SALT

Funds Management

Salt Long Short Fund Fact Sheet – November 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 30 November 2018

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$260.5 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 30 November 2018

Application	1.4839
Redemption	1.4778

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 November 2018

Long positions	82
Short positions	39

Exposures at 30 November 2018

Long exposure	78.81%
Short exposure	-40.91%
Gross equity exposure	119.72%
Net equity exposure	37.90%

Largest Longs	Largest Shorts
Centuria Metropolitan REIT	National Storage REIT
Unibail-Rodamco-Westfield/CDI	BWP Trust
Bingo Industries	Spark NZ
Tower	Auckland Intl Airport
QMS Media	Goodman Group

Performance[1] at 30 November 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%	1.37%	-1.88%	-3.71%		**-3.42%**

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	-4.23%	1.64%	-7.28%
6 months	-4.21%	3.33%	-3.13%
1-year p.a.	0.08%	6.75%	1.05%
2-years p.a.	2.25%	6.75%	8.61%
3 years p.a.	4.13%	6.92%	9.61%
Since inception p.a.	9.25%	7.36%	8.84%

[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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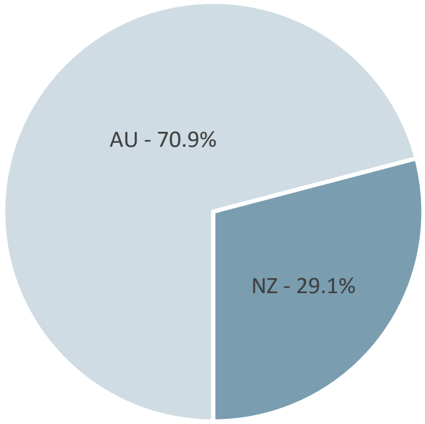
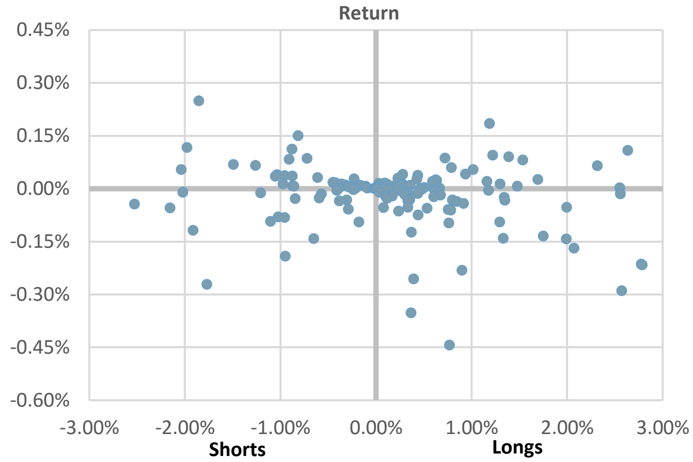
Country Allocation at 30 November 2018 (Gross Equity Exposure)



November 2018 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

The Fund experienced a very disappointing November, declining by -3.71% after all fees and expenses, making this the worst month since inception. Equity markets were clearly volatile but we were unsuccessful in our long-stated aim to preserve capital or even deliver modest positive returns during such periods. Our return compared to the S&P/NZX 50 Gross Index return of +0.81% and the Australian S&P/ASX 200 Accumulation Index decline of -2.21%.

Quarter-to-date, the Fund is down -5.52% compared to NZ -5.64% and Australia -8.13%. With 70% of the holdings being in Australia, the very poor performance of many of our Australian longs is perhaps understandable but doesn't alter the fact that after months of preparing for this sell-off, a perfect storm of conflating events meant we didn't provide the protection we had hoped.

This period of weak performance began with seven days to go in October. At that point we had been sitting in a very strong position, being up +0.38% compared to NZ and Australian markets that were down 6-7% at that stage. From then onwards, everything that could go wrong did go wrong. What happened and what have we done about it? In trying to answer this, we can point to four generic problem areas.

Firstly, we became too long stocks that were trading at alluringly low valuation levels. Historically, valuation headroom has protected us in previous market sell-offs but this time around we saw an unusually high incidence of earnings warnings as the NZ and Australian economies have entered choppier waters. Valuation proved to be no protection and a number of our names proved to be low-priced rather than cheap.

