Salt Long Short Fund Fact Sheet – May 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 May 2022

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$60.7 million
Inception Date	31 October 2014
Portfolio Manager	Matthew Goodson, CFA

Unit Price at 31 May 2022

Application	2.1325
Redemption	2.1239

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 May 2022

Long positions	46
Short positions	34

Exposures at 31 May 2022

Long exposure	93.90%
Short exposure	40.78%
Gross equity exposure	135.16%
Net equity exposure	53.61%

Investment Risk to 31 May 2022

Fund volatility[1]	6.41%
NZX50G / ASX200AI volatility[1]	13.98%
Fund correlation to 50/50[2] (daily)	0.082

[1] Annualised standard deviation since fund inception.

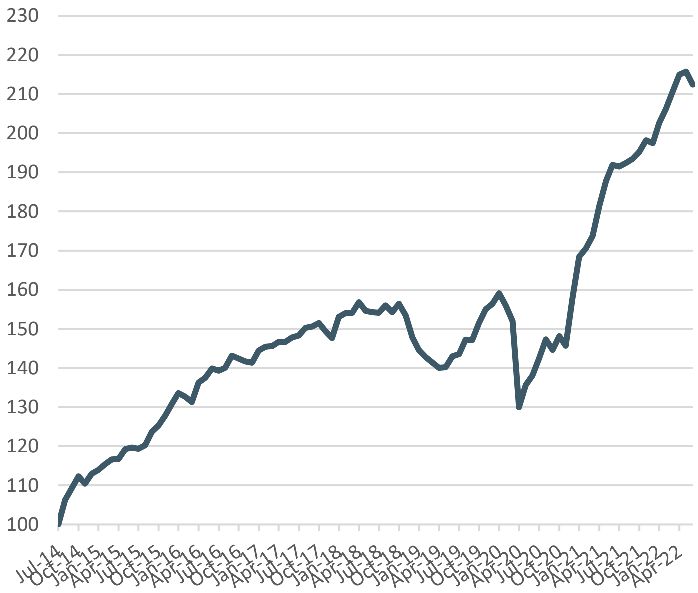
Fund Performance[1] to 31 May 2022

Period	Fund Return	OCR+5% Return	NZX50G/ASX 200AI Return[2]
1 month	-1.55%	0.56%	-3.72%
3 months	0.85%	1.55%	-1.24%
6 months	7.57%	2.96%	-4.97%
1-year p.a.	10.68%	5.67%	-1.82%
2 years p.a.	24.02%	5.47%	9.76%
3 years p.a.	14.11%	5.61%	7.21%
5 years p.a.	7.52%	6.07%	9.10%
7 years p.a.	8.54%	6.42%	8.91%
Inception p.a.	9.98%	6.66%	9.50%
YTD	4.83%	2.47%	-7.39%

[1] Fund performance is after all fees and before PIE tax.

[2] 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 May 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	ASX Limited
Dalrymple Bay Infrastructure	Commonwealth Bank of Australia
Shaver Shop Group	NIB Holdings Ltd
Lynch Group Holdings	Charter Hall Long Wale REIT
GDI Property Group	JB Hi-Fi

