# SALT

## Salt Long Short Fund Fact Sheet – November 2019

### 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 30 November 2019

| | |
|---|---|
| Benchmark | RBNZ Official Cash Rate +5% p.a. |
| Fund Assets | $116 million |
| Inception Date | 31 July 2014 |
| Portfolio Manager | Matthew Goodson, CFA |
| Associate PM/Analyst | Michael Kenealy, CFA |

### Unit Price at 30 November 2019

| | |
|---|---|
| Application | 1.5706 |
| Redemption | 1.5642 |

### 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 30 November 2019

| | |
|---|---|
| Long positions | 66 |
| Short positions | 41 |

### Exposures at 30 November 2019

| | |
|---|---|
| Long exposure | 90.83% |
| Short exposure | -55.58% |
| Gross equity exposure | 146.41% |
| Net equity exposure | 35.25% |

| Largest Longs | Largest Shorts |
|---|---|
| Tower | Ryman Healthcare |
| Kiwi Property Group | BWP Trust |
| Contact Energy | Orica |
| Marsden Maritime Holdings | National Storage REIT |
| Turners Automotive | Fisher & Paykel Healthcare |

### Performance[1] at 30 November 2019

| 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% | | 8.18% |

| Period | Fund | Benchmark | NZX 50 G/ASX 200 AI[2] |
|---|---|---|---|
| 3 months | 6.29% | 1.46% | 5.01% |
| 6 months | 9.43% | 3.03% | 10.55% |
| 1-year p.a. | 5.85% | 6.44% | 26.51% |
| 2-years p.a. | 2.92% | 6.59% | 13.07% |
| 3 years p.a. | 3.43% | 6.65% | 14.27% |
| 5 years p.a. | 6.73% | 7.08% | 12.28% |
| Since inception p.a. | 8.61% | 7.19% | 11.91% |

[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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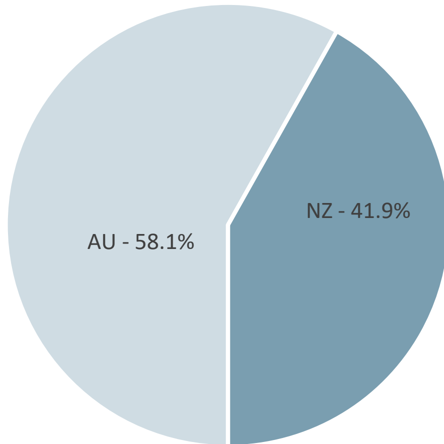
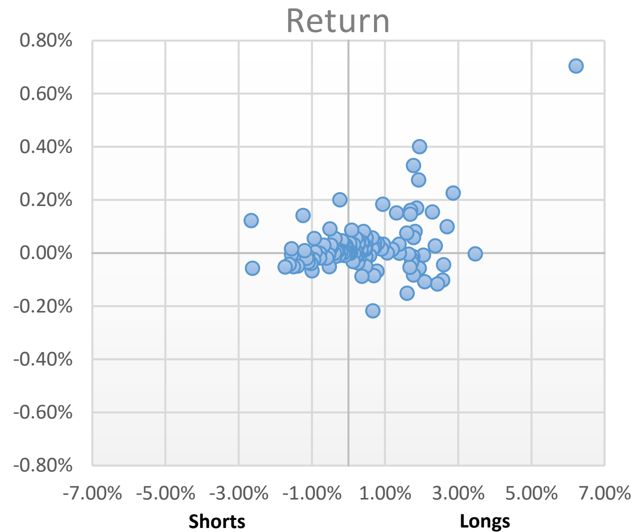
### Country Allocation at 30 November 2019 (Gross Equity Exposure)




