SALT

Salt Long Short Fund Fact Sheet – December 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 December 2021

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$55.5 million
Inception Date	31 October 2014
Portfolio Manager	Matthew Goodson, CFA

Unit Price at 31 December 2021

Application	2.0343
Redemption	2.0261

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 December 2021

Long positions	45
Short positions	31

Exposures at 31 December 2021

Long exposure	97.94%
Short exposure	51.28%
Gross equity exposure	149.22%
Net equity exposure	46.66%

Largest Longs	Largest Shorts
Tower	Arena REIT
Dalrymple Bay Infrastructure	Breville Group
Lynch Group Holdings	Reece
Monash IVF Group	ASX
Emeco Holdings	Goodman Property Trust

Performance[1] at 31 December 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%	0.93%	1.52%	-0.39%	2.62%	20.29%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	3.77%	1.38%	0.13%
6 months	5.83%	2.69%	3.44%
1 year p.a.	20.29%	5.32%	8.20%
2 years p.a.	12.86%	5.36%	9.88%
3 years p.a.	11.90%	5.71%	15.09%
5 years p.a.	7.00%	6.12%	11.97%
7 years p.a.	8.57%	6.56%	11.17%
Since inception p.a.	9.87%	6.69%	11.18%

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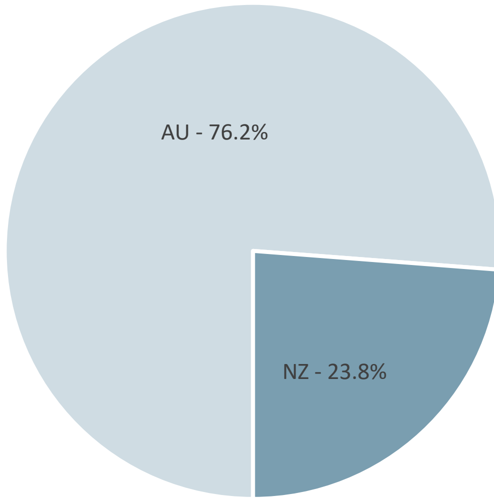
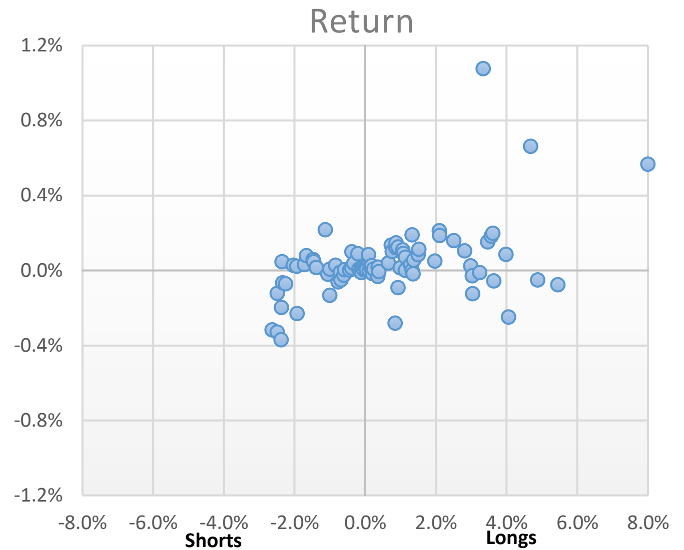
Country Allocation at 31 December 2021 (Gross Equity Exposure)



December 2021 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

The Fund performed strongly in the month of December, with a return after all fees and taxes of +2.62%. This broadly kept up with advances in the long-only NZ equity benchmark of +2.5% and Australia of +2.9% but did so with little correlation and less volatility. Long-only markets benefitted from a late-month surge in high multiple growth stocks which flew in the face of a rise in bond yields which has continued into January.

A major highlight for the Fund during the month was breaking through the $2.00 unit price barrier – those who invested on day one have now doubled their money. There have been a number of peaks and troughs along the journey although their amplitude has been far less than the roller-coaster ride of long-only equities.