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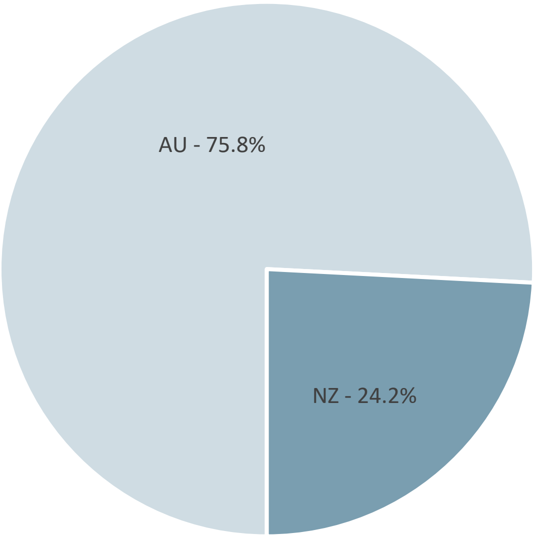
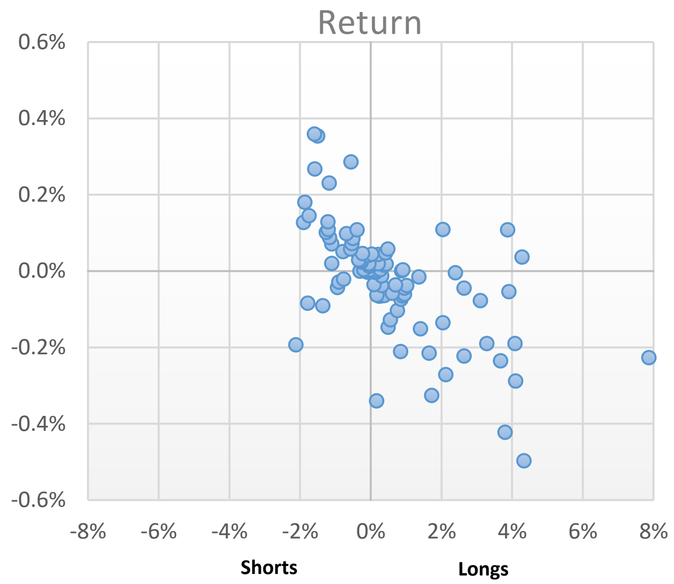
Country Allocation at 31 May 2022 (Gross Equity Exposure)



May 2022 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

The month of May was extremely volatile across many global equity markets as fears rose of slowing economies impacting company earnings, while persistent inflation may force central banks to keep tightening after having waited for far too long.

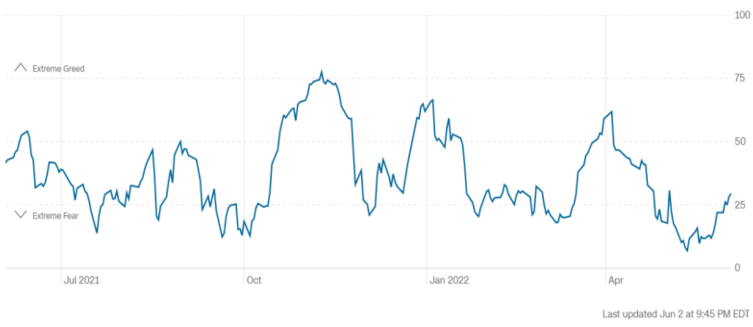
Against this backdrop, the Fund provided a degree of protection but still faced headwinds as selling pressure became widespread due to investors de-risking and seeking liquidity. The return of -1.55% after all fees and taxes compared to -4.85% for the NZ benchmark and -2.60% for Australia. Year-to-date, the Fund is +4.8%, while the NZ index is -13.2% and Australia is -1.3%.

The Fund started the month well but came under pressure as selling spread from the most expensive stocks (which we tend to be net short) to impact right across the market, largely irrespective of company characteristics. Given that we run the Fund net long, we were impacted by this to some degree. This can be seen by how our short book contributed a strong +3.3%, while our larger long book detracted -4.7%. There were no single-stock catastrophes of great note – just exposure to a market sell-off that was broader-based than normal.

We have been consistently nervous for some time and entered the month with unusually low gross exposure of 123% and net length of 41.5%. This helped the Fund to still do considerably better than long-only equities.

