Salt Long Short Fund Fact Sheet – December 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 December 2020

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$49.7 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 December 2020

Application	1.6912
Redemption	1.6843

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 2020

Long positions	49
Short positions	30

Exposures at 31 December 2020

Long exposure	97.72%
Short exposure	41.32%
Gross equity exposure	139.03%
Net equity exposure	56.40%

Largest Longs	Largest Shorts
Tower	Premier Investments
Marsden Maritime Holdings	Wisetech Global
Shaver Shop Group	Property For Industry
Vitalharvest Freehold Trust	Commonwealth Bank
Spark NZ	Xero

Performance[1] at 31 December 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%	-1.81%	2.41%	-1.67%	8.31%	6.76%	5.88%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	13.71%	1.30%	9.41%
6 months	18.21%	2.61%	18.02%
1 year p.a.	5.88%	5.40%	9.21%
2 years p.a.	7.93%	5.90%	17.54%
3 years p.a.	4.48%	6.38%	12.16%
5 years p.a.	4.75%	6.49%	10.82%
Since inception p.a.	8.35%	6.90%	11.48%

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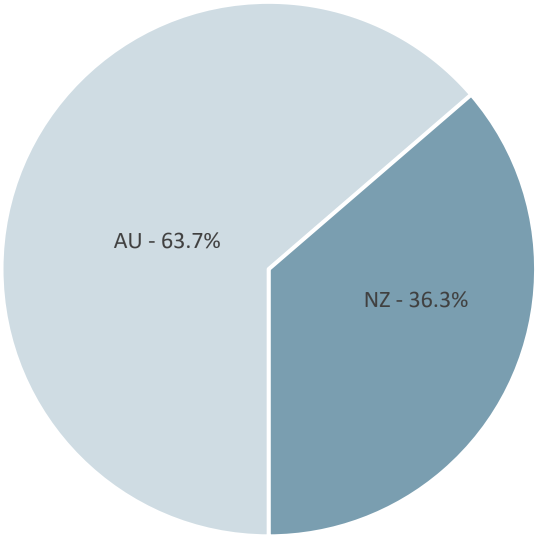
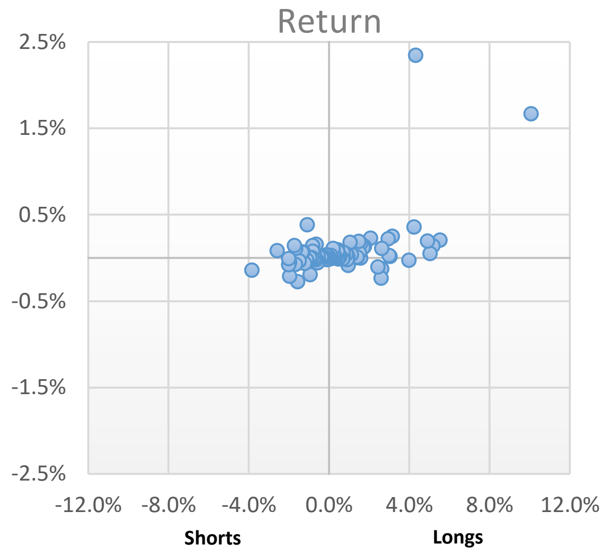
Country Allocation at 31 December 2020 (Gross Equity Exposure)



December 2020 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

Following on from November's record performance of +8.31%, we are pleased to report that December was another outstanding month for the Fund, with a return of +6.76%.

Stock selection was again extremely strong from both sides of the ledger, factor performance wasn't the headwind that it had been earlier in the year and we continued to run net length in the mid-50% region. This limited the headwinds from the short side against a generally strong market backdrop.

While the net length of +56.6% may appear very long, we are not simply riding a rising equity market while masquerading as a long-short fund. Firstly, 8% of the net length comes from quasi-cash positions in Vitalharvest (VTH, under takeover) and 360 Capital Total Return (TOT, a cashbox at a large discount).

