SALT

Salt Long Short Fund Fact Sheet – March 2023

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 31 March 2023

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$70 million
Inception Date	31 December 2014
Portfolio Manager	Matthew Goodson, CFA

Unit Price at 31 March 2023

Application	2.2214
Redemption	2.2124

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 March 2023

Long positions	49
Short positions	33

Exposures at 31 March 2023

Long exposure	90.19%
Short exposure	43.44%
Gross equity exposure	133.63%
Net equity exposure	46.76%

Investment Risk to 31 March 2023

Fund volatility[1]	6.40%
NZ50G / ASX200AI volatility[1]	13.92%
NZ50G / ASX200AI correlation	0.080

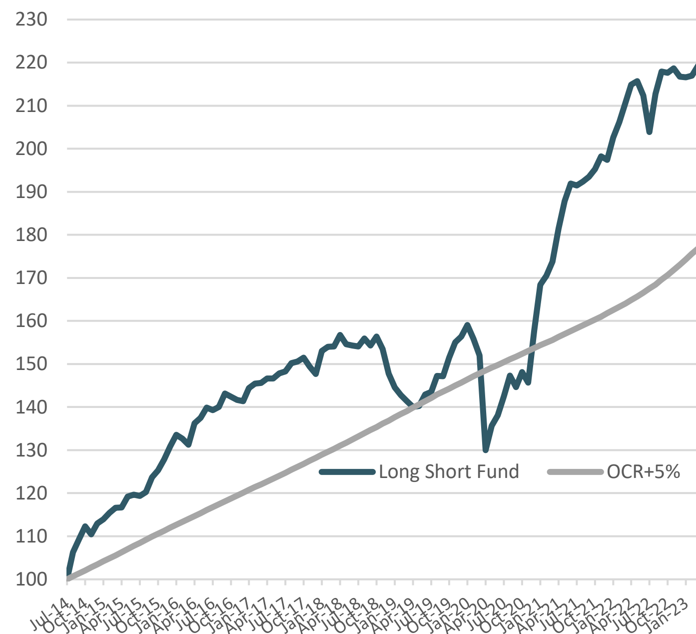
1. Annualised standard deviation since fund inception.

Fund Performance[2] to 31 March 2023

Period	Fund Return	OCR+5% Return	NZ50G/ASX 200AI Return[3]
1 month	0.90%	0.69%	-0.12%
3 months	2.16%	2.21%	3.54%
6 months	1.67%	4.27%	10.32%
1-year p.a.	2.95%	7.79%	-0.91%
2 years p.a.	10.42%	6.61%	2.20%
3 years p.a.	19.39%	6.15%	12.18%
5 years p.a.	7.13%	6.30%	8.31%
7 years p.a.	7.17%	6.47%	9.12%
Inception p.a.	9.50%	6.80%	9.08%

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 31 March 2023



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	Reece
GDI Property Group	Ebos Group
Global Data Centre Group	Stockland Ltd
Monash IVF Group	Auckland International Airport
Kina Securities	REA Group

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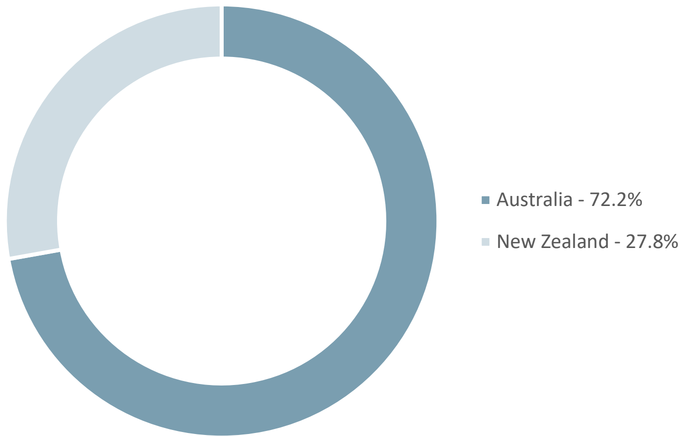
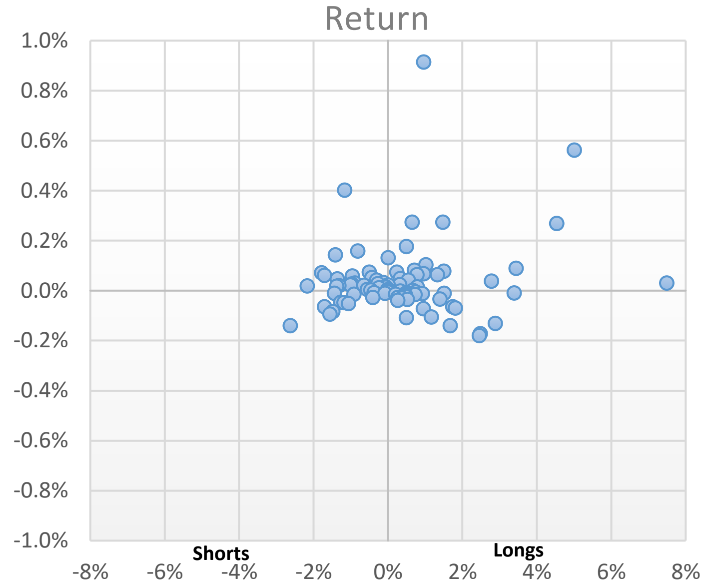
Country Allocation at 31 March 2023 (Gross Equity Exposure)