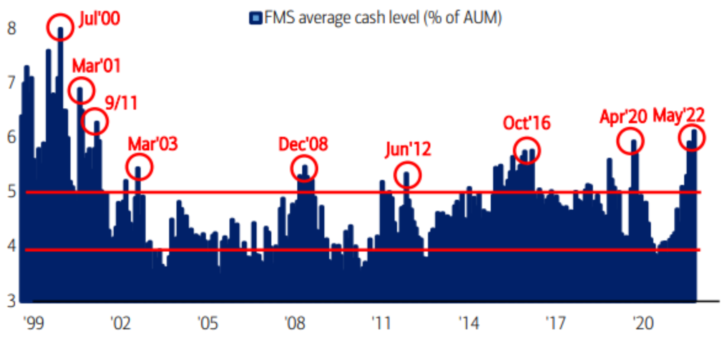
While we remain wary of the inflation outlook forcing tardy central banks to do a mini-Volcker and continue tightening as economies slow, the sell-off has now seen markets price this in to some degree. Markets are not yet fundamentally cheap overall, with overall multiples still on the high-side, earnings at some risk and bond yields looking to push higher. However, under the hood, an increasing number of good companies are selling at attractive multiples of mid-cycle earnings.

At the same time as valuations are becoming less offensive, the charts below show that market sentiment fell into an abyss and cash levels reached their highest levels since 2001. This may set us up for a short-term rally and we therefore used weakness to lift our gross to a relatively normal 135% and our net length to a relatively aggressive 53.6%. Our timing was less than perfect but we expect this to pay off in the period ahead.



The CNN Fear & Greed Indicator was mired deeply in "extreme fear" for much of the month, hitting an extraordinarily low reading of 6 at one point. This has tended to give good short-term buy signals for brave contrarians.

Chart 1: FMS cash levels rise to highest since 9/11
FMS average cash balance, %



Source: BofA Global Fund Manager Survey

The Bank of America Global Fund Manager survey showed that cash levels have hit their highest levels since the aftermath of September 11, 2001. This is not an infallible signal but previous cash high-points have tended to be a useful contrarian buy signal at least in the short term – assuming we have reached a cash high for this cycle. Similar data shows that hedge fund manager net length is at unusually low levels (in contrast to our increase in the month).

So, fear has hit extreme levels and cash is at multi-year highs, meaning the scene is set for a bounce on any modicum of good news. If markets bounce, could it turn into something more enduring? Possibly, but the problem is that central banks are beginning to drain the monetary punchbowl, with the speed and magnitude of this liquidity withdrawal depending on inflation readings in the months ahead. CPI outcomes will really matter.

QT starts this month in the US at $47.5bn/month for three months, ramping up to $95bn/month. On current plans, the Fed's $9trn of assets will decline to a mere $7.5trn by end-23. At the same time, the ECB looks set to dramatically reduce and then end its own QE. This only leaves Japan, whose targeting of a 0.2% 10-year bond yield has driven a sharp decline in the JPY.

The worst-case outcome for markets is that tighter monetary policy is initially ineffective against inflation. Negative supply-side shocks may continue to drive a nasty combination of inflation and recession that central banks have no choice to keep tightening into. This is the Big Bad Wolf rather than the persistent Goldilocks of pre-Covid times.

Best case outcomes would be an end to hostilities in Ukraine, a re-opening of China from its sudden Covid lockdowns (tentatively starting to occur) and a "bull-whip effect" suddenly seeing inflation outcomes surprise on the downside.

What do we mean by this? The most obvious examples are hand sanitiser and RAT tests. An initial surge in demand met supply that was short term inelastic leading to soaring prices. Some players chose to hoard rather than sell in the expectation of even higher prices. However, production has now well and truly expanded, leading to a collapse in price and excess supply everywhere as inventories are liquidated.

