SALT

Salt Long Short Fund Fact Sheet – November 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 November 2023

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$76 million
Inception Date	1 July 2014
Portfolio Manager	Matthew Goodson, CFA

Unit Price at 30 November 2023

Application	2.3372
Redemption	2.3277

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 2023

Long positions	53
Short positions	34

Exposures at 30 November 2023

Long exposure	111.09%
Short exposure	61.94%
Gross equity exposure	173.03%
Net equity exposure	49.15%

Investment Risk to 30 November 2023

Fund volatility[1]	6.47%
NZ50G / ASX200AI volatility[1]	13.65%
NZ50G / ASX200AI correlation	0.074

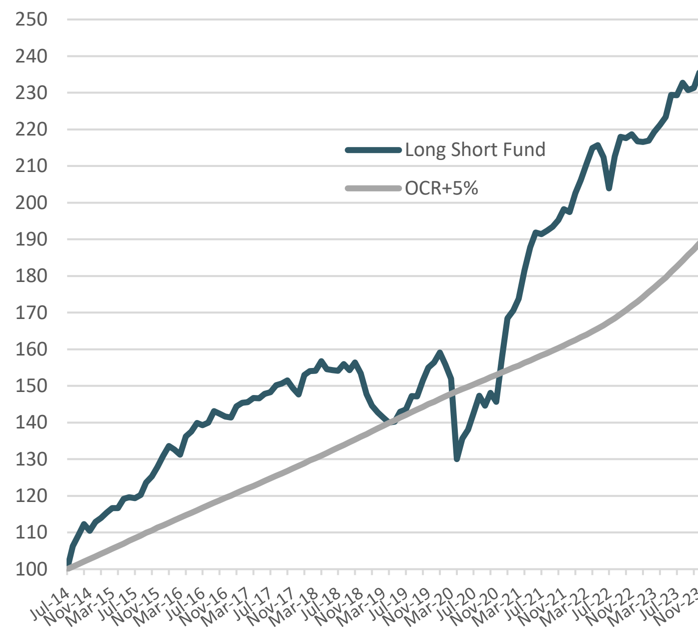
1. Annualised standard deviation since fund inception.

Fund Performance[2] to 30 November 2023

Period	Fund Return	OCR+5% Return	NZ50G/ASX 200AI Return[3]
1 month	-1.16%	0.82%	5.18%
3 months	0.88%	2.51%	-1.87%
6 months	1.44%	5.11%	-1.49%
1-year p.a.	7.38%	10.06%	-0.65%
2 years p.a.	8.58%	8.48%	-1.50%
3 years p.a.	13.84%	7.40%	1.39%
5 years p.a.	9.51%	6.82%	7.57%
7 years p.a.	7.39%	6.80%	7.86%
Inception p.a.	9.39%	7.08%	8.16%

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 November 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	Commonwealth Bank of Australia
Global Data Centre Group	Ebos Group
Lynch Group Holdings	Data#3
Superloop	Goodman Property Trust

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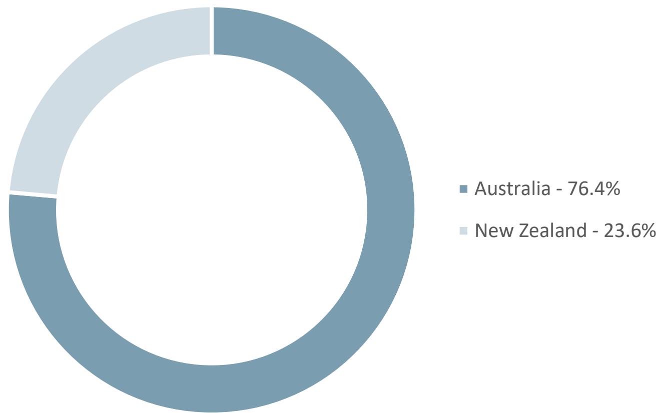
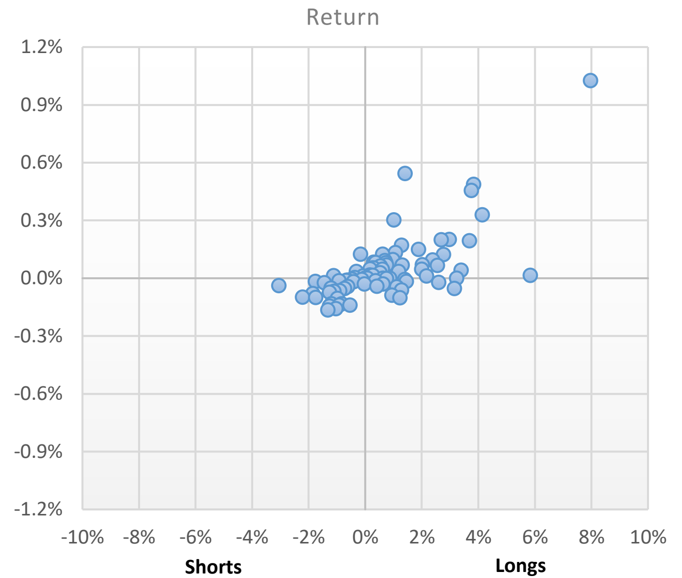
Country Allocation at 30 November 2023 (Gross Equity Exposure)



