SALT
Funds Management

Salt Long Short Fund Fact Sheet – August 2018

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 2018

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$273.0 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 August 2018

Application	1.5493
Redemption	1.5430

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 2018

Long positions	85
Short positions	42

Exposures at 31 August 2018

Long exposure	81.07%
Short exposure	-49.37%
Gross equity exposure	130.45%
Net equity exposure	31.70%

Largest Longs	Largest Shorts
Centuria Metropolitan REIT	Ryman Healthcare
QMS Media	National Storage REIT
Tower	Goodman Group
Bingo Industries	Dulux Group
Investore Property	Cochlear

Performance[1] at 31 August 2018

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%					0.84%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	0.02%	1.66%	4.48%
6 months	0.12%	3.35%	6.84%
1-year p.a.	2.45%	6.75%	14.67%
2-years p.a.	3.81%	6.77%	11.19%
3 years p.a.	7.66%	7.00%	13.95%
Since inception p.a.	10.97%	7.40%	11.40%

[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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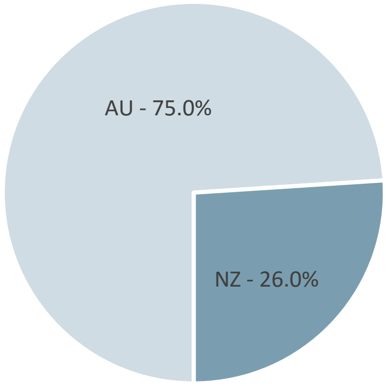
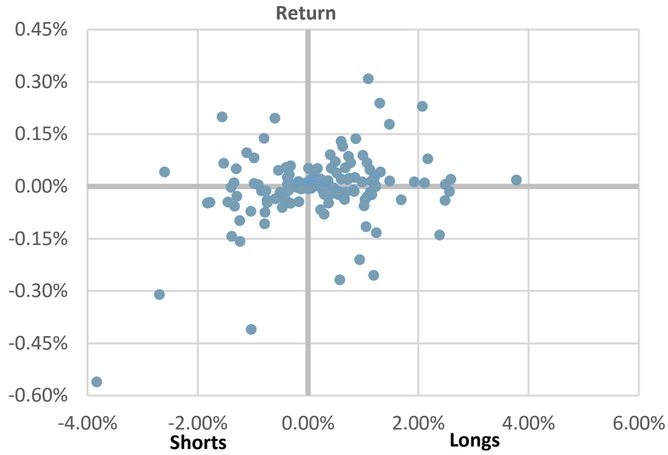
Country Allocation at 31 August 2018 (Gross Equity Exposure)



August 2018 Individual Stock Contribution



Fund Commentary

The Fund experienced a disappointing August, with a performance of -1.06% after all fees and expenses. This compared to the S&P/NZX 50 Gross Index return of +4.38% and the Australian S&P/ASX 200 Accumulation Index advance of +1.42%.

Since inception on 30 June 2014, the Fund has now returned +54.3% after all fees and expenses. Thirty-five of those fifty months have had positive returns, our volatility remains far below long-only equities and our correlation to quite extraordinary markets remains zero.

August was a remarkable month for Australasian equities. Rather than dying, the great NZ bull market is raging on to ever greater heights. The one year forward PE for NZ rose from 24.7x to a scarcely believable 26.6x (using FNZC numbers) due to a combination of the market advance and slightly weaker earnings forecasts for 2019. Bond yields did fall from 2.76% to 2.54% but this warranted 0.4 PE points of multiple expansion, not 1.9 points. This market has exhausted most adjectives.

Digging into the market surge, the top 10 stocks in NZ rose by 6.8% but the S&P/NZX 50 Gross Index excluding these stocks advanced by a far lesser 1.2%. Our take is that large amounts of offshore money have flooded into ultra-expensive large cap names, while many other names have been left languishing at less absurd valuation levels. Heaven help the large cap glamour companies when something changes and the coterie of momentum and passive investors try to get out of a very small exit door at a time when it is slamming shut. The NZ market can be a lobster-pot but this has been forgotten in the current euphoria. When the day arrives, we will try our very hardest not to cover our shorts too early.

Using a different data series, Forsyth Barr estimates suggest that the median PE is sitting at an unusually wide 5.2 PE points below the average. We have certainly found this in our portfolio, with many of our reasonably valued longs being moribund, while our nose-bleed expensive shorts moved up into haemorrhage territory.

