SALT
Funds Management

Salt Long Short Fund Fact Sheet – February 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 28 February 2018

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$265.3 million
Inception Date	30 June 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 28 February 2018

Application	1.5474
Redemption	1.5411

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 28 February 2018

Long positions	84
Short positions	52

Exposures at 28 February 2018

Long exposure	80.28%
Short exposure	-50.54%
Gross equity exposure	130.82%
Net equity exposure	29.75%

Largest Longs	Largest Shorts
Centuria Metropolitan REIT	Ryman Healthcare
IVE Group	Insurance Australia Group
Ingenia Communities Group	CSR Limited
Turners Automotive	Fisher & Paykel Healthcare
Investore Property	ASX Limited

This Fund is actively managed. Holdings are subject to change daily.

Performance[1] at 28 February 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%											0.72%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	4.37%	1.62%	2.00%
6 months	2.32%	3.29%	7.33%
1-year p.a.	5.84%	6.75%	13.46%
2-years p.a.	8.36%	6.90%	16.03%
3 years p.a.	9.73%	7.27%	8.81%
Since inception p.a.	12.52%	7.48%	11.03%

[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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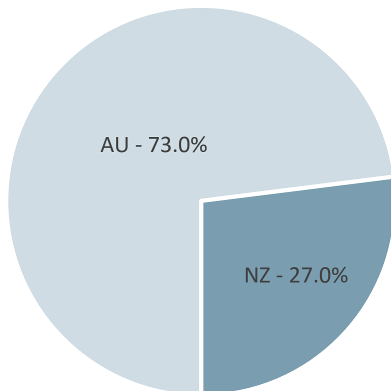
Country Allocation at 28 February 2018 (Gross Equity Exposure)



February 2018 Individual Stock Contribution

Fund Commentary

Dear Fellow Investor,

The Fund experienced a moderate month in February, delivering a return of +0.05% after all fees and expenses. This seemingly somnolent month at an overall level for the Fund belies a bevy of significant winners and losers below the surface as share prices moved violently in the wake of result season reactions and overreactions. Diversification works.

Since inception on 30 June 2014, the Fund has now returned +54.11% after all fees and expenses. Thirty-three of those forty-four months have had positive returns, we are yet to have a negative quarter and our correlation to suddenly volatile equity markets remains statistically zero. This matters in a world where every asset class is expensive and is now showing signs of ceasing to move in a straight line upwards.

The Fund's fractionally positive performance compares to the +0.36% turned in by the S&P/ASX 200 Accumulation Index, while the S&P/NZX 50 Gross Index had its first negative month since December 2016, declining by -0.81%. Interestingly, without the rocket-ship that is a2 Milk, the NZ market would have fallen by a sharp 4.2% in the month. Under the hood, the NZ market has been very weak as the valuation extremes that we have long pointed to have suddenly started to matter. The US S&P 500 Index fell by 3.9% and gyrated in a staggering 10.7% range.

The highlight of the month was the US "flash crash" on 5 Feb, when their market fell by 4.1% and the follow-up on 8 Feb which saw a decline of 3.8%. The 5 Feb move in equities was seemingly caused by the biggest one day jump in the VIX volatility measure ever. The 20.01 point rise was a 116% increase, with the next biggest move ever being a mere 64% - that history encompasses events such as the Asia Crisis, the Nasdaq Crash and the GFC meltdown and shows just how out-of-control the machines and the associated hot-money quant strategies are. It beggars belief that volatility would move almost twice as much on a modestly higher wage inflation catalyst on Feb 5 as compared to those huge potential Armageddon situations in the past.

Liquidation and forced outflows enveloped all of the volatility shorting, CTA momentum chasing, faux-sophisticated risk parity fund pumping investors that we have raged about periodically in this letter from time to time over the last several years. CFTC volatility futures net positioning data showed a reversal from a near record net short early in the month to a near record net long in the space of just one week, with this requiring sizeable forced selling of equities. Investors in these products all picked up pennies from in front of the steam-roller for years but then they became stuck in the tar-seal. With 40% of the US market being owned by ETF's, fundamental investors were very weak on the other side of the trade.

