Salt Long Short Fund Fact Sheet – December 2023

Manager Profile

Salt Funds Management is a boutique investment management firm wholly owned by its employees which specialises in actively seeking to maximise returns while managing the risks of the investment.

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 July, 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 December 2023

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$75 million
Inception Date	1 July 2014
Portfolio Manager	Matthew Goodson, CFA

Unit Price at 31 December 2023

Application	2.3066
Redemption	2.2973

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 December 2023

Long positions	52
Short positions	34

Exposures at 31 December 2023

Long exposure	114.96%
Short exposure	65.18%
Gross equity exposure	180.14%
Net equity exposure	49.77%

Investment Risk to 31 December 2023

Fund volatility[1]	6.47%
NZ50G / ASX200AI volatility[1]	13.62%
NZ50G / ASX200AI correlation	0.074

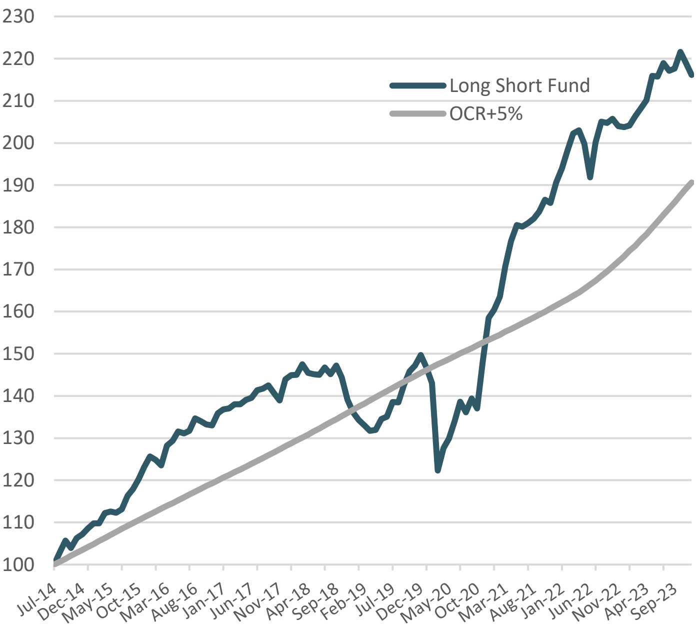
1. Annualised standard deviation since fund inception.

Fund Performance[2] to 31 December 2023

Period	Fund Return	OCR+5% Return	NZ50G/ASX 200AI Return[3]
1 month	-1.31%	0.79%	5.57%
3 months	-0.69%	2.51%	6.29%
6 months	0.17%	5.08%	3.12%
1-year p.a.	6.08%	10.13%	6.96%
2 years p.a.	6.48%	8.65%	-0.09%
3 years p.a.	10.90%	7.53%	2.60%
5 years p.a.	9.70%	6.87%	8.76%
7 years p.a.	6.85%	6.84%	8.38%
Inception p.a.	9.15%	7.10%	8.71%

2. Fund performance is after all fees and before PIE tax.
3. NZ50G/ASX200AI is a 50/50 blend of the S&P/NZ50 Gross Index and the S&P/ASX 200 Accumulation Index and is for comparison purposes only.

Cumulative Fund Performance to 31 December 2023

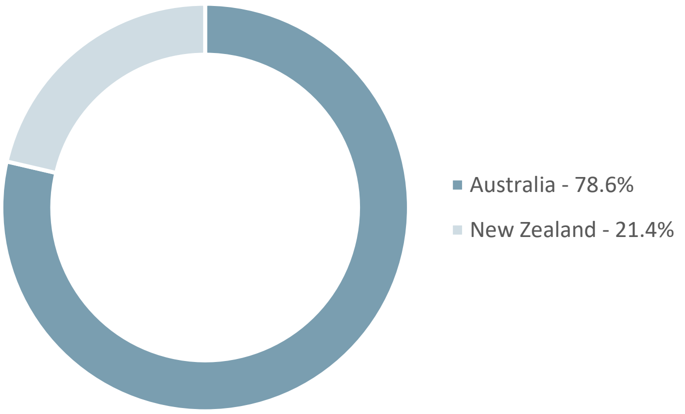


Fund performance has been rebased to 100 from inception.
Past performance is not a reliable indicator of future performance and no representation or warranty, express or implied, is made regarding future performance.

