Salt Long Short Fund Fact Sheet – August 2022

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 August 2022

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$63.8 million
Inception Date	31 October 2014
Portfolio Manager	Matthew Goodson, CFA

Unit Price at 31 August 2022

Application	2.1885
Redemption	2.1796

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 August 2022

Long positions	43
Short positions	32

Exposures at 31 August 2022

Long exposure	86.82%
Short exposure	39.43%
Gross equity exposure	126.25%
Net equity exposure	47.39%

Investment Risk to 31 August 2022

Fund volatility[1]	6.47%
NZX50G / ASX200AI volatility[1]	13.99%
NZX50G / ASX200AI correlation	0.087

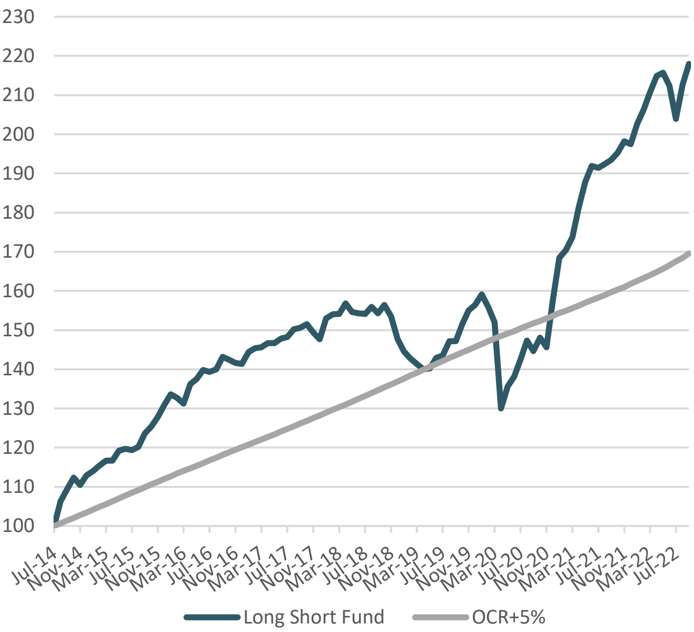
1. Annualised standard deviation since fund inception.

Fund Performance[2] to 31 August 2022

Period	Fund Return	OCR+5% Return	NZX50G/ASX 200AI Return[3]
1 month	2.48%	0.67%	1.06%
3 months	2.62%	1.80%	0.10%
6 months	3.49%	3.38%	-1.14%
1-year p.a.	12.67%	6.20%	-7.84%
2 years p.a.	22.76%	5.72%	5.74%
3 years p.a.	13.99%	5.70%	5.43%
5 years p.a.	7.67%	6.10%	8.46%
7 years p.a.	8.43%	6.39%	9.90%
Inception p.a.	10.01%	6.68%	9.21%

2. Fund performance is after all fees and before PIE tax.
3. NZX50G/ASX200AI 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.

Cumulative Fund Performance to 31 August 2022

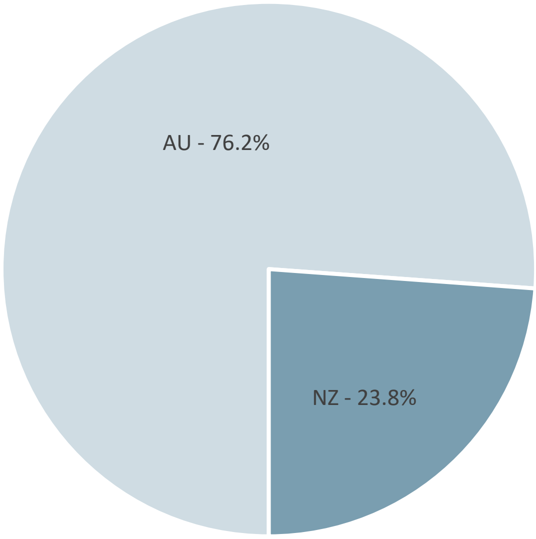


Fund performance has been rebased to 100 from inception.
Past performance is not a reliable indicator of future performance and no representation or warranty, express or implied, is made regarding future performance.