Flows data suggested that fundamental investors were also whip-sawed over the period. A classic example was the change in view from the widely followed Ray Dalio of Bridgewater, who in late January was telling a Davos audience that, *"we are in this Goldilocks period right now. Inflation isn't a problem. Growth is good, everything is pretty good with a big jolt of stimulation coming from changes in tax laws. If you're holding cash, you're going to feel pretty stupid."* Since then, Bridgewater has publicly and aggressively built a huge short position in Europe and Dalio stated in an FT interview that, *"There had been a lot of complacency built up in markets over a long time, so we don't think this shakeout will be over in a matter of days. We'll probably have a much bigger shakeout coming."* Whiplash anyone?

Higher than expected US wage inflation and CPI inflation outcomes were the apparent trigger for the sell-off but bond yields were largely unchanged over the worst days of the sell-off and utility equities outperformed. Perhaps the flight to safety impulse dominated. Our sense is that the "flash crash" nature of the moves reflected extremely extended positioning, phantom machine liquidity disappearing and poorly designed structured products. Moreover, even after another couple of weak days in early March, the US market is merely back to where it was in December.

In our view, the real significance of the February sell-off was that it definitively marked an end to the era of Goldilocks, where economic and earnings growth occurred year after year at a solid pace without awakening the big bad inflationary bear. Two numbers released in the month changed this. Annual wage inflation for the year to January came in at +2.9% and US core CPI inflation came in at +0.35% for February versus expectations of 0.2% and it was quite broad-based in its composition.

The US economy is finally showing signs of being near full capacity and this will only be exacerbated by aggressive tax cuts at the top of the cycle and an inflationary US move back towards trade protectionism. Capital Economics estimates that the US fiscal deficit will rise from 3.4% of GDP to 5.0% by year's end. Imagine what it will look like when the US economy eventually slows.

Our sense is that investors are becoming very nervous as years of tight fiscal and loose monetary policy are being tipped on their head and a combination of future and current inflationary pressures are coming to the fore. The goldilocks paradigm is being replaced by one where many companies are delivering earnings growth, but this is being accompanied with higher discount rates/bond yields. Looking forward toward the end of 2018, the period of earnings growth may actually be quite brief as the earnings high from tax cuts fades and continued steady tightening of monetary policy begins to bite.

We are now in a more difficult environment where rather than low bond yields lifting all boats, performance will be far more mixed. At Salt, we will deal with this as we always do by seeking to buy companies that are cheap and short sell companies that are expensive, with potential catalysts preferably being identifiable. Right now, what we are finding in the market is that valuation means very little and that making short term earnings expectations means everything. This is leading to some episodes that are very painful in the short term but full of opportunity beyond that as profit hiccups or beats get priced as though they will last forever.

The earnings season in Australia/NZ carried this lesson to an almost absurd extreme. The valuation anchor had very little meaning and instead companies that deviated from expectations were either sent to the moon or on a one-way road to perdition. A classic example of the former was a tiny short we had left in Breville Group (BRG) – the coffee machine and pop-up toaster maker on a forward PE of 27x. Their result was a marginal beat and the share price promptly ran from $12.25 to $13.90, with a little extra juice coming from an analyst upgrade due to their "earnings momentum". We promptly shorted a lot more in the high $13 region and have just finished covering as this is being written back in the $12.40 region. The wall of momentum money made us feel really bad for all of two days.

One classic sign of a market top is a lift in aggressive accounting behaviour and associated issues. Just think back to the GFC with the likes of MFS, South Canterbury, City Pacific et al; to the Nasdaq boom with all the various vapourware companies; and to the array of "colourful" companies in NZ in 1987. Well, 2018 is a case of déjà vu all over again. In Australia, Getswift (GSW, -79.3%) had some issues announcing customer sign-ups but forgetting to announce when they didn't buy the product; Big Un (BIG, -39.3%) had disclosure queries around an associated finance company providing the money for a large chunk of their sales; while closer to home, CBL Insurance remains in suspension and may perhaps never return to the bourse after they have reportedly under-reserved for their long tail French builders' insurance. The problem with 10-year exposure is that very small assumptions changes can lead to very large changes in profitability. It will also be fascinating to see if the projected profits from writing this insurance were being booked across the full 10-year period.

