SALT

Salt Long Short Fund Fact Sheet – June 2021

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 June 2021

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$52.8 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 30 June 2021

Application	1.9223
Redemption	1.9145

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 June 2021

Long positions	58
Short positions	37

Exposures at 30 June 2021

Long exposure	100.33%
Short exposure	56.35%
Gross equity exposure	156.69%
Net equity exposure	43.98%

Largest Longs	Largest Shorts
Tower	Reece
Shaver Shop Group	Cochlear
Dalrymple Bay Infrastructure	GPT Group
Monash IVF Group	Xero
Marsden Maritime Holdings	Sonic Healthcare

Performance[1] at 30 June 2021

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%	1.74%	-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%	-0.03%	2.93%	2.34%	0.90%	1.70%	**10.02%**
2020	-2.01%	-2.51%	-14.47%	4.35%	1.80%	3.18%	3.39%	-1.81%	2.41%	-1.67%	8.31%	6.76%	**5.88%**
2021	1.24%	1.90%	4.42%	3.52%	2.16%	-0.23%							**12.27%**

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	5.52%	1.28%	4.49%
6 months	13.67%	2.56%	4.60%
1 year p.a.	34.37%	5.24%	21.02%
2 years p.a.	15.49%	5.55%	11.35%
3 years p.a.	7.50%	5.93%	11.41%
5 years p.a.	6.56%	6.28%	12.33%
Since inception p.a.	9.72%	6.78%	11.49%

[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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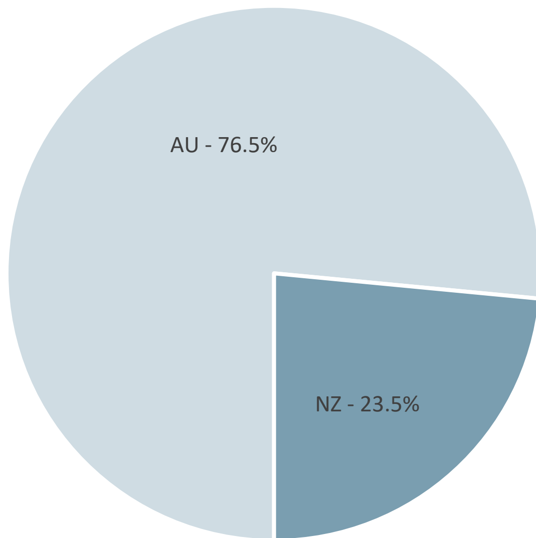
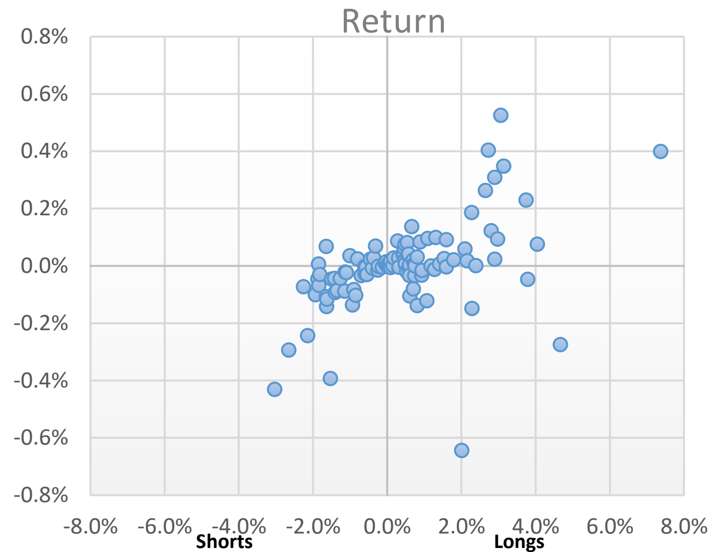
Country Allocation at 30 June 2021 (Gross Equity Exposure)



June 2021 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

The month of June saw the Fund experience a slight hiatus in its run of strong performances, with a return of -0.23%. The results of stock selection were more variable than previously, with several instances of brilliance being offset by several cases of the opposite. Strong performance from our long book was offset by a large drag from our shorts.

