Salt Long Short Fund Fact Sheet – March 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 March 2022

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$59.7 million
Inception Date	31 October 2014
Portfolio Manager	Matthew Goodson, CFA

Unit Price at 31 March 2022

Application	2.1578
Redemption	2.1491

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 2022

Long positions	45
Short positions	26

Exposures at 31 March 2022

Long exposure	86.43%
Short exposure	39.72%
Gross equity exposure	126.15%
Net equity exposure	46.72%

Largest Longs	Largest Shorts
Tower	Arena REIT
Dalrymple Bay Infrastructure	Johns Lyng Group
Lynch Group Holdings	Wisetech Global
Shaver Shop Group	JB Hi-Fi
GDI Property Group	Corporate Travel Management

Performance[1] at 31 March 2022

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%	1.70%	10.02%
2020	-2.01%	-2.51%	-14.47%	4.35%	1.80%	3.18%	3.39%	-1.81%	2.41%	-1.67%	8.31%	6.76%	5.88%
2021	1.24%	1.90%	4.42%	3.52%	2.16%	-0.23%	0.48%	0.56%	0.93%	1.52%	-0.39%	2.62%	20.29%
2022	1.76%	2.15%	2.04%										6.07%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	6.07%	1.41%	-2.48%
6 months	10.07%	2.81%	-2.36%
1 year p.a.	18.45%	5.47%	5.41%
3 years p.a.	14.21%	5.65%	10.01%
5 years p.a.	7.66%	6.09%	9.93%
7 years p.a.	8.81%	6.50%	8.95%
Since inception p.a.	10.38%	6.66%	10.44%

[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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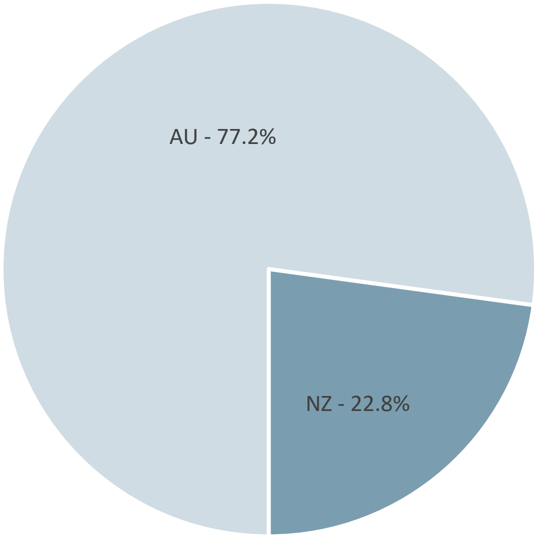
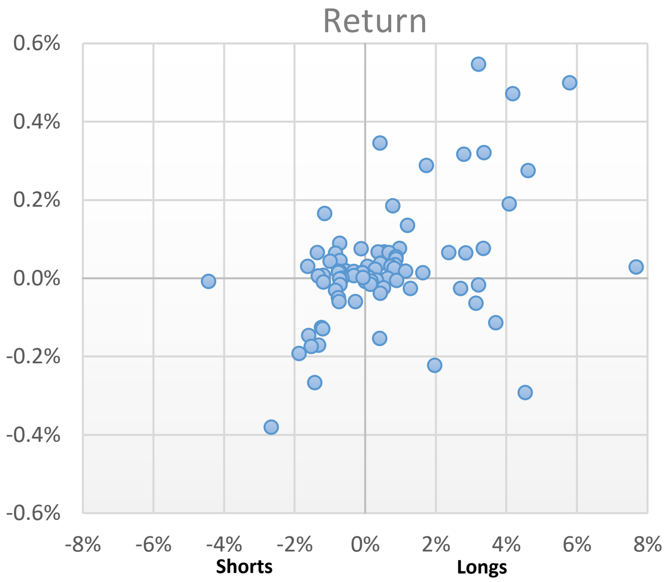
Country Allocation at 31 March 2022 (Gross Equity Exposure)



