SALT
Funds Management

Salt Long Short Fund Fact Sheet – July 2019

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 July 2019

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$119.5 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 July 2019

Application	1.4782
Redemption	1.4722

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 July 2019

Long positions	65
Short positions	46

Exposures at 31 July 2019

Long exposure	82.54%
Short exposure	-60.45%
Gross equity exposure	143.00%
Net equity exposure	22.09%

Largest Longs	Largest Shorts
Tower	Ryman Healthcare
Spark NZ	Monadelphous Group
Turners Automotive	Auckland International Airport
Pacific Current Group	BWP Trust
Marsden Maritime Holdings	GWA Group

Performance[1] at 31 July 2019

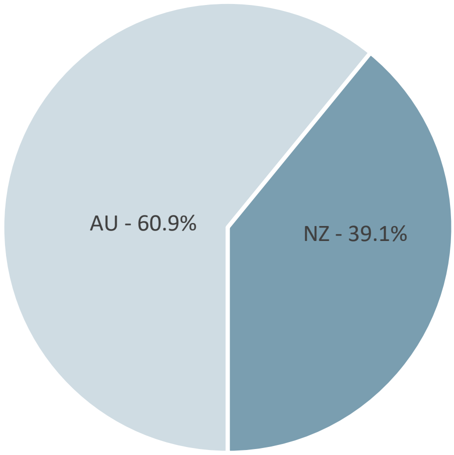
Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2014							6.28%	2.85%	2.74%	-1.67%	2.27%	0.89%	**13.96%**
2015	1.28%	1.07%	0.04%	2.17%	0.38%	-0.28%	0.75%	2.84%	1.34%	2.04%	2.37%	2.04%	**17.21%**
2016	-0.67%	-1.08%	3.81%	0.92%	1.72%	-0.39%	0.50%	2.26%	-0.51%	-0.57%	-0.20%	2.19%	**8.14%**
2017	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%	-2.16%	**-5.50%**
2019	-1.26%	-0.97%	-0.96%	0.14%	1.94%	0.42%	2.56%						**1.82%**

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	4.99%	1.62%	8.51%
6 months	3.12%	3.25%	18.21%
1-year p.a.	-5.60%	6.71%	16.87%
2-years p.a.	-1.01%	6.73%	14.78%
3 years p.a.	1.69%	6.76%	11.82%
5 years p.a.	6.73%	7.25%	11.69%
Since inception p.a.	7.91%	7.27%	12.02%

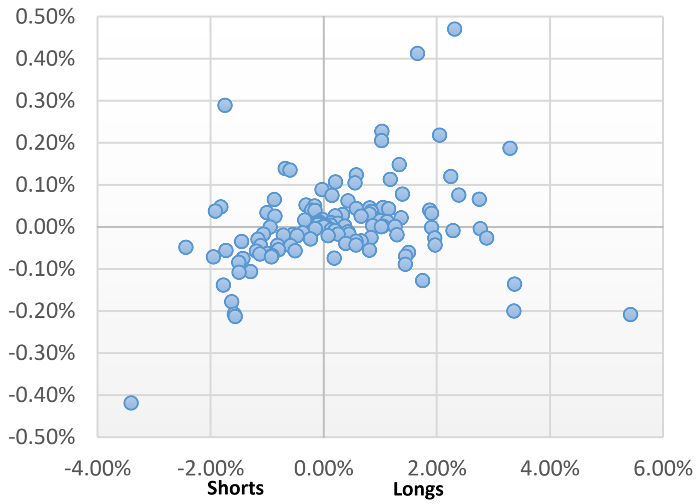
[1] Performance is after all fees and before PIE tax.
[2] NZX 50 G/ASX 200 AI is a 50/50 blend of the S&P/NZX 50 Gross Index and the S&P/ASX 200 Accumulation Index and is for comparison purposes only.

SALT FUNDS MANAGEMENT
Level 3, The Imperial Buildings, 44 Queen Street | PO Box 106-587, Auckland 1143
P: +64 9 967 7276 | E: info@saltfunds.co.nz | www.saltfunds.co.nz

Country Allocation at 31 July 2019 (Gross Equity Exposure)



