SALT

Salt Long Short Fund Fact Sheet – April 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 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 30 April 2023

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$71 million
Inception Date	31 December 2014
Portfolio Manager	Matthew Goodson, CFA

Unit Price at 30 April 2023

Application	2.2427
Redemption	2.2336

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 April 2023

Long positions	46
Short positions	38

Exposures at 30 April 2023

Long exposure	93.04%
Short exposure	51.56%
Gross equity exposure	144.60%
Net equity exposure	41.48%

Investment Risk to 30 April 2023

Fund volatility[1]	6.38%
NZ50G / ASX200AI volatility[1]	13.88%
NZ50G / ASX200AI correlation	0.079

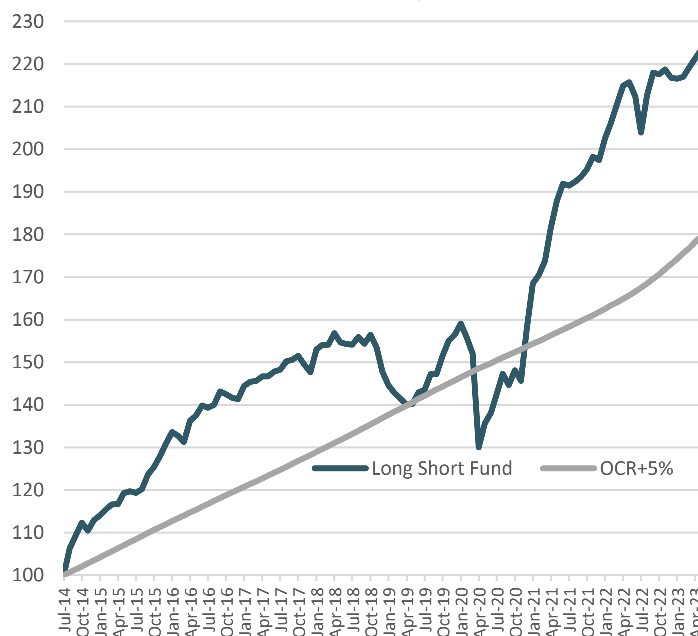
1. Annualised standard deviation since fund inception.

Fund Performance[2] to 30 April 2023

Period	Fund Return	OCR+5% Return	NZ50G/ASX 200AI Return[3]
1 month	0.96%	0.74%	1.49%
3 months	2.95%	2.24%	-0.18%
6 months	2.14%	4.49%	7.40%
1-year p.a.	3.54%	8.39%	1.95%
2 years p.a.	9.05%	6.95%	1.74%
3 years p.a.	18.09%	6.38%	9.83%
5 years p.a.	7.64%	6.39%	8.06%
7 years p.a.	7.18%	6.52%	9.01%
Inception p.a.	9.52%	6.85%	9.18%

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 April 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
Tower	Reece
Global Data Centre Group	Stockland
GDI Property Group	Technology One
Monash IVF Group	Meridian Energy
Kina Securities	Chorus

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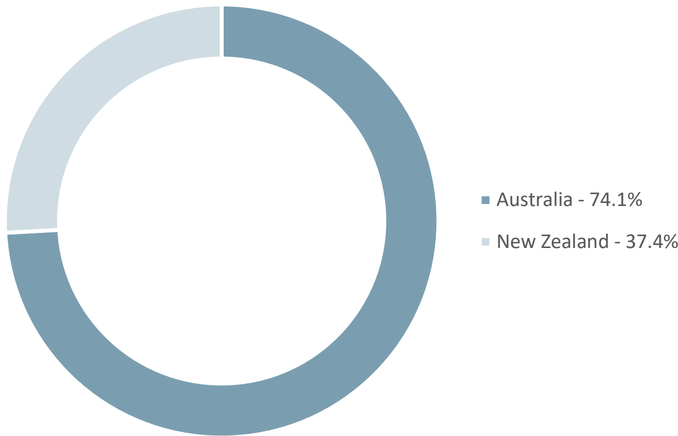
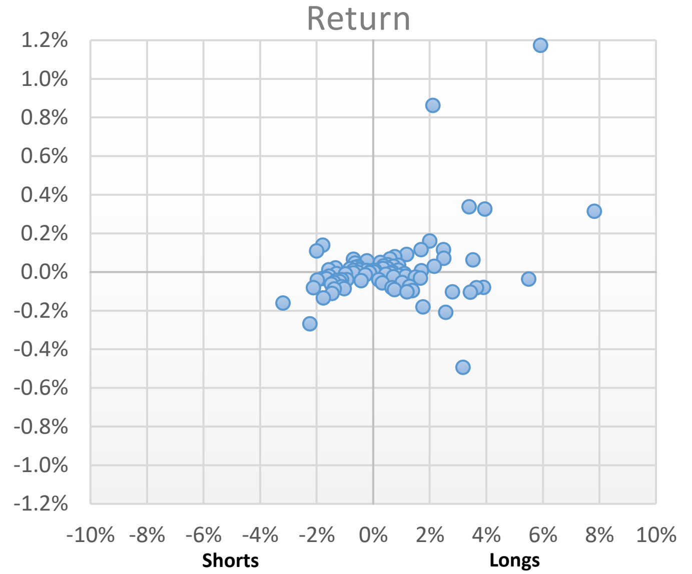
Country Allocation at 30 April 2023 (Gross Equity Exposure)