### November 2019 Individual Stock Contribution

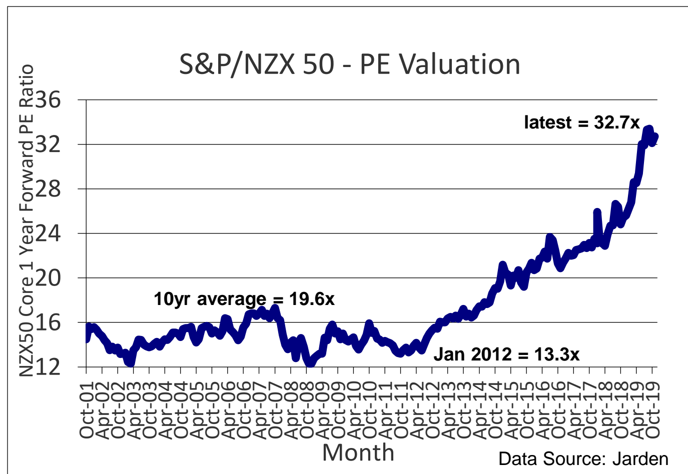



### Fund Commentary

Dear Fellow Investor,

The Fund experienced a solid month in November, with a return of +0.90% after all fees and expenses. In contrast to previous months, where volatile markets saw us add value from both sides of the ledger, general strength in November saw a headwind from our shorts but this was more than offset by several of our eclectic longs doing very well. Since inception, the Fund has returned +56.4% after all fees and expenses.

In line with the last several months, the Fund's net length of +36% appears unusually bullish by our somewhat cautious standards over the last several years but the nature of our longs is even lower beta than normal. The Fund is continuing to provide strong downside protection. There were just six down-days for the NZ/Australia average index during the month, with an average return of -0.42% on those days. We were up on five out of the six days and had an average return across them of +0.18%. Note that post month-end, the Fund was up sharply on the major sell-off on 3 December.

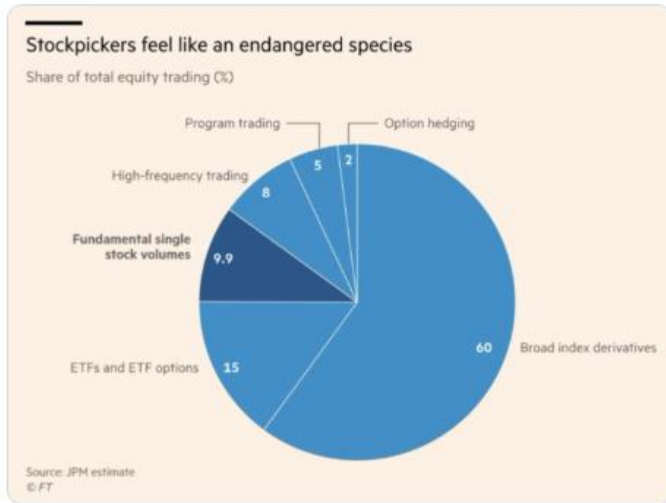



Long-only equity markets continued to party in November, with Australia rising by +3.3% and NZ rampaging ever higher, with a quite staggering +4.9% advance. Within this, the S&P/NZX10 Gross Index rose by +7.9%, while the other 40 stocks lagged far behind with an advance of a mere +0.9%. As shown above, moderate earnings upgrades were not enough to prevent the NZ core PE rising from 32.1x to 32.7x. The median PE actually fell from 19.4x to 19.0x and the median stock has far better forecast earnings growth than the average. Bond yields were unchanged.

This would normally be a very difficult set-up for the Fund, with our bias of generally being short expensive, liquid large caps and long a variety of cheaper names across the market cap spectrum. However, thanks to a number of our longs defying the market cap bias, we managed to turn in a solid month's performance.

Our sense is that the key driver of the ongoing large cap bias is the continued flood into passive funds at the expense of their active cousins. As an example of the torrent of flows, the iShares MSCI Australia ETF saw US$250m of net inflows in November, its strongest month since October 2009. According to Australia's ETF Securities, Australian ETF investments have lifted from $40bn to $57bn year-to-date. It is quite noticeable that when we analyse "size" as a factor, it never really mattered in NZ until about 18 months ago but has since

taken off to trump all other factors.