More importantly, the underlying drivers of markets changed quite dramatically, with a return to outperformance by very expensive momentum and quality growth stocks, while the reasonably valued cyclicals that have done so well for us in recent months lagged.

This change in underlying drivers reflected a welter of conflicting economic data and even more conflicting central bank prognostications. The US Fed made a slightly hawkish tilt which saw yield curves flatten but then attempted to walk that back to a degree. Inflation and growth data came in hot and heavy across the key markets that we really pay attention to of NZ, Australia and the USA. However, central banks showed little inclination to move beyond talking about relenting on their unprecedentedly easy monetary policy settings.

The bulls took this as a signal that "goldilocks" is alive and well and charged back into the momentum and quality names that have dominated in recent years. Quite simply, when bond yields decline, these stocks outperform. In just one month, the MSCI World Growth Index outperformed its Value cousin by 5.4%.

We disagree that goldilocks has returned and view its resurrection in the final weeks of June as a last hurrah. Central banks are hopelessly behind the curve and at some point, will need to act. Worse, their explicit move to a "data dependent" rather than a forecast approach to monetary policy means they are being far less forward-looking than in the past, creating a significant risk for investors around pivotal data releases.

As Barbara Tuchman put it in a different context in her famous book, The Guns Of August, "on history's clock it was sunset, the sun of the old world setting in a dying blaze of splendour never to be seen again." That is how we feel about the goldilocks trade.

The Fund's net length continued to decline, moving from 47% to 44% - a far cry from the low-mid 50% region that we ran for a number of months. Our gross position grew quite sharply from 140% to 156% as we aggressively took advantage of opportunities on both sides of the ledger in the changing markets in the last two weeks of June.

We view our positioning as relatively market-neutral but as always this depends on what factors are working in the market relative to our normal positioning of being long stocks that are cheap relative to their growth prospects and short overpriced darling stocks. We did not do quite as well as usual on the eight down days in June for the 50/50 index of Australia and NZ. We were up on only three of them and we averaged a return of -0.06% although this was still markedly better than the -0.37% average for long-only markets.

Interestingly, the first day of July saw a sharp reversal of market drivers, with the long-only return of -0.15% being starkly below the Fund's return of +0.94%. The Fund is continuing to deliver on its mission of providing equity-like returns with no correlation to equity markets and less volatility than them.

A classic stylised inflation cycle begins with a move higher in commodity prices as demand expands faster than their relatively inelastic supply. This feeds through to PPI inflation and then firms use up their spare capacity and need to both invest and hire more staff. As skilled labour gets used up, wage inflation begins and firms then need to lift their prices. It is this last phase where inflation moves beyond being transitory. With labour being 60-70% of the cost of everything, this potentially sets the scene for a wage/price spiral. If this occurs as the evidence is suggesting, then central banks will need to act, and the brief hiatus in the performance of cyclicals will be brief indeed.

The ANZ Bank Business Outlook survey for June showed pressures continuing to intensify. A remarkable 86.5% (81.3% in May) of firms expect costs to rise over the next year; 62.8% (57.4%) expect to lift their selling prices; and CPI inflation expectations lifted from 2.22% to 2.41% in just one month. Official GDP growth for the March quarter came in at +1.6% YoY compared to the RBNZ's wildly incorrect projection of -0.6%. They are way behind the curve.

Australia is little different. May employment rose by 115k in what UBS described as a "super boom". Unemployment fell from 5.5% to 5.1% to be just above the post-GFC low, while the participation rate of 66.2% is only just below the record of 66.3%. Yet monetary policy settings remain at emergency levels, with rates out to three years pegged at 0.25%.

