Salt Long Short Fund Fact Sheet – September 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 30 September 2023

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$77 million
Inception Date	1 July 2014
Portfolio Manager	Matthew Goodson, CFA

Unit Price at 30 September 2023

Application	2.3226
Redemption	2.3132

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 30 September 2023

Long positions	55
Short positions	36

Exposures at 30 September 2023

Long exposure	104.12%
Short exposure	51.53%
Gross equity exposure	155.64%
Net equity exposure	52.59%

Investment Risk to 30 September 2023

Fund volatility[1]	6.44%
NZ50G / ASX200AI volatility[1]	13.75%
NZ50G / ASX200AI correlation	0.076

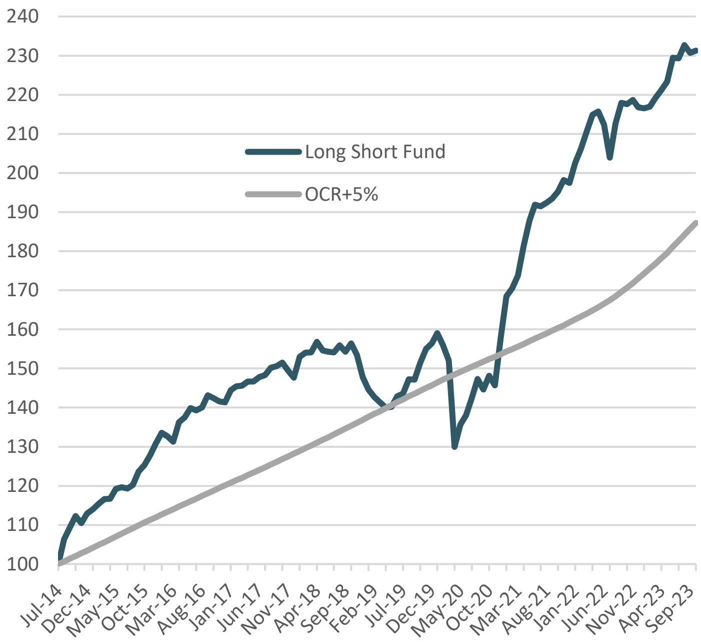
1. Annualised standard deviation since fund inception.

Fund Performance[2] to 30 September 2023

Period	Fund Return	OCR+5% Return	NZ50G/ASX 200AI Return[3]
1 month	0.25%	0.79%	-2.53%
3 months	0.86%	2.51%	-2.99%
6 months	4.56%	5.04%	-2.80%
1-year p.a.	6.31%	9.70%	7.23%
2 years p.a.	8.85%	8.05%	-3.03%
3 years p.a.	16.02%	7.11%	5.17%
5 years p.a.	8.14%	6.70%	5.90%
7 years p.a.	7.17%	6.72%	7.32%
Inception p.a.	9.49%	7.01%	8.24%

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 30 September 2023

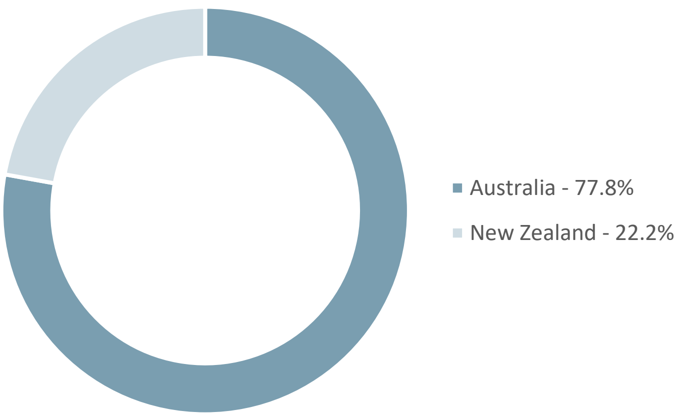


Fund performance has been rebased to 100 from inception.
Past performance is not a reliable indicator of future performance and no representation or warranty, express or implied, is made regarding future performance.