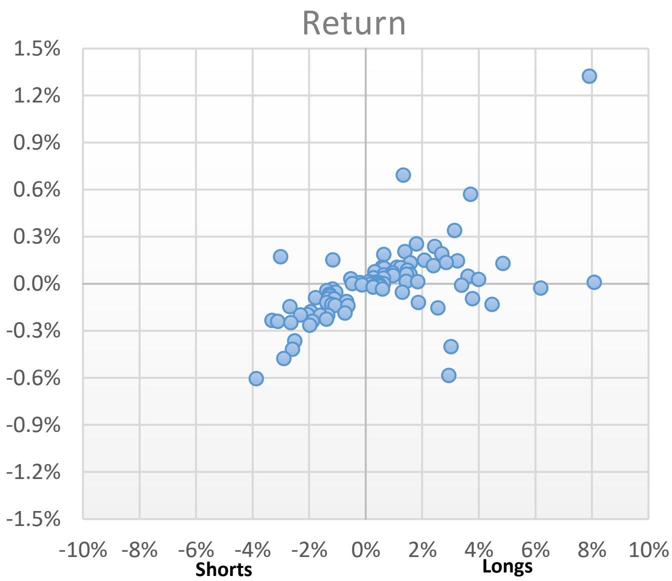
Largest Longs	Largest Shorts
GDI Property Group	Reece
Tower	Commonwealth Bank of Australia
Global Data Centre Group	Data#3
Superloop	REA Group
Lynch Group Holdings	Fortescue Metals Group

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 December 2023 (Gross Equity Exposure)



December 2023 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

The month of December was party-central for euphoric equity markets. Unsurprisingly, our high beta shorts tended to rise far more strongly than most of our lower beta longs and we ended the month with a return of -1.31%. Our long book added +4.3% but was overrun by the -5.5% decline from our short book. If anything, stock-specific fundamental news was a net positive for us but this was blown away by the general momentum-driven surge.

For the December quarter as a whole, the Fund was down -0.69% - a rare negative quarter for the Fund. This was disappointing but we almost kept our head above water in what was a painful period for many market-neutral long-short funds around the world.

It is early days in January but equity markets have retraced some of their earlier gains, with the Fund contrastingly performing well. For so long as expectations of Goldilocks stalk the land, we suspect our usual zero correlation with equities will be a negative correlation. Given that Goldilocks is a fairy-tale for momentum-addicted long-only managers, we think the low-volatility, zero-correlation role that our Fund plays within a diversified portfolio will prove very useful as 2024 unfolds.

In the very short term, equity markets have become extremely overextended on momentum measures, with all sorts of indicators flashing red. Summing them all up in one measure via the CNN Greed & Fear Index below, the dalliance with "greed" in November and "extreme greed" in December can be seen starkly. It was quite the bounce from "extreme fear" in October.

Our reading of the Goldilocks thesis is that investors believe that inflation will return rapidly towards central bank targets; that the Fed will cut six times in 2024 and that other central banks will follow; that recession risks won't materialise; that earnings forecasts will hold up satisfactorily; that extended valuation multiples won't overly matter; and that black-swan risks such as US elections, the Russia/Ukraine war, the Middle East et al will be resolved or won't materially impact inflation or GDP growth around the world. The temperature of the porridge will be just right.

