SALT
Funds Management

Salt Long Short Fund Fact Sheet – October 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 31 October 2018

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$272.3 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 October 2018

Application	1.5410
Redemption	1.5347

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 October 2018

Long positions	88
Short positions	45

Exposures at 31 October 2018

Long exposure	82.19%
Short exposure	-46.73%
Gross equity exposure	128.91%
Net equity exposure	35.46%

Largest Longs	Largest Shorts
Centuria Metropolitan REIT	Goodman Group
Unibail-Rodamco-Westfield/CDI	National Storage REIT
Bingo Industries	Auckland Intl Airport
QMS Media	Dulux Group
Turners Automotive	BWP Group

Performance[1] at 31 October 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%	1.76%	-1.40%	-0.21%	-0.11%	1.20%	-1.06%	1.37%	-1.88%			0.30%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	-1.59%	1.66%	-3.92%
6 months	-0.73%	3.35%	-0.67%
1-year p.a.	2.71%	6.75%	2.85%
2-years p.a.	4.10%	6.75%	9.55%
3 years p.a.	6.27%	6.95%	10.08%
Since inception p.a.	10.39%	7.38%	9.20%

[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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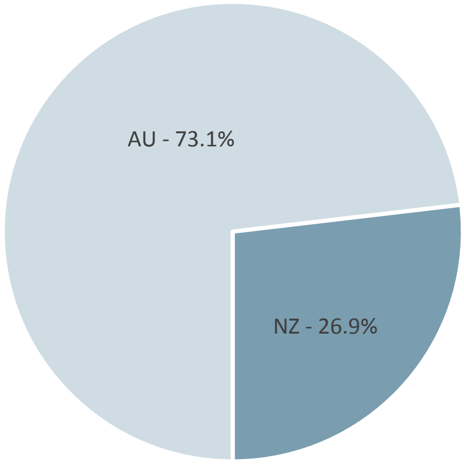
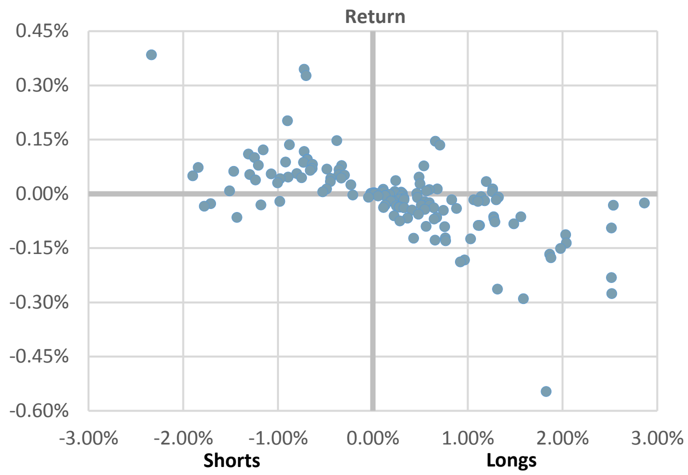
Country Allocation at 31 October 2018 (Gross Equity Exposure)



October 2018 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

The Fund held up extremely well in modestly positive territory for the first three weeks of a tumultuous October but any schadenfreude was short-lived as we suffered a torrid last few days to end with a performance of -1.88% after all fees and expenses. This compared to the S&P/NZX50 Gross Index return of -6.40% and the Australian S&P/ASX 200 Accumulation Index decline of -6.05%.

Since inception on 30 June 2014, the Fund has now returned +53.5% after all fees and expenses. Thirty-six of those fifty-two months have had positive returns, our volatility remains far below long-only equities and our correlation to highly volatile and expensive markets remains zero.

While the Fund fell by far less than equity markets in the month, we were disappointed to have not preserved capital. A run of 7 consecutive negative days at month's end moved us from being up +0.38% to the negative outcome that was delivered. There was no one major event behind this but several of our larger longs came under heavy selling pressure while our shorts did not protect us to the degree they did earlier in the month.

In response to the sharp declines and volatility, we are deliberately running the Fund at the lower end of our historic gross positioning of 130%. We have used extreme bouts of weakness to cover shorts and build the size of longs where we have particularly high conviction, with this seeing us running slightly higher net length than in recent times of 35-36%.