July 2019 Individual Stock Contribution



Fund Commentary

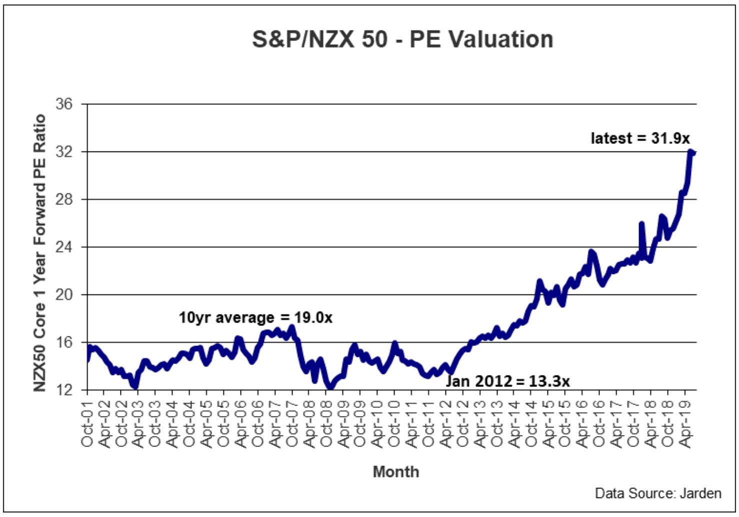
Dear Fellow Investor,

The Fund delivered a strong return of +2.56% after all fees and expenses during the month of July. Several of our larger Australian longs worked extremely well although we continued to suffer in NZ from a quiet bear market in smaller stocks combined with a rampant bull market in the ten largest. More on this shortly. Since inception, the Fund has now returned +47.2% after all fees and expenses.

The July return was particularly pleasing in that the Fund was carrying heavy protection via our short positions, with our net length declining from 29% to as low as 21% near month-end. Given our style of being long what is cheap and short what is expensive and/or structurally challenged, our current experience is that a net position in the low-mid 30% region is market neutral. Risk-adjusted, we were net short throughout the month but delivered strong returns despite markets rising.

The Fund is set up to navigate the tension between providing protection for when hideously overpriced markets finally fall, while trying to hang in there for so long as the party is raging. Our recent success in providing this protection can be seen when one examines the seven negative days during the month for a 50/50 index of the S&P/NZX50 and S&P/ASX200. The Fund was actually up on six of those seven days and delivered an average return for those days of +0.30% versus the average for long-only markets on those days of -0.42%.

This Fund is providing a true uncorrelated alternative and while its returns may currently look a touch sparse relative to booming long-only equities, this comparison will change quickly when the market turns. In a world where so many investment classes are expensive, we will continue to stick to our knitting. The chart below shows why we think having uncorrelated assets in one's portfolio is ever more important.



The remorseless advance of the NZ equity market has entered a parabolic phase, with the one year forward PE for the core market (ex-property and Infratil) now being 31.9x. Share prices keep going up, although for the first time in a while, earnings did keep pace last month. The median PE is a far more supportive 18.0x. With ten year bond yields at around 1.4%, we would even argue that the median stock is somewhat cheap if one can successfully tip-toe through the varying array of earnings risks. Unsurprisingly, this is how the Fund is positioned in NZ, with many of our longs being in mid-cap names which offer strong value or under-priced growth, while trying to avoid cyclical earnings risks. Larger examples here include Tower, Scales and Sanford. Conversely, most of our shorts are in ultra-expensive larger cap names, with NZ examples including Ryman and Auckland Airport.

The chart above illustrates how “size” as a factor has utterly dominated returns over the last year. “Valuation” has been irrelevant and “earnings downgrades” have generally been of mere passing interest. Even “earnings and price momentum” have done no better than the market – all that has mattered has been size.

The chart splits the S&P/NZX50 Index into groups of ten ranked by size and shows the 10 largest names have risen by an average of +26.4% and the second group has risen by +16.4%. Remarkably, the 30 smallest stocks in the index have fallen on average. Passive and quantitative funds have had an outrageously large impact on the NZ market, with Macquarie data showing 40% of all NZ trading volume is now being squeezed into the 15 minute match versus 20% offshore. Importantly, this trend to passive has coincided with a bull market. We invite you to ponder what will happen when there is a left-field shock and passive funds turn into forced sellers - we look forward to covering our shorts at significantly lower prices.

The passive effect has been particularly large in NZ but it has been a factor everywhere. Historically, the failure of market breadth to confirm market highs has been a classic technical sign of a bull market top, but for now, the remorseless trend towards passive has changed the rules of the game. According to BAML, the past 10 years has seen $4.1tn flow into passive investment funds globally and $1.5tn gush out of active managers. Along with this, just 6% of MSCI World Index stocks account for 53% of global returns so far in 2019.