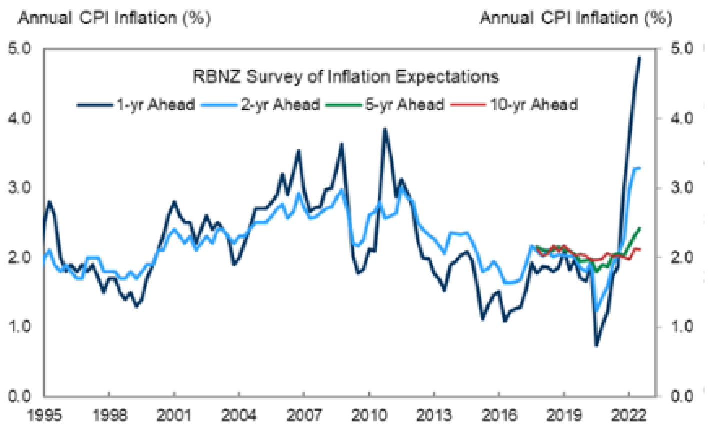
Every market is different, depending on demand and supply elasticities. However, a classic current example is gib board. Prices are rising rapidly, Fletcher Building is rationing supply and we have heard stories of market players hoarding supplies so that they can be sure to have access. However, new capacity is being built and it is quite possible that we could be talking about a collapse in pricing in a year or two.

Many countries last year experienced a surge in pent-up consumer demand as they emerged from lockdowns. This met severed supply chains that simply could not cope in meeting that demand. Stories of port congestion, inventory shortages and rapid price increases were everywhere.

Supply chains are still deeply disrupted but there are some signs they are beginning to resolve, with measures of US port congestion for example starting to fall quite sharply. In recent weeks, we have seen Amazon seek to hand back some distribution capacity and the Walmart and Target share prices hit hard as they have warned of a rapid shift in consumer demand, cost pressures and excess inventories. Overall data suggests that inventory/sales ratios are still very low but these tentative pieces of evidence may point to a bullwhip effect possibly beginning to get underway.

Another interesting example of a future potential bullwhip effect is the NZ housing market. After rising in a straight line for years and being a no-brainer source of levered wealth creation, things are starting to change. Prices are suddenly down 5-10% from their late 2021 peak (depending on measure and sub-market), while the number of homes for sale on realestate.co.nz in May was 77% above the level in May 2021. This is happening just as the RBNZ is in the middle of unleashing a series of rate hikes, net migration flows have turned negative and building consents have reached record levels. It is very early days as to where this downturn will end up but the seeds of the next cycle are already being sown. We are short retirement villages.

A key risk is that inflation may be peaking but it could remain at high levels. This depends on whether inflation expectations become embedded, spilling over to wage inflation, which with labour being 70% of the cost of everything, could lead to a classic 1970's spiral. Incredibly tight labour markets in NZ and globally suggest that this is a real risk and that central banks may need to recover from their glacial start and move quickly to break the expectations cycle. The chart below does give some hope that while short term expectations have soared, they remain relatively well anchored in the longer term. We shall see.



When the Fed tightened by 50bp in early May, the S&P500 responded with a 3.0% rally. This was the first sign that markets may try to tease out a "bad news is good news" narrative. We saw several more instances of this during the month, with the basic idea being that "bad enough" economic news will force the Fed to stay its hand. This may work but we would suggest the jury is still very much out on whether we have a (hopefully short-lived) recessionary scenario where price pressures peter out or a more stagflationary scenario, where supply chains are broken for some time and inflation expectations veer out of control.

Amidst all of these varying possibilities for the future, we have changed the Fund's make-up from 18 months ago when we were heavily positioned in cyclical stocks to benefit as economies rebounded from Covid-19. We are using selloffs to lift our holdings at attractive valuations in a collection of special situations, where we are buying growth companies at value multiples. We run through some of the larger ones below.