The imprimatur to believe the rate cut part of Goldilocks was given by a surprisingly dovish Fed Statement in early December. It removed the last hike from the Fed's dot-plot and added a further cut in 2024 to make three rate cuts. The market promptly priced in six. The Fed's reasoning was that GDP growth had eased from its strong Q3 pace, that employment was still strong but softening and that while inflation remains elevated, it is easing. All of this is perfectly fair but it is unclear what new news had emerged since earlier more hawkish Fed positions. Since then, core CPI inflation for November was an as-expected +4.0% YoY, while the core PCE deflator was also as-expected at +3.2%. The latest November non-farm payrolls data contained higher than expected wage inflation.

Globally, according to Citigroup research, global core inflation for November was +3.2% versus a recent peak of +4.5% but this is still well above the 1.5%-2.0% levels pre-Covid. The key issue is global services inflation is only gradually slowing and stands at +3.9% (<2% pre-Covid), with the critical issue here being wage growth. Goods inflation has fallen sharply thanks to weak Chinese data and plunging transport costs post their earlier Covid spike (at least until current Red Sea issues).

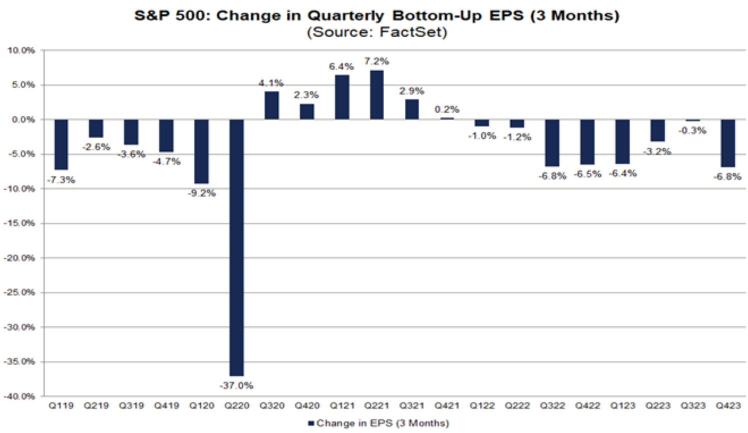
So, put this together and what really matters for the rate cut leg of Goldilocks is that core inflation keeps falling quickly and this allows the Fed (followed later by other central banks) to cut 5-6 times in 2024 rather than 2-3 times. This is possible but we have three concerns.

Firstly, the major secular drivers of low inflation pre-Covid (when we really did have Goldilocks) are over. Labour markets are tight everywhere and wage inflation is likely to be with us for some time. Moreover, while China is cyclically weak at present, the huge disinflationary supply-side shock of them joining the world economy which has driven zero tradables inflation has now played out.

Secondly, after the initial supply-side driven inflation shock of the 1970's, the Arthur Burns-led Fed made the historic mistake of easing too quickly on signs of a peak in inflation and at a time of expansionary fiscal policy. What happened next was a further oil shock that combined with expansionary monetary/fiscal policies to drive a historic inflation surge and a deep bear market in equities. Barring a dramatic expansion of the current Middle East war, we find it hard to see a repeat of this but the historic nature of this policy error may guide the current Fed more towards the three rate cuts in their dot-plot rather than the six priced by the market.

Thirdly, if these first two concerns are misplaced and inflation really does fall more quickly than expected, it will almost certainly be because the labour market pressures dissipate due to a recession. This will see the rate cut leg of Goldilocks work but it will be accompanied by the earnings forecast leg being ripped apart. The porridge will be too cold rather than just right.

Fears of recession and ongoing earnings forecast cuts have long been pointed to by the negative slope of the yield curve and the historically reliable signal from the Conference Board measure of US Leading Economic Indicators. In November, the LEI fell for the 20th straight month, resulting in the Conference Board calling for a "short and shallow recession" in the first half of 2024.