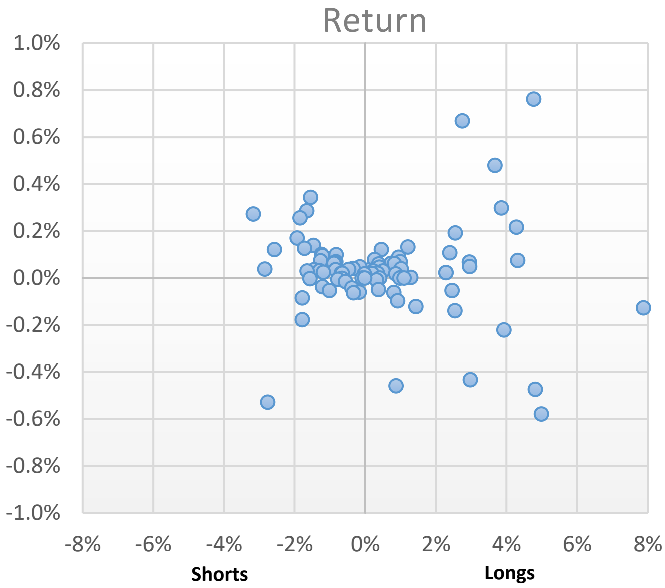
Largest Longs	Largest Shorts
Tower	BWP Trust
Global Data Centre Group	Ryman Healthcare
GDI Property Group	Fortescue Metals Group
Monash IVF Group	Wisetech Global
Lynch Group Holdings	Breville Group

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 August 2022 (Gross Equity Exposure)



August 2022 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

After an extremely strong prior month, the Fund delivered another month of very strong performance in August, with a return of +2.48%. Long-only equity markets were relatively muted, with the NZ benchmark rising by +0.94% and Australia advancing +1.18%.

Most companies report during the August result season, which means there is heightened potential for volatility at an individual stock level. While we stood on a couple of tiny landmines, these were heavily outweighed by having far more successes than failures in terms of our positioning.

Over the last 12 months, the Fund has returned +12.7%, while Australia has declined -3.5% and NZ has fallen -12.2%. So far in calendar year 2022, the Fund has returned +7.6%, while NZ equities are -11.0% and Australia is -3.6%. We are continuing to deliver on our mission of providing equity-like returns over the long run but with less volatility and no correlation to equity markets.

The moderately positive performance of markets "down under" was perhaps a little surprising in the context of NZ 10-year bond yields soaring from 3.40% to 3.97% and Australian 10-years going from 3.06% to 3.60%. The strength also defied the MSCI World Index, which declined by -4.2%.

Result season across NZ/Australia was perhaps a little less bad than feared, with earnings being broadly in line with expectations at an overall index level and beats moderately exceeding misses at an individual company level. Without being too cynical, this does perhaps reflect companies' ever-increasing expertise in managing analysts' near-term forecasts, so that they can deliver a "beat".

Company revenues tended to be higher than expected, while margins generally missed slightly, with an inability to fully recoup inflationary cost pressures from labour, transport costs, electricity costs and commodity inputs being evident. Forward guidance saw downgrades somewhat outnumber upgrades and an unusually large number of companies defer the provision of any guidance at all in the face of the uncertainties they saw. One suspects that even as cost pressures become less bad in the months ahead, we will see a downgrade cycle as the NZ and Australian economies slow. Excess inventories will be another key theme to monitor although several companies described their build-up as a planned strategy to counter disruption risks – we shall see.

The month saw some unusual volatility in global markets following the Fed rate hike by 75bp in late July. At the time, the market interpreted it as a "dovish hike" and that the Fed may have perhaps been minded to thereafter lift its foot from the pedal if markets pulled back too hard.

