SALT
Funds Management

Salt Long Short Fund Fact Sheet – March 2019

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 March 2019

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$179.6 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 March 2019

Application	1.4059
Redemption	1.4002

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 March 2019

Long positions	70
Short positions	40

Exposures at 31 March 2019

Long exposure	74.81%
Short exposure	-48.70%
Gross equity exposure	123.50%
Net equity exposure	26.11%

Largest Longs	Largest Shorts
Centuria Metropolitan REIT	Ryman Healthcare
Tower	Auckland Intl Airport
Turners Automotive Group	Genesis Energy
Investore Property Limited	Charter Hall Retail
Restaurant Brands NZ	Technology One

Performance[1] at 31 March 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%	1.76%	-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%										**-3.16%**

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	-3.16%	1.62%	10.76%
6 months	-10.48%	3.31%	3.02%
1-year p.a.	-10.70%	6.75%	12.07%
2-years p.a.	-2.30%	6.75%	10.48%
3 years p.a.	0.91%	6.83%	11.46%
Since inception p.a.	7.34%	7.32%	10.52%

[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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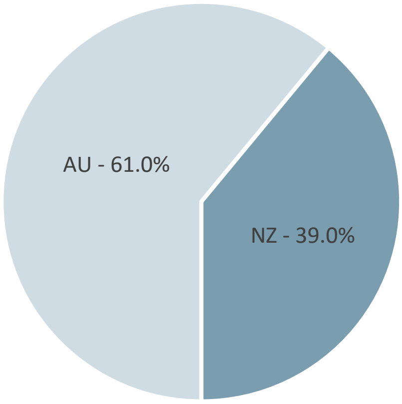
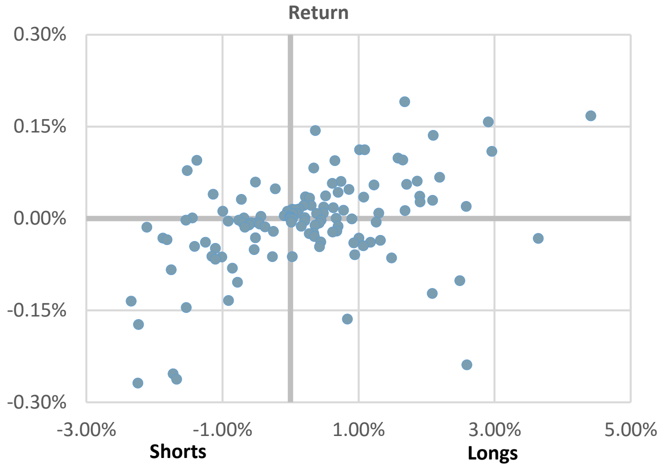
Country Allocation at 31 March 2019 (Gross Equity Exposure)



March 2019 Individual Stock Contribution



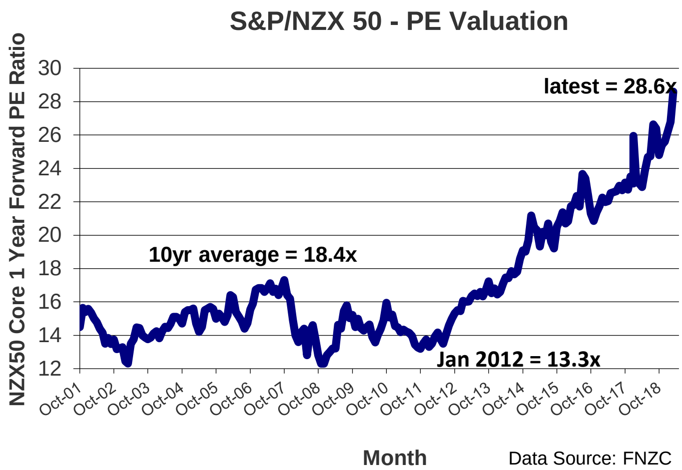
Fund Commentary

The Fund delivered a return of -0.96% after all fees and expenses during the month of March. After a soft start, we had ground back up to flat with three days to go but then a dovish RBNZ Statement sparked a sharp fall in bond yields and a wave of indiscriminate buying which saw many of our extremely overpriced shorts rise even further.