March 2023 Individual Stock Contribution



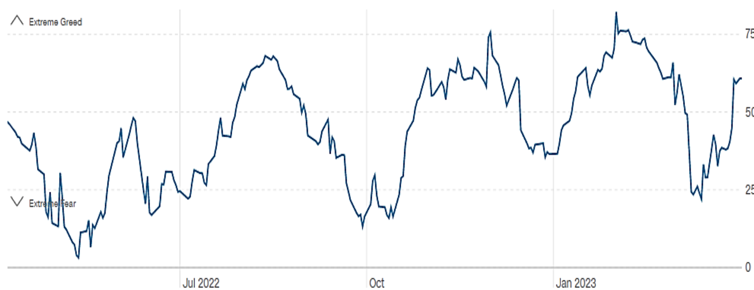
Fund Commentary

Dear Fellow Investor,

The Fund delivered a solid return of +0.90% in the month of March, which compared well against slightly negative returns from the NZ (-0.1%) and Australian (-0.2%) equity markets.

These seemingly somnolent outcomes from long-only markets concealed a month of considerable volatility amongst the mayhem of bank failures in the US. NZ closed near its highs after being down as much as -3.5% and similarly Australia had been down as much as -4.1%. Our Fund's far lesser volatility can be very valuable to a diversified portfolio in such times.

March saw a veritable roller-coaster of investing emotions. As shown below by the CNN Fear & Greed Index, it began with a reading of 66 on March 1, which was near "extreme greed", plunged to as low as 22 on March 15, which was firmly in "extreme fear" territory and ended the month back at 60, which was back in the "greed" zone.



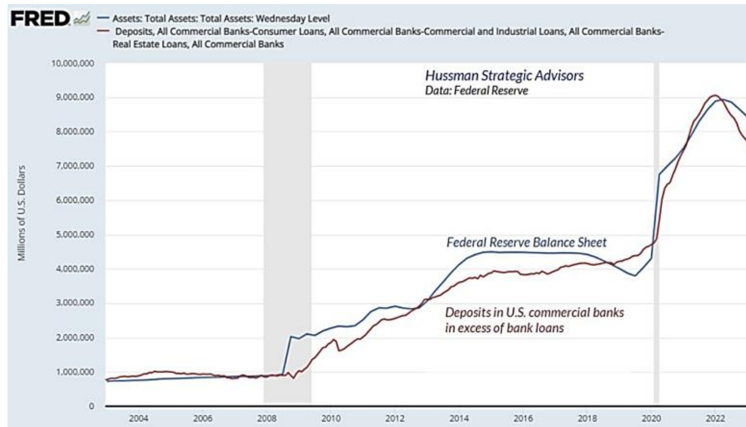
The drive of this sentiment roller-coaster was of course the sudden crop of bank failures in the US market, with Silicon Valley Bank and Signature Bank being quickly closed down by the FDIC and their assets fire-sold off. What happened? As in the case of many insolvency situations, the failures seem to have been a case of happening slowly and then suddenly.

The seeds of disaster trace back a combination of regulatory failure coinciding with years of ultra-loose monetary policy creating a disastrous reach for yield. In a time of zero/negative rates, SVB reached for yield by taking their callable deposits and investing in long duration securities. An unusually high proportion of these deposits came from tech companies, were over $250k and thus were uninsured. This didn't matter for a long period of time, as SVG carried on merrily.