The raging bull market since we founded the Fund has obviated its zero-correlation purpose and delivery to some degree but we believe that this lack of correlation will come into its own over the period ahead. The reasons for this Fund's existence are stronger than ever in being a part of a diversified portfolio without any correlation to equities. We are now taking a deep breath and fastening the safety belt as we embark on the long and winding path to a $3.00 unit price.

Calendar 2021 was a record year for the Fund, with the return of 20.3% beating the previous record of 17.2% back in 2015. Pre fees and tax, our long book added circa 23.8%, while our short book detracted -2.8%. NZ long-only equity markets fell by -0.4% and Australia rose by +17.2%. With the fund being roughly 35/65 in NZ/Australia over the year, we are pleased with the performance of each side of our strategy.

We had a number of major successes from the likes of Graincorp, Turners, Australian Vintage, Intega Group, Virtus Healthcare, OFX Group, Pacific Edge, Ryman (short) and others. However, we are not entering 2022 with a range of stale positions that have already played out. We have moved on from some of our winners and some of our larger longs are still to be discovered. Key names that we have high hopes for include Tower, Emeco Holdings, Dalrymple Bay Infrastructure, Lynch Group et al. They are all very cheap relative to their growth outlooks and should have macro and/or company specific tailwinds in 2022.

While we are greatly looking forward to 2022, it may be a little hopeful to expect a repetition of last year's returns. They are certainly possible but our benchmark is OCR +5% and we would be delighted to beat that with a moderate margin on top. We think a return in the 7%-10% range would prove highly satisfactory against a backdrop of markedly tighter monetary policy that creates a far more volatile and complex environment for long-only equities. We expect a zero-correlation asset such as this Fund to be very useful in 2022.

For some years now, we have used our December newsletter to examine what we believe will be the key investment themes for the year ahead and also consider some left-field possibilities.

Inflation Will Peak But Stay Above Central Bank Targets

We have spent most of 2021 arguing that inflation pressure is breaking out everywhere and that central banks in western countries are hopelessly behind the curve. They are slowly beginning to stir from their somnolence but the evidence for this view remains compelling in NZ and overseas.

We have recited numerous examples in recent months and they show no signs of slowing. The NY Fed one-year ahead inflation expectations measure hit a staggering 6% mid-month. US headline inflation in November was +6.8% YoY, the highest since 1982. Core measures were strong too.

The RBNZ's own household survey of inflation expectations for the December quarter saw median 1-year ahead inflation expectations at 4.0% (was 2.2% in Dec20), while 5-year expectations soared to 5.0% (was 3.0%).

The argument as to whether inflation is transitory is largely over although we do have some sympathy with the view that supply chain blockages will ease as economies open up and countries begin to treat Covid-19 as no more than another endemic disease. However, there are two problems with the fairy-tale ending that current shortages will flip into being gluts and that low inflation will live happily ever after.

The first is that inflation expectations have soared and will become embedded into wage inflation, which with labour being 70% of the cost of everything, will lead to price inflation and before we know it, some form of a wage/price spiral. The second issue is that even if price pressures prove partially transitory, that will still be enough to have inflation at/above the top-end of target ranges. For the last decade or two, NZ has experienced tradeable inflation of 0% and non-tradeable inflation in the low 3% range. Zero percent tradeable inflation will never return, while non-tradeable inflation is creeping ever higher.

Central banks have lost control, they need to tighten and they are finally beginning to realise this. Which brings us to the hoariest but truest cliché in finance….

Do Not Fight The Fed

The FOMC Minutes released on Jan 6 pretty much said it all, "Participants generally noted that, given their individual outlooks for the economy, the labour market, and inflation, it may become warranted to increase the federal funds rate sooner or at a faster pace than participants had earlier anticipated….some participants also noted that it could be appropriate to begin to reduce the size of the Federal Reserve's balance sheet relatively soon after beginning to raise the federal funds rate."