April 2023 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

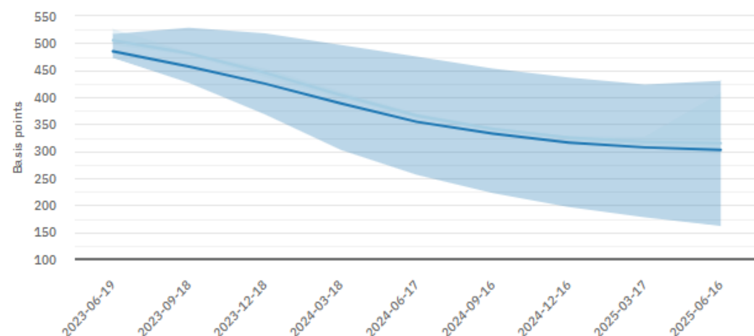
The Fund delivered another solid performance in the month of April, with a positive return of +0.96%. Our long book contributed strongly, with overall returns being held back by a large number of small headwinds from individual shorts that rose in price as the NZ (+1.1%) and Australian (+1.8%) markets shook off earlier volatility and moved firmly higher. Such is the nature of grinding out positive returns in a Long Short Fund with no correlation to the underlying equity markets from which those` returns are generated.

Concerns around US bank failures, rising central bank policy rates and signs of Chinese growth peaking post-re-opening were all defied by generally rising equities in most markets around the world. The MSCI World Accumulation Index rose by +1.8% and volatility declined.

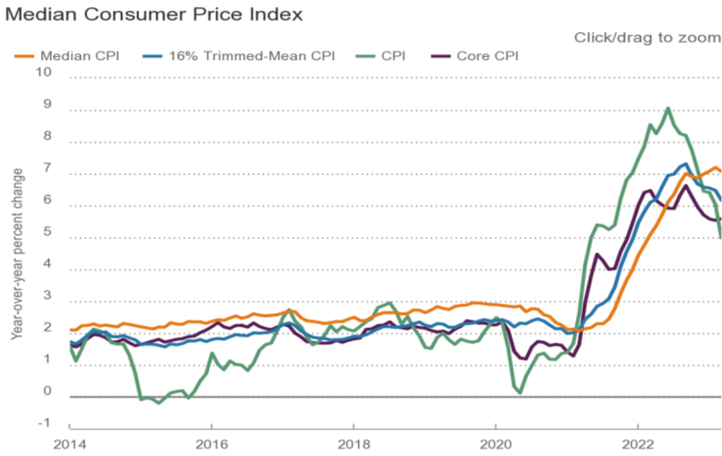
While we find continued market advances difficult to understand, potential explanations do exist. The strongest in our view is that financial markets continue to be awash with liquidity even as central banks gradually remove the punchbowl. US money supply growth (M2) is now in outright decline at -4.1% YoY in March, consistent with tighter policy and the weakest outcome since the 1930's. However, this is only partially reversing earlier sins, with the US$20.9tn stock of US M2 still being $5.5tn higher than the last pre-Covid month in 2020. Money is merely easy rather than absurdly easy.

We suspect the second reason for markets advancing in April was that they started searching out a peak in inflation and an accompanying peak in monetary policy tightness. This is possible but we are sticking firmly to our consistently held view that while inflation is indeed peaking, large components will prove sufficiently sticky that it will be a long time before policy is eased.