The largest short in the Fund remains our position in Ryman (RYM, -2.5%) which worked moderately well during the month. The thesis is quite simply that NZ housing is at the tail-end of a once in a generation boom and that RYM's share price is behaving as though this will last forever. Conversely, our view is that as the market slows, RYM will get hit by a double-whammy of slower future unit price growth assumptions and more importantly by a build-up in used and new inventory that they may not have the balance sheet wherewithal to handle. Their model of using a modicum of equity, with a slice of bank debt and a vast amount of occupier finance has delivered wonderful leveraged upside to shareholders through the boom but could become very difficult indeed in a housing downturn. Where will future repayments to deceased residents come from when RYM cannot re-sell the units at acceptable prices?

We are almost certainly too early in our position but when the market starts to sour, we suspect it will sour quickly. As yet there are only glacial signs. The results of Oceania, Metlifecare and Summerset all showed early signs of inventory building although they largely explained this as the timing of developments – this may or may not be the case. Official housing data paints a picture of house price growth being strong in the provinces and Wellington, topping out in Auckland and falling slightly in Christchurch. Sales numbers have fallen sharply and inventory has climbed. Fletcher Building stated for their residential division that, *"the Auckland housing market has seen softer pricing year to date with still some risk to prices for remainder of the year."* Add in a bevy of moves by the new Labour-led Government, (the latest being extending the Bright-Line test for investor status from 2 years to 5 years), and this is what a top feels like. Just wait until the foreign buyer ban is enacted, AML/AFT legislation is applied to lawyers and realtors and supply keeps gradually rising.

We have balanced this strongly held short view with a large long in the Australian listed Ingenia Communities (INA, +2.2%). Their model is to develop a village and make a one-off development profit when a low value pre-fab house is sold outright to an incoming resident. More importantly, they charge a CPI-indexed land rental, with this generally being paid out of a resident's means-tested pension and accommodation supplement. It is a model aimed at working class residents and allows them to free up what is typically their only source of capital, their home. With first home buyer's grants frequently occurring at the first whiff of market weakness in Australia, it strikes us as a model that isn't dependent on an everlasting housing boom. Current cap rates on the land are circa 8%, which seem ridiculously high to us when you have a CPI-indexed land rental stream for many decades into the future.

Returning to the performance of the Fund in February, our meagre return of 0.05% reflected a poor "winners to losers" ratio of exactly 50%. Moreover, our large contributors and detractors saw little skew, with an even mix of genius and ignorance being on full display.

The largest negative by some distance was our mid-sized long in the NZ childcare operator, Evolve Education (EVO, -34.6%). We had actually lowered the holding over the previous couple of months into share price strength but were caught by another earnings warning. Their basic issue is that they have a high degree of fixed costs, (teacher salaries and rents), giving them a high degree of operational leverage to relatively small changes in child occupancy. We had been hopeful that motivated management in the form of CEO and large shareholder, Mark Finlay would be able to turn the ship around, but this has not occurred yet. With government payments having been frozen in recent years, there is perhaps some hope of a lift under the new Government, but this is far from certain. EVO generates strong free cashflows, its balance sheet is adequate and it is now on a Mar2018 PE of just 8.3x much downtrodden earnings. We do wonder if its future may be akin to that of Affinity Education in Australia, which was somewhat troubled when taken over by Anchorage Capital several years ago but has reportedly made great strides since then out of the public glare. A small partial sectoral offset for the Fund was a modest short in G8 Education (GEM, -16.7%).

Our second notable headwind was a repeat offender in our small remaining long in BPS Technology (BPS, -38.6%) which engaged in the mother of all clearing-the-decks exercises under their capable new MD, Iain Dunstan. Former management have departed, new management made sizeable write-offs of carrying values and capitalised business development costs, they cut short term earnings guidance due to delayed cost out, announced a 2/3 rights issue and acquired the digital payments business, Gruden. We retain a view that with a suitably sized cost base, BPS should be conservatively able to generate $10m EBITDA within 2 years from its core Bartercard and Entertainment Book businesses, with sizeable digital growth beyond that. The pro forma market cap is circa $60m and they will now have no net debt on average over the year. If we had only won the narrowly contested shareholder vote last year, these much-needed changes would likely have all occurred at double the current share price. The proxy advisory firms should hang their heads in shame.