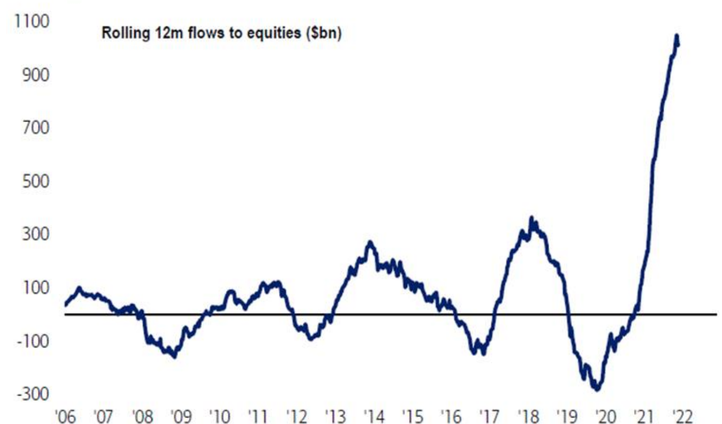
So, 2022 will not just see several rate hikes but it may also see the beginnings of Quantitative Tightening (QT). The last time the Fed tried QT was in 2018 and resulted in the mother of all equity market dummy-spits in 4Q18, with the S&P500 falling by -19.9%. It subsequently regained that ground as the Fed backed off in the face of this reaction and relatively subdued inflation outcomes.

Analysis of that episode by the Council On Foreign Relations found that an average of US$24bn/month of QT in the year to Oct18 was equivalent to 0.68% of policy rate hikes and lifted long bond yields by 0.17%. This suggests a higher and flatter yield curve if QT resumes.

Another way of thinking about how far monetary policy may tighten is to consider the Taylor Rule, which until its abandonment in the Bernanke era, modelled central bank rate-setting rather well. The Rule says that the policy rate is a function of the natural real interest rate, the gap between actual and targeted inflation and the output gap. John Taylor wrote a prescient article in Project Syndicate in June titled "Is The Fed Getting Burned Again". He argued that his Rule implies a 5% policy rate and that the Fed should hurry up and get there. Inflation has only risen and the output gap has tightened in the months since then. For example, the 4-week average of US jobless claims just hit its lowest level since 1969, when the population was far smaller.

This coming sea-change in central bank activity will really matter as ultra-loose monetary policy has been a key driver of financial and property markets. Record negative real yields have "forced" investors into all sorts of weird and wonderful positions. If the chart below does not scare you as to what might happen when the monetary punchbowl is removed, then nothing will.

Chart 4: $1.0tn to stocks in '21
Rolling 12 month flows to equities



Source: BofA Global Investment Strategy, EPFR

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The RBA Will Have To U-Turn

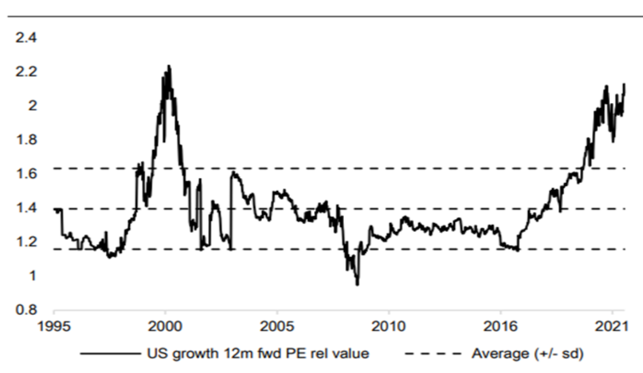
After initially being late to the easing party, the RBA experienced a "road to Damascus" conversion in 2020 and is now perhaps rivalling the ECB as being the most dovish central bank in the world. They are continuing to run a cash rate target of 0.1% and are eviscerating their credibility by continuing to suggest that they will maintain this for another three years. Moreover, they are continuing their merry money-printing, with QE running at $4bn per week although they will at least review this in February.

This all seems so 2020 and ignores the reality of the same inflation pressures and disappearing output gaps that are being faced by every other economy.