Secondly, our shorts didn't quite give us the protection we had hoped, with a collective negative contribution of -0.12% in November. We had no major problems and a number did fall quite sharply. Our main issue was that we tended to cover some of our highest beta shorts whose prices fell the hardest and we replaced them with very expensive large cap defensives such as Spark, Auckland Airport and Goodman Group which actually performed moderately well during November as investors flocked to safety. In our view, they are overpaying for safety in some of these names at a time when credit spreads are widening but this hurt us a little in the short term. Our secondary problem was that with markets plunging, we covered a little too much a little too soon, leaving us with net length in the 35-38% region and therefore susceptible to the continuing market weakness.

Thirdly, our largest high conviction longs in the Fund have a very strong track record over a number of years of providing positive returns but we are sometimes guilty of being too large, too soon – especially in falling markets. Several fell quite sharply in the market maelstrom in October and November, with some lowlights including Bingo (BIN, -24%, -7%), Unibail-Rodamco-Westfield (URW, -10%, -7%), Tower (TWR, -9%, +4%), QMS Media (QMS, -10%, -1%) and Star Entertainment (SGR, -9%, -8%). Our investment theses remain intact with these businesses although Bingo suffered from the ACCC surprisingly having issues with their Dial-A-Dump acquisition. We generally used the month's weakness to add to our high conviction longs provided the fundamental outlook didn't change for them.

Fourthly, we have a successful albeit volatile history in the Fund of being long a diversified range of small high-risk positions. Over time, some of these have being spectacular multi-bagger successes and others have failed. With the change in market and economic conditions, we have decided that this is very much a bull market strategy and have carried out a thorough pruning. We walked into several surprisingly sudden cyclical earnings warnings; a cavalcade of general de-risking which saw valuation multiples fall sharply; and a receivership from RCR Tomlinson (0.89% position) which had reiterated guidance just two weeks prior and which had undergone extensive due diligence from a top tier investment bank prior to being recapitalised two months earlier. We had been selling RCR but did not exit in time.

Having analysed what went wrong, we did not sit idly on our hands during the month's volatility. We shorted overbought "safety stocks", we exited or greatly reduced those longs where our thesis was wrong or uncomfortably high risk, while we added to a number of higher quality longs where we are comfortable with the business outlook and where the valuation ratios are attractive. Things can change very quickly in markets and just as we have lost an unusual amount of performance in the five weeks since late October, so we hope and expect to earn it back again. This is a long-term game.

Overall, we lowered our gross positioning to circa 120% and we lifted our net length towards the high end of our historical ranges to sit in the 38% region, with a last day market sell-off in Australia being used to accentuate this move. Risk-adjusted, we now view the Fund as being moderately net long, which we are comfortable with in the short term given the size of the market sell-off that we have seen and short-term bullish signals post month-end from the Fed and from trade talks.

Where markets go from here depends on how several conflicting arguments play out over differing timeframes:

1) The bull case is that we are due a sentiment bounce. Numerous large cap stocks are heavily oversold on technical measures, with classic examples being the FAANG stocks. Compared to 2018 highs, November bottoms saw Facebook -40%, Amazon -27%, Apple -24%, Netflix -37% and Google -21%. These huge movements have reverberated around the world, although in NZ, we merely saw a takeover bid for Trade Me (no position). The degree of the sell-off across all asset classes this year is illustrated by Deutsche Bank's finding that as at end-October, 89% of all assets that they collect data on had negative returns in USD terms, surpassing the previous record of 84% in 1920. Conversely, only 1% of asset classes had negative returns in 2017.

2) In addition to stocks being oversold on technical momentum measures, retail investor sentiment surveys point to a potential contrarian bounce. The long-running bull-bear ratio in the USA shows individual investor sentiment fell below 35% and that average six month forward returns from here are +12.7%. Notably however, it failed in 2008 and various measures of brokerage cash levels suggest that investors are heavily over-invested in equities – it is just that they are now feeling unhappy about that. Similarly, another classic gauge of dismal investor sentiment is that the average discount of US closed-end funds to their NAV's of around 9% is back at the levels of the 2008 and the brief China meltdown in 2015. These were good contrarian buy signals.