The story is the same in the US, with the chart below showing that job openings are not merely at a record, they are smashing all previous levels. As this inevitably translates into employment and wage inflation, upcoming monthly US non-farm payroll releases may be a flashpoint for financial markets.

An irony is that the extreme levels of quantitative easing being carried out by the Fed are pushing on a piece of string in terms of the real economy. Vast amounts of cash are washing around the US banking system but are not being lent. This is driving a phenomenon of massive reverse repo usage by US banks, which reached almost $1trn overnight at the end of June. What the Fed is giving with QE, it is having to sterilise with reverse repos, which perhaps betrays that a key reason for continuing QE is to support financial markets. For now.

Perhaps the most extreme example of the madness pervading central banks and thence global financial markets is how Greek 5-year bond yields moved into negative territory during the month despite the country being bankrupt. CPI inflation is only 0.1% but still. This clearly shows the degree to which some prices in financial markets are now administered rather than market determined.

Linking this barrage of macroeconomics back to investment implications, we are becoming more and more convinced that central banks are way behind the curve and may have to tighten surprisingly quickly and dramatically if/when there is an inflation data surprise. In our view, equity markets are not positioned for this.

Most vulnerable are the "GAAP" (growth at any price) companies which have been quite volatile in recent months, swinging wildly as long-term bond yields move in relatively narrow ranges. Vapourware tech companies epitomise this group of stocks. We are heavily net short such names with there being one or two speculative longs only.

The other obvious risk segment are the TINA stocks (there is no alternative) as investors have been forced out of derisory term deposit rates into the superficial seduction of dividend yields. Property is perhaps most vulnerable here although one would not know it as a frenzy of investor activity is seeing cap rates collapse across most segments. This has been a slow train coming and we have been long property in the Fund for some time but have pulled this back to neutral and are not having difficulty finding attractive yields in other special situation areas (e.g. Dalrymple Bay Infrastructure, Redcape Hotels et al).

The final group of stocks to be wary of in a rising rate environment are high quality dependable growth names. There is a price for everything and their valuation multiples have logically expended dramatically in a very low-rate environment as investors pay up for the relative earnings growth certainty. We are net short these names.

Aside from stocks which defy easy categorisation (like many of our longs!) the obvious relative and perhaps absolute beneficiary of the likely change in monetary paradigms is the cyclical segment. As a group their top-line revenue growth from volumes and prices offsets the negative of their discount rate rising. We are comfortably net long this group of stocks. While there is some overlap, we would contrast it slightly with pure value names, who typically have operationally and/or financially

levered business models and which are often in sunset industries.

Returning to the performance of the Fund in June, our return of circa -0.15% (pre-tax and costs) saw very strong returns from the long book (+2.51%), which were more than given back by the short book (-2.66%). Our overall "winners to losers" ratio was a solid 57% but there was a skew to having slightly more large losers than large winners.

The largest headwind came from an unfortunately timed long in Genworth Mortgage (GMA, -19.7%). GMA is Australia's largest mortgage insurance company. We have traded a position for some time – buying into weakness and lightening into strength. The basis for the holding is that they have significant positive leverage to the exceptional strength that is playing out in Australian house prices. While there is a moratorium on mortgagee sales post-Covid, the ability to re-sell the dwelling and recoup all that is owed thanks to strong house price inflation should see GMA perform very well. GMA trades at a material discount to its NTA of $3.43 because they have historically struggled to earn a fair return on capital but our view was that the strength of the housing cycle would make it different this time.

We think we will still ultimately be correct but GMA fell sharply when it announced that their multi-decade client, CBA is putting its mortgage insurance business up for tender when the current contract expires at the end of 2022. The complexities of shifting make it highly likely that GMA retains the business but a haircut is possible. The worst case of losing CBA's business may not actually be the worst case as GMA would then be able to realise its NTA over a period of years. The closing share price of $2.20 is a 36% discount.