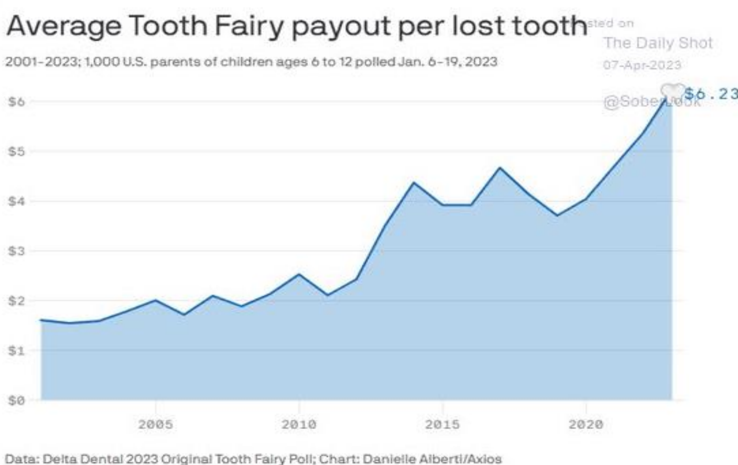
The chart below is sourced from the Atlanta Fed and shows that even though the Fed still likely has at least one hike to go from the current 4.75%-5.0% range, market-implied pricing at end-April was calling for a 50-point cut to 4.25% by Dec23, 3.44% by Jun24 and just 3.16% by Dec24.



In our view, this optimistic pricing of large near-term rate cuts is contrary to the evidence. April provided clear data across NZ, Australia and the US that while we are now experiencing goods disinflation, services inflation remains far too high as a wage-price feedback loop has taken hold. The chart below shows this clearly in the US, with headline annual CPI (green) having peaked nearly a year ago but the median CPI (yellow) is still rising and core CPI (purple) has only fallen a touch.



The Fed's preferred inflation measure is the core PCE deflator, with the annualised March rate of +4.2% being far below the cycle high of +7.0% in Jun-22. However, while goods inflation was just +1.6% YoY, services inflation was +5.5% and ex-energy, it actually printed a new multi-decade high of +7.1%. Finally here, the chart below shows clear inflationary pressure in a critical service industry.



The story in Australia is similar. The indecisive RBA elected to pause rate hikes early in the month and the market cheered the CPI release in late-April, which came in largely as expected at +7.0% YoY versus a peak of +7.8% in December. While goods inflation slowed from 9.5% to 7.6%, services inflation actually rose from 5.5% to 6.1%. As this is written in early-May, the seemingly random decision-making by the RBA saw them reverse and hike by 25bp.

NZ is no exception to inflation pressures. The March quarter CPI came in at +6.7% YoY versus the RBNZ at +7.2% but annual non-tradeables inflation of +6.8% was actually up on the +6.6% in the year to December and is a new multi-decade high. This is supported by the April monthly ANZ Business Outlook Survey, where a staggering 84% of firms expect their costs to rise over the next year while "only" 54% intend to lift their own prices – this is down from the peak but is still far too high as a wage-price spiral has taken hold.

Put all this together and markets have reacted over-exuberantly to some rather ordinary inflation data. Equities have gotten far ahead of themselves in pricing in future rate cuts.

Not only are markets being too optimistic about persistent inflation pressures but they are perhaps downplaying the effects of past Fed rate hikes that are still flowing through the system. As this is written, the FDIC has taken control of First Republic Bank and handed the remnants to JP Morgan, in what is the second largest US bank failure ever. Equities yawned although bond yields did briefly rise by around 15bp.

First Republic was very much the third horseman of the apocalypse alongside SVB and Signature Bank in that it stood out as having both huge unmarked losses from long duration loan/security assets and a high proportion of uninsured deposits.

We suspect that the worst of the US bank failures may now be behind us but what is left is a sector that is still vulnerable but just not to the unique extent of those three names. There are still pockets of uninsured deposits, loans will always be longer duration than their funding sources and some of these loans are vulnerable to cratering retail and office property prices. Unsurprisingly, lending standards are tightening dramatically, which is a flashing red-light warning for a future recession.