The chart above was sourced from J P Morgan research and published in the Financial Times. It refers to the US market and shows that less than 10% of the US market's trading volume now comes from fundamental investors. We suspect the numbers are a little different in NZ, with broad index derivatives being lower but ETF's being larger and likely having a very large price impact as they invest at the highest price possible in the closing match of our small, often illiquid market.

The trillion-dollar question is what happens when something changes? The great financial historian Charles Kindleberger found that most manias and subsequent crashes begin with a financial market displacement, where some form of financial innovation sees risk expand beyond prudent limits. This time around, could it be that passive funds are setting the scene for the next crash? Our specific fear is that when there is some form of left-field political or economic shock, the forced selling from passive funds could overwhelm the much-diminished appetite and capacity of fundamental investors such as ourselves to take the other side. This is particularly the case in the illiquid NZ context. Passive investors have enjoyed years of bidding up the largest stocks to the exclusion of all other factors. It is almost certain that they do not understand the risk they are taking.

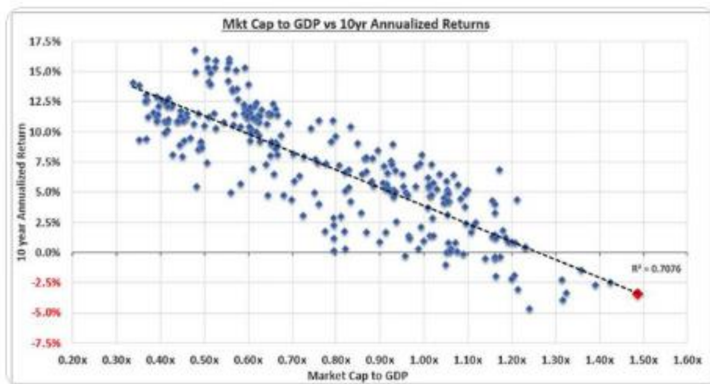
Taking the impact of passive to an absurd extreme, a memorable example of index inclusion impact occurred in the HK-listed Chinese stock, Artgo Holdings during the month. As shown below, it rose over 37x from its share price at the start of the year but then gave it all up in a day when MSCI decided not to include it in its China benchmark. It makes the shenanigans surrounding Mercury, Contact Energy and Fletcher Building over the last few weeks look positively tame!

By their very nature, passive funds tend to purchase large cap momentum stocks. The larger a company is and the more it goes up, the more they have to buy. This has led to an interesting contrast between what has worked in Australia/NZ versus what has worked globally in the last few months.

According to Credit Suisse research, global factor performance since August has seen value +12%, small caps +3%, quality is +0%, low beta is -6% and momentum is -14%. Contrast this with Australia/NZ where we have seen a surge in momentum-driven names in the technology and healthcare spaces (we have been busily shorting) and notable continued underperformance by small cap (we have been carefully buying). Growth versus value comparisons are less meaningful given the structural changes affecting Australian banks and their dominance of value indices there.

With markets on fire, we have seen a fascinating array of signs signalling over-optimism in both a macro and individual stock sense. One of my favourites was in the Australian "darling" stock CSL, where an analyst at a major firm moved its WACC to just 5% and could still only contort a share price target 8% above the actual share price – it was just enough to retain a buy call. At a company level, there was a fascinating 111-page presentation from Coca Cola Amatil at their investor day. On p92, we learnt that Coca Cola sales were weak because a number of close cricket games had left, "patrons too engrossed to leave their seats." In a bull market, investors really do believe that the dog ate my homework.

At a macro level, the "Buffett Indicator" shown below signals extreme caution, with the current US market cap as a percentage of GDP pointing to 10-year ahead returns of -3%.




Another somewhat concerning big picture chart is shown below and highlights that the price/sales ratio for the S&P500 Index has returned to a level last seen in 1999. Yes, profit margins are higher this time around but it was "different this time" back in 1999 as well. Mean reversion is an interesting beast.

