SALT
Funds Management

Salt Long Short Fund Fact Sheet – January 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 January 2018

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$264.4 million
Inception Date	30 June 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 January 2018

Application	1.5466
Redemption	1.5403

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 January 2018

Long positions	85
Short positions	54

Exposures at 31 January 2018

Long exposure	79.67%
Short exposure	-51.97%
Gross equity exposure	131.64%
Net equity exposure	27.70%

Largest Longs	Largest Shorts
Centuria Metropolitan REIT	Ryman Healthcare
Turners Automotive Group	ASX Limited
Investore Property	Meridian Energy
IVE Group	Goodman Group
Graincorp	Heartland Bank

This Fund is actively managed. Holdings are subject to change daily.

Performance[1] at 31 January 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%												0.67%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	3.09%	1.66%	3.33%
6 months	2.53%	3.35%	8.81%
1-year p.a.	5.92%	6.75%	15.94%
2-years p.a.	7.75%	6.93%	15.93%
3 years p.a.	10.10%	7.31%	10.55%
Since inception p.a.	12.81%	7.51%	11.37%

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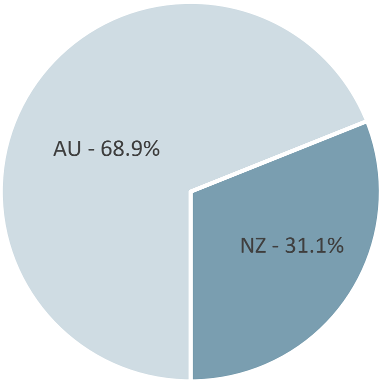
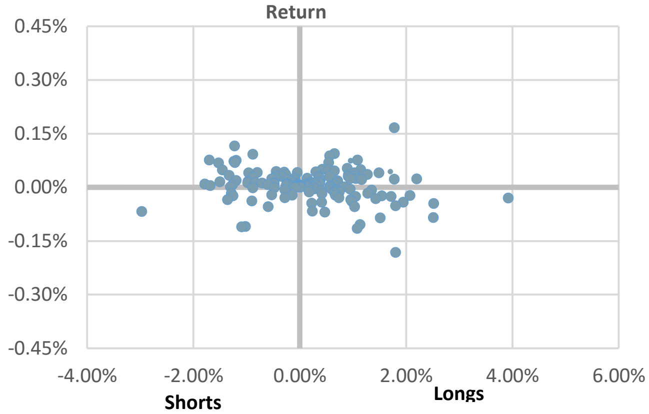
Country Allocation at 31 January 2018 (Gross Equity Exposure)



January 2018 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

The Fund experienced a satisfactory month in January, delivering a return of +0.67% after all fees and expenses. This return could easily have been somewhat better but for the NZ market experiencing a rather questionable 3.0% turnaround in the last hour of trading for the month. This heavily impacted our shorts. Whilst this caused much gnashing of teeth, it does bode well for our February start point as we enter result season.

Since inception on 30 June 2014, the Fund has now returned +54.03% after all fees and expenses. Thirty-two of those forty-three months have had positive returns, we are yet to have a negative quarter and our correlation to eternally bullish equity markets remains statistically zero.

We were most disappointed to get no responses to our generous offer last month of 10/1 odds to anyone who thought either of the NZ or US markets would do a repeat of 2017 and be up for every month of the year. As it happens, the S&P 500 was up 5.6% and the S&P/NZX 50 Gross Index clawed its way up to +0.52% after being down -2.0% for the month earlier on the day of 31 January. One almost becomes paranoid when witnessing such turnarounds, but we suspect it largely reflects forced buying at awful prices by ovine index investors. Given the impact they have had on the upside in recent years, the downside could be dramatic in the event of outflows at some future point. The S&P/ASX 200 Accumulation Index declined by 0.45%.

While the returns of the Fund may appear somewhat sedate relative to those of long-only equities, we are delivering these returns with less volatility than most balanced funds and doing so with no correlation to the equity markets that we are extracting the returns from. That was our aim from day one and it will remain our aim no matter what the equity market backdrop. This bull market is getting very long in the tooth and we aim to still be grinding out positive returns when the inevitable day of reckoning sees volatility sky-rocket and equities pull back.