While many of our longs did well, this sudden return to a bull market is seeing little interest in solid companies on 8-12x PE ratios that have 10-15% growth. This market is being driven by a bar-bell of egregiously overpriced growth names and very expensive dividend yielders. Any investor requiring yield has been forced dangerously up the risk curve from corporate bonds into equities.

Since inception on 30 June 2014, the Fund has now returned +41.4% after all fees and expenses, with thirty-four of the fifty-seven months having had positive returns. While the last few months have been torrid, the Fund's long-term track record remains solid. There are no material problem children that concern us and we believe we are well placed to benefit when this aged bull market comes to its inevitable end.

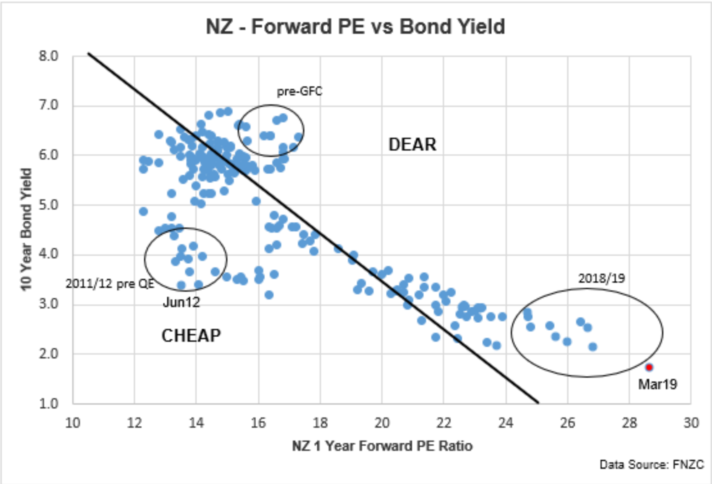
We have cried wolf for a couple of years now as equities have ground remorselessly higher, even in the face of year-ahead earnings forecasts that have fallen 7% since April 2018. We do not typically include charts in our commentary but words no longer do our market justice.



This shows the year-ahead "core" PE based on earnings forecasts that roll forward a year every month. It excludes property companies and Infratil to avoid one-off revaluations. There is an argument that the PE's for the large gentailers are overstated given they depreciate their hydro-dams too quickly but this is not hugely material. The picture is fairly clear – and yes, we were bullish back in what seems like the mists of time in 2011-13.

The obvious reason for the PE multiple expanding is that bond yields have plunged and we must confess that they have fallen far further than we ever thought possible. In March alone, the NZ 10-year yield fell from 2.16% to 1.75%. This is below the 1.9% CPI inflation rate and illustrates just how central banks everywhere are forcing investors uncomfortably up the risk curve.

Frighteningly, the chart below shows that even at these ultra-low bond yields, the NZ equity market is very expensive.



This scatter-plot looks at the one-year forward PE versus the 10-year bond yield for every month going back to October 2001. Without overplaying the mathematical precision, the line is a regression best fit and suggests that the fair value PE at current bond yields is a mere 23.2x versus the 28.6x that we closed the month at. The market is 23% expensive.

Over time, the market is very rarely at fair value and there have been three clear paradigms in this period. The first was pre-GFC, when bond yields were in the 6-7% region and PE's of 16-17x were too high relative to that – the GFC soon solved that. The second paradigm was the extended period of under-valuation in 2011-12, when the world's stuttering post-GFC recovery was particularly manifested in deep concerns in Europe. This was solved by QE and Draghi's "whatever it takes".

Finally, we have the current paradigm of slowing growth, lowflation and central banks that seem determined to ease monetary policy to achieve an elusive 2%+ inflation goal rather than being satisfied with low positive inflation. This has forced investors to overpay for equity risk in order to generate income, while very low bond yields are also disproportionately helpful to long dated growth companies. One day, this current paradigm will change but for now, that is what we have.

Work we have seen on these valuation models overseas shows they have little predictive power about short-term and one-year returns but strongly predict longer term 3 to 5-year returns.

Over the last several months, the Fund has been well and truly "beaten by the bull". Our set-up is similar to what it has always been, in that we short-sell over-priced mid-large cap companies and go long a variety of companies that are outright cheap or have under-priced growth right across the market cap spectrum.

A key problem for us has been that the market's advance has been disproportionately concentrated in the largest stocks, with the average PE at month-end being 28.6x, which is at a record divergence to the median PE, which is sitting back at a very attractive 16.8x. Our large cap shorts have become even more expensive, while our far cheaper (and often smaller cap) longs have risen far less. Australia has been directionally similar.