As interest rates rose, the mark-to-market losses on long term bonds didn't need to be recognised as they were classed as "held-to-maturity". Eventually though, some depositors began to notice that these theoretical mark-to-market losses exceeded SVB's equity capital. So, as an uninsured depositor you would be foolish not to withdraw. This very act of withdrawal meant that SVB couldn't hold their securities to maturity, so they had to sell and realise sizeable losses. The trickle of deposits out the door became a flood and it was game over.

The regulatory failure aspect of this was how on earth was SVB ever allowed to hold such a duration mismatch? In Australia/NZ, such a mis-match requires more capital to be held, which acts as a natural counter-balance to the temptation to reach for yield.

We have bemoaned for years that ultra-loose monetary policy has generated a vast carry-trade across many different assets. SVB and Signature Bank were merely the penny-pickers who lingered too long and were summarily dealt with by the steam-roller. The chart below shows how central banks must bear significant blame for creating this penny-picking temptation.



The surge in the Fed's balance sheet was accompanied almost dollar-for-dollar by a surge in bank deposits in excess of commercial loans. The system was bloated with excess deposits, many of which were uninsured. The money was not lent to the real economy, it inevitably leaked out across financial markets in a search for yield, with consequences that are now playing out.

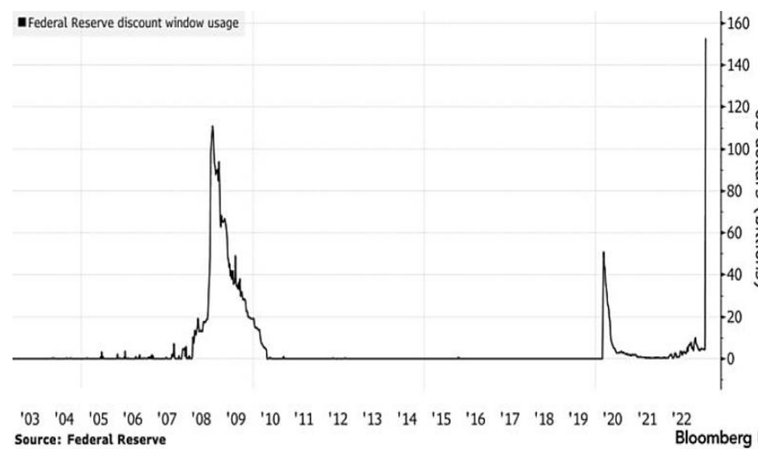
What contagion effects might play out from here? There are some obvious first-round impacts such as on the tech companies funded by SVB and the effect on US commercial property markets. Signature Bank was 12% of total commercial real estate lending in the New York City area plus there has been a more general flight to safety as deposits leave smaller banks and move to "too big to fail" institutions. In the US market, smaller banks are major CRE funders. US real estate markets have been weak for very good reason.

The second-round impact is a move out in credit spreads. SVB had $72bn in assets that were sold at 77 cents in the dollar, with this including $13bn of direct and securitised real estate exposures. Investors are now not quite sure which banks are completely solid and which aren't and which companies' funding lines could be subject to risk.

The bigger picture impact that we see is that all carry trades are coming under increasing pressure in a world of sharply higher short term interest rates. In NZ, we see this particularly manifesting itself in unlisted property syndicates, which we suspect are entering a world of pain as funding costs rise, cap rates expand and vacancy becomes a risk as the economy slows. Globally, several major unlisted property funds such as those run by Blackrock and Starwood have large redemption queues and we would not be surprised if this starts to spill over to general private equity in reasonably short order. You would be mad not to get out at prices that have not yet been marked to market. Massive leverage funded by cheap debt is so 2021….

The final elements of contagion from the relatively well-contained failures of SVB and Signature is the great gusher of credit provided by the Fed to stop any contagion to other commercial banks. In short, they opened their discount window and they put a new BTFP facility in place to allow commercial banks to borrow cash using bonds as collateral at their original face value.

JP Morgan estimated that via several methods, the Fed injected $440bn of reserves into the US banking system in just one week, which reversed a third of the $1.3trn of gradual reserve tightening since the end of 2021. The extreme short-term use of the discount window to generate cash to re-pay depositors is shown in the rather sobering chart from Bloomberg below.