It is perhaps unsurprising these valuation extremes are being accompanied by very positive investor sentiment. The chart below illustrates the CNN Fear & Greed Index which sums seven separate market constituents for an overall read on sentiment. It hit a high of 89 in early November and has drifted back to a still mildly optimistic 62 as markets are being crushed as this piece is written. It tends to be a useful contrary indicator as one can see by the returns since December 2018 when it was well into extreme fear territory.

All this bullishness palaver has occurred against a backdrop where some central banks have clearly begun to feel a degree of discomfort surrounding the effects of negative rates and "QE forever". There has been a perceptible increase in the degree of discussion around the impact of ultra-low and negative rates on bank-funded lending channels and also on the "reversal rate" (beyond which easing has a perverse negative economic impact). This has manifested in Japanese 10-year yields rising from a low of -0.30% to -0.04%, German yields from -0.71% to -0.28%, French yields from -0.40% to +0.02% etc. Several months ago, we pointed out that the buyers of Austrian 100-year bonds had doubled their money – easy come, easy go.

These yield moves really matter as the Japanese and Europeans have been major bond buyers globally and the impact of convexity on bond prices is extreme at such low yields. Similarly, this transmits to a nonlinear impact on equity valuations. In NZ for example, our non-linear regressions estimate a "fair" forward PE for the NZ market of 32.8x at a 1% yield but only 25.6x at a 2% yield and 21.4x at a 3% yield (all hold earnings growth expectations constant). Incidentally, at a 6% bond yield the fair value PE is 14.2x.

Returning to the performance of the Fund during the month, the return of +0.99% pre fees and tax had highly divergent contributions. As one might expect in a bull market, the longs added +2.72% while the shorts detracted -1.73%. Most importantly, our "winners to losers" ratio had another very strong month, with 62% of our holdings adding value.

Compared to previous months, an array of strong positives was offset by three painfully large negatives from shorts in Ryman Healthcare, Technology One and Fisher & Paykel Healthcare. These were all pure momentum rocket-ships which we happened to be short in a month which saw wickedly strong performance by technology and healthcare stocks. The former two did not even have particularly good results. We view them as egregiously over-priced and look forward to gravity reasserting itself as markets change.

Our Technology One (TNE, +24.7%) short was the most painful. We have long been wary of this enterprise software company for numerous reasons. Firstly, we have written at length in the past about the complexity of their accounting and how major changes in the move to a new AASB15 accounting standard wiped out the retained earnings from profits that had been reported in the previous several years. Secondly, they have banged the drum to an enormous degree about their (superficial) shift to a SaaS model. They still receive lumpy contract revenues but they have chosen to account for them on a daily SaaS-like basis. Language has created so much value! It strikes us that their enterprise customers are most unlikely to agree to a sharp lift in prices from a bog-standard software vendor and the payment terms should be largely irrelevant but SaaS is so hot right now. Thirdly, TNE is on a forward PE of 43.4x for reported earnings growth of circa 12% and this includes a result where they capitalised more costs than guided or they would have missed their number. Finally, management sold stock during the month. Our position will ebb and flow but we will stay short.

The second key negative was a large short in our old friend Ryman (RYM, +17.0%). Their H1 result was actually quite weak, with higher costs pressuring the care business, while development deliveries will be very much H2 weighted. Despite this, uncontracted stock rose from 69 units (1.0% of portfolio) to 111 units (1.6%) in the half. It will take a herculean sales effort in H2 to sell their significant delivery pipeline and there is some risk of rising debt levels getting up to potentially

uncomfortable levels – especially given a backdrop where every man and his dog are delivering retirement units. Despite several years of disappointing deliveries, the market appeared to buy the lift in RYM's medium term delivery target to 1,600/year which distracted from the rather difficult current environment.