A recession would clearly invalidate Goldilocks thanks to earnings downgrades. Indeed, given the time it takes economic data to be released, it is often only in retrospect that it becomes clear that an economy has been in recession. We think this might actually be the case for the US and NZ right now. The chart above shows that S&P500 earnings forecasts for 4Q23 were cut by -6.8% during the quarter. This compares to the long-term average of over-optimistic analysts being pared back by c3.5%. Australian and especially NZ earnings forecasts are behaving similarly as economies slow and the earlier excess savings of households have been exhausted.

Put all this together and the varying evidence as we enter 2024 feels like a shallow recession accompanied by gradual rate cuts rather than Goldilocks. This means weak growth and persistent albeit gradually declining inflation rather than a return to the pre-Covid Goldilocks nirvana.

Translate this into our Fund holdings and we emphasise our consistent message over the last several months – we are net long under-priced rate-sensitives that benefit from falling bond yields and are net short expensive cyclicals. We have covered most of our technology shorts and our largest longs are in either special situations or rate-cut beneficiaries such as GDI Property, Global Data Centres, Servcorp et al. These worked to some degree in the quarter but we were over-run by a nonsensical momentum-driven surge in many of our cyclical shorts. Looking forward, we really like how we are placed and January has started well as small pieces of evidence have started to go our way.

Fund Performance in December

Returning to the Fund's performance in the month of December, our overall return of circa -1.2% pre fees and tax was comprised of our long book adding +4.3% but this being overwhelmed by the headwind from our short book detracting -5.5%. By their nature, many of our longs are special situations and low beta, tending to march to the beat of their own drum. They rose to some degree, but even with good news from a couple of key names, just couldn't keep pace with the broader surge. Conversely, despite no obvious fundamental drivers, our shorts were all aboard the momentum express. Our overall "winners to losers" ratio was an unusually poor 50%, with only 4 out of 36 shorts adding value, whereas 14 of our 56 longs declined.

Our gross exposure rose further over the month from 173% to a near-record 180%. This reflected higher absolute prices for both our longs and our shorts, as well as opportunities being created from sharp price movements. Our net length was largely unchanged at 50%. When markets have these sharp momentum-driven moves, they can continue for some time, and we are conscious that in the very short term, we have become negatively correlated in any case.

December was a month of relentless strength. There were only 6 negative days for the 50/50 index of Australia and NZ, with the worst of them being a mere -0.49%. Unusually, we did poorly on these days, which we put down to the small sample set and randomness. We were down on 5 of those 6 days, with an average return of -0.30%. For the first month in quite some time, we did far better on positive days than negative ones. Such is the nature of running a Fund that is uncorrelated over time. Sometimes we are up, sometimes we are down and sometimes we are flat.

Headwinds were dominated by news-free momentum driven surges in a number of Australian companies in our short book. Typically, these were names that are very expensive on any sensible valuation and/or have a degree of cyclical risk attached to them. Broker forecasts for such names tend to have very optimistic earnings tracks and forecast growth that is not accompanied by a great deal of capex, so that ROIC unrealistically explodes higher over time. For some years we have carefully shorted such "darling stocks". This has been painful at times when the market has surged but ultimately many of these positions have worked out well, so long as the forecasts have indeed proven too optimistic.

In January, the largest detractor was the Australian/US plumbing retailer Reece Group (REH, +15.8%), which is a favourite in many "quality" portfolios. The only problem is that it is on a Jun24 PE of 40.2x going to a mere 37.4x in Jun25. It is a good business but their opportunities for core business growth in Australia are now limited, with much depending on growth in the hyper-competitive US market. We have traded the position around but current multiples are stretched to put it mildly. It has already retraced -3.4% as this is written in early January.

Another similar momentum driven surge came from REA Group (REA, +16.7%) which is on a Jun24 PE of 50.2x. They have successfully positioned themselves as an intermediary that clips ever more of the ticket from their realtor clients but we do wonder how businesses such as this and Carsales will fare in 2-3 years' time as AI tools allow global giants to shoulder into the game. A realtor will always need to exist but is an intermediary like REA actually needed when Google or Microsoft's AI engine can show you every possible listing in response to a defined query? Meanwhile, REA is expensive and has a degree of cyclical risk.