3) A further bull argument is that central banks blink in the face of slowing economic growth and the whiplash decline in oil prices. This indeed happened late month, with Fed Governor Powell stating on 28 Nov that, "*The funds rate is just below the broad range of estimates of the level that would be neutral for the economy*." This compares to his October 3 statement that, "*We may go past neutral. But we're a long way from neutral at this point, probably*." Aside from intense political pressure perhaps driving this U-turn, US housing sales, housing starts and car purchases were all very weak.

4) Now that central banks are blinking in the face of slower growth outcomes, a very negative scenario would be if the lagged inflationary impact of economies operating at full capacity comes through. The Fed would lose credibility and bond markets would "puke", to coin a technical phrase. To this end, with the US Employment Cost Index in October was a very high 3.1% and the upcoming November release will be unusually important. Back in NZ, the RBNZ has shed its dovishness on a stronger than expected September CPI outcome. Stagflationary outcomes are the biggest current threat to the next move in equity markets.

5) The OECD Global Leading Indicator released mid-month showed the tenth consecutive monthly decline, and in level terms, it is at its weakest point since December 2012. German GDP fell at 0.8% annualised in Q3, Japan was -1.2%, signs of weakness abound in China, while the US economy has weakened. We are net short commodity plays.

6) Credit spreads are blowing out. The US CDX 5-year high yield spread has risen from recent lows of 290bp to now sit at over 400bp, with other indices painting a similar picture. Low oil prices and the potential downgrade to junk of the behemoth that is General Electric are two obvious reasons for this but years of debt-funded share buybacks and low covenant loans also appear to be catching up with the market. Closer to home, recent issuances by Fonterra and Kiwi Property did not appear easy sells although Chorus did manage to move its monster $500m 5-year issue at the low end of its 180-190bp margin range. The key point here is that if investors are demanding higher returns in the debt part of the capital stack, then surely equity risk premia will expand too. Keep an eye on high yield spreads.

7) Earnings forecasts have generally moved into downgrade mode which makes sense given the general economic weakness outlined above. In line with weak business confidence readings, year ahead forecasts for NZ peaked back in April and have retraced about 6% since then. Australia and the US are similarly pulling back and aside

from mixed revenue lines, cost pressures from labour are another common denominator. There is little we can point to that suggests the downgrades are over yet.

8) The sharp market sell-off has been partially accompanied by earnings downgrades which means that valuations are still expensive. Using FNZC data, the one year forward PE rose from 24.8x to 25.4x in November. This is below the ludicrous 26.4x it hit during the August madness but it remains 21% above our fair value estimate.

9) Aside from inflation outcomes, bond yields over the period ahead remain susceptible to two other factors. The Fed is now implementing QT and the ECB's QE finishes at end-Dec – who will buy Italian bonds then? Secondly, the slowdown in the US economy could see some uncomfortably large fiscal deficits which may make the bond market sit up and take notice. Higher yields in these markets would work their way into asset valuations all around the world.

10) A left-field factor is the ongoing trade saga between the USA and China. The market's euphoric reaction early in December following the G20 summit to what is merely a 90-day truce surely paves the way for more twists and turns in this soap opera. Will China really make the meaningful changes to IP protection and investment openness that the US is seeking?

11) Finally, a pall has been cast over the Australian equity market by the sharp slowdown in their housing market and related exposures to it. There is a unique factor in the form of the Royal Commission and they have also had a stronger supply response than NZ. However, we also have a host of factors suggesting that we may follow with a lag. Our market is extremely expensive, bank munificence may pare back somewhat, negative gearing will end over the next year, the foreign buyer ban is in place, a supply response is gradually building and AML legislation is about to be applied to realtors and lawyers from January.

