SALT

Funds Management

Salt Long Short Fund Fact Sheet – August 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 August 2019

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$117 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 August 2019

Application	1.4777
Redemption	1.4717

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 August 2019

Long positions	69
Short positions	38

Exposures at 31 August 2019

Long exposure	86.33%
Short exposure	-55.05%
Gross equity exposure	141.38%
Net equity exposure	31.28%

Largest Longs	Largest Shorts
Tower	Ryman Healthcare
Spark NZ	Auckland International Airport
Marsden Maritime Holdings	BWP Trust
Unibail-Rodamco-Westfield	Woolworths
Turners Automotive	REA Group

Performance[1] at 31 August 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%	0.14%	1.94%	0.42%	2.56%	-0.03%					**1.78%**

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	2.96%	1.55%	5.28%
6 months	4.10%	3.23%	12.34%
1-year p.a.	-4.62%	6.63%	11.71%
2-years p.a.	-1.15%	6.69%	13.18%
3 years p.a.	0.92%	6.73%	11.36%
5 years p.a.	6.13%	7.21%	11.14%
Since inception p.a.	7.77%	7.25%	11.46%

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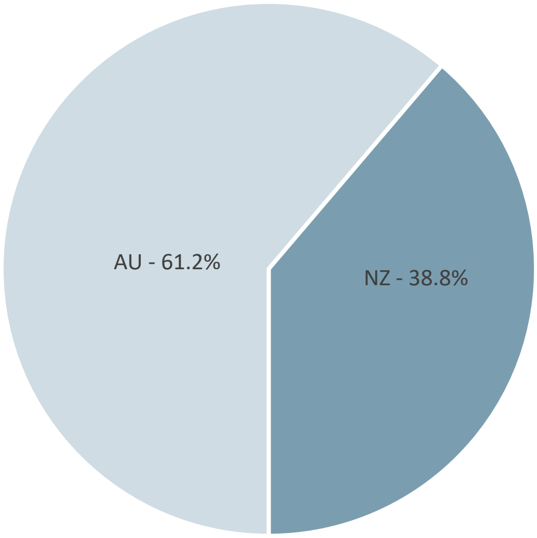
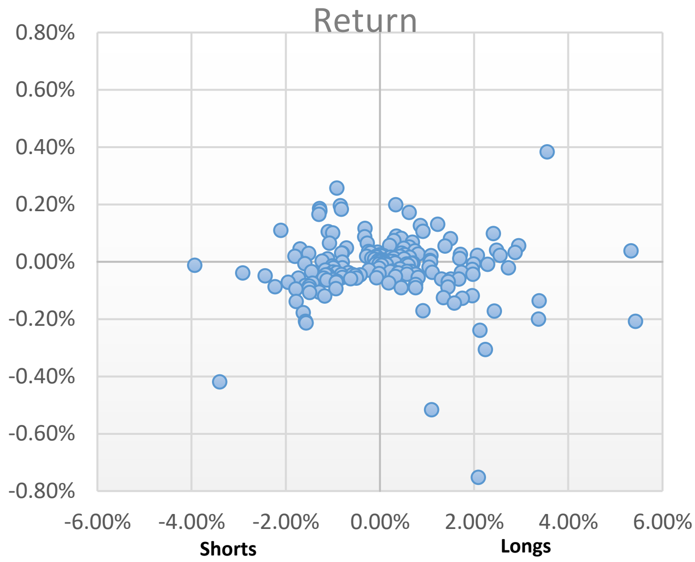
Country Allocation at 31 August 2019 (Gross Equity Exposure)



August 2019 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

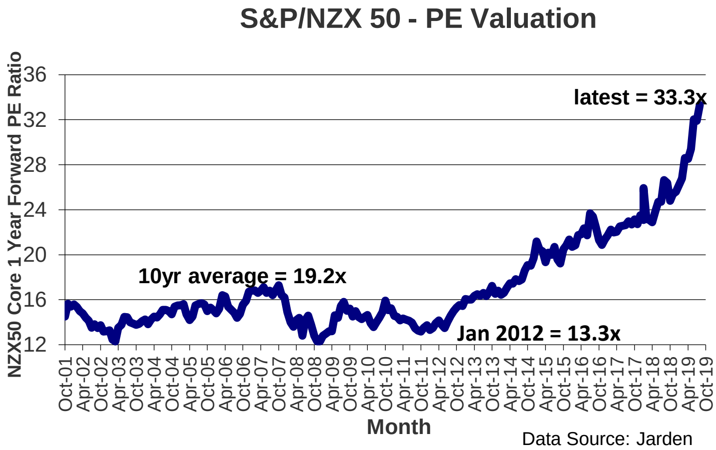
In the face of volatile and weak equity markets, the Fund ended with a flat outcome for the month of August, with a return of -0.03% after all fees and expenses. Since inception, the Fund has returned +47.2% after all fees and expenses.