A fascinating piece by JP Morgan strategists in Australia delved into what drove their market in August. Paraphrasing their work, they describe the Australian market in August as a *"P'E explosion, being all price and no earnings".* Pulling the S&P/ASX 300 apart into five PE quintiles, they showed how the top quintile of most expensive stocks rose by an average 9.6% in August despite its EPS forecast falling by an average -3.9%. This combination drove a PE multiple expansion of a staggering 4.2 points. At the same time, the bottom two PE quintiles (i.e. 40% of cheapest stocks) saw virtually no multiple expansion. Unfortunately, this area tends to be where this Fund invests from the long side.

Even worse, the top 25 stocks had a PE multiple expansion of 9.6 points – we could only gaze on in wonderment as a small number of our shorts had mediocre results and promptly rose to a galaxy far, far away. A classic example was Cochlear, whose moderate result and guidance saw 8% downgrades, yet the share price rose by 6.1%, putting it on a forward PE of 45.9x. It has been fascinating watching some analysts tie themselves in knots trying to keep up with rampant share prices. Price target increases frequently accompanied earnings downgrades in the month, while my favourite is the broker that has a $8.46 valuation and $20.83 price target on Wisetech (WTC, +40.1%). What on earth is wrong with having a sell call? Sometimes the market simply makes no sense and that is why we diversify.

Something happened on 14 August. Up to this date, Cochlear was -5.2% but it then rallied 12.2%; a2 Milk was +3.0% and then rose a further +17.1%; CSL was +2.6% and then rose +13%; Ryman was +4.7% and then rose +10.5%; and Fisher & Paykel Healthcare was flat at 0.0% and then rose +11%. We do not know whether it was short-covering, flows into ultra-aggressive momentum-driven managers or perhaps a combination of the two.

Such periods have happened before in market history with the performance of high multiple stocks in 1999 standing out – then 2000 happened. Before our time in markets, the "Nifty Fifty" period in the US saw a group of large cap stocks trade on PE's of 40-50x plus through the late 1960's and early 1970's – a grinding bear market followed. As Sir John Templeton famously said, "*bull markets are born on pessimism, grown on scepticism, mature on optimism and die on euphoria*." We have euphoria.

Another way to understand August is to look at the MSCI Australia Growth Index which is now up by +27.7% in the last year versus the Value Index at +2.5%. This 25.2% gap was last seen prior to the GFC, following which the gap reverted sharply in the opposite direction. A long-term data series shows that these two polar-opposite styles do tend to mean revert in their relative performance and that value actually wins in the long run. Salt is a long way from being a pure value investor and we like an under-priced growth stock at least as much as most people. That said, the Fund is now positioned for mean reversion to occur.

The extremely narrow leadership, the outperformance of growth versus value and the extended valuation multiples are phenomena across most developed markets, although they do seem to be particularly evident in our markets. We did come across some other interesting off-beat measures of just how markets are placed.

The "Buffett Indicator" looks at the ratio of the US Wilshire 5000 Index relative to US GDP. It has just hit a new all-time high of 138%, surpassing the 136.9% reached during the Nasdaq bubble. It hit 105.2% in the 2007 peak and troughed at 56.8% in the post-GFC bust. This tells us that profits and/or the valuation multiple placed on those profits are at an unsustainably high share of GDP.

Research from the Leuthold Group reported on Bloomberg went back to 1952 and looked at circumstances when PE ratios were in their highest quintile, while correlations between stocks were in their lowest quintile. What they found is that subsequent annualised returns were -9.5%, while they were +26.5% when PE's were cheapest and stock correlations highest. Right now, NZ and Australian markets are ultra-expensive and have very narrow leadership, meaning correlations are low.

One of our old favourites, the "Sotheby's sell signal" has again reared its head. The BID.US share price tends to show when money is easy and flooding into high-end art. It peaked in 1999, again in 2007 and looks to have peaked again recently in June 2018.

Commercial property is red-hot and two Australian transactions particularly took our eye. The AFR reported that a small shop leased to a fashion retailer in Brighton, Melbourne sold on a 2% yield. Slightly later in the month, a Singaporean investor bought a D-grade Sydney building on a 3.5% yield for $61m. This building last sold for $7m in 1994.