In our view, this median PE of 16.8x is very attractive versus current interest rates, with the trick being to find names which can still deliver earnings growth in a sluggish AU/NZ economic environment. Names such as Tower, Monash IVF and the outdoor advertising companies are examples of the types of names which are on modest valuations yet have solid growth outlooks with some degree of structural underpinning. We are just waiting for the rest of the market to agree with us.

NZ's extreme valuation divide between large caps and everything else may be part of a wider global phenomenon, which encompasses a similar value versus growth divergence.

A study by the Australian strategy team at JP Morgan split the S&P/ASX 200 into quintiles ranked by PE multiple and looked at the one-year performance of each group. The most expensive quintile had a staggering PE multiple expansion of 18.7x PE points over the last 12 months, quintile #2 expanded by 3.2x PE points, quintile #3 by 1.7x PE points but the bottom two were unchanged. We do not question that falling bond yields should drive higher PE's but 18.7x PE points? Really? Anecdotally, Australia has seen a wall of redemptions from value managers (and thence forced selling) in favour of go-go growth momentum players who are "partying like it's 1999". Our ardent hope is that they will soon be, "oops, out of time".

Similarly, in the US market, AB Bernstein analysis showed that the valuation gap between value and growth is at its widest in 70 years and that all of the multiple expansion has been in the most expensive part of the market, even as earnings forecasts there have fallen.

No wonder that Citigroup found that their basket of the most shorted names in the Russell 1000 Index outperformed the broader market by the most on record during the March quarter and at one point had a return double that of the Index. These severe headwinds for value-based short-sellers have manifested in only 1.2% of the US market cap being short-sold. This has only been lower in three weeks since 2007. It had peaked at 3.1% post-GFC but shorts have latterly been brutalised out of the market. We can and have felt this pain but it is surely a contrarian sign.

We are investing in highly unusual times but the hardest question is what causes the current paradigm to change? Central banks everywhere have been hell-bent on reviving CPI inflation but have failed in their quest and have merely sparked huge inflation in equity, property and bond prices instead.

We had thought for most of last year that the catalyst for a paradigm shift would be re-emerging inflation forcing central banks to tighten. However, tentative moves in this direction have been rapidly withdrawn with the Fed officially on hold, the ECB wavering and the RBA and RBNZ looking likely to cut as their next moves.

Despite gathering strength in wage inflation across many economies, the pass-through to CPI inflation has been muted. Moreover, there seems a sudden desire from some central banks to interpret their CPI targets in a symmetric fashion, so that outcomes above 2% could be tolerated for a period. The irony is that inflation readings are actually sitting at their multi-decade averages across much of the OECD, but in a world with over $10trn of negative yielding debt, interest rates are more akin to a deep depression.

While the role of a credible 2% target was critically important in breaking the inflationary paradigm of the 1970's and 1980's, we wonder if it has any relevance in modern economies which are running very modest levels of positive inflation (with the exception of Japan). In trying to force an extra 0.5%-1.0% in defiance of structural disinflationary forces via technology and ebbing working age populations, central banks have ignited enormous asset market inflation instead.

The concomitant levels of extremely high debt may see a debt/deflation bust at some point in the future. Moreover, extended periods of ultra-low rates appear to be zombifying economies as companies over-invest and consumers save rather than spend in order to hit their targeted income levels. We are very concerned with what may happen next and repeat our citation of a BAML study last month which argues that hot money could drive a short-lived mini-bubble (they're right so far) but this will then be ended by either a debt deflation trap or an outbreak of inflation in the second half of this year as wage pressures finally feed through.

While the bulls are running amok, there are an array of signs that we could be due another sharp correction. Net short positioning in the VIX volatility index is now more than 40% of the open interest. This is even lower than the 35%-38% net short levels reached prior to the very sharp retracements in February and October 2018. Similarly, inflows into the S&P500 Growth ETF hit their highest levels ever in the month of March.