November 2023 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

November was a somewhat disappointing month for the Fund with a return of -1.16%. Just as the Fund had done far better than dismal equity markets in the prior October month, so we sharply lagged behind the euphoric U-turn in November, which saw the MSCI World Index rise by a staggering +9.4%, Australia lift by +5.0% and NZ join the party at +5.3%.

Sometimes, marching along one's own uncorrelated path can be a very good thing and at other times, one can suffer from long-only performance envy. To put it in context however, quarter-to-date the Fund has returned +0.88% versus +0.30% for NZ equities and +1.06% for Australia. The Fund continues to provide equity-like returns with far less volatility and no correlation – it's just that we would have preferred some correlation this month.

As one might expect, our short book weighed heavily on returns but the disappointment perhaps came more from the long-side. While some of our longs rose sharply, we had several key laggards where price movements either left us a little bemused or should hopefully prove temporary. More on this shortly.

The key driver of everything in November was the largest monthly decline in bond yields since 2008. US 10-years fell from 4.84% to 4.26%; Australia moved from 4.92% to 4.41% and NZ from 5.57% to 4.95%. This came despite a downgrade by Moodys to the US credit rating outlook from "stable" to "negative" mid-month citing the "polarisation" in the US Congress creating risks on the ability and willingness of the US to rein in its debts. This seemed rather important and no solution looks to be in sight but US real bond yields (10-year TIPS) subsequently fell from 2.51% to 2.10%. This made up 41bp of the 58bp US bond rally. Perhaps they had been oversold earlier but sometimes clear explanations defy analysis.

While central banks continued the time-honoured tradition of keeping all options open by speaking out of both sides of their mouths, markets honed in on several pieces of inflation data and priced in rapid easing in 2024. At the start of the month, the US market was pricing in a 4.62% overnight cash rate by Dec24 but by month's end it was 4.16% - this implies 116bp of easing. Antipodean markets took their cue off this despite the RBA delivering a Melbourne Cup Day rate hike and the RBNZ being surprisingly hawkish in their Monetary Policy Statement near month's end.

We suspect the tinder for the massive rally actually lay in prior speculative positioning. CFTC data showed that large speculators/HFs were net short US T-note futures at -13.0% of total open interest. Since 1997, there had only been five other occasions when speculators have been this short and a sharp rally followed each time. Similarly, the heavily shorted

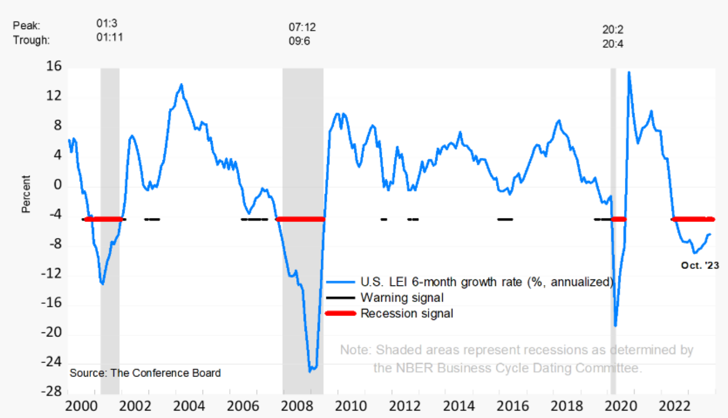
small cap Russell equity index had also reached an extreme of speculative shorting. Our conclusion from this is that we have just seen the mother of all short-covering rallies. Whether it continues will depend on how the next pieces of fundamental data unfold.