We have been slow to recognise this trend but in recent months have been scouring the Aust/NZ markets for large cap opportunities from the long side and have been aggressive when they have popped up. Examples include switching from a large short in Spark (SPK, -1% in July) in the $4.20 region to a very large long in the $3.60-$3.70’s and buying a reasonable size long in Brambles (BXB, +2%) when it fell to the low $12 region as transport cost pressures are abating and a monstrous buyback will be unleashed post result. That said, we think that earnings risks will trump the size effect when they materialise, so we have stayed well clear of large cap cyclicals such as Fletcher Building (FBU, +2%) and had some success shorting global cyclicals such as Fortescue (FMG, -8%) and Rio Tinto (RIO, -5%) near their highs.

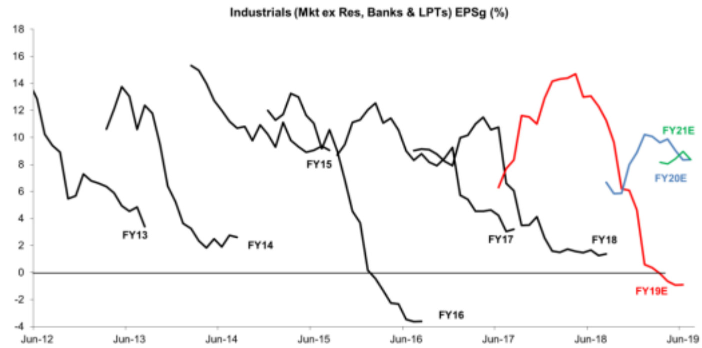
One surprise from this size performance divergence is that NZ hasn’t seen greater equity issuance nor greater M&A activity by the large cap sharks swallowing up the smaller cap tiddlers. There has been modest equity issuance from the likes of Arvida and Tourism Holdings but M&A activity has been very light on the ground. Our expectation is that the stars are surely aligning. Debt costs are very low, private equity funds are bulging at the seams and a slowing economy creates the temptation for listed companies to grow by acquisition when organic opportunities are limited.

Australia has been quite different, with there being a number of IPO’s and a veritable surge in equity issuance, with property companies leading the way. The contrast with NZ is an indictment on those cautious domestic Boards who are failing to take advantage of a generational opportunity to raise equity at a large premium to any reasonable estimate of fair value. Thanks to Australia, the “deal” folder in our in-box is bulging as we have picked our way through the various opportunities in that market. Moreover, the month saw a takeover battle erupt for our small holding in GBST (GBT, +31%) and an attractive bid put on the table for our medium sized holding in Pacific Energy (PEA, +42%).

The madness of August result season is almost upon us and our portfolio positioning is conscious of the earnings risks that exist both for the reported Jun19 year numbers and more particularly around the Jun20 guidance where broker forecasts are well into cloud cuckoo-land relative to current economic realities.

Research from Macquarie highlighted that at this time last year, Australian analysts expected market EPS growth (ex-banks, property, resources) of +14.7% for Jun19 and this has now been gradually whittled back to -0.8%. Current forecasts for Jun20 are +8.4% and are on the way down from just over 10%. Similarly, using Jarden numbers, NZ year-ahead EPS forecasts are 6% lower than they were one year ago when this is normally a number that rises due to inflation and reinvestment of retained earnings.

Fig 2 Industrials EPSg is forecast to rebound to +8.4% in FY20E after a modest 0.9% fall in FY19E. Excluding forecast margin expansion, Industrials FY20E EPSg is closer to 2%



Source: Macquarie

What is truly frightening is that on Macquarie's numbers, total Australian EPS growth for the entire last decade has been just 11% and this includes M&A, a good portion of which has been debt funded. Barring the post-GFC snapback, expected earnings growth has started every year in the +10-15% region and eventually been whittled down to the reality that averages a mere +1.1% per year. The market is clearly vulnerable as we head into earnings season with F20 earnings forecasts far too high.

The unrealistic expectation of strong earnings growth flies in the face of weak business confidence surveys and a variety of other soft indicators. The monthly ANZ Survey shows that firms' own activity outlook currently sits at +6% compared to a long term average (since late 2001) of +24%. We need to go back to May 2009 to find a weaker reading and it consistently registered readings in the +30% to +50% region in the halcyon days of 2010-2017 when the market was a lot cheaper. We were generally bullish until the latter part of that period. Australian surveys paint a similar picture, and yes, they are well correlated with listed company profits.

Unfortunately, this economic scenario means that unimaginative, narrowly focused central bankers will continue to push on a piece of string in their vain attempts to deliver on their 2% inflation targets. Try to find a piece of research on any central bank website conclusively showing that a symmetrical 2% target is optimal rather than say 1% or 1.5%. We have tried and what we found was a survey by Federal Reserve economist, Anthony Diercks which surveyed over 100 academic studies and found an optimal target of somewhere between -4% to +6%! The studies also show that deflation only matters when debt levels are very high.