While relatively pleasing in the context of equity market returns of -2.4% for Australia and -0.93% for NZ, we had been far better placed mid-month when we were up in the region of +1-1.5% while markets were down 3-4%. A furious and largely inexplicable rally by long-only equities on the last day of the month stole some of our relative thunder. Importantly, the performance of the Fund through a highly volatile month shows that our mission of providing equity-like returns with a degree of downside protection and far lower volatility than equities is once again succeeding.

The Fund ended the month with a net position of +31.3%, which is very much middle of the road in terms of our history. Given our style of our longs being significantly cheaper than our shorts, our experience has been that somewhere around the low 30% region is market neutral.

During the month, our net position varied unusually widely from 22.2% to 40.1%, with this aggressive manoeuvring in response to the opportunities thrown up by volatility offsetting somewhat patchy stock selection outcomes during the month. Critically, our net length has been greatest in yield sensitive securities, while our net shorts are largest in a diversified grouping of glamour growth stocks which trade on absurd multiples that resemble some of the great bubbles of the past.

The year-ahead forward PE for the “core” NZ market charged ever higher in the month, rising from a mere 31.9x to set a new record of 33.3x due to earnings downgrades in the aftermath of result season overwhelming the pullback in share prices. The median PE for the “core” market (which excludes property and investment companies) is a rather more palatable 18.9x and this is even more attractive when one considers that forecast growth for the average stock is -2% but it is still +5% for the median stock. Passive funds and ETF’s have wrought havoc on fundamental valuation factors, with “size” being the only factor that is working for now. We are seizing the fleeting moments when a large cap is attractive but we are unsurprisingly finding far more opportunities in mid cap land.



We examined this stark divergence by size last month and it is worth reiterating how the 10 largest stocks in the S&P/NZX50 Index have risen by a simple average of around 26% over the last year, the second 10 by around 16%, while everything else has fallen on average. Under the hood, there has been a stealth bear market which has been disguised by a torrential inflow of price-insensitive passive money. One glorious day, when there is a sharp left-field shock, our largest cap stocks will be both the most expensive and the riskiest as the tide inevitably goes back out. Our market has become a playground for passive funds, with this disappointingly being led by the NZX itself, which then promptly wonders why it struggles to attract new listings.

The earnings season saw a plethora of year-ahead earnings downgrades to the point that NZ market forecasts are now 12.5% below the peak reached back in April 2018. Normally this would spark a sharp sell-off but the saving grace was the furious rally in NZ 10 year bond yields from 1.47% to 1.07% in August alone. Relative valuations of long duration assets such as equities become extremely sensitive to very small bond yield moves at such low levels as "convexity" becomes ever greater.

A move in bond yields from 1.1% to 1.0% matters far more than a move from 5.1% to 5.0%. However, even modelling this non-linear impact, NZ equities are still very expensive on a PE of 33.3x, which is an earnings yield of just 3.0%. The median stock's PE of 18.9x translates to an earnings yield of 5.3%, which is a far more palatable spread for taking equity risk compared to risk free bonds.

A classic example of the impact of convexity came with the issuance of E5.8bn of 100 year Austrian bonds at a yield of 2.1% in September 2017. These now trade at a yield of 0.61% which equates to over 200 cents in the dollar. This means you are guaranteed to lose more than half of your principal by the time you eventually get it back in 2117. Aside from the likelihood of being dead, Austria has also had one or two wee events in the last century – losing World War 1, the break-up of the Austro-Hungarian empire, Anschluss with Germany, losing World War 2 and being split into 4 zones following WW2. They have defaulted 7 times since 1800. I'm sure the next 98 years will be just fine and that 0.61% will both compensate for inflation and be a fair price for any risks along the way. Ironically, as a reminder of what can go wrong, Argentina's 100 year bond lost another 37% of its value during the month.

Deutsche Bank research early in the month highlighted that 43% of the global ex-US investment grade bond index now trades on negative yields. Mid-month, the Danish Jyske Bank offered a 10 year fixed rate mortgage at -0.5%. All German bond yields are now negative, but mind-bendingly, their yield curve is inverted.