On this front, the commonly cited catalyst for the rally in bonds and small cap equities was the surprisingly low US CPI outcome on 14 November. The core came in at +0.2% (0.3% expected) and +4.0% YoY (+4.1% expected and previous). While this was encouraging, 4.0% is still a long way from the 2.0% target and the market blithely overlooked a one-off -34.0% YoY decline in health insurance costs due to a change in the way they are measured. In any case, 1-year yields had already rallied from 4.88% to 4.59% prior to this release and this saw them fall a further 15bp on the day and 33bp in the rest of the month. The market seized on this narrative to juice its short-covering rally. NZ and Australia merrily tagged along.

From here, we suspect inflation outcomes will gradually wane as goods inflation has fallen to zero and services inflation slowly retraces from high levels. We doubt that this will happen fast enough to justify the significant easing that the market is pricing in for 2024 but we have probably seen the bond yield highs. Our idea over the last several months to be long bond-yield proxies and short cyclicals looks to be playing out although the latter part of the trade has not worked as yet.

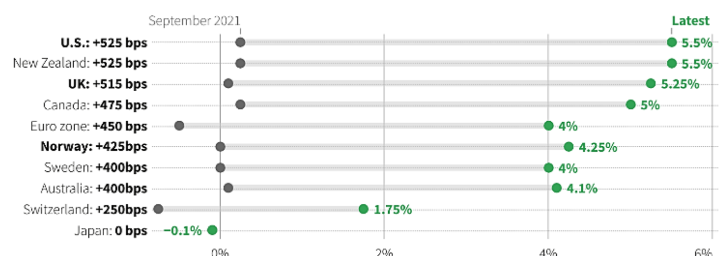
This brings us to a key question for all equity markets in 2024. How will earnings growth fare? According to JP Morgan strategists, consensus expects 10.2% earnings growth for the S&P500 in 2024. This view is essentially for a return of "goldilocks" – inflation will keep falling but economies will stay just strong enough to drive continued earnings growth.

While "goldilocks" is possible, the chart below of the Conference Board US Leading Indicator Index suggests it is rather unlikely. Rather than seizing on any single statistic, the LEI uses ten different components which have a strong statistical relationship with future GDP growth outcomes. While the LEI is not quite as negative as ahead of past recessions, the duration of the down-move generates a future recession signal. Maybe the domination of US equities by the secular growth of the" Magnificent Seven" sees markets shake off these headwinds but maybe the cycle wins. It certainly looks a very different LEI set-up to the past period of goldilocks in the late 2010's prior to Covid. <u>The degree to which cyclical earnings risks materialise will be the key to markets next year.</u>



The NZ and Australian economic outlooks are at slightly different stages of the monetary policy cycle to the US. As shown in the chart below, NZ has carried out relatively aggressive monetary policy tightening but the late-November Monetary Policy Statement depicted a continued hawkish RBNZ. Inflation pressures are still too high and we are still too far away from the 1%-3% target band for their liking. Very loose fiscal policy has been a problem and we now have a year ahead where this will tighten alongside a continued tough monetary stance. Beaten-up bond proxies feel more appealing than cyclicals against this backdrop, as we could still have another round of earnings downgrades to suffer through.

Australia by contrast has hiked by considerably less and may get away with one more rate hike at the most. With their population booming, the chances of pulling off a "goldilocks" perhaps look best for that country in 2024.