If we are correct and the RBA reverses course, this will have significant implications for what works in the Australian equity market, where 60-70% of this Fund is typically invested. Price momentum has been a massive performance factor in that market but we suspect that valuation may matter more in a rising rate environment. We are short the growth darlings and the most extended of the Australian property stocks, while being long a range of special situations and cheap cyclicals.

Value/Cyclicals Will Outperform Growth

We are cheating slightly with this one as we have had a helpful head-start in the first few days of January but we have argued this for some time and believe it continues. Growth has trounced value as a style for the last few years, with zero interest rates favouring long duration securities. Interestingly though, the price performance of growth stocks relative to value has far exceeded their relative earnings upgrades. This has left growth unusually expensive relative to value, meaning they are very vulnerable to a reversal in the discount rate declines that have driven them. The chart below applies to the US market but it is also very much the case from material we have seen for Australia.



Quality Stocks May Also Lag In 2022

As we argued earlier in 2021, who doesn't like a stock with a high ROIC, strong and stable margins and good re-investment opportunities? However, if it were that easy, these stocks would outperform always and everywhere and their valuation multiples would tend to infinity. That is simply not the case. They have had a remarkably good few years but this need not repeat.

Such stocks are very attractive in a mixed economic environment because they tend to hit their earnings numbers whereas other companies struggle. However, this dependability isn't as valuable in a cyclical upswing when the financial and operating leverage of lesser quality names comes through. At the same time, falling bond yields and a dearth of other solid investment opportunities in recent years mean it has made sense to pay ever higher multiples for the earnings that quality names generate. The problem is that a 40x PE is now the old 20x and if we enter a period of higher bond yields, the multiple attached to these companies may contract.

The NZ Housing Bubble Finally Starts Deflating

NZ housing is truly world-leading – in terms of nominal price increases, real price increases, price/rent ratios and price/income ratios. We have become so inured to our bubble that it seems normal and that it will never end. It will.

We are building more than 40k housing units per year when we need 20-25k (remember people squeeze up when house prices and rents rocket); immigration has ceased thanks to Covid and may be matched by emigration when fortress NZ eventually opens again; mortgage rates are rising rapidly and have further to go, with the benchmark 3-year swap rate having risen from 0% in Nov20 to 2.5% today; 40% of all NZ households will have to refinance their mortgage in the next 6 months and 70% in the next year.

Bulls will argue that house prices cannot fall because land prices, building material costs and tradesperson costs have skyrocketed. The problem is that each of these inputs is highly cyclical and may fall just as fast when the downturn hits. The storm clouds are gathering already, with Barfoot auction clearance rates having plunged to less than one-third and sales inventory starting to rise quite quickly. We are again short the retirement village sector.

China – Iron Ore Prices Fall

We cannot pretend to understand all the swings and roundabouts of the Chinese housing market and the downfall of Evergrande, which is spreading to Shimao as this is written.

However, it does seem that this is a policy-induced situation due to concern at the risks posed by the sheer size of the residential property sector and its enormous prices increases. The dictum that houses are for living in rather than speculating on is being taken seriously.

The obvious implication for Australia is iron ore demand and prices. Yes, iron ore has fallen from the unprecedented $200-$220/t peak back in mid-2020 but it is still at $120/t, which in times past would have been regarded as a high price. There seems little reason why it won't revert back to cost curve support in the $50-70 region, especially when one considers near record-high China iron ore inventories below. Recovering Brazilian production may add to this.

We have re-shorted Fortescue into its rally of the last few days to play this view.

ESG stocks outperform again

As an investment house, Salt has dramatically enhanced its focus on ESG issues over the last several years and has integrated this into our portfolios. This Fund is at the lower end of our ESG product continuum but it is still an important factor in our decision-making. For example, we have long exited a former holding in Aurizon (AZJ), which looks a very cheap infrastructure play but which will face ever diminishing demand to transport thermal coal as domestic power plants close. Conversely, we remain long Dalrymple Bay Infrastructure (DBI), which has a much-longer dated future from its focus on coking coal exports and which has a credible long term transition plan, enhanced by its location in a formally designated renewable energy hub.