Secondly, about 8% of the net length comes from longs in other real estate stocks and another 5% comes from Spark. This has been a winning strategy given the outperformance of TINA stocks (there is no alternative) in the frantic quest for yield at any price but we are starting to trim these names and will likely continue to do so in the weeks ahead. As we discuss shortly, while TINA stocks largely ignored the moderate rise in bond yields in late 2020, we think yields may rise further in 2021 and these stocks will underperform.

Thirdly, we continue to keep a close eye on how we are performing on negative days. It is important that we fall by less than the market and preferably rise when there is a sell-off. This continued to be the case in December. There were nine down-days for the 50/50 index of Australia and NZ, with an average return on those days of -0.49%. The Fund was up on eight of those nine days and delivered an average return of +0.32%. Interestingly, our average return on the eleven up-days in the month was a very similar +0.35%.

This is clear evidence that the Fund is continuing to deliver returns that are truly uncorrelated to equities. What really matters for the Fund is stock selection and relative factor performance (e.g., growth, value, momentum) versus how the Fund is positioned. Over time, we are providing equity-like returns with no correlation to equities. That may seem merely interesting given the backdrop of a raging bull market but it will really matter to have alternative sources of return in your portfolio when the bull market eventually but inevitably ends. Perhaps that will be in 2021.

Setting the scene for what might lie ahead, markets have ended 2020 against a backdrop of investor euphoria. For the current nano-second, generalised optimism seems well-placed. Vaccines appear to be working, so the outlook for economic and earnings growth is very strong once re-openings occur. At the same time, central banks appear happy to run extraordinarily loose monetary policy settings.

Investors earn nothing in term deposits, so there is no alternative, buy equities.

This brings us to the first of a number of key questions that will determine performance in 2021.

1) Can remarkably bullish investor sentiment be sustained?

There can be little doubt that the shoeshine boy is invested in this market and then some. We see signs everywhere of over-stretched investor enthusiasm but the hard part is the timing and nature of the catalyst that ends this. Possible candidates include some macro, viral, or political shock or a lift in bond yields due to inflation emerging. A wall of money would rush for a very small exit door at the same time.

The renewed interest in equities was exemplified by a motherhood and apple-pie NZ Herald article on Jan 5, "*New To The Sharemarket. What You Need To Know?"* Markets around the world are awash with new money, bringing back uncomfortable memories of 1987 and 1999. Just a few examples that we have seen:

i) ETF inflows are off the scale and beginning to distort the prices of the underlying securities that they invest in. The ARK Innovation ETF (ARKK) is the poster child for this but there are many others. The iShares Global Clean Energy ETF's listed in the US and UK have surged from US$2.5bn to over US$10bn over the last two months and have dramatically impacted the Meridian Energy and Contact Energy share prices. In a piece of vicious circularity, the ETF share prices rose by 20% in each of November and December as they bought ever more of the 30 stocks that they have to own. We have even noticed one or two of the Smartshares ETF's starting to impact share prices in less liquid parts of the NZ market. It's not hard to see the seeds being sown for an illiquidity crisis when some unknowable catalyst reverses these flows and sees forced selling. To every cycle there is a season.

ii) US call option volume has soared to 2.5x the levels it was at the start of the year. The gamification of such trading on Robinhood is a key driver of this. According to the New York Times, Robinhood users trade 40 times more than Schwab users, with option trades being 88x greater relative to account size. At the same time, call options are disproportionately expensive versus puts for a given level of volatility. This will surely end well.

iii) Tesla rose by 743% in 2020 because…. They should use their absurd valuation to buy a profitable business but that would be a bit like the Yahoo/Time Warner deal in 1999.

iv) According to a WSJ article sourcing Jay Ritter, the median revenue multiple for a US tech company on its first day post-IPO in 2020 was 23.9x versus a typical 6x for most of the period post the Nasdaq bubble from 2001-2019.