March 2022 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

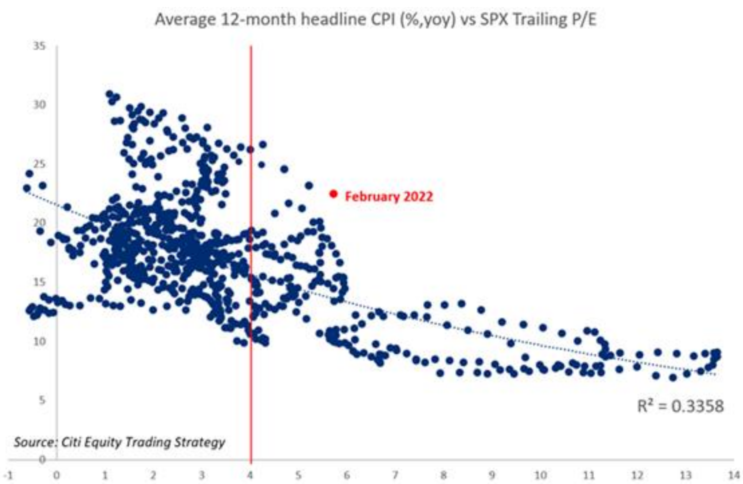
The Fund pleasingly experienced another strong month in March with a return of +2.04% after all fees and taxes. The overall March quarter saw a return of +6.07%, with this being the eighth quarter in a row of positive outcomes. The market backdrop is volatile to put it mildly and we are satisfied that the Fund is delivering on its aim of providing equity-like returns, with less volatility and no correlation to long-only equity markets.

Markets are in a strange transitional phase at present. Inflation is fulfilling our warnings and bursting out everywhere, bond yields are rising, yield curves are inverting and even the most dovish of the Fed Governors is talking about having to make 50bp rate hikes and embark on QT. The Ukraine war is adding fuel on the inflationary fire of over-heating economies.

Equities are reacting to these gathering storm-clouds in a volatile manner and generally bounced in March on what seems to have been a mix of short-covering, short-dated call option buying creating a gamma squeeze and a technical bounce from extremely weak sentiment levels (e.g. the CNN Fear & Greed Index had staged a rare foray into Fear territory).

Goldman Sachs estimated that the week ended 18 March was the largest 5-day de-grossing event in the last decade. Some of the most speculative stocks bounced the most, with the Ark Innovation Fund for example rising 18% during that week although it still fell by 6% in the month. Subsequent to month-end, stories have emerged of extremely heavy losses from technology investment focused funds in the March quarter which may have contributed to this volatility.

It is beyond question that significant inflationary pressure is upon us. The key question for equities is what flavour will it be? The jury is still out on whether it sets in above 3-4% for an extended period (bad for equities); whether some countries tip into stagflation (horrid for most equities); or whether we merely experience a bout of inflationary growth (quite good for some equities).



The chart above from Citigroup shows how high PE ratios tend to decline as inflation rises above 3.5%-4.0%. Indeed, when I started in markets in the early 1990's, the "Rule Of 20" was commonly referred to, with this holding that fair value is when the forward PE and CPI inflation sum to 20x. This is simplistic and abstracts from changing EPS growth but it still provides a useful anchor. Right now, the median NZ PE is around 20x, so it would be rather helpful if inflation returned to its old 2% region and did not linger at 5-6%+.

Evidence of high inflation continues to abound. Spain came in at 9.8% for the March year and Germany recorded 7.6% versus the 6.8% expected. After being briefly negative early in the month, German 10-year bond yields closed at 0.57%, while Spain closed at 1.5%, up from near zero earlier. These are still deeply negative levels in real terms and suggest that bond yields may have far further to rise as the ECB ends QE and perhaps even moves to lift rates.

