SALT

Funds Management

Salt Long Short Fund Fact Sheet – July 2018

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 31 July 2018

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$278.3 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 July 2018

Application	1.5658
Redemption	1.5595

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 2018

Long positions	86
Short positions	43

Exposures at 31 July 2018

Long exposure	82.94%
Short exposure	-52.56%
Gross equity exposure	135.50%
Net equity exposure	30.38%

Largest Longs	Largest Shorts
Centuria Metropolitan REIT	Ryman Healthcare
Star Entertainment Group	Goodman Group
Investore Property	National Storage REIT
QMS Media	Lend Lease Group
Tower	Invocare

Performance[1] at 31 July 2018

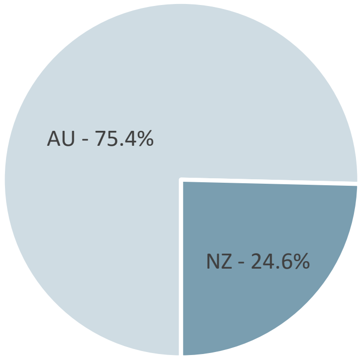
Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2014							6.28%	2.85%	2.74%	-1.67%	2.27%	0.89%	**13.96%**
2015	1.28%	1.07%	0.04%	2.17%	0.38%	-0.28%	0.75%	2.84%	1.34%	2.04%	2.37%	2.04%	**17.21%**
2016	-0.67%	-1.08%	3.81%	0.92%	1.72%	-0.39%	0.50%	2.26%	-0.51%	-0.57%	-0.20%	2.19%	**8.14%**
2017	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%						**1.92%**

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	0.87%	1.66%	3.38%
6 months	1.25%	3.29%	3.59%
1-year p.a.	3.81%	6.75%	12.72%
2-years p.a.	5.54%	6.79%	9.38%
3 years p.a.	9.06%	7.04%	10.51%
Since inception p.a.	11.50%	7.41%	10.87%

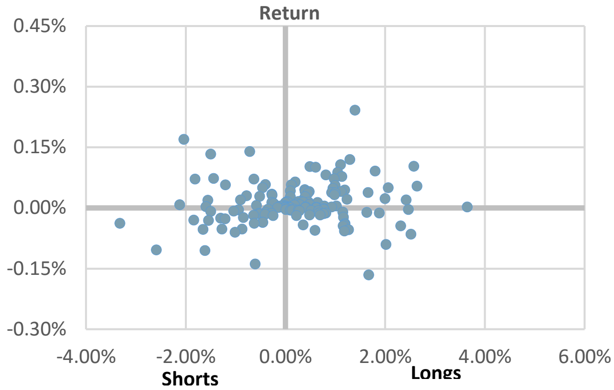
[1] Performance is after all fees and before PIE tax.
[2] NZX 50 G/ASX 200 AI is a 50/50 blend of the S&P/NZX 50 Gross Index and the S&P/ASX 200 Accumulation Index and is for comparison purposes only.

SALT FUNDS MANAGEMENT
Level 3, The Imperial Buildings, 44 Queen Street | PO Box 106-587, Auckland 1143
P: +64 9 967 7276 | E: info@saltfunds.co.nz | www.saltfunds.co.nz

Country Allocation at 31 July 2018 (Gross Equity Exposure)



July 2018 Individual Stock Contribution



Fund Commentary

The Fund staged a return to form in July, with a performance of +1.20% after all fees and expenses. This compared to the S&P/NZX 50 Gross Index return of -0.24% (yes, it can fall) and the Australian S&P/ASX 200 Accumulation Index advance of +1.39%.

Since inception on 30 June 2014, the Fund has now returned +55.95% after all fees and expenses. Thirty-five of those forty-nine months have had positive returns and our correlation to extremely expensive markets remains zero. Moreover, the Fund's volatility is far below that of the NZ and especially the Australian equity markets. Our mission to provide equity-like returns with less volatility and no correlation to equity markets remains firmly in place. While our returns are now slightly behind the bull market of the last several years, the true value of this alternative approach will become apparent when the bull market falters. The signs for this are gathering and we discuss further in the context of six different themes below.