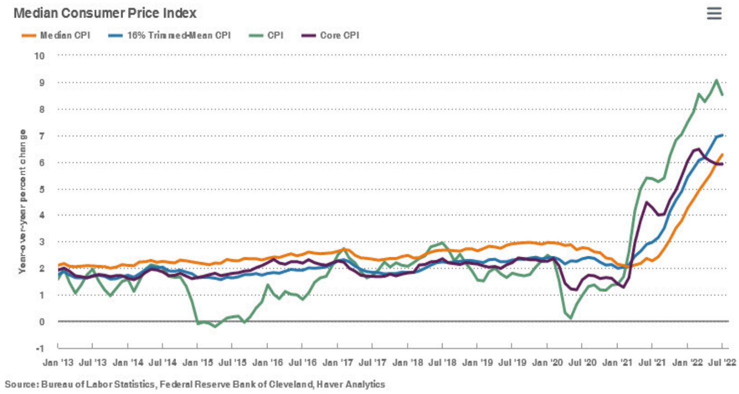
According to Goldman Sachs, this brief epiphany of a "Fed pivot" led to one of the sharpest 20-day easings on record in their financial conditions index, with all the accompanying speculative behaviours that one might expect alongside that.

Subsequent Fed statements debunked these hopes of a pivot and the reality is that US liquidity conditions continue to tighten. From a peak of 20%+, US M2 growth eased to +5.3% in July (from 5.9% in June) and is on course to outright contract by early 2023. Remember that the Fed's QT process has barely begun, with $45bn/month of bond repurchases ramping up to $75bn from the start of this month.

Concept stocks rallied hard and we saw a furious but brief revival in what will likely prove one last hurrah for the "meme stock" bubble. The chart below for the latest fad stock in Bed, Bath & Beyond (BBBY) is a thing of beauty. This covers just the month of August and features a surge from $5 to a brief high of $30, with a classic head and shoulders top. Thereafter it falls away to $9 and BBBY announced plans to raise new equity, close stores and cut staff as this is being written – how rude of fundamentals to intrude on a meme stock bubble!

Our over-arching macro view remains unchanged. We see that inflation has just about peaked but that it is unlikely to retreat any time soon to the desired levels of central banks. This means an extended period of higher interest rates will be required. Forget any thoughts of an early pivot. Further, given that much of the inflationary pressure was sparked by negative supply-side shocks, this may be a stagflationary rather than just a deflationary slowdown.

The view that inflation is peaking is supported by how a range of conflicting evidence is beginning to come through. On the hawks' side, wage inflation is high around the Western world and will be the key issue that takes time to get on top of. Furthermore, core measures of inflation pressure are showing that we are seeing a generalised lift in prices across many items rather than one that is confined to just a few items. The chart below from the Cleveland Fed shows this starkly and it is similar in NZ.



Countering this, there is some cause for hope in the most recent data. As this is being written, the US ISM Purchasing Managers Index for August showed a sharp fall in the Prices Paid sub-index to 52.5 from 60.0 in July and a recent peak of a staggering 92.1 in June. Sharp falls in soft and hard commodity prices are rapidly feeding through and there is increasing evidence that transport channel blockages are unclogging and perhaps even unleashing a "bull-whip" effect in places as excess inventories are exited.

One crude way of looking at transport bottlenecks and excess demand for freight capacity is to consider the Baltic Dry Index in the chart below.

While these signs of falling inflation pressure are encouraging, it is yet to really come through in the latest NZ data. The August ANZ Bank Business Outlook survey showed that firms' selling price intentions only came back slightly from 74.0 to a still very high 70.1 and general inflation expectations are a very high 6.13%. It may take central banks some time to bring this back under control and quite some time to return inflation to our 1%-3% target range.

Disturbingly, our views on the macro back-drop seem to have become aligned to the views of central bankers themselves. It is far more comfortable to rail against their ineptitude than it is to actually agree with them!

The August RBNZ Monetary Policy Statement lifted the OCR target by 50bp to 3.0% as was widely expected. More interestingly, they slightly lifted their target for the future peak in the OCR cycle to 4.1% and they project an average OCR in the Mar24 year of 4.1%, only slightly declining to 4.0% in the year ended Mar25.

The sharp rise in bond yields over the month saw tighter policy priced in across Western markets. We are returning to more normal levels of interest rates than those we became used to in the post-Covid emergency. If you assume a long-term NZ real bond yield of 1%-2% and inflation outcomes of 2.5%-3.0%, then a bond yield range of 3.5% to 5.0% comfortably encompasses the 4.07% 10-year bond yield as this is written. The rise in yields is entirely justified and is not an overshoot. The problem is that the NZ and Australian equity markets ignored the yield spike – don't fight the Fed.