There is significant data documenting the general outperformance of ESG strategies over the last several years. We suspect part of this is the sheer weight of money crowding into the same names, with the epitome being the absurd spike in Contact Energy and Meridian Energy last year thanks to a clean energy index fund. However, we also believe that a portion of the ESG stock outperformance is rational as the operating horizon for many dirty industries is rapidly shortening.

It is hardly a unique insight but we do expect high-scoring ESG stocks to again outperform in 2022.

The Non-Fungible Token Mania implodes

Think of NFT's as postage stamps or art or bottles of burgundy. They are nothing more than digital collectibles and there is a long, storied history of collectibles prices exploding higher when money is easy and collapsing when money tightens. As this is being written, GameStop is soaring 36% after-hours on reports that it is starting a NFT unit to develop a marketplace for the tokens as well as creating crypto partnerships, blah blah blah…. If only there was a listed NFT entity in Australia or NZ that we could short.

Left-Field Risk - The Lithium Boom Fades

We missed one of the great investment opportunities of 2021 by standing aside from the lithium mining boom, with billion-dollar market caps proliferating faster than unicorns at a San Francisco frat party. In fact, we somehow made modest profits by twice shorting and quickly covering the correlated Lynas (LYC), which had the temerity to advance by 155%.

The thesis to buy lithium stocks is obvious. Supply is expanding but it cannot keep up with an exponential explosion in demand for lithium-ion batteries for transportation and for electricity storage. If technology stood still in a time-warp, then this could still be the opportunity of a lifetime – or it could be like investing in railway stocks in the late 1800s.

What we see is an extraordinary amount of research being carried out into different battery chemistries and solid-state batteries. Lithium-ion technology is old. We do not have the faintest idea what battery technology will dominate in 5 to 10 years' time. In recent weeks alone, advances in sodium-ion batteries have seen them rival lithium-ion in a laboratory environment. The investment problem is that most lithium mines are slated to operate for many decades – hope they're still needed from 2030 onwards. At some point the market will focus on this risk and the sector will be a wonderful short. This is a very dangerous trade to be early but if we see the sector continue to rocket as contrary evidence emerges, we will look to implement it. We throw it out there as a left-field risk for 2022 and 2023.

Fund Performance in December

Returning to the Fund's performance and positioning in the month of December, our net length fell quite sharply from

50.5% to 46.6%. Around 2% of this came from the Intega takeover being paid out but we would highlight that almost 3% is a long in Virtus (VRT) which has received a conditional bid from private equity.

In risk-adjusted terms, we very much feel as though we are currently net short and that was certainly how the Fund performed in December. There were 9 down-days in the month for the 50/50 index of Australia and NZ, with the average loss for the market being -0.36% on those days. The Fund was up on 7 of those 9 days and delivered an average return on them of a strong +0.41%. Unusually, we were fractionally down overall on up-days for the market.

This negative correlation with equities has continued in the volatile early trading days of January, with the Fund pleasingly performing well thanks to being short the implosion of lesser quality growth stocks. We have used this to cover off a little of our exposure but do see the rapid change in monetary policy expectations as heralding the beginning of the end for overpriced growth darlings. I am having flashbacks to March 2000, when many of the portfolio managers driving the space at the moment were still in primary school. As just one example, we immediately and profitably shorted Megaport (MP1) when it was picked by a growth manager at the Sohn Hearts and Minds conference as our feedback has been that their website traffic growth has slowed quite sharply.

The Fund's performance in December of circa +3.0% (pre fees and tax) was comprised of exceptional +4.2% gains from our long book offset by a steady headwind of -1.2% from our short book as a number of the growth darlings ground higher. Our overall "winners to losers" ratio was a rock-solid 61%, with a couple of particularly sizeable gains from our longs.