STOP PRESS - This commentary is being written as US markets have fallen 2% and then 4% and the VIX volatility measure has spiked by 28% and then 116%. Is this a mere head-fake or does it mark a move to a different market paradigm?

We strongly suspect the latter and that this is the end of Goldilocks. The initial catalyst for the selloff was a fundamental driver in the form of a much higher than expected US wage inflation reading. Bond yields initially spiked and equities sold off, but this then morphed into a far broader risk-off correction. Ironically, interest-rate sensitive defensives actually sold off the least.

It is hard to say exactly why the initial spark turned into a conflagration, but the main suspect is that volatility shorting strategies blew up. They have been picking up pennies from in front of the steam-roller for years, but the steam-roller caught up. Newswires are carrying a number of articles pointing to multi-billion dollar products issued by the likes of Nomura and Credit Suisse as having imploded and nearly all the investors' money being lost. As Nomura put it, "we apologize from the bottom of our hearts for causing great inconvenience….". Indeed.

It seems that this then morphed into calls from the margin clerk (e.g. Interactive Brokers suspended intra-day margin), panic from retail (e.g. several robo-advice sites froze as did Schwab and Fidelity online for a period), redemptions, forced selling from trend-following CTA funds and forced selling from risk parity funds – when volatility rises they need to hold less of an asset class. Every good boom has a dose of financial innovation and now that the tide has gone out, we can see which of those innovations have been swimming with no clothes on.

Returning to fundamentals, the emergence of inflation is being coupled with central banks slowly dialling back on QE. Furthermore, the US tax cuts will lead to far larger deficits and juice their economy at a most inopportune time when it is already close to full employment. While we totally buy the arguments that US and European earnings growth is strong and that result season has been good so far, the issue for markets is that the Goldilocks era of strong earnings growth coupled with ultra-low bond yields may finally be coming to an end.

While our record of crying wolf in recent quarters has proven a tad premature (until just now), we are far from being perma-bears. Indeed, while doing a holiday clean-up, we came across an old presentation from June 2011 and the chart titles read: "Business confidence bodes well… firms' profit outlook is improving… earnings forecasts are rising… the market PE is below average… while bond yields have fallen… so the market is cheap…"

In the nearly seven years since writing those slides, the NZ market has risen by 2.4 times on a gross basis from 3448.35 to 8442.01. Unfortunately, each of those six bullish points that we outlined nearly seven years ago has now flipped: business confidence is falling, earnings forecasts are flat (ex A2 Milk), the market PE is at a record level above its rolling average, bond yields are rising somewhat and the market is very expensive. So, what is an investor to do? For our part, we will retain a cautious tilt and stay very disciplined in managing our net positioning.

January was notable in that a plethora of signals emerged suggesting that markets globally are extremely toppy and that the last marginal investors are all aboard (we wrote this prior to the last two nights). However, there have been few signs until early February of cashing up and we would also highlight that the Australian and NZ markets have decoupled to some degree from the US, which has been propelled by the short-term earnings elixir of their unfunded corporate tax cuts. There are so many signs that we are due a correction that it is hard to know where to start, so bullet-point form seems easiest:

- The American Association of Individual Investors (AAII) Index of net bullishness has risen to a 7 year high of 60% net bulls. It has historically been a useful contrarian indicator signalling complacency. According to Credit Suisse, the last time it reached the net 60% mark, the S&P 500 peaked 4 months later and then fell as much as 19%.
- According to UBS, US households' holdings of stocks in 3Q17 hit 36.3% of their financial assets. This is the highest in 67 years with the exception of the 40% peak in March 2000. We may be back at that level right now and we know what happened next on that occasion. Earlier peaks occurred before the "Nifty 50" meltdown in the late 1960s and in 2007.
- Rydex Funds offers a variety of bull and bear funds, with the ratio between these strategies reflecting investor sentiment. In early January, the ratio of bulls to bears hit 20:1. The previous peak was 13.6:1 in February 2015 just before a decent correction and historically it has ranged between 1:1 and 5:1.
- The Goldman Sachs Bull/Bear Market Risk Indicator hit its highest level in January since 2007/08 and before that in early 2000. GS suggests that this does not in itself portend a pullback but that it does point to the risks of a correction being high. The Merrill Lynch (ML) Bull/Bear indicator tells a similar story.
- GS also points out that correlations across asset classes have increased sharply, making a correction in one area (say bond yields) likely to cause a correction in others. Balanced portfolios and risk-parity funds may struggle as the correlations prove far from stationary.
- Investor cash allocations are at all-time lows according to sources as diversified as TD Waterhouse, Charles Schwab and ML.
- Hedge fund net length is at near-record highs, being at its 98th percentile on ML data.
- According to GS, the NYSE margin debt to GDP ratio is now above the peaks it reached back in 2007/08 and in early 2000.
- January 2018 was the strongest January for US equities since 1987.
- Crypto is a short-lived bubble. A couple of classic headlines in the month included: "Seagate, WU Surge On Speculation Of Stakes In Ripple," while Eastman Kodak surged from $3.10 to $10.70 on its plans to launch a, "photo-centric cryptocurrency." It is now back to $6.25 and falling. Happy memories of early 2000 and Toys.com just come flooding back…. (not that many current long-only investors would know what happened then).
- As we have pointed out frequently, flows into ETF's may turn into a weapon of mass financial destruction in the event of a sharp drawdown because many have grown to be very large relative to the size of the underlying assets that they invest in. GS calculates that flows into ETF's were 5x the size of flows into active funds during 2017. The madness in the last hour of trading in NZ on January 31 that we highlighted earlier shows what can happen when passive flows become too big for a market. We look forward to assisting some of this money when it turns around and seeks to exit NZ…

All of the points above suggest that far from this being a bull market that is climbing a wall of worry, investors are all-in. This does beg the question of what if they are correct to be so bullish? In our view, to be correct, the bulls will need a continuation of goldilocks - we will need to see strong earnings upgrades, while bond yields remain anchored. On this point, the Citigroup Global Earnings Revision Index hit an all-time high in January and recorded its best early year upgrades since 2000. This appears to be due to US tax cuts, a weak US$ and synchronised global growth.

The key counter to the earnings growth argument making everything okay is that profits are not growing in a vacuum. Bond yields are starting to rise as economies run out of spare capacity, the US tax cuts add to deficits and central banks are pulling back from QE. NZ 10-year yields rose from 2.75% to 2.93% in January, Australia from 2.8% to 2.98% and the USA from 2.41% to 2.71%. They are rising further as this is written. Another illuminating piece from Citigroup points to extremely strong US hiring intentions and that these are closely linked to future wage inflation. We think the recent rise in bond yields is for real and could easily run a fair bit further. We remain cautious.

It is not just the equity market that is seeing investors push their way up the risk curve in the search of returns. Citigroup published a fascinating piece looking at how fixed income managers have tried to juice returns in this ultra-low yield environment. In short, they see the following risks being taken: duration extension; naked forex risk (i.e. carry trade); flows into emerging markets; heavy name and sector concentration; illiquidity; subordination; call risk; and credit risk. This does not bode well for positioning in a world where bond yields are finally starting to rise, and central banks are gradually removing the cookie jar. As an investor, do you know what is in your yield fund?

NZ is not immune from global trends but our economy (and thence earnings) are showing some signs of charting a slightly different course. The NZIER Quarterly Survey of Business Opinion for the

December quarter showed a decline in confidence from +5.2% to -11.1% but capacity utilisation rose from 91.3% to 92.8%, the ease of finding skilled labour deteriorated from -47.0% to -49.2% and a net 30.2% of firms intend to lift prices (up from 26.1%). While NZ did have a surprisingly low inflation read during the December quarter, survey evidence such as this means one wouldn't want to bet on it lasting. Businesses are clearly feeling somewhat nervous about the Labour-led Government at a time where much of the economy's spare capacity has been used up. Translating this to equities, a continuation of the combination of solid earnings growth and quiescent bond yields looks unlikely, with perhaps both legs of the NZ Goldilocks being in a little trouble.