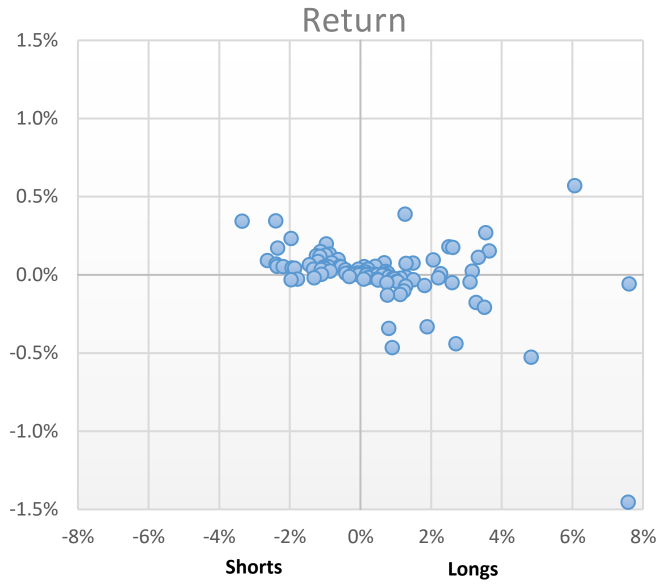
Largest Longs	Largest Shorts
GDI Property Group	Reece
Tower	Data#3
Global Data Centre Group	Commonwealth Bank of Australia
Lynch Group Holdings	REA Group
Superloop	Wesfarmers

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 30 September 2023 (Gross Equity Exposure)



September 2023 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

The month of September saw the Fund deliver a satisfactory return of +0.25%, which contrasted starkly with weakness in long-only equity markets around the world. The NZ index declined by -2.2%, while Australia fell by -2.8%.

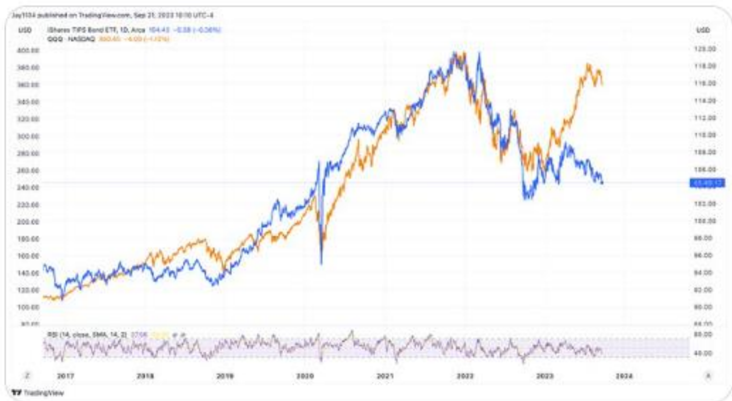
Despite lifting our net length to over 50%, our investment style combined with reasonable overall stock selection saw the Fund eke out a modest positive return. This again showed the value of the Fund in delivering equity-like returns but with less than half the volatility of equities and with no correlation to them.

Australasian markets were far from alone in their weakness, with the MSCI World Index declining by -3.5% in US$ terms. The key driver was simply that the discount rate for all financial assets rose sharply in the month. US 10-year bond yields rose from 4.11% to 4.54%, with yields in NZ and Australia also lifting by 0.39% and 0.42% respectively.

These material moves were driven by the market finally accepting the evidence in front of its eyes that while inflation has peaked, it will take quite some time to return to central bank target ranges. This means that monetary settings will need to stay tighter for longer.

Inflation outcomes in the month were broadly as expected but commentary following the Fed meeting on 20 September really saw views change. The Fed dot-plot saw one last hike still being pencilled in for 2023 but only two 25bp cuts were indicated for 2024 compared to four such cuts in the previous June update. The verbal jawboning accompanying the release had a tone that was very much along the lines of "higher for longer".

In our view, much of the damage to the average equity from higher bond yields may have already been done but there is still considerable risk to overall equity markets. The chart below illustrates this somewhat enigmatic comment.