Other painful shorts in the month included news-free surges in Breville Group (BRG, +14.6%); a sharp lift in Fortescue Metals (FMG, +16.1%) with a strong iron ore price surprising us by diverging from its normal relatively tight relationship with weak Chinese M2 growth; and Super Retail (SUL, +13.5%) rising sharply despite signs of only a satisfactory Christmas for the sector.

We disappointingly suffered a couple of headwinds from two of our mid-sized longs. Omni Bridgeway (OBL, -12.6%) continued to be a festering sore in our long book. We retain our view that the heavy shorting in this name is misplaced. They successfully sold a portion of one of their litigation investment books at a price which franks their carrying values and they made solid progress in raising new investment funds. Ultimately, it seems that only a flurry of successful litigation settlement announcements will convince the bears that OBL is a cash-generative business that won't need to return to its equity holders. Their strong track record leaves no reason to expect that these won't be forthcoming.

The second source of hurt came from our premature investment in APM Human Services (APM, -18.9%). This provider of disability and unemployment services strikes us as a classic counter-cyclical but they downgraded at their AGM in November and they came under further pressure from mooted reforms to the Australian NDIS scheme. However, these reforms seem aimed at cutting out middle-man managers rather than actual end-service providers such as APM. They are on a forward PE of 6.9x Jun24 and 6.0x Jun25 and have seen heavy insider buying.

A final disappointment from the long side was our large holding in Tower (TWR, +0%), which did precisely nothing despite announcing a strategic review, which includes, “a thorough evaluation of our ownership structure”. Unrealistically assuming a full $45m of assumed deductibles for large events, (to date none), they are on a worst-case PE of 8.9x Sep24 and 5.7x Sep25, with a dividend yield well into the teens in that year. TWR has dashed our hopes a number of times but perhaps all the pieces of the jigsaw are finally coming together for a windfall return.

On the positive side, the large long we have built up in GDI Property (GDI, +16.4%), enjoyed a second month of surging returns. It was hardly alone in the property sector but it again strongly outperformed its peers. While this was again due to lower bond yields, we continue to like GDI on pure property grounds and still see it as very cheap, with a share price at $0.65 versus a relatively robust NTA of $1.26. The strong positive net absorption of the Perth office market makes it far preferable to other markets and GDI’s gearing is comfortable. They announced strong leasing progress during the month, with this removing the one possible wrinkle to the thesis.

A second stand-out came from what had been a small position in Intelligent Monitoring Group (IMB, +54.4%). We initiated this some months ago when they raised equity to purchase the leading but much-neglected security monitoring business, ADT from its US parent at a price that was remarkably attractive. They have made further bolt-ons since then as they consolidate the industry and have made moderate earnings upgrades as progress on fixing ADT has been solid.

A final winner of note was a return appearance by DUG Technology (DUG, +13.1%), which we continue to view as having years of growth ahead of it from their super-computing business. It had earlier been knocked down by a slightly disappointing quarter but this was due to a temporary lack of computing capacity in the face of a surging order book. They are still a small player in the large global industry of seismic analysis for oil companies and their order book would seem to add credence to their claims of having a technical analytical edge over their competitors.

Thank you for your continued support and interest in the Fund. The momentum driven surge in November and December saw a disappointing end to what has been another solid year. It is possible that this market surge may continue but it will need a Goldilocks outcome of disinflation allowing central banks to ease but economic and thence earnings growth remaining solid. Geopolitical ructions will need to remain under control and investors will need to contend with valuation multiples that are particularly high for larger cap stocks. Maybe the eye of the needle will be threaded but at the very least there will be periods where the Big Bad Wolf rather than Goldilocks is feared and priced in. We will become wiser as 2024 unfolds but will remain focused on our mission of delivering equity-like returns over the long run but with far less volatility and no correlation.

Matthew Goodson, CFA