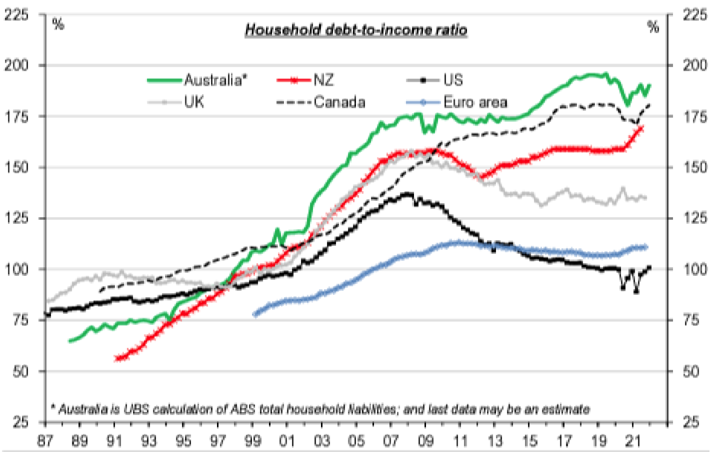
Negative real yields are also a sign that very easy monetary conditions continue to be the case. The chart below is a broader measure captured by the widely followed Goldman Sachs Financial Conditions Index. Liquidity is tightening but only from historically easy levels.

NZ only has quarterly inflation data but the March monthly ANZ Business Outlook Survey showed the net percentage of firms that intend to lift selling prices over the next year rose from 74.1% to 80.5%, while those expecting higher costs went from 92.0% to 95.9%. This is truly uncharted territory. Our 10-year yields rose from 2.77% to 3.27% in the month.

The story is similar in Australia, with the very dovish RBA over-heating their economy. A UBS research piece took our eye at month-end by outlining the sheer degree of excess demand in their economy. Residential approvals are +43% to 224k; private credit growth is running at +7.9% y/y, the strongest since 2008; job vacancies are +47% y/y and the ratio of unemployed people to vacancies has plunged to 1.25x versus its normal 3-4x and 2-2.5x at prior cyclical peaks – this should soon drive wages sharply higher which is an apparent prerequisite for RBA action.

Household debt-to-income is at a very high plateau and the chart below shows that the three major housing bubble countries of Australia, Canada and NZ could actually do with a good dose of inflation to deflate debt relative to rising income. This looks so much like the 1970's. On the bright side, high debt levels mean rate hikes may carry more bite and therefore not need to go so far.

Figure 15: Household debt is among the world's highest, & accelerating credit growth will lift leverage further



Source: ABS, Macrobond, UBS

Equities can still be a useful hedge against high inflation but it is critical to own names with pricing power, where higher nominal earnings from inflation can offset higher discount rates. While perhaps exaggerated by the Ukraine war, Australian sectoral performance in the March quarter provides some insight. The three top sectors were energy (+29%), materials (+15%) and utilities (+14%), while laggards were IT (-14%), healthcare (-10%) and consumer discretionary (-10%). Utilities with inflation-adjusted fee income can be useful especially if their debt is fixed rate and long duration.

The chart below from Credit Suisse shows that value does well versus growth when real yields rise. This is broad-brush as banks are a large part of most value segments and abhor negative yield curves, so whether we have stagflation or merely an inflationary slowdown (with higher yields but a positive curve) will matter a lot. Consumer staples and telcos may work best if the former.