Themes

Theme #1 is that market valuations are in cloud-cuckoo land. This has led to the Fund running lower net length over the last couple of years than was the case prior. We have typically been in the low 20%-low 30% net long region in recent quarters as we are finding a plethora of tempting shorts and relatively fewer longs than previously. Given our style, where our longs tend to be far cheaper than our shorts, anything below 30% is firmly net short on a risk-adjusted basis. Conversely, when markets were somewhat pricey back in 2014 and 2015, our net positioning tended to be more in the 35%-45% region. This was a far easier environment.

At the risk of sounding like a broken record, NZ's one year forward PE ratio sits at 24.7x, having touched a startling 25.0x during the month. Risk premia have compressed everywhere but this PE doesn't even make sense at current unusually low bond yields. The forward PE has a strong statistically significant relationship with the 10-year yield. This rallied 10bp to 2.76% during July but our modelled fair value PE is 20.3x at that yield. If earnings hold together, this requires an 18% market decline. NZ's last decline of anything like that was -10% from peak to trough in the December 2016 quarter. We need to go back to the GFC to find falls of that magnitude.

Moreover, an 18% decline could be light. What if earnings don't hold together, what if bond yields were to rise (they are most unusually 20bp lower than the US benchmark) and what if the market retraces beyond neutral to the cheap side of fair value?

NZ business confidence levels are weak and falling. The end-July ANZ survey showed firms' own activity outlook fell from +9 to +3.8 and firms' profitability outlook from -13.2 to -16.8. The former is consistent with GDP growth of 1% or less, while the profitability measure has a solid relationship with listed company earnings forecasts. It bodes very poorly indeed for revisions. One year-ahead earnings growth has fallen slightly from a peak in April, with earnings downgrades offsetting the natural upside from rolling forward each month into a greater portion of 2019 earnings. The outlook statements in the August results season could be very interesting.

Australian multiples are similarly extended in large swathes of their market. We repeat last month's insight from Credit Suisse showing that the S&P/ASX 200 Industrials ex Financials is now on a forward PE of circa 20.6x versus a long-term average of 15.0x. However, one and two year ahead forecast earnings growth is merely at its average.

Theme #2 is that within the over-valuation paradigm, "growth" has massively outperformed "value". From June 2008 to March 2015, the MSCI Australia Value Index returned 113% while the Growth Index lagged far behind with just a 14% return. From March 2015 to July 2018, Value has returned a pitiful 2.9%, while Growth has returned 41.5%. We think (and hope) the

Australian Financial Review may have picked the very top of this trend with a Chanticleer article on 23 July, which opened with:

"The divergence in performance between the leading fund managers focused on investing for value and those investing for growth is now so entrenched that it may prompt the true believers in value investing to think again."

In the subsequent week, one of our favourite growth shorts, Wisetech (WTC) fell from $17.92 to $15.00 as this is being written; IDP Education (IEL) was $10.21 and is now $9.78 et al. Maybe, just maybe the canaries in the coalmine are sending a signal.

Theme #3 is that bond yields will rise as the US economy has had more steroids pumped into it than a Bulgarian weightlifter. To be running a fiscal deficit of 5% of GDP at a time of full employment is simply frightening. Where will the deficit go to when the cycle turns down and how will the bond market react? As Bill Clinton adviser, James Carville once famously said, *"I used to think that if there was reincarnation, I wanted to come back as the President or the Pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody."*

On top of ultra-loose fiscal policy, a range of measures are showing a pick-up in wage inflation, while the New York Fed's underlying inflation gauge has continued to tick up to 3.33% at end-June. It has risen from a low of 1.5% in 2015 and where it goes, official inflation tends to follow. Cost-push inflation from oil and tariffs can be added to this. Remember that the February market swoon was caused by an inflation surprise.

The third argument for higher yields is that QT is only now starting to ramp up to its full extent in the US, while QE in Europe is being slowly lowered to zero by year-end. Serious questions are even being asked about QE in Japan given the adverse impact on savers and banks. To date, near-zero yields in Europe and Japan have generated an interest-parity type bid for yields everywhere but this will change as QE fades into the dust-bin of history. In addition, Trumpian tax cuts have seen the US Treasury lift bond auctions by US$30bn/month for the rest of the year. We are net short a number of bond-proxy type equities, with Goodman Group, Auckland Airport, National Storage REIT and BWP Trust being examples. This sector has defied high bond yields in recent times (possibly due to reinvested Westfield proceeds) and a correction is well overdue.