The final notable headwind was our short in Fisher & Paykel Healthcare (FPH, +15.7%). This illustrates the danger of shorting a good company based on valuation and momentum measures that had appeared to have run their course but simply kept on running. The forward PE of 46.3x is rather fulsome and compares to Resmed's 35.7x. The reality is that FPH had been in downgrade mode for several years due to patent costs and flat mask sales but has now shifted to a moderate upgrade path albeit a portion of this is low quality from a weak NZ$, new R&D tax credits and a slightly earlier mask release than had been guided. Medium term, we are concerned that potential US price changes may favour machines over masks, which would be a net headwind for FPH.

The standout positive was a repeat performer in the form of our large long in Tower (TWR, +11.8%). Their result was only in line with our expectations but they delivered very strong guidance and dealt with potential concerns in a number of areas. The major IT project which is critical to reducing their costs to industry norms appears well on track; they reiterated the strong upside from their planned acquisition of Youi NZ and Christchurch earthquake settlements have begun to surprise slightly on the downside although new over-cap claims remain an irritant. Importantly, the pricing environment remains firm and TWR now has an extremely strong capital position at circa 260% of the minimum regulatory requirement which places them very well for future growth.

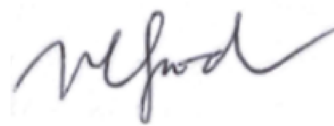
The second key tailwind was our large long in Metlifecare (MET, +21.1%). The share price was already showing signs of shaking off its torpor but this was accelerated by the receipt of a takeover bid at an undisclosed price from an undisclosed party. MET has long traded at a discount to its NTA thanks to its aged units requiring reinvestment and its seeming inability to deliver developments at the margins that others in the sector claim to be able to. Further, we have always been sceptical about NTA's across the entire sector as they are provided by one valuer who has never been rotated, long term house price assumptions seem to assume the boom of the last 15 years will continue ad infinitum and individual village accounts provide only limited free cashflow support for the valuations proffered. For these reasons, a bid that is firmed up close to NTA in the high 690's would likely be seized upon by the market in our view. Ryman trades at 3.4x NTA – hmm. Interestingly, our longs in Metlifecare, Oceania and Summerset more than offset the pain from the Ryman short.

Other notable positives were led by our long in Eureka Group (EGH, +19.0%), the Australian aged rental operator which only now has reached NTA of circa $0.33, with that in turn being based on cap rates of 10.2% which are extremely high for a government funded income stream. Our large long in Graincorp (GNC, +12.5%) did well as they received ACCC approval to divest some grains terminals which will take care of an over geared balance sheet. The drought is nasty for them but they are partially insured and a sum-of-parts including their valuable malting business is well above the current share price. Marsden Maritime (MMH, +8.1%) continued to march ahead as the merits of Northport become more apparent in the public discourse.

Portfolio changes saw us move aggressively to take advantage of two areas of real opportunity in the NZ market. Firstly, the sizeable volume of recent equity raising in the NZ listed property sector has seen us cover our shorts and establish a large new long in Kiwi Property (KPG, -0.6%), with a lot being purchased below its deal price. We purchased it cum its half-yearly dividend which it normally carries quickly and we see the stock as offering low risk 5-10% upside from our purchase price. From being relatively balanced previously, we now have a large net long in NZ property.

The second area of unusual net length is in the NZ gentailer segment which had been a rocket-ship over most of 2019 but was toppled from its highs by the threat that Rio Tinto may close the Bluff aluminium smelter. From peak to trough, Meridian Energy fell -22% from its recent highs and Contact Energy declined -26%, with this being exacerbated by not being included in the MSCI Index, which some had been expecting. From being net short into the previous strength, we are now around 5% net long this sector.

Thank you for your ongoing support of the Fund. From our lows back in February, we have returned to our former steady upward trend. As this piece is written, the Fund has had a very strong start to December in marked contrast to a sharp pullback in long-only markets. This has seen the Fund reach new all-time unit price highs and marks a pleasing return to what the Fund has provided for almost all of its life – equity-like returns with no correlation to equities and far less volatility. We will continue to march to the beat of our own drum and provide a true alternative in a world where almost all assets are expensive versus historical norms.



Matthew Goodson, CFA

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