The quandary for investors is that markets appear ripe for a tactical rebound from deeply oversold levels but negative fundamental drivers still abound. Valuations remain expensive, earnings forecasts in Australia/NZ continue to gradually recede, housing markets are descending from their peaks, global central banks have moved from providing to draining liquidity, the Fed is determined to tighten although the RBNZ remains dovish, benchmark US bonds are under pressure from both rising fiscal deficits and inflation in that economy, while the Chinese growth engine conversely appears to be sputtering. Moreover, in the very short term, US mid-term elections could have a considerable impact on markets if the Democrats regain Congress.

Some of the tactical rebound has already happened. NZ equities rose on each of the last three days of October to be 2.2% above their lows, with a typically strong end-of-month performance by the likes of Ryman. November has started similarly. Australia was also interesting in that it surged by 0.56% in the ten minute closing auction at month-end – hmm.

October's rout moved the one year forward PE for the NZ market from 26.4x to 24.8x. Earnings did get downgraded a little further, with the year-ahead market earnings forecast now being 4.5% below its peak back in April. Downgrades are proving sufficiently large to outweigh the normal upside as you roll forward each month to higher future earnings. Long bond yields fell from 2.65% to 2.54%. This corresponds to a fair value PE of 21.1x – this means that a 15% decline is still required to get to fair value versus the -21% last month. We would highlight that history points to persistent periods of market under and overvaluation but then a rapid switch from one to the other can occur. Given the plethora of fundamental headwinds, we do wonder if October heralded such a change.

October saw the MSCI World Index fall by -8.5% in home currency terms, with Hong Kong being -10.1%, Japan -9.1% and the US S&P500 -6.8%. It certainly didn't feel like it but NZ and Australia actually outperformed. There are as many potential reasons for the sell-off as there are pundits but the initial catalyst appears to have been a speech by Fed Governor Powell on 3 October where he commented, "we may go past neutral but we're a long way from neutral at this point probably." The Greenspan, Bernanke and Yellen puts would seem to be history.

While the Fed is determined to keep lifting interest rates and removing QE, US earnings appear to have peaked across a whole range of sectors. The technology giants are succumbing to maturity, labour costs are rising, tariffs are pressuring profit margins, the global economy is slowing and the stronger US$ is crimping the earnings of multinationals, who dominate the US bourse. Classic examples were the reports of bellwethers 3M and Caterpillar on 24 October – they both spoke to increases in costs, the impact of tariffs and a slowdown in China.

Aside from a hawkish Fed in the face of inflationary pressures, US bond yields are also coming under pressure from rising US fiscal deficits. This can be seen in how inflation-protected TIPS yields haven't increased to the same extent. The last time that the US unemployment rate was below 4%, they ran a fiscal surplus of 2% of GDP. This time around, the deficit will come in around 5%. What will happen when the economic cycle inevitably turns? The deficit could reach Grecian levels when there is a slowdown.

The combination of rising yields and peaking earnings is both unusual and unhelpful for equities. As Morgan Stanley put it, "we are in the midst of a rolling bear market across all assets caused by a drain in liquidity and peaking growth." Historically, equity markets have prospered up until the late stages of monetary tightening because rising earnings have more than offset the negative impact of higher discount rates. This time around, the extended goldilocks period of rising earnings and ultra-low discount rates is beginning to reverse and earnings are peaking earlier in the rate-hike cycle.

Similarly, Goldman Sachs strategists drew some parallels between the events of October and the quant-driven selloff in 2007 that was the entrée to the main course in 2008. Corporate bond spreads and market volatility are at very low levels but rising interest rates mean that investors are no longer adding to strategies that require ever greater leverage.

Very low interest rates and historically tight credit spreads have been a key support for equities as cheap money has seeped out into all risk assets. Early in the month, the Bloomberg Barclays US Corporate High Yield Index reached a spread of 309 points over government yields, its tightest since 2007. At the same time, there has been a boom in the related asset class of leveraged loans. Further potential issues are lurking within investment grade bonds, where Deutsche Bank pointed out that more than 50% of such bonds are now in the lowest BBB rating band and Morgan Stanley projects that more than $1.1trn of such bonds could be downgraded to junk when the next downturn strikes.