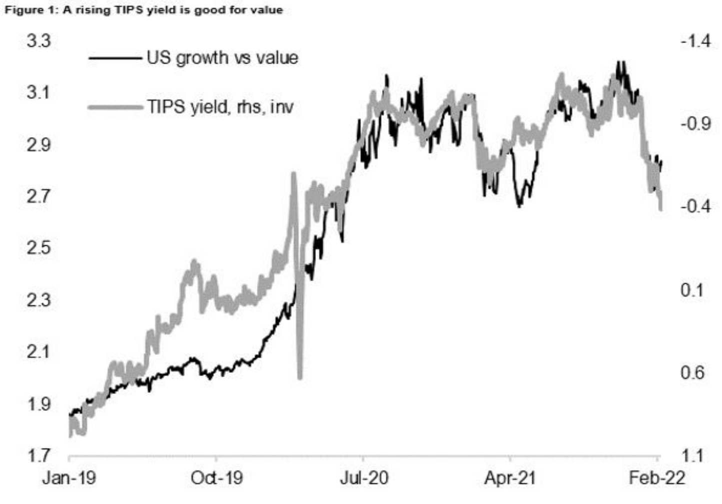


Figure 2: The TIPS yield has not risen as much as the 2y yield

We follow the views of renowned economist, Larry Summers with interest and he has been very clear in recent times that the Fed is moving far too slowly. During the month, he published an interesting paper that examines the likelihood of a soft landing given current levels of inflation and unemployment.

Unfortunately, he found that, "since 1955, there has never been a quarter with average inflation above 4 percent and unemployment below 5 percent that was not followed by a recession within the next two years." https://medium.com/@alex.domash/history-suggests-a-high-chance-of-recession-over-the-next-24-months-78e38d468e05

Add the inflationary impact of the Ukraine war to the equation and the answer to our earlier question about the flavour of inflation is tending towards the stagflationary direction although there is still some hope.

In terms of portfolio positioning, we are preparing for the worst and hoping for the best. We have kept our gross position quite low at 126% and have whittled our net length down from 52% to 47%, with a concentration in special situations and sectors that should hold up.

Fund Performance in March

Returning to the Fund's performance in the month of March, the overall return of circa 2.2% pre fees and tax was comprised of +3.4% from the long book and -1.2% from the short book. In a month where the NZ and Australian equity markets rose, this was to be expected.

Our overall winners to losers ratio continued its recent run of strength. While it was somewhat below February's record 72%, a 61% ratio was most acceptable. There were no notable blow-ups or huge wins. Rather, a number of names meandered in an unhelpful direction, while several long-held positions finally re-rated materially albeit in the absence of any obvious catalysts.

Despite our net length continuing to be a superficially long 47%, we continued to do well on negative days. This continues to be a key metric for us, as a key aim of this Fund is to participate to some degree when the market is rising, while providing at least some degree of protection when the market is sold off. There were 10 down-days in March for the 50/50 index of Australia and NZ, with the average loss for the market being -0.59% on those days. The Fund was up on 6 of those 10 days and delivered an average return on them of +0.06%.

The largest headwind was the short in what we view as the highly over-priced Johns Lyng Group (JLG, +14.3%) which rose sharply on (fair) expectations that it will win a good share of work for insurers managing the recovery from the flooding rains in Australia. JLG is a perfectly good company but is now on a forward PE of 61x Jun22 earnings and 47x Jun23. JLG has single digit margins and it strikes us as potentially having some risks from labour shortages and wage inflation.

Another notable headwind was a repeat offender in our large long in the multinational flower grower and distributor, Lynch Group (LGL, -6.4%). This has been an extremely poor investment for the Fund so far and we continue to be flummoxed as to why. It is on a forward PE of 10.2x Jun22 and 8.5x Jun23, with many years of growth ahead as it pushes on an open door in the Chinese flower market and benefits from supermarkets inexorably taking share form florists in Australia. Covid has been disruptive but they have managed their way adequately through Australian lockdowns and we expect them to be doing the same in China, although the Shanghai lockdown may be an issue if they can't divert supply to other markets. In any case, this should be looked through as one-off in nature as it has been for so many other companies. We will stay our painful course.

A third detractor was our modest short in Sims Group (SGM, +20.6%), where we could and should have moved more aggressively to cover as commodity prices soared from the Ukraine war. That said, the current share price seems to extrapolate extreme product prices remaining the case for many years which we doubt will occur in this most cyclical of sectors.