The blue line is the iShares TIPS Bond ETF (i.e. real yields), while the orange line is an ETF for the Nasdaq-100 Index. Unsurprisingly, the long duration growth stocks in the Nasdaq generally have a very tight relationship with the real discount rate but this has broken down in the last few months. This break-down has coincided with the frenzy for mega-cap AI-exposed stocks, which has seen overall cap-weighted stock indices far outperform the average stock within those indices. Year-to-date, the S&P500 Index is +11.7%, while the S&P500 Equal-Weighted Index is up a mere +0.3%. The rise in bond yields would seem to leave the mega-cap tech stocks rather exposed if they do not follow through and deliver earnings upside from their AI promise.

The chart below from tradingeconomics.com shows the full extent of the move in the 10-year real US TIPS yield. From an absurd -1% in the post-Covid period, it has now risen back to the far more normal levels of around 2.25% which prevailed pre-GFC and prior to the era of monetary madness that central banks unleashed upon us. Maybe it keeps on rising, but at these sorts of levels, it feels like the bulk of the move in real bond yields has now happened. 2.25% is not such a bad risk-free real return.

One final vignette regarding our slowly awakening contrarian interest in bonds is that the current drawdown in the Bloomberg US Aggregate Bond Index has been running for 38 months and has seen a maximum drawdown during this period since August 2020 of -17.2%. The previous worst was for 16 months to October 1981, which saw a -9.0% maximum drawdown.

Aside from inflation proving more persistent than even we fear, (perhaps due to oil prices), the final obvious risk for bond yields is the fate of Japan's long-held negative rate policy. With price and wage inflation both firmly above 2%, the days of this policy should have ended long ago but the BoJ held the line at a closely watched meeting during the month.

With Japan being ground-zero for funding carry trade purchases of bonds around the world, this really matters. That said, the BoJ is fighting a losing battle with markets as the JPY has come under immense pressure. This year, it has sold off from 128 to 149 versus the USD, which both sparks inflation in Japan and forces the BoJ to try to protect it by selling foreign assets such as US bonds.

While equity markets may now be well through the process in pricing in higher bond yields, we do fear there could be one further problem which we have to work our way through – earnings downgrades.

Yield curves around the Western world have been steeply inverted for some time, with 10-year yields being below 3-month yields. As shown in the chart below, such yield curve inversion has been an accurate predictor of recessions over the last three decades, with no false positives – until apparently now. As the chart shows, the inversion spread in the US has been greater than ahead of previous recessions, yet the US economy has stubbornly refused to fall over. Perhaps the risk is not that the yield curve is wrong, it may have just been a little early.

If economies do indeed move into recession as suggested by the yield curve, then earnings downgrade risk will be the key hurdle for equities to contend with. This is particularly informing our positioning in the Fund from the short-side.

In turn, with bond yields possibly near a peak, we are finding ourselves naturally drawn to more longs in sectors that have been hammered by higher yields (e.g. property and some long duration growth names), while we are finding a number of potentially attractive shorts in expensive cyclicals (e.g. Reece, Breville, retailers, iron ore companies et al). This is exactly the opposite set-up to the post-Covid re-opening environment.

Along with markets declining, investor sentiment is finally beginning to sour. September saw a couple of major IPOs which saw the bulls start with a hiss and a roar but then curl up quicker than an Australian rugby player. The major chip technology company, ARM Holdings priced its IPO at $51 and closed day one at $63.59. As this is written it has worked back to $52.20. Similarly, Instacart priced its IPO at $30, hit a high on day one of $42.95 before closing at $33.70 and now trades at $26.95. These are clearly not disasters in a difficult market but it does show that the initial euphoria and outpouring of greed has proven to be rather short-lived.

Not so long ago, we lamented how the CNN Fear & Greed Index was firmly and unshakeably in "extreme greed" territory for much of June and almost all of July. Well, that worm has turned, with September even witnessing a one-day visit into "extreme fear" territory. Dwindling liquidity provision by central banks finally seems to be impacting on markets as we have long argued.