The largest winner by some distance was a large holding we had built up in Virtus Healthcare (VRT, +28.8%), the IVF treatment provider. From a peak of $7.00 in August, it had been slammed down to $5.00 in October and November for reasons that made no sense. Yes, the ACCC was blocking their acquisition of the small Healius IVF business and VRT had raised equity at $6.80 to pay for it. However, at the $5 level, this left VRT on a PE of 10x, a solid 8-10% EPS growth outlook, an ungeared balance sheet that could be invested to grow more rapidly and steady tailwinds from demand growth in the Covid era. This ticked all our boxes and private equity agreed with what we view as an under-priced conditional bid.

Closely related to this, our second stand-out winner was our large, long-held position in Monash IVF (MVF, +14.1%) which rose on the coattails of the Virtus bid. When we initiated the position in MVF, it had all the same virtues that we have just described for VRT. It has now re-rated somewhat to a forward PE of 15.5x but has a solid growth outlook which their pristine balance sheet has the ability to enhance with organic and inorganic investments. Nothing may ever happen but MVF would also tick all the acquisition metrics for private equity.

Our third large tailwind came from our old friend Tower (TWR, +7.4%), which continued to rise following the plans it announced in late-November for a capital return in early 2022. We believe they have had a strong start to their Sep22 financial year thanks to an absence thus far of floods and storms. Their reinsurance arrangements see them take the first $20m (pre-tax) hit from large claim events before reinsurance kicks in. They have hit this limit for several years in a row, so the market seems to assume that will be the case every year. The reality is that there have been some years with almost no large claims and TWR should really be valued on a long-term average. This is fairly material in the context of forecast NPAT of $22m. TWR's short duration investment book also means they are a rare beneficiary of a higher OCR.

Our main detractors were generally a lot smaller than our contributors, with the worst of them being prematurely reinstating a short position in Reece (REH, +15.4%). We made strong returns earlier in 2021 when it fell from $25 to $18 following a mediocre in-line result but it has now inexplicably rallied to as high as $28. As a reminder, REH is a quality but moderately growing plumbing retailer that is now on a forward PE of 50x. Every price momentum fund in Christendom must be full of it. The Australian and US housing cycles may be getting close to peaking and we eagerly await the market's reaction to another in-line result.

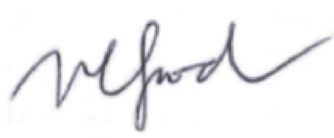
The second headwind of note came from a short we have built up in Arena REIT (ARF, +11.2%). ARF is an internally managed owner of childcare facilities. It ranks at the bottom of our property valuation model. It has benefitted from rapidly contracting cap rates as private investors have found buying a childcare asset for 4.5% is preferable to having money in the bank. Never mind rates, insurance and maintenance and the fact that replacement values are seeing plenty of supply come on in a sector with few entry barriers. Despite all this, ARF has risen to a 70% premium to its much-upgraded asset value. Yes, there may be one more turn of cap rate driven upgrades to come but index inclusions have driven the share price to ludicrous levels.

A final notable headwind came from our short in the exceptionally expensive Johns Lyng (JLG, +22.7%), who used their PE of 50x to buy a US business on an EV/EBITDA of 8x. These roll-ups that use their excessive public multiples to buy

"cheap" private business often seems to end in tears as it turns out that the "cheap" private multiple is actually the correct one. We covered some of our short as we could see what the short-term market reaction would be and will trade it from here.

Thank you for your continued support of the Fund. We think 2022 will be a very different year for equity investors and not provide the easy returns to which we have all become accustomed. Monetary policy is finally beginning to respond to higher inflation and it is a futile strategy to fight the Fed. We are long special situations and cheap cyclicals, while we are short the growth darlings and overpriced income stocks that should suffer in the new paradigm.

We would be delighted to repeat the 20%+ returns of 2021 but would not bet the house on this recurring. We are focused on achieving our benchmark of OCR+5% and doing so in a manner that is both uncorrelated to long-only equities and is far less volatile than them. This Fund has delivered on that mission for over 7 years, which shows the valuable role it plays as an alternative asset in a diversified portfolio. It may be particularly valuable in 2022.



Matthew Goodson

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