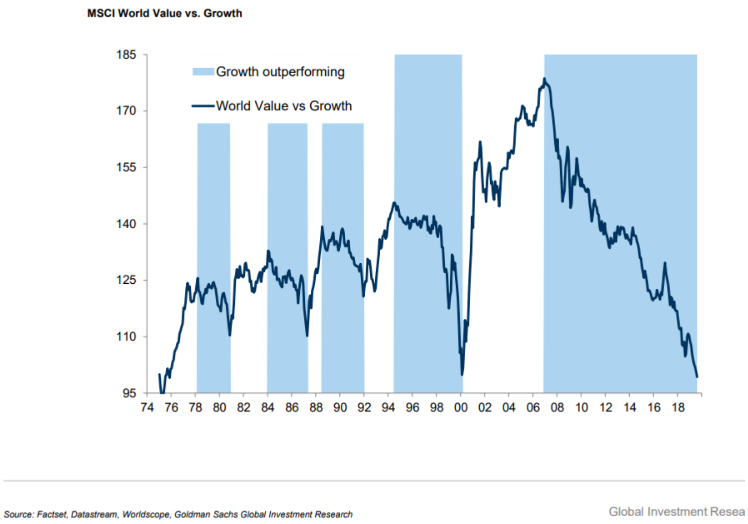
Phrased another way, the gods (aka central bankers) have gone crazy and driven a bond market bubble that will be looked back upon in wonderment in a few years' time. Their zeal to achieve 2% CPI inflation would make the flat-earth society proud. There are huge questions as to whether 2% is the right inflation target, whether there have been structural changes which make a lower target more desirable and whether the expectations-based models of inflation relied upon by central banks even works at very low levels of inflation. As Harvard economist, Jeff Frankel put it, "*perhaps it is time for the Fed and other central banks rather than doubling down on their oft-missed 2 per cent inflation target, to quietly stop pursuing it.*"

We wrote a detailed article in the NZ Herald on these issues, with the link being here: https://www.saltfunds.co.nz/news/2019/8/15/whats-the-emergency- . Academic research is beginning to ask these questions but we suspect it will take a long time to filter through to central banks and there is not the slightest sign that they harbour doubts as to whether their repeated courses of leeches are helping the patient or not.

Meanwhile, the party is raging like there is no tomorrow and it would be folly as an investor to stand against it. Accordingly, while we are short some of the most egregiously overpriced situations, the Fund is heavily net long yield sensitive segments such as property, utilities and telcos. We would like to win a medal by fighting against prevailing market forces but not posthumously.

While financial assets are on fire, the party is definitively not raging in the real economy. Business confidence and activity readings across most of the world are weak and NZ is no exception. Ultra-low and negative interest rates are feeding through only to financial markets. A tweet storm by eminent economist, Larry Summers argued that there are a host of reasons for interest rates being of little help to aggregate demand and that monetary policy is becoming increasingly ineffective. His view is that, "*…central bankers' ingenuity in loosening monetary policy is exactly what is not needed. What is needed are admissions of impotence to spur efforts by govts to promote demand through fiscal policies.*"

This is a crucial point in our view. When this policy paradigm shift eventually arrives, it will be critical as an investor to recognise it quickly and make a major move from "safe" yielders and go-go growth names into utterly friendless value stocks. It might be quite some wait. Despite huge academic support for its long-term outperformance, "value" has been simply dreadful as a factor in the aftermath of the GFC – in fact, it looks as bad today as it did just prior to the March 2000 Nasdaq meltdown.



The chart above from Goldman Sachs shows just how dire the situation has been. We are more attracted than most to cheap valuation multiples but we have been very conscious for some time of trying to avoid value traps in terms of both individual names and sectors. There will be a time for such companies but it is not here yet.

Historically, cheap operationally and financially leveraged companies have tended to outperform coming out of recessions but business confidence surveys and inverted yield curves suggest we are still on the way down. According to CLSA, there have been five occasions when the US 10yr-2yr yield spread has inverted and a recession has followed each time thereafter within 10-18 months. There has also been a sharp spike in “recession” as a google search term.

Returning to the performance of the Fund during the month, the return of +0.12% (pre fees and tax) was comprised of -0.94% from the long side and +1.06% from the short side. This is what one would expect in the face of weak markets although we didn’t manage to particularly outperform from either side. Our “winners to losers” ratio was a very strong 59% but there was a strong skew to our two largest losers being of much greater magnitude than our winners as we stood on a couple of land-mines from the long-side. We only lost a limb or two and they will grow back.