Theme #4 is that China faces real policy conflicts, and these became apparent during the month with a massive Yuan depreciation. From a recent low of 6.27, the USD/CNY has now moved to 6.81. This move has been far larger than those that roiled markets in 2015 and 2016, although Hong Kong's Hang Seng Index is 15% off its January highs and the Shanghai Composite is down 21%.

China's key issue is that their economy is slowing but US monetary policy is tightening. Their quasi-fixed exchange rate means they can either choose to follow higher US interest rates or accept a weaker currency. With Trump's tariffs also being a critical issue, China chose to ease, and the currency has plunged accordingly. The implications of a much weaker Yuan for offshore property purchases, tourism flows and Chinese ability to purchase commodities are obvious. We will continue to play resources from the short-side although we did tactically cover some names during the month on sharp pullbacks.

Theme #5 is that over-bought housing markets are finally beginning to crack. This is most apparent in Australia, with Corelogic data for end-July showing that nationwide prices are -1.6% on a year ago, Melbourne is -0.5% and Sydney is -5.4%. NZ data is not that negative thus far. While prices are down from their peak earlier this year, Quotable Value data shows Auckland is still +0.4% on last year, while wider NZ is +5.1%. However, sales numbers have fallen sharply, and it is a classic end-cycle sign that provincial areas are finally moving after being moribund for years. With a plethora of policy measures yet to hit the market, being underweight retirement village plays is an obvious call. Ryman (RYM) is our largest play here and it has been disappointingly strong from our perspective on the back of sizeable offshore buying. Last in, first out.

Theme #6 is a bullish view that M&A activity will pick up. A M&A boom is a typical late cycle phenomenon as management confuse the cycle with their own brilliance. Despite high overall market valuations, many value stocks and small-mid cap stocks are languishing, funding costs remain very low and private equity funds are flush with cash. The Fund has begun to benefit from this activity in the last few weeks, with competing bids for Gateway (GTY, since exited), a bid for HT&E's (HT1) outdoor business and Evolve Education (EVO) confirming that there is potential corporate interest in their business. As this is being written, there is press speculation of interest in Monash IVF (MVF). Many of our undervalued longs potentially fit the bill from a M&A stand-point and it is a theme that the Fund has tended to do well out of over time.

Returning to the performance of the Fund during July, our return of +1.20% after all fees and expenses was underpinned by a solid "winners to losers" ratio of 56%. Our longs contributed +1.27% while our shorts chipped in with a collective 0.01%. Adding a modicum of value from the short-side was pleasing given that 70% of the Fund is in Australia and that market rose by 1.4%. It reflects an overdue dip in "price momentum" and "growth" names which was particularly notable following disappointing results from the likes of Facebook and Twitter. This benefitted many of our over-priced high beta shorts in Australia, but it was hardly apparent in NZ with the likes of Ryman and Fisher & Paykel Healthcare being largely immune - for now at least.

Incidentally, in a reminder of how one should always challenge the conventional wisdom and not just step aboard the momentum train, 91% of Facebook analysts had a "buy" on it prior to its result and subsequent 21% share price plunge. Interestingly, Facebook is now on a Dec19 consensus PE of 20.3x, which falls to 18.2 times if we adjust for their $52bn of net cash. Without having any great understanding of the company, it does place the 24.7x forward PE for the NZ market in an interesting light.

Contributors

Our stand-out winner was a somewhat eclectic mid-sized long in the PNG banking business Kina Securities (KSL, +17%). They expanded their banking business several years ago with the purchase of Maybank's business in PNG. Maybank's escrowed stake in KSL had been viewed as an overhang ever since. We took the view that KSL was very cheap, and it would bounce when the overhang was dealt with. This indeed happened, and the upside was added to by KSL's low-priced and highly synergistic purchase of ANZ Bank's consumer facing business in PNG. KSL is now on a Dec19 forecast PE of just 6.2x and Dec20 of 4.1x (the first full year of ANZ). The key risk is a devaluation in PNG's managed exchange rate regime but the risks of this may be fading as the resource-rich country looks set to benefit from a LNG boom in the region.