In the US, a number of Fed Governors pushed back hard against the pivot thesis, with a series of hawkish comments at what they clearly saw as a misconceived market reaction to their 75bp rate hike in late-July. At month-end for example, Loretta Mester commented: *"it is far too soon to conclude that inflation has peaked, let alone that it is on a downward path to 2%....I anticipate that policy will need to move into a restrictive stance in order to put inflation on a sustained downward trajectory to 2%....my current view is it will be necessary to move the fed funds rate up to somewhat above 4% by early next year and hold it there."* So much for the supposed Powell pivot.

Linking this back to equity markets, our views remain unchanged. Fighting the Fed has never been a particularly profitable strategy and remember that the S&P500 Index declined by c20% the last time that the Fed became moderately serious about QT in 2018.

Higher bond yields are here for quite some time but it is still possible to find plenty of slightly shop-soiled "darling stocks" on PE ratios of 25x to 50x. Unless they have extraordinary compounding earnings growth, why would one accept a 2% to 4% earnings yield when the risk-free government yield is 4%? Momentum junkie "growth at any price" investors have not yet read the central bank memo.

We also remain wary of the universe of "there is no alternative" yield stocks. Some of these have performed surprisingly well in the face of rising bond yields although property stocks generally remain well below their 2022 highs. One-year term deposits now yield 4.0% and 5%+ corporate bond yields are stiff competition. What to own? We continue to focus on longs in stocks that are very cheap, which are special situations and which have earnings outlooks that are hopefully robust to the widespread margin pressures through the economy.

Fund Performance in August

Returning to the Fund's performance in the month of August, the overall return of +2.6% pre fees and tax was pleasingly driven by strong contributions from both the long book (+1.1%) and the short book (+1.6%). Our overall "winners to losers" ratio was an exceptionally high 74% and we had far more high magnitude winners than we did losers. We couldn't have been happier with this outcome in what were somewhat directionless markets.

We used the volatility of August's result season to reduce our gross positioning quite sharply from 150% to 126%. We particularly covered off a number of shorts which had worked well and we now have plenty of ammunition to get set in our next round of new ideas as they come forward. Our net length did rise from 42.5% to 47% but we are comfortable with this as we turned in very strong relative performance on days when market returns were negative.

Looking at the 50/50 index of Australia and NZ, it had nine down-days in August, with an average return on them of -0.49%. The fund was actually up on seven out of those nine days and delivered a positive average return of +0.19%. As it happened, this was slightly stronger than the +0.04% average return we delivered on positive days for the market. This Fund is uncorrelated – irrespective of whether the market is up or down, we may be up, down or flat.

The largest positive contributor was the long we have built up in Lynch Group (LGL, +16.4%), the dominant flower grower and distributor in China and Australia. Its result was in line with (earlier downgraded) guidance and featured strong revenues despite earlier lockdowns in Australia and current lockdowns in China. They suffered considerably from elevated air-freight costs and labour availability issues, but to us, these are Covid-driven problems that are disappearing into the rear-view mirror and should have a PE of 1-2x put on them. There was some very lightly sourced press speculation that LGL might be a takeover target but as pleasant as that would be in the short term, we would rather stay the course on a business that is on a forward PE of 11.4x F23, 8.6x F24 and 7.4x F25. On top of a post-Covid rebound, they have strong organic earnings growth as they invest in more capacity in China and supermarkets inexorably take share off florists in Australia.

A second stand-out was our long held position in the mining equipment rental business. Emeco Holdings (EHL, +24.5%), where a result in line with expectations was enough to spark into life what was a deeply oversold name. We have consistently bought the dips and sold the bounces in EHL for the last couple of years and will continue to do so as it goes through overly abrupt sentiment shifts. It will never be a high multiple stock but the forward PE of 5.9x still feels a little light for a well-positioned business, with a balance sheet that is in solid shape.