Fund Performance in September

Returning to the Fund's performance in the month of September, our overall return of circa +0.3% pre fees and tax had starkly divergent contributions from our long book (-2.6%) and our short book (+2.9%). This was as expected in a tough month for markets. Digging under the hood a little, strong stock selection more than offset relatively long positioning and strong headwinds from a couple of large detractors. Our "winners to losers" ratio was a very high 67%, so even though it was a satisfactory month overall, we were a little frustrated that we were hurt by a couple of large but likely temporary movements.

Our gross exposure fell over the month from an unusually high 165% to a still relatively full 156%. Market weakness saw out net length rise further from 49% to 53% as we covered some shorts and added to oversold longs. This positioning is perhaps starting to get to the longer end of being market-neutral but we still provided strong protection when the market sold off.

The 50/50 index of Australia and NZ had an extremely high 14 down-days in September, which is the highest number that we can remember. Those 14 days had an average return of -0.35%. Pleasingly, we were up on 8 of the 14 days, with an average positive return on all of them of +0.14%. So, despite being over 50% net long, we made money on negative days and lost money on positive ones. We suspect this reflects a degree of randomness intersecting with a small sample set but it does show how our overall returns are uncorrelated to what long-only equities are doing.

By far the strongest headwind came from our largest position, which is the painful long we have built up in the Perth-centric office property owner, GDI Property (GDI, -16.4%). This was against a nasty backdrop where the ASX Property Index fell by -8.4% in the month, so we did somewhat offset it with shorts in other names but it still stung. The frustration was that there was no new news driving the decline. GDI was aggressively sold on larger than normal volumes, with our view being that it likely reflected a combination of margin-clerk selling and maybe some forced mandate change selling. There was no obvious lift in short interest over the period. The selling did seem to climax just prior to month end.

What attracts us to this name? Our start-point is the Property 101 fundamental that Perth has strong population growth. It is currently running at around +2.5% (versus Australia at +1.7%) and since 2007 has been in a range of +1.1% to +3.4%. Population growth like this inevitably drives absorption of office space. Secondly, Perth has not experienced anything like the work from home theme that has impacted many other markets. Thirdly, the WA economy has a significant dependence on the mining sector, with lithium, gold, oil & gas, and iron ore being the largest. The outlook for these isn't uniformly positive in price terms but the scene does look set for strong volume growth in the years ahead. Every property analysis we read on Perth speaks to positive net absorption and declining vacancy rates, especially in premium and upper A-grade properties. Effective rental growth is strong as incentives are falling quickly.

The final and most important attraction is valuation. The share price of $0.535 compares to the NTA of $1.25, on top of which there are management fee streams (and embedded future performance fees) from a number of syndicates that GDI manages. The NTA is based on a realistic cap rate of 6.55%, far above the alleged cap rates in the currently inferior office markets of Sydney and Melbourne. Unlike many names in the sector, gearing is under control at 31%. Taking NZ's FDR tax regime into account, we estimate the current gross dividend yield to a NZ investor is 11.0%.

What needs to happen for the share price to climb out of the latrine? On the fundamental side, GDI needs to continue leasing up vacant space. This appears to be well in hand, with enquiry levels reportedly very strong but getting to over 90%

occupancy will likely take much of the current financial year. Secondly, there is clearly concern about the departure of the colourful and capable former CEO, Steve Gillard for personal reasons and the fate of his holding. We do not know but we suspect this may have already played out. Finally, there are potential catalysts with several of GDI's properties potentially saleable at strong prices should they choose to go down this route. We will happily bank the 11.0% yield while we wait for this to come right. Meanwhile, we bought aggressively at what are hopefully the lows.

The second largest detractor was a frequent flyer in these pages in the form of Lynch Group (LGL, -12.7%). There was no new news following their satisfactory result in the previous month. There was possibly some negative sentiment regarding the Chinese economy and how that may be affecting flower sales there but even this was starting to see more mixed rather than negative data towards month-end. Sometimes price moves are just random and driven by flows.