Put all this together and we remain medium term bearish due to valuations that remain extended, economic/earnings outlooks that are turning south and credit spreads that are widening. Nearer term however, there has been a large degree of capitulation and as central banks are taking a wee breather, early December is seeing an attempt a market rally which is providing some interesting opportunities to establish new shorts. As the famous saying goes – in the short run, the market is a voting machine but in the long run it is a weighing machine. Returning to the performance of the Fund during November, the -3.71% return was driven by three related factors. Firstly, our "winners to losers" ratio was a disappointing 47%. Secondly, we underperformed from both the long and short sides of the ledger, with our longs detracting -3.57% and our shorts surprisingly hurting us by -0.12%. Thirdly, our losers were far larger in magnitude than our winners.

The worst performer by some distance was the 0.89% position that remained in RCR Tomlinson (RCR) which entered receivership. We had been selling as we were wary of the risks but were only doing so slowly as we saw the potential for major rail contract wins which would have led to a re-rating and a better exit point. RCR had reiterated guidance at their AGM just two weeks prior, directors had been buying shares and the business had undergone extensive due diligence prior to being recapitalised just two months earlier. Normally, owning these situations post recapitalisation is exactly the time to do so. This situation reeks and it will be fascinating to see if there are insurance recoveries down the track.

Our modest long in Evolve Education (EVO, -26%) has turned into a very disappointing saga. We bought far too early in the expectation of a turnaround of a business that has been poorly run and on the strong possibility that private equity interest in the sector could extend to EVO. We may have got close on the takeover scenario but the purchase of a strategic stake at $0.65 (versus the current $0.32) by the successful Australian investor, Chris Scott stymied this possibility. The sector has been squeezed by excess supply, staff shortages and tight Government funding under National. However, the key driver is nitty gritty centre-by-centre management in each local market to get occupancy up from the current 77% to 82%. This would leverage EVO's fixed cost base and thence earnings. We have confidence that the new CEO, Rosanne Graham is the right person to drive this but it will take time and while the business is cash generative, the balance sheet is now stretched. Recent evidence does tentatively point to the business stabilising at weak levels.

Our modest long in the Australian tyre retailer, National Tyre & Wheel (NTD, -41%) ran into an earnings warning. Earlier trading feedback had been solid but October saw very poor sales and a timing issue with passing on higher imported costs. We had invested on the basis that it was a steady business on a low multiple that would grow by bolting on independents to its network at very cheap prices. Post downgrade, NTD is now on a forward PE of 6.4x and a dividend yield of 7.8% but it will take time to rebuild trust and return to its former strategy. We have retained our small holding as the business is not broken.

Our large long in Turners (TRA, -10%) has delivered strong returns in the past but ran into a result that was weaker than their earlier upbeat comments had suggested. While used car sales are holding up well, we underestimated the margin impact from a squeeze on car inventories due to greater difficulty and costs in sourcing Japanese imports. We had thought that TRA's diversified sources of car supply would allow them to ride this out. In addition, TRA has experienced some obsolete inventory issues in their purchase of Buy Right Cars and their non-recourse finance offer has proven to be mis-priced. These latter two issues have largely been worked through and the import issue will not last forever. We remain fans of TRA's unique vertical and horizontal integration in a highly fragmented industry with large profit pools. In the short term we have called the cycle wrong but in the long term we think this is a business on a sub 10x PE with many years of growth ahead of it.

Our small 0.5% long (pre fall) in Far Limited (FAR, -48%) made the cardinal sin of drilling a dry hole in what was a moderately risky (in exploration terms) 900m barrel oil prospect. If this had come up trumps, the share price would have risen by several multiples. The backstop is their stake in the SNE field that is being developed by Woodside and a legal dispute where FAR possibly has pre-emptive rights over the stake that was bought by Woodside. Most analyst valuations of FAR's stake are at least twice the current share price.

A small speculative long in the dental roll-up Smiles Inc (SIL, -58%) was disastrous. The management driving the business had strong roll-up track records and their model of partial 60/40 ownership with dentists made theoretical sense in driving ongoing incentivisation. However, some of the acquisitions have performed poorly, a key operator died and central costs have proven higher than expected. Latest trading does appear to be improving but trust in this business is shot to pieces and it is now a very small holding.