v) In 2020, there were 19 IPO's that doubled on listing day versus 25 in the entire decade prior. As an example, Airbnb priced its IPO at $68 and closed day one at $144.70 after hitting as high as $165. Out of 18 trading days, it has moved by more than 3% on 70% of them. Doordash priced at $102, closed at $189.51 on day one and has since ebbed to $139 on similar volatility.

vi) Numerous measures show very extended sentiment levels. For example, the Citigroup Panic/Euphoria model hit a level of euphoria in mid-December that was last seen in early 2000 and implies a 100% chance of a market decline over the next 12 months (or a 100% chance of their model being re-estimated!) The CNN Fear & Greed measure briefly hit "extreme greed" before pulling back to neutral late in the month.

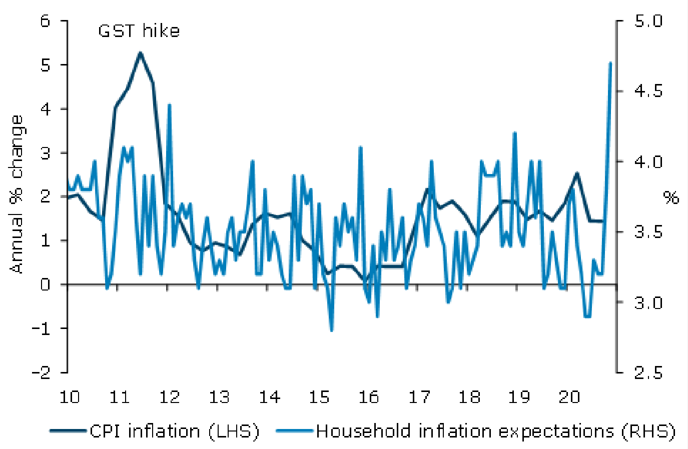
vii) Short selling levels are extremely low. Estimates we saw mid-month showed that the median S&P500 stock has only 1.6% shorted versus 2.1% a year ago. Australian data also shows a sharp decline.

2) Will inflation rear its head and drive higher yields?

We see this as the key risk for 2021 or perhaps 2022. As argued last month, the housing boom is lifting housing costs and rents; labour costs are rising as immigration has halted and the minimum wage is being lifted; prices in transport and accommodation may surge upon re-opening; and an inventory shortage is lifting prices across a huge range of goods, with part of this being short term due to Covid-19 but part of it reflecting a paradigm shift of more permanent deglobalisation.

We repeat last month's chart that was sourced from ANZ Bank showing a surge in household inflation expectations. Similarly, the December ANZ Business Confidence Survey showed firms' selling price intentions rose from +26.1 to a very high +35.1 over the month. The RBNZ has over-cooked this – no wonder long bond yields are rising. They have plenty of further upside potential from their extremely low levels. Who on earth would want NZ bonds at 0.9% when CPI inflation is running at 2%+? The RBNZ may choose to hold yields down right along the curve but this would spark a weaker NZ$ and even more inflation.

Household inflation expectations and CPI inflation



Source: Statistics NZ, ANZ Research

3) Will the TINA and GAAP stock boom come to an end?

While cyclical stocks did very well in the December quarter, the cheer-leading GAAP (growth at any price) and TINA (there is no alternative) darlings also generally continued to rise despite bond yields in NZ rising from 0.46% to 0.99%. On the TINA front, NZ property stocks rose by 8.5% in the quarter, while on the GAAP front, the S&P/ASX200 Information Technology Index rose by +24.7%. Neither of these make any sense given the rise in bond yields.

The valuation convexity at very low bond yields is huge. At an unchanged equity risk premium, we estimate the NZ fair value PE falls from 40.9x to 32.9x with such a move. That's fine if you are a cyclical and benefitting from top-line upgrades but the risks are sizeable for other names and they may begin to notice soon, even though they didn't in the last quarter. There is a strong chance that TINA and GAAP underperform in 2021. We are lowering our net length in the former and we are well short the latter.

4) Will cyclicals continue to outperform?