Returning to the performance of the Fund during January, we saw the +0.67% advance as actually being a touch disappointing. We had been up by more than 1.0% for much of the month prior to an awful last hour. Our winners to losers ratio was an extremely strong 62.6% and this would normally see a far stronger return recorded. The basic problem was that we had many small positives but no major stand-out winners in what was a quiet month for the market. Conversely, while we didn't walk into any buzz-saws, we had five mid-sized headwinds which detracted from performance.

The biggest winner was our large holding in Perpetual (PPT, +8.3%) which we had built up on undue weakness in the December quarter. As a value-oriented active manager, PPT does not sit entirely in the sweet-spot of current fund management industry trends but it retains an outstanding brand name and is well placed for when current conditions change. More importantly, they have two adjacent businesses in the form of Perpetual Corporate Trust and Perpetual Private which are growing strongly and together are not far off the size of the Perpetual Investments business.

The second tail-wind of note was our mid-sized short in Fisher & Paykel Healthcare (FPH, -7.0%) which gave back most of its unusual gains associated with entering the MSCI Index the month previously. FPH is a great company but we have to torture our valuation to get to current levels and it is facing short term headwinds from the NZ$ and a strong Resmed product cycle relative to their own.

Other modest positives included small longs in Shaver Shop (SSG, +11.4%) and BPS Technology (BPS, +16.1%) and shorts in Trade Me (TME, -7.0%) and Goodman Group (GMG, -3.9%). Finally, one small positive contributor that we need to highlight was a tiny long in Xero (XRO) which we purchased on forced index selling at $28.20, which was 12% below its month-end price of $31.47. This highlights both the generosity of passive investors and the way in which Xero was prepared to ignore the harm caused by its NZ exit. Our only mistake was not purchasing a larger position. We will sell our holding when the inevitable breathless initiation pieces from Australian analysts start hitting the tapes.

The stand-out detractor was our large long in Graincorp (GNC, -9.7%). We had traded some of our position out when it bounced sharply to $8.40 early in the month but it fell like a stone thereafter. We like GNC because it has fallen more than 30% from its recent highs due chiefly to a poor growing season in Australia. We attracted to the structural growth in their malting business from craft beer and this is performing well. However, their grain storage and distribution assets have massive operational leverage to the size of the export crop and in a very poor year there can be little to export at all. Their woes have been compounded by bumper Northern Hemisphere crops keeping prices low. One thing we do know in investing is that weather should never be capitalised into a share price on the upside nor the downside. GNC is now trading on a cash PE of just 10-11x a normal growing season.

There were four other notable headwinds of relatively equal size. Our mid-sized long in HT&E (HT1, -9.8%) fell sharply as the Australian Tax Office ramped up its demands in their tax dispute; our mid-sized short in Whitehaven (WHC, +10.8%) caused further pain as coal prices held up surprisingly well; our short in the extraordinarily high-priced Wisetech Global (WTC, +9.4%) rose further as momentum investors carried on their merry way (but it has plunged so far in February). A forward PE of 100x strikes us as a tad aggressive especially when WTC is buying small private software companies at very low multiples and also capitalising a good degree of their costs. Finally, a moderate long in Macquarie Atlas Roads (MQA, -8.7%) hurt as it fell sharply due to high bond yields despite having significant long-term hedging in place.

Thank you for your continued interest and support. We were pleased to follow up the strong December returns with another solid month in January but were frustrated that it could have been a good deal better. As we write this, NZ and Australian markets are down by circa 2-4% for the month in what is a highly volatile moving feast. We are pretty much flat so far in February as our shorts have successfully offset most of the pain from our longs. We will stick to our knitting and do our level best to grind out positive returns irrespective of the performance of the equity markets that we use to generate them.

Matthew Goodson, CFA