Putting all the above together, our view is that the October sell-off was driven by a mix of earnings that have peaked and credit conditions that have bottomed. It wasn't just a flash-in-the pan swing in sentiment. The situation for NZ and Australia is a little different in that the RBA is in neutral mode and the RBNZ is dovish. This means that interest rates are not really rising here at all but with US rates going up, this is seeing our currencies depreciate instead. However, our housing markets and economies are most certainly slowing and this is putting earnings under pressure for large swathes of the market. This is not a good match with valuation multiples that remain extended.

Returning to the performance of the Fund during October, our return of -1.88% after all fees and expenses was driven by an awful "winners to losers" ratio of 44%, which is as bad as anything we can recall. Rather than poor stock selection, it was a case of faulty positioning where we had too many longs in a big down month. Only 20 of our 92 longs rose and they collectively detracted -5.25%. Conversely, 42 of our 49 shorts worked and they contributed +3.45%. With the benefit of hindsight, we were simply too long. While our longs tend to be low beta, everything comes under the cudgel in such a negative month.

Our largest detractor was a former standout contributor in the form of Bingo Industries (BIN, -24%) which was pole-axed despite there being no negative news. We had previously lightened our large holding into strength above $3.10 and used the weakness during October to as low as $2.38 to build this back up into one of our largest holdings. We see its well-located landfill and recycling facilities as fortress-like assets. While the Australian housing slowdown is unhelpful, the ongoing infrastructure boom should ensure that business conditions remain robust and multinational competitor Suez called this strength out in their Australian segment result. BIN is now on a PE of just 13x Jun20 forecast earnings which is the first year of the full integration of their Dial-A-Dump acquisition. This strikes us as far too low for this "Buffett-like" business.

The second key headwind was our largest holding, Centuria Metropolitan REIT (CMA, -4.2%). We had gradually lightened this into earlier strength but their acquisition of a large office portfolio and associated discounted equity raising saw us subscribe for our proportionate holding. There are two key attractions and one main issue with CMA in our view. Dealing with the latter first, their external management by Centuria does lead to the suspicion that growth of the vehicle may at times be prioritised over value and this latest deal had shades of that. That said, previous deals have worked out well after initial pressure. The first key attraction is that CMA is perfectly placed to benefit from the tail-end of the Australian office property boom, with a strong rental and valuation growth outlook remaining. This gives us confidence in the forecast numbers and leads to the second attraction, which is that CMA models as very cheap relative to other Australian property names when one considers its dividend yield versus drivers such as gearing, portfolio quality and free cashflow generation. On our calculations, the gross yield for a NZ investor is 8.6%. We are short a number of the most expensive property names to partially hedge this holding.

The bronze medal in the detraction stakes was won by a mid-sized long in the integrated wealth manager, IOOF (IFL, -16.3%) which came under heavy pressure from falling markets and Royal Commission fears. On our analysis they have little to no exposure to key issues such as "grandfathered commissions" and "fee for no service". Any moves away from vertical integration could be problematic but this has not been recommended to this point and IFL are well placed given their open architecture platforms. The other potential issue is if the ANZ Wealth purchase doesn't close but there appears little basis for this not to happen particularly given that IOOF has higher customer satisfaction measures than the ANZ business. IFL would be a huge beneficiary if Labour's policy to lift compulsory super contributions from 9.5% to 12% is enacted and they are on a Jun20 PE ratio of just 9.4x, which is the first full year of ANZ.

A fourth notable problem was our large long in QMS Media (QMS, -9.7%). We are attracted to the structural growth in digital billboards, with there being a real kicker next year with Federal and State elections. We believe QMS is benefitting from recent industry consolidation, with competitors being internally focused and there is less competition for sites. That said, the entire category is performing strongly. QMS has also made a large move into global digital sports rights via both teams and stadia. This is potentially a major growth area as different digital ads are played depending on the location of the viewer. We would note that KKR's investment into a rival sport-tech business implies very favourable multiples for QMS. There were a number of press rumours during the month suggesting that QMS may have interest in buying Val Morgan cinema advertising and/or the Mediaworks assets in NZ and/or Oaktree (the owner of Mediaworks) being interested in buying QMS.

Number five in the tale of negativity was a mid-sized long in Monash IVF (MVF, -17.4%), a name we have previously made very strong returns from and in which we are hoping to ride the cycle again. Recent IVF numbers have been mediocre albeit not disastrous and new competition from one of their key former doctors is now well understood. The low-cost competition from Primary Healthcare appears to have peaked. This is a sector which has long term structural growth as women choose to have babies later. The departure of the relatively new CEO did not help but we do not believe that major issues lay behind it. Various takeover rumours have circulated in the press but obviously come to nothing at this point. MVF is on 10.7x Jun19 and 9.5x Jun20 earnings forecasts and is a strong free cashflow generator.