Here I will lean on my economist training and answer yes and no. Overall, we have been bullish on cyclicals throughout the December quarter and this has been rather helpful. As argued above, we see long bond yields continuing to rise and yield curves steepen. This typically goes hand in glove with cyclical outperformance as earnings upgrades more than offset the negative discount rate impact.

In fact, this performance by cyclicals is a key reason why equity markets have historically tended to be a good hedge against inflation until around the 3% region. That is where higher discount rates have offset earnings upside. We do wonder if that trade-off will kick in at a lower inflation level this time around given how low discount rates are presently (it doesn't take much of a rise to have a big valuation impact).

To give a flavour and examples of where we like cyclicals, we are strongly positioned in soft commodities (Graincorp, United Malt), retail (Shaver Shop, Turners), finance (Kina and Turners), coking coal (Coronado), mining/infrastructure services (Emeco, Cardno, Intega), hotels (MCK) and residential land development (Peet, CDL Investments).

We see four cyclical areas to be wary of. Firstly, we are avoiding structurally challenged value traps. Some have actually done quite well in the Covid-inspired 2H20 surge but we are not huge fans of shopping centres, department stores, printing companies, blacksmiths et al.

Secondly, a lot of speculative froth is building in parts of the rare earths and clean energy metals segments. Easily extractable lithium and graphite are very common in the earth's crust. Australian base metals exposures also strike us as having already priced in strong upside scenarios.

Thirdly, we don't like the balance of risks for iron ore. Brazilian (and other) production will rise sharply later this year, China is making noises about keeping a lid on steel production and a huge African production increase looks set to be financed by China in the medium-term. Brazil will expand ahead of this.

Fourthly, a number of cyclical names have run far too hard on the "Covid-19 nesting trade", with a big multiple being applied to earnings that have a large one-off component. We are cautiously shorting such names when they have strong days.

5) Will Covid-19 vaccines work and allow re-opening?

Our assumption, which is very much in line with consensus, is that immunity from past infections combined with encouraging results from the various vaccines will see much of the world re-open in the second half. Consequently, we have used the latest bout of Covid-19 fears and shutdowns in various countries to buy attractive re-opening longs such as Redcape Hotels and United Malt Group and cover off shorts such as Auckland Airport and Air NZ.

The obvious risk is that the Covid-19 virus mutates and the vaccines prove ineffective or they need to be tweaked and given annually. Cautious governments might then hesitate to re-open. We are not scientists (obviously!) but this is a tail-risk that bears watching.

Returning to the performance of the Fund in December, we delivered a return of +6.77%. Markets were relatively strong, with NZ +2.5% and Australia +3.0%. Against this backdrop, our long book delivered a very strong 6.76%, while our short book was almost as pleasing, in that it returned +0.01% despite the strong market headwind. Our closely followed "winners to losers" ratio was an excellent 71%, with the magnitude of the largest winners being far greater than the largest losers. Some of this ratio was a mix effect of having more longs than shorts in a strong up-month but the ratio within our longs was 83%, while it was still a respectable 53% in our shorts.

The largest positive by quite some distance was our large long in Pacific Edge Biotechnology (PEB, +71.8%) which surged from $0.71 to $1.22 on bullish broker initiations, with price targets up to the mid-$1 region. Our only comment is that any "fair value" at this stage of PEB's life cycle has a huge band of uncertainty around it. However, they are a small company in a huge market with a testing technology that has now been endorsed by some of the industry's leading players. In 2021, we expect to see significant news-flow and progress that will hopefully validate the upside valuation cases.

The second stand-out tailwind was another large long-standing long in Tower (TWR, +17.4%). Just why it moved so strongly during the month is a little hard to pin down especially as several weather events during the month make it likely they will be hit on their full reinsurance excess again in 2021. However, it remains on a very low multiple and the key balance sheet risk of their dispute with the EQC has now been cleaned up, leaving them replete with funds. This puts them in a position to pay dividends, do share buybacks and grow strongly both organically and inorganically. A small step in the latter was their purchase of a boat insurance referral agreement from Club Marine, which is exiting the market.