A final low-light was buying a position in United Malt Group (UMG, -10.9%) a little early as it came under pressure from investors fearing their exposure to soaring grain prices in general and barley in particular. We are attracted to their leading global position in the highly concentrated malting industry, their exposure to secular growth in craft beer and whisky, they are a large beneficiary from bars and restaurants re-opening around the world, and they are on a 10% free cashflow yield in a normal year. Their gearing is a touch high but should fall quickly and they have pass-through mechanisms in their malting contracts which will cover most albeit perhaps not all of their input cost pressures. We look forward to selling it in a year or two when it soars as grain prices plunge on record plantings.

The most notable positive was our long-held position in Monash IVF (MVF, +15.9%). There was no particular new news but there remains a strong secular growth backdrop, it is still on a sub-market PE of 17.9x and has a debt-free balance sheet that can fund a welter of organic and inorganic growth opportunities. Further, its main rival Virtus is in the throes of being taken over by private equity and MVF has seen similar speculation.

Our second key contributor was a large long we have built up in Dalrymple Bay Infrastructure (DBI, +8.1%). DBI is primarily a major coking coal export port and also has an interesting long term angle given its designation as a renewables development zone. Nearer term, there is expansion potential given growing capacity constraints and upside from moving from a heavy-handed to light-handed regulation. The cash yield of 8.5% is highly attractive given NZ's unusual FDR tax regime which taxes stapled securities on an assumed return of 5%.

Our third tailwind was one of last month's losers in the form of a large holding that we had built up in Pepper Money (PPM, +12.1%). Even though PPM has a number of potential risks, sometimes a 5x PE for a company that is exceeding prospectus and analyst forecasts really is too cheap. Mortgage margins are under pressure but they have offset this with an aggressive move into asset finance growth and post month-end they purchased Stratton Finance to enhance this growth. Higher interest rates also mean less refinance activity.

There are several risks which have seen us (potentially prematurely) lighten the position somewhat into strength. Firstly, PPM has a heavy reliance on securitised funding and it is performing well in this space. However, we do have flashbacks to markets seizing up in 2008 and you do not want to overstay your welcome if sharply higher policy rates or fears around banks' Russian exposures ever saw these markets tighten up. Secondly, PPM has made up for tighter margins by continuing to grow its book strongly – we do worry about the quality of mortgages that are being written right now as they season over the next several years. Continuing low unemployment is the key to them being okay. Finally, if the RBA ever lifts policy rates, the major banks will have a competitive advantage from their zero-interest deposit base.

Other winners of note were led by our holding in Global Data Centres (GDC, +9.0%) which we had built up into quite a sizeable position amidst prior weakness. It is trading well below NTA and we believe the value of their small holding in the unlisted mega-player Airtrunk may be materially under-cooked within this NTA.

Other contributors were longs in Silk Logistics (SLH, +11.5%), the coking coal producer Stanmore Resources (SMR, +61.9%), our old friend Shaver Shop (SSG, +5.3%) and the litigation funder, Omni Bridgeway (OBL, +16.9%).

Thank you for your continued support and interest in the Fund. We will continue to chip away finding interesting longs whose prospects are under-priced and shorting names where we can see catalysts or which are egregiously expensive. This combination has delivered equity-like returns with no correlation to equity markets and far less volatility than them. No correlation and less volatility are not attributes that investors have particularly valued against the backdrop of a raging bull market but we think they are coming back into vogue.

Long-only markets are proving volatile against a backdrop of war and ever-increasing inflationary pressure. Central banks are beginning to talk about really getting tough and that this time they really, really mean it. We are not so sure that markets entirely believe them just yet – the credibility that they have established is that they are doves who will abandon ship at the first signs of market turbulence. Maybe that occurs yet again but as the old saying goes, don't fight the Fed.

Matthew Goodson, CFA