The euphoric 20x oversubscribed listing of Lyft on 29 March saw memories of 1999 come flooding back. It priced at $72, opened at $86.60, closed day one at $78.30 and then closed day two below the IPO price at $69. A classic case of surge pricing. Another classic case of ringing the bell came from the legendary distressed debt and alternatives investor, Howard Marks who sold 62% of his Oaktree business to Brookfield. I know what side of the trade I'd rather be on there and it feels very similar to Sam Zell selling Equity Office Properties to Blackstone in 2007 – the bell has rung.

Returning to the performance of the Fund in March, the return of -0.96% saw the longs do relatively well with a return of +1.04% but our shorts hurts us in the strong market, returning -1.93%. Our "winners to losers" ratio was a disappointing 47% and the largest detractors hurt us more than the largest contributors helped.

The strongest headwind was our long-standing short in Ryman Healthcare (RYM, +11.4%) which was extremely strong for reasons that are known only to those buying it. Grey clouds continue to gather over the NZ housing market, with Auckland house prices now falling slightly and growth elsewhere slowing. Just as importantly, the number of transactions has fallen sharply. Although fixed mortgage rates have fallen on the back of RBNZ dovishness, a plethora of other negative factors persist such as foreign buyer restrictions, AML/CFT legislation, affordability levels, restrictions on negative gearing and looming requirements for banks to hold more capital in NZ. Ryman also has the extremely difficult Melbourne housing market to contend with. We cannot get remotely close to the current share price on a fundamental basis.

The second largest detractor was a short we had built in Charter Hall Group (CHC, +16.7%) which is bringing back memories of past property cycles by having its satellite funds buy anything and everything that isn't nailed down. For now, it seems to have caught the imagination of growth and momentum investors but we view the funds management component of their business as being extremely overpriced at what is a late stage in the property cycle. We have a partially offsetting long in the far cheaper and just as rapidly growing Centuria Capital (CNI, +3.7%).

Our third major source of pain was a short in Genesis Energy (GNE, +15%) which soared in line with other large cap yield stocks during the month. We have offsetting longs in the relatively cheaper and better positioned Contact Energy (CEN, +12.8%) and Mercury (MCY, +8.0%) but slowly took a little off the table as the entire sector has moved to extremely ritzy levels on the back of a desperation for high dividend yields.

A fourth headwind of note came from our relatively large long in Pacific Current Group (PAC, -10.4%) which fell despite investment markets that should have been favorable for the various fund management businesses that it owns. While PAC's interim result back in February was mediocre for temporary reasons, they look set for a very strong second half and it actually traded quite well post result. The only driver we can point to is forced transitional selling flows in a name which has only sporadic liquidity. We remain attracted to the sizeable net cash on the balance sheet ($80m versus $230m market cap), the upgrade potential as this cash is put to work, and the consensus PE of 10.3x Jun19 going to 9.1x in Jun20 and 7.8x in Jun21. Another way of looking at it is that PAC is trading at a 42% discount to a conservatively stated NAV of $394m.

The largest positive contributor was our mid-sized long in Oh! Media (OML, +9.6%) which bounced from its sharp sell-off in the previous month. There was no particular fundamental news driving this although the general outdoor advertising sector does continue to be the subject of vague M&A rumours.

This is hardly surprising given the circa 10% free cashflow yields that the sector provides and the solid structural growth outlook. Our larger holding in QMS Media (QMS, -5.4%) was disappointingly weak as it suffered from heavy forced selling as a large holder had their fund liquidated.

The second largest winner was our long-held long in Centuria Metropolitan REIT (CMA, +3.8%) which continued to claw its way up from the large equity issue that it carried out in the December quarter. CMA models out as strong relative value and we view it is having greater rental upside than most of its peers from its late-cycle non-CBD office exposures.

The third stand-out of note was our long in Turners (TRA, +5.6%) which finally bounced after a very disappointing period. We have talked often of our attraction to their integrated business model right through the value chain of what is a huge but very fragmented used car market. Cyclical conditions are clearly mixed but we believe TRA should be capable of meeting their guidance, which puts it on a PE of circa 8x and a net dividend yield of 7.5%.

Thank you for your ongoing investment and support of the Fund. The weak performance since late October has been very disappointing but we do see this as beginning to stabilise. We have been caught out by many of our high beta shorts rising sharply while our longs are lower beta and have simply not participated to the same degree in the meteoric market upside. Our long-term track record does remain solid and we see the Fund as being very well placed to deliver solid performance when overheated markets stage an inevitable pullback.

Matthew Goodson, CFA