- Tower Limited (TWR) – a growing general insurer with a strong balance sheet. Insurers are classic investments in a rising rate environment as higher yields lead to a dramatic lift in earnings from their insurance float. The underlying business is growing strongly but this is being obscured by their retained deductible for large events of $20m – sizeable relative to forecast NPAT of $23m for this year. The market assumes they will hit this limit every year when history shows some years when there are no large events at all. We just hope that the market puts the same 10x PE on earnings in that year! TWR is now almost through re-pricing for claims inflation pressure, with the upside impact to come through in Sept23. TWR is on a consensus forecast PE of 8.8X and cash dividend yield of 9.7% in F23, with good growth thereafter.
- Dalrymple Bay Infrastructure (DBI) – we lifted our holding further when we helped clear a block seller at a discount. A major coking coal export port which is also a designated renewables development zone. On a 10.5% gross yield to a NZ investor with growth as they expand and get the benefit of moving to light handed regulation – we expect news on negotiated price hikes imminently. Higher bond yields get reflected in what they can charge.
- Shaver Shop (SSG) – a multi-bagger for the Fund in recent years that has pulled back 15% on no news. A net cash balance sheet, a cash dividend yield of 9% and a cash PE of 8x with growth opportunities ahead from online, store and range expansion. While retail cyclicality is a risk, personal care is very defensive.
- Lynch Group (LGL) – a poor investment so far for the Fund thanks to Covid impacts but we see a long-term growth business on deep value metrics. They are a major flower grower and distributor in China and Australia. This year has been tough but their updated guidance for Chinese lockdowns during the month has them on a PE of 11.7x unusually low trough earnings. They are on 8.0x last year's earnings. They have many years of growth ahead as they reinvest at a marginal pre-tax ROIC of 25%+ as they expand production.
- Global Data Centres (GDC) – has been under pressure in line with the sector but this small cap owner of stakes in data centres has a historic NAV of $1.95 versus a share price of $1.43. This includes a small stake in the mega-player Airtrunk that is held at cost but we believe this could now be worth materially more, potentially driving NAV into the mid-$2 region. GDC is internally managed, so has been under no pressure to seek aggressive valuations. Ultimately, GDC could be an interesting platform for someone to enter what has been a hot investment sector.
- Australian Vintage (AVG) – the largest Australian wine exporter to the UK and is materially improving returns as it shifts from bulk to branded wine. A leading producer of low/non-alcohol wines which are growing very quickly and also gives them a low-cost entry point into making branded spirits. The transport cost pain and delays have peaked. On a PE of 9.9x

Jun22 consensus forecasts, going to 8.5x Jun 23 and 7.7x Jun 24. Value multiples for a growth company.

- GDI Property (GDI) – an internally managed Perth-focused property trust led by Steve Gillard who is aligned with a 6% stake. Has a share price of $1.02 versus a lowly geared NTA of $1.28. On top of this, GDI part-owns and manages a range of property syndicates which appear to have solid potential valuation upside and embedded performance fees. Perth has seen little new investment since pre-GFC and rents have fallen dramatically, just as its key economic drivers of iron ore, oil and gold are doing exceptionally well.

We have one or two remaining cyclical and re-opening plays which are simply too cheap to sell on a through the cycle view. At the same time, we have shorted a range of stocks whose earnings are vulnerable to the cycle or where valuation multiples are egregious at a time when bond yields have risen sharply. Our single stock positions in the short book are smaller than they have been for some time and we are currently using it more for overall risk control.

Fund Performance in May

Returning to the Fund's performance in the month of May, the overall return of circa -1.4% pre fees and tax was composed of a major headwind of -4.7% from our long book, significantly offset by +3.3% from our shorts. In a negative month pretty much across the board, we simply had too much net length and the sell-off did not distinguish between the wheat and the chaff.

Our overall "winners to losers" ratio was a solid 55% but the skew of our negatives was larger than our positives because our high conviction longs tend to be bigger positions than our shorts. 35% of our longs worked, while a pleasing 85% of our shorts added value.

One disappointing aspect to the month was that we did not add value on negative days, although as one would hope, we did do less badly. This reflected the broad-based nature of the sell-off on those days. There were an unusually high 11 down-days in May for the 50/50 index of Australia and NZ, with the average loss for the market being a heavy-0.86%. The Fund was only up on 3 of those 11 days and delivered an average return on them of -0.24%.