Passive investment is culpable to at least some degree in the current boom. According to FC Stone, the average US stock is in 115 indices. Those in more than 200 indices are 2.5x more expensive than those in less than 75 indices – spot the market inefficiency?!

August 29 marked the longest bull market in US history, with there being 3,453 days without a 20% decline on the year.

According to the Bank of International Settlements, US$ loans rose from $5.8trn in 1Q2009 to $11.4trn today. $3.7trn of this increase went to emerging markets – as the New York Times put it, this went to build shopping malls in Turkey, empty skyscrapers in China and 100-year bonds in Argentina.

The current bull market may seem bullet-proof but a reminder of how quickly things can change in markets comes with the emerging markets meltdown during August. The rising USD has created major problems for those countries with large foreign currency debt and current account deficits. It was only in June 2017 that Argentina was swamped with demand for their US$2.75bn issue of 100-year US$ bonds at 7.9%. Fast forward 17 months and the country has only had the one IMF rescue so far this year, short term domestic interest rates have been lifted to 60% and the ARSUSD cross-rate has halved from 5.4 to 2.6 in 2018.

Put all of the above together and we are genuinely concerned about what happens next, but we are also conscious that in running the Fund over the last 12-18 months, we have underestimated the duration and magnitude of the impact of cheap money on NZ/Australia equity markets. We will continue to diversify carefully and we have lifted our net length a little to the low 30% region although this was of little help in August as the cheap stocks that we like were largely moribund.

Looking globally, it is clear that QE is ending and QT is beginning, with the US economy in particular showing numerous signs of over-heating and requiring further rate hikes. NZ and Australia are somewhat different. There is cost-push inflation but little sign that the RBA or RBNZ will hike any time soon, with new leadership in NZ even showing early signs of dovishness. This clearly points to a weaker NZ$ and A$ and has been a key theme in our stock positioning – the frustration is that it seems to be that only the ultra-expensive stocks that have benefitted. This will change.

Returning to the performance of the Fund during August, our return of -1.06% after all fees and expenses gave back most of the good work in July. Our "winners to losers" ratio of 53% was a little light but was no disaster. Our longs contributed a disappointing +0.43% in a strong up-month, with a couple of land-mines and a general exposure to moribund low multiple stocks being headwinds. Unsurprisingly, in a month where ultra-high multiple stocks surged, our shorts proved rather painful, detracting -1.43%.

Detractors

The largest headache was a medium-sized long in RCR Tomlinson (RCR, -47.2%). We had purchased RCR on earlier weakness and had been impressed by a strong interim result, a robust outlook across their various contracting segments and several potentially large contract wins as catalysts for share price performance. We particularly liked their exposure to booming infrastructure markets. What we didn't count on was a single major one-off project issue due to unreported difficult ground conditions at one of their solar projects. This necessitated a major dilutive equity raising for RCR to restore their balance sheet. Being naturally suspicious of contracting companies, we had done considerable earlier checking with analysts and the industry, but this did not turn up the scale of the problem that was encountered. It particularly grates to have lost money in an area where we have long been cautious. We had sold a portion of stock prior to the problems coming to light and from here intend to hold the position. RCR now has an acceptable balance sheet and a significant project pipeline which will hopefully now begin to convert. However, it will doubtless take quite some time for market forgiveness.

The second key headwind was our large long-suffering short in Ryman Healthcare (RYM, +15.8%) which caught a powerful bid in line with many other ultra-high multiple stocks. Directors and management sold shares and the actual fundamental news in recent weeks has been poor to mediocre. The NZ housing market (and Auckland in particular) remains in the doldrums, with numerous negative measures yet to hit. Melbourne house prices are outright falling according to Corelogic data and Ryman's AGM in late July talked to cost pressure from nurse wage increases. Competitor results from Summerset and Metlifecare were solid enough but showed signs of inventory levels beginning to build, which dovetails with marketing incentives and promotions being particularly aggressive at present. One player's feedback was that a competitor offered $20k discounts in return for settlements before balance date. Hmm… Development is booming in the sector and we believe an overbuild will occur in some regions. We covered our small Summerset (SUM, -0.7%) short on weakness and retain a moderate partially offsetting long in Metlifecare (MET, +2.9%).