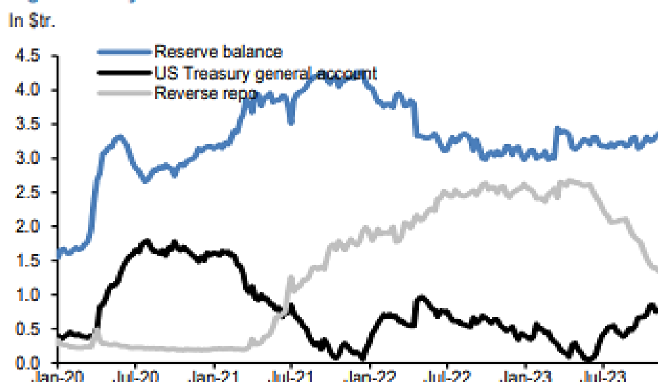


One thing that has bemused us is that while investor sentiment has gone through its ebbs and flows over the last few months, a general predisposition towards positive "animal spirits" has not been broken by 400-500bp of rates hikes, significant ongoing QT, and outright declines in M2 money supply around the world. Indeed, the month saw a near perfect contrary indicator occur when renowned short-

seller Jim Chanos shut down his fund – that sort of thing does not happen in a bear market.

As shown above, CNN Fear & Greed is firmly back in the greed zone after its period of fear in October. A simple eye-balling shows that investors have generally been far more greedy than fearful. We think this reflects just how outrageously loose monetary policy became in the post-Covid era, with so much juice added to the punchbowl that it has required an extended period of emptying.

One interesting measure that we may be close to the bottom of the punchbowl is to look at the rundown in US reverse repo volumes. Reverse repos effectively take money from the banking system when there is too much liquidity. When banks have more money than loan demand, they park it with the Fed. As JP Morgan points out, huge liquidity has been provided to markets and the economy with a $1.3trn run-down in this facility since the end of May. This has more than offset the impact of QT on bond markets and the Treasury issuing T-bills to return to a normal cash balance. We could easily have a few more months of this yet.



Putting all this together, our view remains to own previously beaten-up bond proxies and generally be wary of cyclicals. Atypically for the Fund, we have few shorts in expensive technology stocks at present, having covered them into prior weakness. While one is always somewhat biased towards being sceptical of markets when one runs a long-short fund, we do feel last month's rally was primarily driven by short-covering and does not herald the beginnings of a glorious new goldilocks era.

Fund Performance in November

Returning to the Fund's performance in the month of November, our overall return of circa -1.0% pre fees and tax was comprised of our long book adding +3.4% but this was more than offset by the headwind from our short book detracting -4.4%. Our longs just didn't do well enough in a strong positive month. Our overall "winners to losers" ratio was a relatively weak 54% and it was telling that only 5 out of 42 short positions added value.

Our gross exposure rose sharply over the month from 153% to an unusually high 173% as sharp price moves created numerous opportunities. Unsurprisingly, our net length declined from 54% to 49% as we shorted and sold a number of names into undue strength.

While November was a strong month overall, the 50/50 index of Australia and NZ still had a surprising 10 down days. It's just that their magnitude wasn't that large at an average -0.37%. Despite our net length, we were up on 6 of these 10 days, with an average positive return on them of +0.12%. It was the big positive days that saw us struggle in the month.

Our largest headwind came from a frequent mention in these pages in the form of our long in Lynch Group (LGL, -12.2%). We are a sucker for businesses that have strong balance sheets, dominant market positions, significant medium term reinvestment opportunities and free cashflow yields in the 20%+ region. Unfortunately, LGL has been anything but a straight line upwards for the Fund as it has been buffeted by a number of headwinds since Covid. Their AGM update in the month was a little disappointing with flower prices to Chinese consumers being depressed for most of the half-year to date. This is in line with numerous other companies reporting depressed activity from Chinese consumers, but we are hopeful that this is turning given policy easing that has occurred. Indeed, LGL commented that they are seeing improving prices late in the period and the key selling events are in the second half in any case. Australia is improving as hoped, with supermarkets winning share off florists, while labour and transport cost headwinds continue to dissipate. We have seen Director buying since the decline.

Another key detractor came from a moderate premature long in APM Human Services (APM, -27.8%) which was hard hit on a warning at its AGM. In short, APM does well in times of high

unemployment with its jobseeker assistance programmes and we just haven't seen a notable lift as yet. That said, we think it is only a matter of time before conditions become easier for them and the sell-off has left them on a PE of 7.5x Jun24 and 6.7x Jun25 earnings. We have seen massive buying by the founding Director and we have topped up our holding on the pullback. They do carry a reasonable amount of debt but we are comfortable re its serviceability.