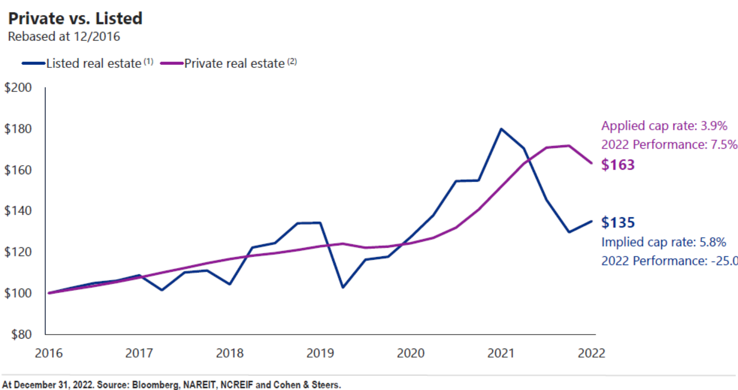
Aside from heightening recession risks, the death of the most exposed US banks also signifies the death of the highly lucrative decade-long "carry trade" across a wide array of asset classes that central banks juiced when they moved to "QE infinity" policies. Yield curves are now steeply inverted. When rates were zero/negative, it seemed as if there was nothing too exotic to borrow short and invest long in. Argentinian bonds, 100-year Austrian bonds, levered shopping centre syndicates in Whanganui – you name it and a carry trade was put on it.

Rather than stabilising such clearly dangerous trades, the geniuses running our central banks reacted to Covid-19 by

pouring bioethanol on the fire. They flooded banks with cash via their funding for lending schemes and other varieties of QE for which real economy loan demand simply did not exist. This excess cash inevitably sloshed out into financial markets and all sorts of longer duration securities. The failed US banks were merely the most egregious examples of this.

Investors should be extremely cautious in re-entering carry trades too early. The weak NZ listed property market has not missed this but alleged valuations for unlisted property and a whole plethora of exotic private asset funds should be treated with caution. This is why some of the largest and superficially safest unlisted property funds (such as Blackrock and Starwood) have large redemption queues. Who wouldn't want to get out at last year's prices?

According to Mercer NZ, the return from NZ unlisted property in 2022 was 4.3%, while NZ listed property returned -22.3%. Those private investors must be better than Buffett. Similarly, global private equity apparently returned -1.5%, while global equities fell -11.4% and global bonds fell -11.7%. What truly astounding resilience despite its leverage. The chart below looks at listed versus unlisted global property and tells the same tale. The great carry trade of the last decade is over, it is just that some asset classes haven't priced that yet. Get out if you can.



At December 31, 2022. Source: Bloomberg, NAREIT, NCREIF and Cohen & Steers.

Pull all these strands of our macro view together and what are the implications for the Fund? We see equities as having priced in rate cuts far too aggressively. While long bond yields have likely done most of their work, short term policy rates are still rising and yield curves are becoming more inverted. Together with tighter lending standards from banks, the omens are certainly gathering for future recession across many Western markets.

To us, this says the key risk to equities is no longer rising bond yields but a combination of buoyant liquidity reversing and fundamental earnings downgrades. We have been in a phase where "bad news is good news" because it might mean an end to rate hikes. Now, we may enter a phase of "bad news being bad news" because it means earnings downgrades and the stagflationary element to price pressures means that central banks will have to keep the pressure on.

From a bottom-up perspective, we are finding it increasingly difficult to source longs which are both cheap and where we are comfortable with future earnings risks. The special situation longs in the Fund are having to become ever more special. This has seen our net length fall from 47% to 41% over April. This still sounds quite long but we regard it as market-neutral to even slightly net negative on a risk-adjusted basis given our investment style. Interestingly, our gross exposure rose from 134% to 145% over the month as we found an increasing number of names that we see as both expensive and having earnings downgrade risk.

Fund Performance in April

Returning to the Fund's performance in the month of April, the overall return of circa +1.0% pre fees and tax was dominated by a 2.0% return from our long book, partially offset by a -1.0% headwind from our short book. This was as expected in a generally positive month for equities. Our "winners to losers" ratio was again a relatively ordinary 55% but our two largest winners were significantly bigger than our notable losers.

The 50/50 index of Australia and NZ had a normal number of eight down-days in April, but volatility was low, with the average return on them being a modest -0.19%. There were no big scary 2%+ down-days. With our net length falling over the month, it might be expected that we did relatively well on the down days and that was indeed the case. We were up on six out of the eight negative days, with an average return of +0.13%.

By far the most significant contributor was our large holding in Global Data Centres (GDC, +19.8%). As we highlighted last month, we formally wrote to the RE and the Manager requesting a strategic review, with potential outcomes including a full sale. We are delighted to report that in combination with approaches from other key investors, they have agreed with this and have now moved to a value realisation strategy.

The Manager's fee structure has been changed and is now heavily incentivised to achieve strong sale outcomes over a reasonable period of time. On our assessment, getting $2.50/share over the next two years is roughly equivalent to their former fee structure. To put the potential upside in context, the GDC share price rose from $1.285 to $1.54 over the month. This is a classic example of the sort of special

situation stock that this Fund tries to seek out, and in doing so, deliver returns that are uncorrelated with the broader equity market.