The third laggard of note was our large long in Turners (TRA, -9.7%). The decline has been somewhat puzzling as they reported a strong result back in late November and all indications point to continued reasonable trading. We can only view it as an overhang from their poorly managed share issuance last September. The stink bug infestation affecting used car imports should be a small short term positive as it tightens up used car stocks and pricing. At current levels, TRA is on a Mar17 PE of 10.7x and Mar19 of just 10.0x – too low in our view.

The fourth headwind was our valuation-based short in Insurance Australia (IAG, +13.3%). The result was solid and several analysts became excited by a very strong insurance margin, whereas we viewed this as merely being an outcome of a quota share arrangement that they had entered, where rather than paying away a reinsurance premium (and lowering their margin), they effectively paid away a portion of their volume instead. Consensus forecasts have IAG on forward PE ratios of 17.8x and 18.7x over the next two years, making it one of the world's most highly priced insurers.

Our largest winner was a mid-sized short in the growth stock darling, the logistics software company, Wisetech Global (WTC, -31%). This had hurt us previously, so there was a very strong sense of schadenfreude when they released a result showing very little in the way of organic revenue growth (ex numerous small acquisitions that they have been making). Even post their share price plunge, they remain on a forward PE of 74x, with this being after a sizeable and growing dollop of capitalised costs.

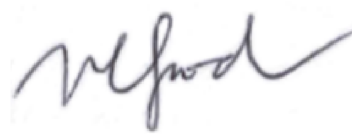
The second key positive was our large long in Webjet (WEB, +16.1%). We had previously written about how WEB is cheaper than it looks because of a deal with Thomas Cook to take over management of TC's 3,000 hotel contracts. Until this room inventory transitions over in 2H19, WEB gets hit with the goodwill paid for the acquisition. Hence WEB's forecast PE goes from 19.6x in 2019 to 14.2x in 2020, largely due to this issue. WEB delivered a solid result, and while we took a little profit, we remain attracted to their strong growth at a reasonable valuation.

The third stand-out was our slightly unusual long in a name with zero broker coverage in the form of Australian Vintage Group (AVG, +20.4%). They are the only listed winemaker besides Treasury Wine and were formerly known as McGuigan Wines. After years of struggling there is finally some light at the end of the tunnel that is not a train coming the other way. Onerous grape purchase contracts have been exited, they have moved away from bulk bladder wine exports to branded bottled wine, after UK earnings were slammed by a weak GBP it has now reversed favourably, competing European wine volumes were whacked by a late frost last year and AVG are rapidly developing export volumes into China. This latter aspect could be particularly interesting in taking them to the next level if they can execute well in meeting what is clearly strong demand for Australian red wine.

The final stand-out positive was a mid-sized short in Heartland Bank (HBL, -12.1%). While their result met expectations, the composition was a little mixed with some early signs of a deterioration in credit quality. We have been short HBL for three simple reasons. The first has been valuation, with it having been on a peak PE of 16x (it is still on 14.7x forecast), making it by far the most expensive bank in Australasia. The second issue is HBL will always have a higher cost of funds than the majors and will therefore be more expensive to borrow from.

This means that we are a little suspicious of the adverse selection that might naturally apply to their lending book and how it might fare in a recession relative to the books of other banks. Thirdly, we are wary of their reverse mortgage business at this stage of the cycle.

Thank you for your continued interest and support. As is often the case in result season, February was something of a roller-coaster ride as a torrent of new information was released. We would have hoped to have done a touch better than 50/50 but we were pleased to come through it unscathed overall. Markets changed significantly in the month and it is clear that the era of Goldilocks is over. We believe we have entered a more volatile late-cycle period which will hopefully reward stock picking and the ability to short sell. It is early days, but March has started solidly, and whatever lies ahead, we will continue in our aim to try to deliver positive returns irrespective of market gyrations.



Matthew Goodson, CFA

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