While it is hard to link the amorphous concept of "liquidity" directly to equity market performance, our read on the above is that financial conditions tightened massively post the bank failures in mid-March and then loosened just as massively as the Fed took action over the rest of the month. Global equities rallied sharply off their lows, US 10-year yields rallied from 3.95% to 3.57%, and sentiment swung from "greed" to

"extreme fear" back to "greed" again. The bank failures and rapid Fed action created a giant whip-saw effect.

The Fed responded aggressively to deal with contagion risks caused by sudden bank collapses. Nothing from this should be inferred regarding the bigger picture of persistent inflation pressures still requiring an extended period of tight monetary policy, which may potentially drive a recession. The temporary gush of credit in late-March may well prove to be a head-fake for investors and you should not "fight the Fed".

Our macro view remains very much unchanged. Inflation has peaked in most countries and goods inflation is showing some welcome signs of receding. However, services inflation is proving slower to decline as spillovers into wage inflation are driving a wage-price feedback loop in an era of structurally low unemployment. This means short term interest rates may be close to their peak in most countries but any optimism about early rate cuts should be put back firmly in the drawer.

Evidence in March continued to build for our thesis. The US PCE deflator, the Fed's favourite price measure, came in as expected at 4.6% versus a peak of 5.3%. While the goods PCE pulled back nicely to +3.6% YoY, services inflation remained worryingly high at +5.7%. Wage inflation shows no real signs of coming back down to earth.

Even amidst the turmoil of major bank collapses in the US and Credit Suisse being forcibly merged into UBS, the ECB lifted their rate target by 50bp, commenting that "inflation is too high for too long".

The NZ picture is similar. Survey data shows firms' cost expectations and pricing intentions are inching lower but doing so at a glacial pace and remain far too high relative to the RBNZ's 0%-3% inflation target. In the latest ANZ Business Outlook, a staggering 86.4% (was 88.3%) of firms still expect costs to rise over the year ahead and 56.8% expect to lift prices (was 58.8%). The masterminds running NZ economic policy are hardly helping matters with their 7% minimum wage increase, which will ripple right through relative wage settings – one almost feels sorry for Adrian Orr and the RBNZ – almost.

Our clear view remains that monetary policy will stay tighter for longer across much of the Western world. This requires a cautious and selective view towards long-only equities, particularly towards companies dependent on the great carry-trade of the last few years. On top of this, black clouds are building in terms of potential recession and earnings risks. The Fund is mid-40% net long but the names we own tend to be somewhat unique and have their own particular drivers, rather than being high beta plays that lurch up and down with the market.

<u>Fund Performance in March</u>

Returning to the Fund's performance in the month of March, the overall return of circa +1.0% pre fees and tax was composed of positive contributions from both our long book (+0.45%) and our short book (+0.55%). The former was pleasing in a slightly negative and volatile month for markets. Our "winners to losers" ratio was a relatively average 55% but our large winners were a little bigger than our large losers.

We have been running the Fund at unusually low levels of risk exposure for a number of months but this began to change in March as we took advantage of the opportunities delivered by volatility to lift our gross from 120.4% to a more normal 133.6% and our net length rose from 40% to 47%. This is still near-enough to market neutral given the nature of our longs relative to our shorts.

The 50/50 index of Australia and NZ had a relatively high 10 down-days in March, with an average return on them of -0.59%. We did not do as well as normal on these days, being up on only four of them and having an average return of -0.06%. As it happened, we did a little better than normal this month on up-days, which is a reminder than having no correlation to markets truly means having no correlation. When the market is down, we may be up, down or flat. Likewise when the market is up. That is the point of a market-neutral long-short fund.

The largest positive by some distance was the medium-sized long we had built in the last several months in United Malt Group (UMG, +33.1%). We had bought the stock on the basis that their share price had fallen back from recent highs; their issues with surging barley costs were in the past thanks to a good growing season in Canada; huge hikes in shipping costs were beginning to abate; and the demand backdrop for high-quality malt was continuing to improve thanks to growth in high-end craft beers and whiskies. In the background, we were aware of the occasional past press murmur of private equity interest in UMG given that it operates in a concentrated global industry structure and generates good free cash-flows. As it happened, they received a bid from a large French operator, who will be a good geographic fit. Sometimes, you make your luck by playing in the right places.