The largest headwind was our long-held position in Shaver Shop (SSG, -10.4%), which has been a multi-bagger for the Fund. There was no new news but the market decided to shoot first and ask questions later for all stocks that are perceived as cyclical. We are hopeful that personal care names should prove defensive and SSG has tended to benefit from the change from work to home and vice versa. As detailed earlier, SSG's multiples are very attractive and they have several growth channels from new store roll-out, further online development with a more sophisticated CRM and product range expansion. They have a strong net cash balance sheet to fund this.

A second key detractor was our long in Global Data Centres (GDC, -9.6%), which we examined early. There was no new news and we can only assume it was caught up in a thematic of higher bond yields. We see the revaluation of their key holdings such as Airtrunk as a major catalyst that lies ahead.

A third headwind came from prematurely building a position into weakness in Ooh! Media (OML, -11.5%). The Australian outdoor advertising market now has an attractive industry structure with OML and JC Decaux being the leading players by some distance. Their digitisation and customer measurement tools for billboards should see ongoing structural growth, while the whole sector is clearly a major re-opening play. OML appears to have been caught up in a rotation out of anything with perceived cyclicality by Australian investors. We pulled the trigger too early.

There were a range of other mid-sized detractors but these were generally a function of share price movements rather than negative fundamental news. The only short that did not play its part was our long-standing short in Ryman Healthcare (RYM, +8.6%), which was subject to huge volumes and unusual price volatility around its removal from the MSCI Large Cap index. This position has added considerable value to the Fund over time and we have retained it given the difficult period that lies ahead as the NZ housing market slows abruptly.

The largest positive contributors by some distance all came unsurprisingly from the short side. The stand-out was our formerly painful position in the darling stock, Johns Lyng Group (JLG, -32.9%). It suffered from a mix of generalised pressure on high multiple stocks, a negative signal from a large management sell-down, and the absence thus far of a widely expected profit upgrade. We did cover it slightly prematurely as we feared it would be included in the S&P/ASX200 Index, which did not subsequently transpire.

Another highlight was our short in Homeco (HMC, -17.2%), which is perhaps the most aggressive of the Australian property fund managers. While we admire their entrepreneurial zeal and it is a favourite of many sell-side analysts, we see an environment of expanding cap rates as being very difficult indeed for rapidly expanding fund managers, who rely on a virtuous circle of rising valuations and equity raisings for their growth. It may come again in a few years' time.

A third tailwind was our formerly large short in Arena REIT (ARF, -11.1%), the childcare property owner that traded at a massive premium to NTA. We viewed the former premium as unsustainable as their tenants are facing a squeeze from sharply higher labour costs, while ARF's ultra-long lease terms are a negative in a rising rate environment. Longer term, we also suspect that structured lease agreements will combine with gradually ageing buildings to leave properties that are over-rented versus market and replacement costs.

Other winners were shorts in the darling stock, Corporate Travel (CTD, -15.5%) which we have since covered; JB Hi-Fi (JBH, -13.2%) in very much a pure cyclical hedge; Sims Group (SGM, -15.1%) which had been defying weakening scrap steel prices and where we suspect a sharp fall in US auto industry scrap rates will hurt; and Charter Hall Long WALE REIT (CLW, -8.2%) whose long lease durations and high gearing are a tough combination as bond yields rise.

Thank you for your continued support and interest in the Fund. May was a difficult month thanks to the breadth of the market sell-off but there were no movements that we would regard as permanent impairments due to a mistaken investment thesis.

Market sentiment is very poor and points to a contrarian bounce but it is poor for very good reasons. We are keeping an open mind as to how far central banks will have to go and whether we merely see a cyclical decline in profits or whether a deeper stagflationary shock is upon us. We have used opportunities to lift net length but have done so in a range of special situations, where we can see clear catalysts and where we are feeling like rather lonely bulls – that is where many of our best returns have come from over time.

This Fund will strive to continue its history of being less volatile than equity markets and endeavour to deliver positive returns irrespective of whether markets rise or fall.

Matthew Goodson, CFA