There were a number of other solid contributions, with these being led by our short in IDP Education (IEL, -18.9%). We cannot fathom why this provider of student placement services and English language tests is on a PE of 50x Jun22 earnings, when these largely assume a return to normality and will require downgrading. Smaller winning longs included Turners & Growers (TGG, +6.4%); Turners (TRA, +8.4%); Emeco Holdings (EHL, +9.6%) and Kina Securities (KSL, +7.1%). KSL's purchase of Westpac in PNG and Fiji is an absolute game-changer, with the stock now being on a forward PE of just 3.8x Dec22 earnings which assumes little in the way of cost synergies. Country risk is high but PNG should benefit given a generally strong outlook for commodities. A PE multiple of less than 4x coupled with a strong growth outlook grabs our attention!

Our detractors were far smaller than our contributors and were somewhat random in nature. They were led by moderate damage from an unsuccessful attempt to short Meridian Energy (MEL, +15.4%) into the face of a truly wondrous ETF bubble.

As we wrote last month, MEL is one of 30 stocks in the S&P Global Clean Energy Index with a weighting of around 5.5%. Two huge clean energy ETF's are benchmarked to this index. At the time of Joe Biden's election, these had assets of US$2.5bn. They grew to US$5.5bn at end-Nov and are now around US$10.5bn as this is written. This is no doubt being added to by active funds of a similar persuasion. The two passive funds alone now hold around 10% of the MEL free-float and we are seeing dot.com like price moves of 7-8% in a day. As this is written, MEL farcically rose +15.8% on Jan 5. Never mind that MEL is absurdly expensive on any free cashflow based metric.

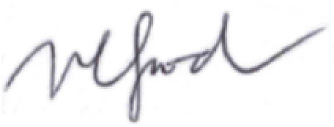
This is a classic example of passive starting to become too big for the underlying securities that comprise it. MEL will likely be rebalanced down in the index but this is unlikely until April and who knows where it will be by then. We used a fleeting pull-back to cover most of the short and will be rather cautious in trying again. However, when it cracks, it will crack into an abyss.

Other headwinds were small in nature and were led by a random price move in the engineering and environmental consultancy Intega Group (ITG, -8.3%). ITG has a strong balance sheet, is on a Jun22 PE of 7.7x and has tailwinds from its sectoral exposures. It has been somewhat rudderless since being spun out of Cardno Group and we note that the private equity house Crescent Capital still owns 49.2% of it, while the activist investor Viburnum has over 6%. ITG has announced but not yet implemented a 10% share buyback.

Other modest detractors included a small random price decline in the trustee company, EQT Holdings (EQT, -4.3%); a premature attempt to time the end of the iron ore cycle by carefully re-shorting Fortescue Metals (FMG, +28.5%); and a continued march upwards by our short in the egregiously expensive Xero (XRO, +10.8%). The rise in bond yields over the December quarter went almost unnoticed by investors in GAAP (growth at any price) stocks such as Xero but think it is likely to continue in 2021 and it will start to impair the performance of the TINA and GAAP names at some stage, with cyclicals and perhaps value continuing their recent run.

Thank you for your continued support of the Fund. 2020 was a challenging and unusually volatile year but it was extremely pleasing to finish on such a strong note and return the Fund to its former performance trends. Sticking to our philosophy and style has paid off. We will continue to stay focused on our disciplines of short selling expensive names with identifiable catalysts or weak business models and being long companies that are cheap, either on current multiples or relative to the growth opportunities that they have in front of them.

Markets are currently in a sweet spot of growth expectations recovering while bond yields are extremely low on any historical measure. However, yields have begun to rise from their lows, warning signs of future inflation are beginning to pick up and retail investor sentiment is reminiscent of 1987 and 1999. We think 2021 could be a very interesting year indeed.



Matthew Goodson, CFA