The third key laggard was our modest short in Wisetech Global (WTC, +40.1%) which staged a remarkable move on what we viewed as a middling result. WTC slightly beat expectations but only did so by capitalising more costs than had been expected. Their guidance was a slight downgrade and was also accompanied by greater cost capitalisation. WTC is on an EV/sales ratio of over 22x, which is the highest globally amongst SaaS companies covered by major brokers. They purchase many small software companies on very low multiples of revenue and EBITDA, and when you strip this acquired revenue out, WTC's organic "growth" is relatively poor. The vertical spike in the stock was unprecedented and actually came after one of the key brokers following it put out a "first impressions" post-result calling it down 5% on the day. One explanation circling the market was that a hedge fund closure had led to forced covering of the position at any price. A key broker following the name has a DCF of $8.46 and a price target of $20.83. This is so February 2000.

Contributors

The strongest positive was our large long in Bingo Industries (BIN, +19.5%) which we supported eagerly in their equity raising to purchase Dial A Dump. The attraction of Bingo is that it is systematically building a fortress-like position in the Sydney waste disposal and recycling market. They now have two landfills in excellent locations that will deliver supernormal returns as the market runs gradually out of space. Added to this, they have a well-placed network of recycling facilities. While it now trades at our in-house DCF valuation, we are conscious that this valuation has seen strong growth over time as management has invested in the business to earn returns well above the cost of capital. A cross-check of forward PE's shows BIN on 15.1x Jun20 and 12.4x Jun21 forecasts. A final catalyst is that BIN has now reached a size where it will start being added to a plethora of indices, likely starting with the S&P/ASX200, generating a wall of passive buying. BIN has high short interest of almost 9%, which in our view is based on stale stories such as the Queensland waste levy (actually a positive for BIN) and the Tartak family selling down (they aren't).

Our second key tailwind was a blast from the past in the form of a moderate long in Qantm Intellectual Property (QIP, +28.4%). This has been a serial disappointer since listing but benefitted from finally meeting guidance and also from vague takeover talk from the giant in the space, IPH Limited. We have no view on whether that will ultimately come to pass but the attraction of QIP remains a largely capex-free business with exposure to patent filings that have generally grown at slightly above GDP, exposure to a weak A$ and forward PE multiples of 13x going to 12x. Past disappointments have placed QIP firmly in the dog-box but continued delivery on guidance may see it gradually re-rate irrespective of any M&A activity.

A third notable positive was a repeat from last month in our medium-sized offbeat long in Kina Securities (KSL, +14.3%) which continued to rerate following the sell-down of Maybank's former large holding. KSL is integrated across personal banking, fund management, superannuation and trustee services in PNG. It has extremely strong growth ahead of it as it integrates the purchase of ANZ's consumer bank and the PNG economy slowly financialises. KSL has quite extraordinary metrics including a loans to deposit ratio of 70% and a net interest margin of 8.1%. The risks are everything that come with investing in an emerging market. PNG's economy has been weak in the last several years but with APEC in November and several major LNG developments on the way, the outlook is quite promising. We have taken a little profit but the forward multiples of 7.1x Dec19 PE and 4.4x Dec20 (when ANZ is integrated) remain very attractive.

A final winner of note was our large long in Star Entertainment (SGR, +8.7%). It delivered a solid result and remains on relatively attractive valuation metrics versus the market. Catalysts for further performance include overblown fears of Sydney reconstruction disruption, regulatory approval for Chow Tai Fook to buy a further 10% of SGR on-market as per their deal and strong potential upside from this deal to aid their high roller business, Views towards management seem very mixed from the Australian investment community but we used this to invest at what we saw as an attractive price.

Thank you for ongoing investment and support of the Fund. The last 12 to 18 months have not been easy as we seek to protect capital in the face of quite extraordinary market valuations, which have continued far beyond what we expected. We will stick to our discipline in diversifying widely and not betting the Fund on any one name or on the bull market ending tomorrow. We do not want to be down 20% before we are up 30%. Given the extreme valuation disparity detailed in this report between cheap and expensive stocks, we have actually lifted our net positioning slightly in the last couple of months into the low net 30% region. The irony of this bull market is that there are actually quite a number of attractive longs at the low-multiple end of town which are in some parallel universe to the momentum-driven group of our ultra-expensive shorts.

Matthew Goodson, CFA