A third loser of note was our large long in Tower (TWR, -4.7%), with the share price decline leaving us somewhat bemused. Their result was largely as expected, their guidance for the coming Sep24 year was a little weaker than consensus but was based on ultra-conservative metrics, while their initial Sep25 guidance around key metrics was far above market. The insurance cycle is turning in their favour, with strong premia increases, while claims cost inflation is starting to top out. Interest earnings on their float remain high. Unrealistically assuming a full $45m of assumed deductibles for large events, they are on a PE of 8.9x Sep24 and 5.7x Sep25, with a dividend yield well into the teens in that year. Post month-end they have announced a strategic review which will hopefully lead to a change of control transaction but we will just have to wait and see.

A large group of other headwinds came from the short-side, where expensive names rose with the market. Data #3 (DTL, +16.0%) rose sharply on hopes that it will profit from the distribution of AI products – this looks longer term in nature and memories seem very short on the shellacking handed out to them post their weak result in August. Expensive cyclicals such as Reece (REH, +10.8%) and Breville (BRG, +12.1%) bounced from prior weakness, while our negative view towards the iron ore price outlook is proving somewhat premature, with Fortescue (FMG, +12.1%) advancing strongly.

On a happier note, the large long we have built up in GDI Property (GDI, +12.6%) bounced strongly along with many other property names in the month. While this was obviously due to lower bond yields, we like GDI on more fundamental grounds. The Perth office market continues to see positive net absorption thanks to a mix of strong population growth and generally strong commodity markets. Supply looks limited for the next couple of years and net effective rents are rising nicely from very depressed levels. To recap the thesis, GDI is at $0.58 versus an NTA of $1.26, which is based on relatively realistic cap rates of c6.7%. Gearing is under control at 31% and there is some sleeper upside in the sizeable syndicates they manage.

A second satisfying tailwind came from a mid-sized long we bought in Iress Limited (IRE, +40.9%) post its recent troubles. We had been staggered at just how aggressively it had been sold down and taken the view that they have an exceptionally strong market position in Australia/NZ and an ability to sell assets at reasonable prices elsewhere. They duly upgraded guidance to a degree from their previous downgrade near month's end.

Our large multi-year long in Turners (TRA, +13.4%) once again added strongly to returns. They delivered an excellent result for the September half, highlighted by very strong car retailing performance more than offsetting the headwinds from their partially hedged finance book. As rates stop rising and then eventually start falling, this will turn into a tailwind. Meanwhile, we see them continuing to inexorably take market share as undercapitalised competitors gradually exit. In early December, it was confirmed that they will be added to the S&P/NZX50 index.

A final stand-out positive was the long we have built up in the leading serviced office company, Servcorp (SRV, +11.7%). While a lot of office owners are trying to enter this space, SRV are far and away the industry leader. We view them as a counter-cyclical play, as they get to enter cheap long- term leases for office floors and then make a spread by leasing them out at an ever-higher margin as the market hardens in future. They delivered a solid earnings upgrade at their AGM and trade far below fair value in our view. They are on a Jun24 PE of 7.8x, dividend yield of 7.5% and they have net cash of $115m versus a market cap of $330m.

Thank you for your continued support and interest in the Fund. We had a couple of minor black eyes in November but we think they will prove temporary hiccups rather than lasting invalidations of our investment cases. We lagged sharply behind long-only equities in the month that witnessed a sharp short-covering rally. Interestingly, in the last two months, we are largely in line with equities but with far less volatility and no correlation.

Bond yields staged a sharp rally and while we have no conviction on this rally continuing, we do think the recent peaks of 4.94% in the US and 5.5% in NZ are unlikely to be surpassed. We retain our view that one should tilt towards bond-proxies and away from cyclicals which may suffer as long-awaited economic slowdowns finally get underway.

Overall market valuations still generally appear extended although this seems heavily concentrated in larger cap securities. Central banks continue to drain the liquidity punchbowl, but as November's market movements showed, it's not quite empty yet.

Matthew Goodson, CFA

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