The second largest tailwind came from a medium-sized holding in Silk Laser Australia (SLA, +45.7%), which received a takeover bid from Wesfarmers. It is always hard to differentiate between luck and skill in fund management. While landing a juicy bid within a couple of months of owning the name might be characterised as lucky, there is also an element of making one's luck by playing in the right places. Buying a stock at entry on a PE of 7x with reasonable growth and a sound balance sheet does give one a chance of being in the right place. We view the Wesfarmers bid as being a little light, with SLA still only on a PE of 14x going to 11.8x and having solid synergies with the bidder. We suspect it will be their first bid rather than their final one.

Three other longs also made notable contributions in April although none to quite the extent of the two above. Our holding in Superloop (SLC, +9.8%) has generally been disappointing but it managed to bounce off its lows. We retain a view that while they are operating in a highly competitive segment of the Australian telco market, their own infrastructure gives them an edge over their reseller competitors. Each marginal dollar of revenue has a high drop-through to the bottom line.

Our long-standing holding in Monash IVF (MVF, +7.9%) again performed solidly and it remains our favourite structural growth company. Its balance sheet is strong and the forward PE of 17x is low relative to the mind-bending multiples that Australian growth investors seem to love paying for inferior stories to this one. Finally, Tower Limited (TWR, +4.0%) advanced moderately on no new news. We look forward to commentary around strong premium increases when they deliver their result this month.

The largest detractor was the long that we have prematurely built up in Omni Bridgeway (OBL, -13.9%). This is a name that we have owned on and off in the Fund for some years and it tends to trade in unduly large ranges as bulls and bears take their turns dominating the register of a company whose earnings are decidedly acyclical.

The core business of OBL is litigation funding and they are a key player across Australia, the US and Europe. However, these days, they take little balance sheet risk with their funding, with this instead provided via a series of funds supported by wholesale investors. These funds have modest base fees coupled with waterfall type structures, where investors receive the first tranche of payments up to a certain target return, with OBL participating thereafter. Even though one of these funds in particular is about to move into harvest mode for OBL, the market appears to have run out of patience. OBL can also accelerate cashflows by selling the rights to future litigation payments on the secondary market. While the last couple of quarters have been a little slow, there is no evidence that they have suddenly lost their ability to source funding agreements or convert them into income at 15% of the headline figure funded. The share price has halved in recent months and shorts have risen sharply. We like how their earnings are entirely unrelated to the economy and they are one good quarter away from another sea-change in views towards them.

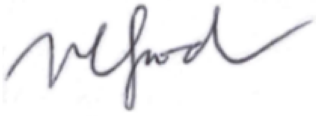
The second notable detractor was a premature and possibly mistaken short we initiated in Stockland (SGP, +11.8%). It ran hard on a sudden view in Australia that housing has bottomed because the RBA is on hold and immigration is about to boom. These factors may play out but there is still a large mortgage refinancing cliff for the market to negotiate and SGP also has moderate quality commercial property assets that will be under the same pressure as the rest of the sector. We think the stock has run far too hard but will likely cover on any material pullback.

A third headwind came from our relatively large position in United Malt Group (UMG, -7.4%) which delivered a moderate profit downgrade at month-end. While they reiterated their full-year guidance this now clearly carries greater risk and there is now a modicum more risk surrounding the takeover bid for them by the French malting company, Soufflet. It would be a surprise if largely short-term issues derailed a multi-decade opportunity but one never quite knows, so we have de-risked slightly. UMG closed at $4.40 versus the indicative bid at $5.00.

Thank you for your continued support of the Fund. April was pleasing in that a couple of key holdings played out as we would have hoped but it was also frustrating in that strong returns from these names were partially eroded by a series of small headwinds.

April was a relatively strong month for global equities but performance was notably narrow and dominated by a few mega-cap tech names. We see markets as being highly premature in pricing central bank easing when there is a mass of evidence that inflation is proving sticky. Worse, recessionary clouds are building across many countries and earnings forecast risks should be paramount in investors' minds.

We repeat our refrain from the last few months. “Don’t Fight The Fed”. While interest rates may be close to peaking, there will be an extended plateau with no early easing. At the same time, equities are fully priced and have increasing earnings risks. We will keep marching to the beat of our own drum and seek to grind out positive returns regardless of what end-markets are doing.



Matthew Goodson, CFA

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