A final negative standout came from our large long in Tower (TWR, -8.6%) which fell back from a minor spike in September for no particular reason. We believe their business is travelling very well with strong premium growth in excess of claims inflation and a far quieter period on the storm front. It now has very little sell-side coverage but on our numbers is trading on a PE of just 8.6x for Sept19 and 6.8x for Sept20, when cost savings from their current heavy IT investment begin to come through. We would also highlight that the escalation clause attached to Bain's purchase of 19.9% from Vero at 80cps expires on 8 December.

Winners unsurprisingly largely came from the short-side, with the stand-out being our large long-suffering short in Ryman Healthcare (RYM, -13.6%). It had been down further intra-month but enjoyed a typically strong last day. We used the weakness to significantly lower the size of what had been our largest short but this is a trading view and we have since lifted it post month-end. Fundamentally, we are very wary of the lack of equity in the capital structure, the aggressive early booking of sales, the opaque capitalisation of costs, looming signs of an inventory build in the sector, a NZ housing market that is clearly peaking, an outright decline in Melbourne sales and prices, and a valuation that is extraordinary.

The second key tailwind came from a brace of well-timed mid-sized shorts in Domain Holdings (DHG, -29.1%) and REA Group (REA, -16.7%). They both fell sharply following an earnings warning from DHG early in the month, where lower listing and auction volumes are seeing lower digital media revenues. While there are no signs yet that the decline in Australian property is easing, we took profits and covered DHG, especially as a strategic investor began to build a stake.

A third winner was our formerly painful short in Wisetech Global (WTC, -27.3%). The share price volatility of this SaaS logistics IT business is absurd. We see it as trading at the very top end of global SaaS valuation multiples but it is only delivering tepid organic growth and is relying on its enormous multiple to make a series of small Pacman-like acquisitions around the world. We can only imagine the complexity of integrating these acquisitions, forecasting and collecting cashflows and managing multiple untethered entrepreneurs. Our WTC position will continue to ebb and flow in the opposite direction to the share price. Even though it is 30% off its highs, WTC is still on a Jun19 PE of 72x.

Other smaller winners came from a short in the funds management holding company Pinnacle Investments (PNI, -30.6%) which had been trading on a very aggressive PE of over 30x. This contrasted with our long in Pacific Current Group (PAC, -5.1%) whose fund manager holdings have far less exposure to markets, which has sizeable net cash on the balance sheet and is on a PE of 10x. We also had two rare winners from the long side, with a modest Pacific Edge Biotech (PEB, +25%) holding leading the way as they demonstrated solid progress in getting their bladder cancer test accepted through the urological market. The other long that worked well was a mid-sized MYOB (MYO, +11.6%) position which was subject to an indicative bid from KKR. We halved the holding given sizeable risks around deal closure but events post month-end are moving in the right direction.

The Fund finished October with net positioning of 35.4%. This includes a 5% holding in Centuria Metropolitan REIT (CMA) which is a little larger than we would ideally like but where we saw little choice but to support an equity raising during the month. It remains a stand-out on relative valuation grounds and we have partially hedged the risk with related shorts in the sector. We are modestly net long gold, short housing exposures, short high valuation/momentum names and net long names that will benefit from a weaker NZ$ and A$. We are long an eclectic mix of very cheap names with potential catalysts and which will hopefully display little market exposure. We retain clear views that the US will tighten more aggressively than Aust/NZ as their economy overheats, China is slowing, housing will weaken further and short term market risks are balanced. Valuations are less egregious post the October meltdown but remain stretched.

The first key risk to hurdle in November will be US mid-term elections with the likelihood that the Democrats regain control of Congress. On the plus side, that may curtail the so-called trade wars with China but on the negative side, could see even greater US fiscal recklessness in the face of a bond market that is already beginning to revolt.

Thank you for ongoing investment and support of the Fund. 2018 has not been an easy year for investors and October was especially difficult. The Fund delivered a "less bad" result than most but this was not what we were hoping for following a tough last few days. We will stick to our investment disciplines and aim to deliver positive outcomes irrespective of what increasingly volatile markets deliver.

Matthew Goodson, CFA