. MVF is on a PE of 11x and has solid structural growth as women delay having babies until later in life. We had previously purchased MVF in the low $1 region and sold it in the $2 region and we have high hopes of staging a repeat. As a left-field catalyst, the Chinese suitor of Healius (Jangho) has reportedly built a holding.

Our third stand-out was a somewhat eclectic long in the Papua New Guinean bank and financial services business Kina Securities (KSL, +17%). KSL is on truly remarkable metrics with a PE of 8.0x falling to 5.2x and then 4.3x as it integrates the ANZ Consumer Bank business that they purchased. Their forward dividend yield of 14% is extremely attractive for a NZ investor, where thanks to the FDR regime, we only pay tax on the first 5% of it. KSL has a loan impairment expense of 0.58%, a cost/income ratio of 54% and falling, a capital ratio of 29% of risk-weighted assets, deposit growth of 29%, a loan/deposit ratio of just 65% which falls further when ANZ is completed, a net interest margin of 7.6%, and a foreign exchange business which is literally a licence to print money in a fixed rate regime. Sovereign risk manifesting via a devaluation from the USD currency peg is clearly the key potential investment risk but PNG's reserve position has improved sharply over the last year thanks to a successful bond issue and a recovering economy. This gave us the confidence to build and run the position.

Ruralco, Monash and Kina are typical of many of the longs we hold in the Fund in mid-cap companies which are fundamentally good businesses but have little analyst coverage and are on very cheap multiples just awaiting discovery. As a general comment, even though overall equity market valuations are exceedingly expensive at present, there is also a record gap between the valuations of large cap and small/mid cap companies. This has been painful for the Fund as this divergence has been the case for some time and it even worsened in the recent December sell-off as investors flocked to liquidity at any price. However, this is where the opportunity set currently lies, and for better or worse in the short term, this is how we will continue to position the Fund in terms of many of its longs. That said, we are becoming increasingly ruthless in exiting those names where we have erred or where catalysts just aren't apparent.

Thank you for your ongoing investment and support of the Fund. After four and a half years of not having a negative quarter, the weak performance since late October has been a rude wake-up call. Valuation has been of unusually little protective use in down-markets and ultra-expensive defensives and growth companies have rallied sharply to become even more expensive in up markets. We retain strong confidence that the Fund's recent drawdown is a blip in what remains a solid long-term track record and we are confident that we can recover the drawdown and then some in the months and quarters ahead.

Matthew Goodson, CFA