Even worse, we would suggest that the 2% target is beset by measurement errors and that the reasons for inflation being low have nothing to do with central bank policies and their narrowly specified models that revolve on inflation expectations.

An article in "The Age" quoted Fidelity International research and looked at the Australian CPI since 2000. The overall CPI has risen by 57%, wages have risen by 78% but medical services have gone up by +195%, electricity +194% and secondary education +203%. Conversely, audio-visual and computing has fallen -89%, games -16%, cars -14% and clothing/footwear -10%.

Alongside these composition issues, we would point to structural deflationary factors such as a non-linear explosion in computing power, disruptive network effects which have removed excessive pricing that depended on information limitations, and a BIS paper that showed significant demographic effects where societies with low working age populations and large groups of old people tend to have far lower inflation. We would also point to the structural emergence of cheaper production sources in China, Eastern Europe and South-East Asia. As an example, we have fond memories of our old investment in Coats Group where they first shifted their thread production from Western Europe to China and then to the likes of Cambodia, Vietnam and Bulgaria.

Does anyone seriously think that the prognostications of RBNZ or other central bankers have the slightest impact relative to these major structural trends? Even worse, the experience in Europe is that ultra-low rates will see banks bleed deposits and limit their ability to lend as they are required to keep their targeted retail versus wholesale funding ratios. Further, a zero cost of debt is prolonging the life of zombie companies and excess capacity. It also makes it very cheap to fund disruptive technologies that are deflationary by their very nature. As Willem Buiter, the ex IMF and now Citi economist put it in a widely cited speech, current monetary policy is, "*in the land of make believe*".

For now, we can rail all we like at what we perceive to be the counter-productive folly of central bankers but they are showing no signs of wavering just yet. Indeed, there are even signs that they may double-down, with the ECB examining moving to a 2% symmetric inflation target while the RBNZ is reportedly considering how negative rates might work. Until we see signs of change, we will play the game and are 9% net long real estate, 2% utilities and 7% communication services.

Returning to the performance of the Fund during the month, the return of +2.66% (pre fees and tax) was comprised of +3.68% from the long side and -1.12% from the short side, with strong markets being the obvious driver of the divergence. The "winners to losers" ratio was an extremely good 62% and there was a strong skew to our key winners being more numerous and larger than our losers.

Our two largest headwinds came from the short side and are names that we view as being profoundly overpriced and which have easily identifiable risks that will materialise at some point – hopefully sooner rather than later. There is nothing more frustrating than a short that rises in your face for what you perceive as all the wrong reasons.

The biggest detractor was the large short in our old friend Ryman (RYM, +10%) which exhibited somewhat unusual trading behaviour during the month. The four listed peers rose by a simple average of +0.4% and we believe their businesses are certainly travelling no worse than RYM. Over the last year, RYM has returned 8%, whereas Summerset is -26% and Metlifecare is -27%. The NZ housing and retirement village outlook has darkened dramatically in recent quarters and it seems bizarre that the stock which has the least disclosure, is the most geared and is by magnitudes the most expensive has outperformed its peers by so much. It speaks to the power of passive and unusually aggressive offshore purchasing.

The only other material headwind was our mid-sized short in the bubbly dot.com company, Wisetech Global (WTC, +15%) which we view as the epitome of extraordinarily overpriced Australian growth stocks. WTC is on a Jun19 PE ratio of 172x and a price/revenue ratio of 29x. For this an investor gets modest levels of organic growth supplemented by numerous acquisitions of a potpourri of small software companies around the world at mere fractions of WTC's multiples. We have seen numerous examples of this valuation arbitrage game in many industries over the years and our observation is that they invariably end in tears unless there are genuine synergies. Making matters worse, the global trade recession would not normally be good news for a cargo software company and our understanding of their system is that it is very much "closed box" in nature rather than featuring the open API's that allow leading SaaS companies in other fields to generate a genuine network effect.

One of our favourite pieces of research in the current bubble comes from a well-rated analyst in this name who has a DCF valuation of $7.70 (which we suspect has been well-tortured) and a price target of $33 based by applying an EV/sales multiple of 23x to forecast 2020 revenues. This multiple was generated by application of a random 30% premium to SaaS peers. The DCF valuation is no longer published. He has clearly been right and we have clearly been wrong on this name to date although our losses have been mitigated by aggressively shorting or covering it when it has had particularly large moves. We think it provides very cheap insurance for when fear takes over from greed.