A third tailwind was our long-held and highly successful position in Shaver Shop (SSG, +11%), which we continue to regard as one of the best retailers in Australia. They completely dominate their category, with exclusive rights to many of the key brands. They have extremely high sales per square metre and a very efficient in-store servicing of their rapidly growing online channel. They delivered an excellent result and have seen strong sales continue since then. SSG has been a multi-bagger for the Fund but still pays a 9% dividend yield and is on a cash PE of sub 8x (ex an amortisation charge, where they gradually write off the goodwill from former franchisees that they bought out).

Slightly smaller but still material long-side contributions came from Dalrymple Bay Infrastructure (DBI, +6.8%) and our PNG bank, Kina Securities (KSL, +4.6%) which delivered a solid result and has metrics that would be the envy of any bank in the world. Yes, it is in PNG but the outlook for that economy is strong now they are through their election and massive LNG expansions and other mine openings occur in coming years.

A number of shorts made positive contributions in the month, led by a position in Heartland Group (HGH, -13.0%), where our view that that needed more capital to fund their organic and inorganic growth was validated by a sizeable equity issue. We covered our large short in the childcare property owner, Arena REIT (ARF, -12.7%) as it pulled back sharply on no obvious news aside from higher bond yields. Other highlights were our short in Bunnings Warehouse Property (BWP, -7.0%), which has long been one of the most expensive names in our relative value property model; and a large short in Endeavour Group (EDV, -8.2%), where we couldn't understand the attraction of what was a 30x PE multiple for earnings that had been boosted by the liquor splurge during Covid and where labour cost pressures on a relatively low margin business are not inconsiderable. Supposedly it's a defensive stock but their result suggested otherwise.

Headwinds were led by our old bugbear and one of the most expensive names in the Australian market, Wisetech Global (WTC, +17.3%). Their result was good but appeared to be driven more from the cost side than any new beat to revenue and profits that had previously been guided up to a degree in July. WTC now has a $19bn market cap for forecast revenue of $770m in Jun23 (24.6x) and NPAT of $246m (77x) – woe betide them if they have the slightest stumble from factors such as competition, a slowing in the freight boom enjoyed by their customers or any reassessment of the multiples given the surge in bond yields.

A second key headwind came from our long in Global Data Centres (GDC, -9.8%) which gave back some of its sharp 23% bounce in the previous month. GDC delivered a perfectly solid result during the month and trades at a large discount to what we view as a relatively conservative NAV. They have net cash on their balance sheet and a solid organic investment pipeline which should see solid NAV growth over time. We retain a view that GDC's investment pipeline in a rapidly growing sector may make them attractive to a number of long-term investors and that their large NAV discount makes them something of an orphan on the listed market.

A third negative was a small long we retained in the formerly very successful Pacific Edge Biotechnology (PEB, -42%). At the start of the month, they suffered a bolt from the blue when the consultant who interfaces with Medicare issued a draft recommendation that their group of tests should no longer be reimbursed. The company believes that this is extremely unlikely to hold up in the final review and that a future strengthening of the wording re the use of CxBladder in the treatment guidelines will ultimately make this moot in any case. We bought more on weakness although it is only a sub-1% position.

A final problem-child was the large long we have built up in GDI Property (GDI, -7.7%) which declined more sharply than the -3.5% retracement in the Australian property index. Their result was a touch disappointing in that they failed to confirm any new leasing outcomes for their significant development pipeline. However, this was perhaps understandable because Covid wrecked much of the period and we understand that they are fielding significant inbound interest. We retain our view that Perth is the best placed office market across Australia/NZ. It has had little development in recent years and is now seeing positive net absorption. GDI is at a 30% discount to NTA, it has valuation upside as it leases vacant space and it has a syndication business with sizeable pent-up performance fees.

Thank you for your continued support of the Fund. August was another strong month of returns and we are very pleased to have delivered in a solid manner against a choppy market backdrop. We remain relatively cautious on the outlook for long-only equities in the short term, with central banks still tightening, earnings forecasts having downside risk and valuations still being far from cheap at an aggregate market level. Against that somewhat sombre backdrop, we will strive to continue delivering equity-like returns over the long run, with far less volatility than equities and no correlation to them.

Matthew Goodson, CFA