The second largest contributor was a large short in the bumper bar maker, ARB Corporation (ARB, -8%) which appeared on the opposite side of the ledger last month. It is a good little company, but it was beyond us as to what attributes drove it to a forward PE of over 33x at its peak. While Australians do have a love affair with their 4x4's, we see risks as skewed to the downside as Australian car sales slow and rising petrol prices may crimp sales in their key gas-guzzling segments.

A third notable winner was a mid-sized short in the copper producer Sandfire Resources (SFR, -19%). SFR's sharply rising share price had decoupled from a weak copper price and this made little sense to us given that SFR has a limited (albeit highly profitable) mine life and has had little recent exploration success. They delivered a strong result, but weak forward guidance was enough to sink the share price. Given that part of the weak guidance appeared to come from scheduling of a high-grade zone, we used the retracement to cover the position.

Other standouts included a mid-sized short in the ultra-high multiple education provider IDP Education (IEL, -7%) which we have written about at length in prior months. They strike us as somewhat vulnerable to a sharp tightening in work visa conditions for students in NZ and to a debate on immigration in Australia that is beginning to heat up. Finally, a mid-sized and long held long in the fund management holding company Pacific Group (PAC, +8%) did well as they deployed their under-geared balance sheet by buying into the alternatives manager, Victory Park Capital.

Detractors

There were no single-stock disasters during the month, but the largest headwind came from a mid-sized long in the Australian rural services company, Ruralco (RHL, -9%) which fell on the back of the nasty drought in NSW and parts of Queensland. This decline came despite an update from RHL on 11 July which highlighted that their exposure in those states is only modest and is being partially offset by good conditions in WA, SA and Tasmania. RHL's decline accelerated following a particularly poor update from Nufarm, whose crop protection sales in NSW have been hammered. We have not yet added to the holding given that the drought has intensified in the affected areas but RHL is now on a PE of only 10.8x Sep18 year and 9.8x Sep19 year earnings.

The second largest detractor was a small short in Technology One (TNE, +16%) the mid-tier IT software and implementation company. They hopped on board the SaaS bandwagon with a major change in their accounting policies that was required by a new accounting standard IFRS/AASB 15. Rather than booking licence sales annually upfront, they will now account for them on a daily basis. The earnings hit from making this change was offset by a change in policy to capitalise significantly more of their R&D expenses. There has been no change whatsoever in TNE's cashflows, but such is the market's current infatuation with software-as-a-service, it was enough to bump their share price up by 15%. Never mind that TNE is still dependent on large one-off software licence sales and has only a very small component of subscription-type sales. We covered a little as we could see what might happen but will run the rest of the position as TNE's recent underlying performance has been a touch disappointing, making them potentially vulnerable on a PE of circa 30x.

Other detractors were relatively small in magnitude with a good-sized short in Sonic Healthcare (SHL, +6%) being unhelpful. US peers reported weak results and there are ongoing German regulatory headwinds yet SHL is on an undeserved record PE of 23.7x forecast June18 earnings. A large short in National Storage REIT (NSR, +4%) was painful. This highly acquisitive storage company has disappointed somewhat on the earnings front, has a geared balance sheet and is amongst the most expensive of the property companies in Australia/NZ in our relative valuation modelling. We can only put the strength down to the vaguest of corporate activity rumours following a changing of the guard at Abacus, but it seems to us that the returns from organic investment in storage are superior to any bid for a vehicle that is trading well above NTA.

A final headwind came from our large long in QMS Media (QMS, -5%) which has missed out on corporate activity in the sector for now. However, we believe that trading conditions are buoyant, and they are in a prime position to pick up people and contracts from upheaval in the sector. A PE of 14.2x Jun18 earnings strikes us as too cheap given the strong structural growth backdrop, with outdoor media gradually taking over from splintering broadcast TV as the way to reach a mass audience.

Summary

Thank you for your ongoing investment and support of the Fund. The latter phases of this historic bull market have not been an easy comparator for what the Fund is delivering but we will continue to stick to our knitting and aim to churn out positive returns irrespective of market conditions. We would love to be bullish, but the market is on a PE of 25x rather than 15x and it is facing a daunting array of challenges, which we have stepped through in this letter. Timing is in the lap of the gods but expected returns from current levels for many long-only investments are very low indeed. It has been hard work running into the head-wind of this bull market in the last few quarters, but we believe it is beginning to pay off.

Matthew Goodson, CFA