The third laggard was a modest position in what is increasingly looking like a mistake in our holding in the mineral sands company, Strandline Resources (STA, -34.3%). The attractions are that it is very cheap and has a resource that will last for decades. Typically, operational risks around mineral sands extraction is not high as they use well understood "technology" if one can even call it that. However, STA's resource is relatively low-grade and they seem to have stumbled into every operational issue that one could imagine. Feedback from analyst site-visits re their ability to fix this has been positive but the share price is telling a different tale at present. We have lowered our risk to some degree, while still seeing material upside if they can get their mine operating as planned.

The final headwind of note was a repeat from last month in our highly volatile position in the litigation settlement fund manager, Omni Bridgeway (OBL, -14.3%). It seems to be subject to an ongoing and aggressive short-selling attack, with short interest now up to 18.5m shares versus average daily turnover of 900k shares. We think the apparent thesis that OBL lacks sufficient working capital to cover their ongoing management costs is mis-placed. Positive litigation settlement announcements have always acted as a catalyst in the past and we expect them to do so again, especially as OBL is on the verge of large waterfall payments from some of their earlier funds now that they are almost through the preferential returns to investors. OBL did see insider buying from two Directors during the month.

The strongest tailwind came from our large and increasingly successful holding in Global Data Centres (GDC, +9.1%). GDC has now risen 80% from its lows at the beginning of this year in a deeply satisfying move which really began when we reached out to the company and other key stakeholders to help instigate a value maximisation strategy to wind-up over time. We still see upside. The official NAV is $2.47 versus the $1.915 closing share price but this includes a small stake in Airtrunk at levels that may be materially below market. There was vague AFR speculation during the month that Macquarie Asset Management, (the main Airtrunk owner) had reached out to investment banks to do the preliminaries for an IPO that might value it in excess of $10bn. We would treat this with a grain of salt at this early stage but material upside from here is still plausible.

The second notable winner was a repeat appearance from the mid-sized long that we bought a few months ago in the uranium developer Paladin Energy (PDN, +30.2%). We had been forming an increasingly positive view on the uranium price outlook as many countries looking to add nuclear capacity and there is a major future supply deficit which will be exacerbated by the Russian situation. Ultimately there is no shortage of uranium in the Earth's crust but it may be quite a few years before the emerging deficit is bridged. The uranium price surged during the month and we did begin to take some profits.

A relatively new name which did well during the month was a mid-sized long we have built up on weakness in Servcorp (SRV, +7%). They are the original serviced office operator, being highly profitable while the cool kids at WeWork were still in their nappies. SRV generates strong free cashflows and we think that the fragmentation of office attendance is a positive for businesses like SRV that offer a range of flexible alternatives. They are also somewhat counter-cyclical in that they do well when they can sign cheap long-term office floor leases and then rent them out over time at a positive margin. They are on a 20% free cashflow yield, pay an 8% dividend yield and have net cash that is about 30% of their market cap.

We also had a number of tailwinds from the short-side. The way was led by Mirvac (MGR, -12.0%), which had earlier performed well due to optimism about their apartments business which ignored that MGR is predominantly an office property company. Our large short in Reece (REH, -8.7%) began to work and it fits in well with our theme of looking to short expensive cyclicals. It is still on a forward PE of 34.8x for a plumbing retailer. Similarly, our long-held and much-traded Breville (BRG, -10.6%) position also did well for the Fund during the month.

Thank you for your continued support of the Fund. September performance was satisfactory, with modest positive returns that contrasted sharply with the sea of red from long-only equities. We were rather frustrated that what could have been a very strong month was held back by what we view as undue and hopefully temporary selloffs in a couple of our highest conviction longs. We continue to deliver equity-like returns over the long term with no correlation and far less volatility.

The sharp sell-off in bond yields in September has seen real long-term yields rise to interesting levels above 2%. Levels that were last seen pre-GFC. Some yield-sensitive sectors have been surprisingly immune (AI-related growth stocks), while some have been butchered (property and some utilities). We think the sell-off in bonds will end when economic growth begins to slow and central banks can start to take their foot off the pedal. We are seeing increasingly interesting opportunities in sectors that have been hammered by higher yields, while we are becoming warier and ever shorter expensive cyclicals.

Matthew Goodson, CFA