Our large, high conviction holding in Bingo Industries (BIN, -7%) has had a tough two months. The problem this month came with the amber light given by the ACCC to their highly strategic purchase of Dial-A-Dump. We believe they will get this through in some form, with minor divestments likely required. Meanwhile, F19 earnings forecasts will be pushed back and uncertainty will sit on BIN for several months. BIN is now at a major discount to our DCF valuation without D-A-D and they have already raised the equity to pay for it. Macquarie estimates that theoretically using this $425m for a buyback at current levels would be 47% EPS accretive. It is hard to think of businesses with a better fortress than well located landfill and recycling facilities in a market where there is little room for more of them and BIN is now trading well below market multiples.

Our large long in Unibail-Rodamco-Westfield (URW, -7%) has fared very poorly in the last two months. They own premium shopping centres across Europe and the US, with around 25% exposure to the latter market. Owning and developing premium shopping centres remains a good business. It is B and C grade centres that are seeing the most pain from the encroachment of online. URW stands out as being remarkably undervalued in our relative property valuation model and we estimate it offers a gross PIE yield to a NZ investor of 9.2% with solid growth as developments mature.

An analysis of the US Thanksgiving weekend by ICSC Research found that 60% of adults — or 151.2m people — visited a mall, with 95.8m adults doing so on Thanksgiving Day itself, up from 91m last year. 71% of shoppers spent in a store, while 42% spent online from physical retailers. Roughly 27% used click-and-collect, by which they paid for products online and picked them up in a store. Of these click-and-collect shoppers, 64% made additional purchases in the store, an adjacent establishment or another unit in the same mall when they went to pick up the merchandise they ordered online. We have upped our holding and will grit our teeth while collecting the dividend cheque.

Notwithstanding the foregoing list of woe, the Fund did have a number of solid winners during the month. These were led by our large short in Coca Cola Amatil (CCL, -13%). This had apparently been a "safety stock" for a number of Australian investors but they delivered a soft confession in a business update late month on several aspects. Indonesia is performing poorly, input costs have risen and there is ongoing need for more reinvestment in the business than had been previously flagged. It is a 17-18x PE company with no discernible growth.

Our longs in the intellectual property space finally bore a little fruit, with our mid-sized Qantm IP (QIP, +15%) holding rising sharply on corporate activity. They appear very keen to push forward with a merger with Xenith IP (XIP, +14%) which is also a small holding but to us this makes little sense relative to an indicative bid at a far higher price from rivals IPH Limited. We are hopeful that this can be consummated despite the QIP Board/management clearly preferring to steer their own course.

Our moderate short in Dominos Pizza (DMP, -15%) fell sharply following muted guidance at their AGM, while our very large short in Ryman (RYM, -4%) has performed well over the last two months. We did cover some of this on weakness but we retain high conviction that there is a sizeable overbuild occurring in the retirement village sector at a time when the domestic housing sector has peaked out. The treatment meted out to Aveo Group in Australia illustrates what can happen when a highly geared balance sheet meets a slowdown in unit sales.

Thank you for ongoing investment and support of the Fund. The last five weeks have been a rude wake-up call after the Fund was seemingly well positioned in late October. We have recognised the step-change in market and economic conditions and moved to exit and reduce a number of our lower quality longs rather than throw good money after bad. At the same time, we have taken advantage of the sharp pullback to add to our highest conviction names at attractive levels. We have rotated our shorts to cover many which have been decimated, while initiating ones where we see earnings risk and have also lifted shorts in a range of overbought "safety trade" names.

A contrarian market bounce is occurring in the short term as investor sentiment is negative, momentum measures are pointing to markets being oversold and central banks are blinking and take their feet ever so slightly off the monetary brakes. Fundamentally however, valuations remain extended and the earnings/economic outlook across NZ/Australia and most countries globally is now headed in the wrong direction. The Fund has returned circa 48% since inception but the 6-7% drawdown from our recent high over the last five weeks has been a nasty interlude. Rather than sitting pat and hoping that some of our battered names bounce, we have moved to reposition our holdings to be well placed for what lies in front of us.

Matthew Goodson, CFA