The second key winner was the large long we have had for some time in Global Data Centres (GDC, +10.8%). We have

argued that GDC is being valued by the listed market at around half the NTA of their collection of data centre assets, with the discount being even greater if a true market value was assigned to their stake in Airtrunk. They are sub-scale and with no market rating, they have no ability to issue equity and grow. The last straw for us came when the European pension fund, Eurazeo invested in their European assets in February at a price that franked their NTA and the investment dramatically lowered GDC's leverage. The market responded with a yawn.

We have formally written to the RE and the Manager requesting a strategic review, with potential outcomes including a full sale. Since then, there has been considerable and helpful change in the share register with special situation investors Sandon and Samuel Terry becoming SSH's. At some point, this long-suffering investment will pay off.

The third notable tailwind came from our moderate short position in The Warehouse (WHS, -30.2%). Their result was very weak and featured a falling gross profit margin which is now alarmingly close to their ever-rising cost of doing business. This is happening at a time when they are carrying reasonable levels of bank debt and large lease liabilities. They have committed to head office cost-cutting but to us they need to cut far further and shed loss-making businesses such as Torpedo 7 and The Market. We are gradually covering into weakness.

There were a variety of other solid winners for the Fund. Our highly successful investment in the super-computing company, Dug Technology (DUG, +16.2%) continued to go from strength to strength and we remain committed holders. They have a huge market opportunity in the area of geophysics processing in particular and they are a great home-spun success story for the two key people who originally left BHP some years ago.

Our gold holdings all did well in a strong month for the only currency that a central bank can't print. Collectively, they added +0.43% to performance, with the stand-out being our position in Resolute Limited (RSG, +71.4%). We exited two of our four names (including RSG) as we do not have a strong view on where the gold price goes from here, especially if rising real yields lift the opportunity cost of owning gold.

The biggest negative was our relatively large, long-held position in Australian Vintage (AVG, -11.8%). They are under the pump from consumer weakness in their key UK market and they are also suffering from extremely high contracted shipping costs which are yet to roll off onto much lower spot rates. To rub salt into the wound, the UK resumed inflation-indexing the wine excise tax which will lift wine prices by about 10% on average. We still see hope for AVG as it is very cheap, it is the global leader in low/no alcohol wine, their strategy to premiumise continues to work well, the AUD/GBP has moved in a more favourable direction and future shipping costs will fall sharply.

Another large detractor was a repeat offender in the holding we have built up in the Australian telco, Superloop (SLC, -14.5%). This has been a poor investment thus far and the market seems focused on the razor-sharp competition in re-selling NBN services. Our simple thesis is that SLC has an edge as they move customers onto their own network and most noise around the NBN seems to be that its pricing will rise. SLC's balance sheet is solid and they are on a clear multi-year path to strong free cashflows.

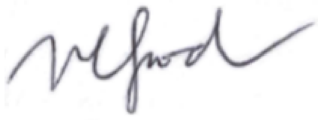
A third stand-out headwind came from our high conviction holding in GDI Property (GDI, -7.7%), which has not done well for us so far. During March there was a very surprising announcement that the long-standing MD, Steve Gillard was leaving with immediate effect. The explanation was sparse other than that the vesting of employment rights showed he was a "good leaver". We have our own thoughts as to what may have happened, and we are not going to speculate here but we believe they are unrelated to the value and performance of GDI as a vehicle. GDI remains extremely cheap, with positive exposure to the best office market in Australia – Perth, whose economy and population is growing strongly.

Other more modest detractors were led by a random share price reversal in Lynch Group (LGL, -5.6%), which had risen by +11.6% in the prior month. Our high-multiple shorts in REA Group (REA, +12.3%) and Reece (REH, +4.9%) hurt somewhat and a new long in the hard-hit Omni Bridgeway (OBL, -12.2%) was bought a little early although it did turn up sharply off its lows.

Thank you for your continued support of the Fund. We are pleased to have delivered another positive month against a background of highly volatile equity markets. The March quarter was bizarrely strong for a number of markets despite bank failures, sticky inflation, continued war, recession fears mounting in many countries and central banks tightening further. That said, performance across the globe tended to be extremely narrow, with many stocks struggling.

As ever, this Fund will stick to its knitting and seek to grind out positive returns irrespective of the fortunes of long-only

equities. Our view remains “Don’t Fight The Fed” and we continue to believe that interest rates may be close to peaking but there will be an extended plateau with no early easing. Equities may be volatile as this plays out and the reality of recessionary pressures begins to weigh ever more on earnings forecasts.



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