The biggest problem was a former large winner in Monash IVF (MVF, -32%) where we had dramatically cut out our former large position following very strong gains but then had rebuilt it prematurely into moderate weakness. We expected a strong result and it wasn’t too far from the mark, with some pluses and minuses from their various geographies. What hurt was a completely left-field loss of 5 fertility specialists, which without mitigating actions, would see NPAT hit by about 10%. The 30%+ share price hit points to wider fears about the economic model but these specialists were off contract and were unique in only having MVF supply some services to them. Almost all of MVF’s remaining specialists are on contract and MVF has successfully hired a number of specialists elsewhere in Australia over the year. With compliance and technical costs only increasing, we believe large groups such as MVF do have a moat relative to smaller players. It will be in the dog-box for some time but MVF has structural growth tailwinds, is a strong free cashflow generator and is on a consensus PE of 11.7x Jun20 and 10.3x Jun21 earnings.

Our second hit came from the medium sized long in the outdoor advertiser, Oh! Media (OML, -31%) which delivered a surprising earnings warning prior to its result on the basis of very weak Q3 bookings. Along with almost all analysts, we had mistakenly thought that OML was through the riskiest part of their advertising cycle as they managed to deal with the election impact in Q2 when companies pulled back on branding expenditure.

OML most unhelpfully blamed general market conditions which promptly weighed on our somewhat larger holding in QMS Media (QMS, -13%). This remained under pressure despite delivering a rock-solid result from both its outdoor and sports media businesses and a confident reiteration of guidance. In piecing together what really happened in the outdoor space, we think it is a mix of lead times being shorter in a digital world with Q3 already being less bad than feared, market weakness, QMS picking up share from OML post-merger (although we expect a three player market to be rational in time) and OML being particularly exposed to the weakest segments such as auto and banks.

A final laggard of note was our recently established long in Next DC (NXT, -13%) which is heavily shorted and whose result and new sales were just a touch disappointing. NXT has been a poor performer since early 2018 but the data centre market is witnessing massive structural demand growth and we believe they will get their share, albeit in a somewhat lumpy manner. The jury is out on their higher cost S2 building programme in Sydney but they are just one hyper-scale contract away from a major short-covering panic. The market does not fully trust that they have an accurate line of sight on the demand that they are currently building for. Data centre assets have massive operating leverage and become akin to a toll road once they fill up. We have been here before in this name prior to exiting near the highs 18 months ago and are hoping for a repeat.

The strongest tailwind for the Fund came from our large long in Spark (SPK, +11%) which we aggressively purchased across all our funds on temporary weakness in April and May. There had been some concern raised by a couple of broking analyst outliers that SPK may cut its dividend slightly but this was definitively refuted as they delivered an in-line result. While we cannot say with hand on heart that SPK is cheap in absolute terms, such quibbles have long since ceased to matter in the NZ market and it is very “cheap” versus other large caps in relative yield terms. Its gross dividend yield at end-August was 7.4% versus 4-5% for the listed property trusts and 3-5% for the gentailers.

We size these positions carefully and cut them when they do not work out. GPR has one of the better gold projects we have seen for some time, with experienced management, a +1moz reserve, strong local support, good infrastructure and a completed DFS showing a payback period of just 2.2 years versus a mine life of 10+ years assuming gold prices that are well below spot. Someone else finally noticed.

Other gains were more dispersed and came from participating in the IPO of leading insurance software provider, Fineos Corp (FCL, +24%); the remains of a formerly large long in Contact Energy (CEN, +8%); and an outstanding result from our modest long-time holding in Shaver Shop (SSG, +13%), which delivered same store sales growth of 11.8%, has online sales >12% of total and growing at 30% and is still only on a consensus PE of 6.8x Jun20 and 5.8x Jun21 when one adjusts for non-cash amortisation of franchise buyback costs. Those are our sort of metrics.

Thank you for your ongoing investment and support of the Fund. August was a volatile month as markets rode the roller-coaster of Trump tweets, had a tail-wind from implausibly low bond yields and reacted and over-reacted to a plethora of profit releases in result season. The Fund did what it was supposed to do in a negative period, turning in a flat return and the comparison was even better prior to the NZ and Australian markets staging a furious and somewhat bemusing last day rally. Market valuations are stretching the rubber-band to a degree that we never thought possible, with this being particularly concentrated in large cap stocks, stocks with high projected earnings growth and dividend yielders. This could keep going for some time or it might end tomorrow but markets are set up for an accident and we will continue to position this Fund to provide a valuable uncorrelated alternative for a portion of investors' portfolios.

Matthew Goodson, CFA