The next three large headwinds came from shorts which in our view have risen to ludicrous valuation levels. Reece (REH, +15.3%) continued to grind inexorably higher but we view the forward PE of 57x Jun21 and 48x Jun22 as being far beyond the pale for a plumbing supplies business where the cycle is relatively close to being as good as it will get.

We built up a modest short in Promedicus (PME, +27.4%) which is a very exciting business allowing advanced interpretation of radiology scans. However, analysts have baked in very strong growth expectations and we view their pace of contract wins as perhaps not being reflective of the implicit upgrades baked into multiples of Jun22 PE of 135x and Jun23 PE of 108x.

Similarly, our modest short in Cochlear (COH, +10.9%) dragged on returns as it remorselessly rose to new highs. Their key competitor, Advanced Bionics has had some product recall issues but these will soon pass into the rear-view mirror and another product cycle will play out. In addition, we do wonder if COH's Australian roots may hinder their success in future Chinese tenders and the strong A$ should be unhelpful.

A final headwind of note came from our erstwhile strongly performing long in Shaver Shop (SSG, -7.0%). They had the temerity to deliver a trading update that merely met revenue expectations and was only a modest upgrade to NPAT. At the moment, Australia is all about the next data point relative to expectations and this can often result in a lack of perspective. What we see is a business generating $30-35m free cashflow on a market cap of $129m with no gearing. There should still be reasonable growth as even though they will come off the Covid highs, they will get the full year benefit of buying out their remaining (highest performing) franchisees, new stores, lower rents and strong on-line growth. A cash PE of 4.0x at the mid-point is incredibly cheap in this market.

The largest tailwind came from our at-times painful long in Emeco (EHL, +17.2%) finally beginning to work. Our thesis has been that they are gradually diversifying away from their coal equipment exposures into base metals and gold. Meanwhile, coal prices have picked up sharply, meaning activity over the next year or two will likely be robust as EHL transitions. We were a touch worried about evidence of rampant wage inflation but took solace from EHL's exposure to this being relatively limited compared to most mining services peers. An update during the month saw them reiterate guidance and refinance some usuriously expensive debt on far more favourable terms.

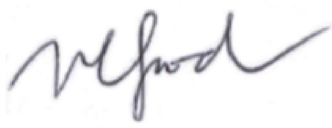
The second key positive was our extremely successful investment in Intega Group (ITG, +14.6%) which has been a gift that keeps on giving. Their cousin Cardno announced a strategic review following the receipt of takeover approaches and ITG also announced a review, "with the objective of maximising shareholder value including by ownership options for Intega." ITG also announced that the business is performing well and that they are well placed to benefit from a strong pipeline of infrastructure investment. We are hopeful of a strong bid.

Other positives were led by a rebound in our large long in Tower, (TWR, +5.5%). We remain highly attracted to TWR investing their surplus capital and delivering strong organic and inorganic growth. However, the market has chosen to put a multiple on a heavy claims year and the claims cost cycle is against them for the next 12 months until they and the entire industry can re-price. Other winners were longs in EQT Holdings (EQT, +13.3%). Elanor Commercial Property (ECF, +8.1%) and Turners (TRA, +10.0%).

Thank you for your continued support of the Fund. June was a choppy month which experienced a change in the underlying drivers of equity markets. The Fund held up relatively well in this context and we believe we remain well-placed given our outlook remains clearly for a pick-up in inflationary pressures, a

tightening in monetary policies across many markets and higher long term bond yields. We used the volatility to lower our net length and lift our gross as a number of names rose to what we view as very attractive short-selling levels.

BAML research published just after month-end showed that the June half was the fifth best for global equities in the past 100 years. An important driver of this is that annualised equity inflows in those six months exceeded the cumulative inflows for the entire 20 years prior. Maybe this continues but I wouldn't bet on it once central banks begin to tighten. Having alternatives such as this Fund may provide useful diversification if events do play out and interesting times lie ahead.



Matthew Goodson

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