The general backdrop that has allowed WTC's performance was brilliantly summed up in a piece forwarded by one of our Australian brokers during the month:

"*Here's the perfect business idea for this environment. Open a $100 Bill Store™. You sell $100 bills for $90 each. You'll lose $10 per transaction but you'll do a trillion in revenues in year one. Maybe you show an ad to everyone who walks into the store and you break even. User growth will be in the order of 1000% per month. A billion users. You'll be the biggest IPO of all time when XXXX's underwriters get wind of that growth rate. Go public and let someone else worry about a competitor selling $100 bills for $85….*"

The largest positive came from our sizeable long in Pacific Current (PAC, +23%) which had appeared on the other side of the ledger in recent months. They delivered some strong funds flow numbers for the June quarter although this was at month-end when the great bulk of the move had already occurred. All that happened is someone else finally noticed that it was on a cash adjusted PE of 7.0x with a solid growth outlook. It is not quite as cheap now post the 23% move and we have taken modest profits but it remains one of our largest holdings.

PAC is a classic example of a number of our longs where we have had to go somewhat off the beaten path but it is still possible to find cheap names of reasonable quality that have solid growth outlooks. Other examples where we are impatiently waiting for Godot are led by Tower (TWR, -2%) which continues to stagnate at an absurdly cheap valuation relative to its strong non-cyclical growth outlook. The business is going from strength to strength but it is not in any indices and it is being sat on by apparent forced selling from portfolio transitions. The latter will run their course, while the former will eventually be solved when the price rises far enough.

What investors don't get about TWR is that it sells insurance as a service (IaaS) with highly repeatable annual subscription revenues, high LTV (life-time value) relative to CAC (customer acquisition costs) and these metrics are improving rapidly due to their outstanding new direct sales website.

While plausible DCF valuations range between $1.10 and $1.50, it is worth $21/share if one places its forecast F20 revenue of $308m on a Wisetech EV/sales multiple of 23x.

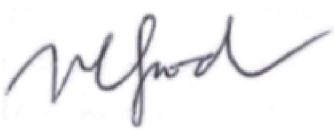
With apologies for this slightly sardonic diversion, the other stand-out positive was our mid-sized long in Pacific Energy (PEA, +42%), which received a takeover bid from QIC. PEA is a build, own operate business for remote power stations chiefly servicing the mining sector. We were attracted to it when it was sold off harshly on fears of competition following the loss of a contract with Newmont. What we saw was a moderately geared free cashflow yield in the low teens with the problem being that it only ever had 4-5 years of contract certainty. Our view is that this simply reflects the limited life of mining projects and that PEA will only ever have 4-5 years of certainty for the next 50 years. The market was pricing their cashflows as not being repeatable when they were. The takeover came as a pleasant surprise but sometimes you make your luck by playing in the right places.

Other stand-out positives were led by our large long in QMS Media (QMS, +19%) which continued its recent sharp improvement to 95cps compared to the dark days when it seemed it would never bounce from 70cps. Outdoor advertising data is relatively robust and a big positive was OIO approval for their deal in NZ where they are combining QMS NZ with Mediaworks NZ in return for a 40% stake and a capital return of A$35m. This deals with any balance sheet discomfort at the parent.

Other notable winners included longs in Oh! Media (OML, +15%), Kina Securities (KSL, +13%), Emeco (EHL, +11%), Eureka Group (EGH, +12%) and Monash IVF (MVF, +9%). All of these shared the characteristic of being good businesses with solid growth outlooks and which were heavily oversold when we entered.

Eureka is particularly interesting as we estimate an NTA of circa 32cps versus a share price that has risen from 26cps to 29cps. They have worked through a difficult legacy from previous management and are realising sizeable non-earning capital which they will reinvest into their elderly rental accommodation villages at cap rates in the 10% region. Nothing in this current world should cap up at 10% especially when the revenue stream is government funded via the accommodation supplement. So, we have a business at a discount to an NTA that will rise and that has internal catalysts to drive earnings upside. We wouldn't be shocked if it ended up trading at a sharp premium to NTA.

Thank you for your ongoing investment and support of the Fund. It is pleasing to turn in another strong month and return the Fund to the positive performance slope that it formerly enjoyed. We have not thrown in the towel by going heavily net long to ride the last vestiges of this aged bull market. Rather, we are at the very low end of our normal levels of net length and this has seen the Fund deliver strong positive returns on the rare down days. We look forward to those down days becoming less rare. August will see a flood of results during earnings season. We have high conviction in the business performance of our largest longs, while booming share prices have given us numerous opportunities to position from the short-side for what we see as an inevitable bevy of earnings downgrades thereafter.



Matthew Goodson, CFA