SALT
Funds Management

Salt Long Short Fund Fact Sheet – April 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 April 2018

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$271.5 million
Inception Date	30 June 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 30 April 2018

Application	1.5523
Redemption	1.5460

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 2018

Long positions	87
Short positions	48

Exposures at 30 April 2018

Long exposure	81.94%
Short exposure	-52.28%
Gross equity exposure	134.22%
Net equity exposure	29.66%

Largest Longs	Largest Shorts
Centuria Metropolitan REIT	Goodman Group
IVE Group	Ryman Healthcare
Turners Automotive	CSR Limited
Ingenia Communities Group	National Storage REIT
Investore Property	REA Group

This Fund is actively managed. Holdings are subject to change daily.

Performance[1] at 30 April 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%									1.04%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	0.37%	1.61%	0.20%
6 months	3.47%	3.29%	3.54%
1-year p.a.	5.41%	6.75%	9.91%
2-years p.a.	6.04%	6.85%	11.43%
3 years p.a.	9.05%	7.17%	9.57%
Since inception p.a.	12.04%	7.45%	10.65%

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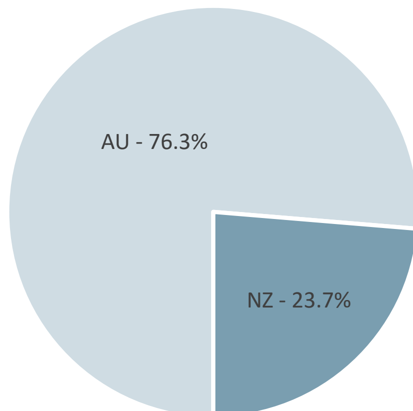
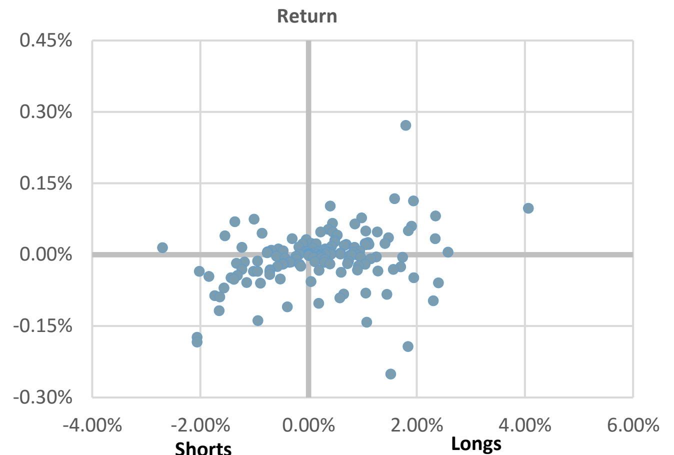
Country Allocation at 30 April 2018 (Gross Equity Exposure)



April 2018 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

After a strong March quarter in the face of volatile markets, the Fund experienced a very difficult month in April, with a return of -1.40% after all fees and expenses. This compared to the S&P/NZX 50 Gross Index advancing +1.50% and the S&P/ASX 200 Accumulation Index rising by a sharp 3.91%. The net positioning of the Fund was around the 30% net long mark for the month, so stock selection and especially style factors were the key areas that caused difficulty. We did not walk into any major earnings warnings from longs or takeovers of shorts, rather there was a steady erosion of performance as high growth momentum stocks rose sharply, while valuation factors languished.

Since inception on 30 June 2014, the Fund has now returned +54.6% after all fees and expenses. Thirty-four of those forty-six months have had positive returns, we are yet to have a negative quarter and our correlation to increasingly volatile equity markets remains statistically zero.

April was a frustrating month where we experienced death by a thousand cuts thanks to a mix of randomness, some peripheral damage from the Australian Financial Enquiry, a rally in interest-rate sensitive companies despite a sharp rise in bond yields (e.g. bank refugees bought the likes of Goodman Group), some minor errors that were punished harshly, and style factors where some of our shorted growth darlings went to stratospheric valuations. While the Australian market was up by 3.91%, the sizeable financials sub-index was up by only 0.1%, meaning we estimate the rest of the market was up by a euphoric 5.7%. We missed the emergency bull market memo.

We perhaps should have looked a little further afield where several signs of bubbly absurdity reared their heads. According to topdowncharts.com, the percentage of US IPO's with negative earnings is running at around 75% - the same level as 1999. On a similar note, Wework managed to issue $702m of junk bonds amidst hot demand on the basis of their forecasts for "community adjusted EBITDA" – which is EBITDA excluding marketing, general and admin, development and design costs. It is also known as revenue! The fact that this bond traded at $0.95 in the dollar just three days after issuance perhaps shows that we are seeing peak junk bond bubble.

Another real oddity in a puzzling month was a sharp move upwards in a range of interest-rate sensitive securities despite bond yields rising around the world on gathering signs of inflation. In Australia, the 10-year yield rose from 2.82% to 2.94% but we saw sharp bounces from the likes of Sydney Airport (SYD, +6.3% - not owned); Goodman Group (GMG, +7.6% to post-GFC highs - a large short); ASX Limited (ASX, +4.6% - a mid-sized short) et al. In our view, this divergence between bonds and bond-proxy equities will prove short-lived as higher inflation and bond yields are here to stay.

We spent much of last week in Australia at the flagship Macquarie Investment Conference (hence the slightly later nature of this letter). Two things really stood out: Firstly, there was a real emphasis by companies on managing investor expectations and on delivering a growth "story". Earnings momentum and index inclusion are everything at present, while valuation means nothing – this will most assuredly change. Secondly, a good proportion of the managers have never seen a bear market and they seem focused on what the next number is going to be from a company rather than what the company is actually worth. The higher the PE, the fuller the room – if a company is on a low PE then there must be something wrong with it.

Numerous signs during the month pointed to incipient inflation. US CPI rose to +2.1% in the year to March and the Fed's favoured target of the PCE deflator reached the 2.0% promised land in a release just after month end. Perhaps more interestingly, the New York Fed's Underlying Inflation Gauge, which is based on a wide

range of price indices, rose by 3.14% in the March year, its hottest level since the good old days of normality back in July 2006.

While the US is enjoying a strong result season (partly due to tax cuts and the previously weak USD), another theme coming out of it has been widespread anecdotal reports of cost pressure thanks to oil, labour, transport, commodities, impending tariffs and the weak USD. A CNBC article highlighted examples such as Caterpillar – "steel and other commodity costs to be a headwind"; 3M – "higher than anticipated costs for transportation and raw materials"; Kimberley-Clark – "significant commodity inflation"; Whirlpool – "significant raw material inflation"; Halliburton – "there will likely be wage inflation and additional pricing will be necessary for cost recovery" et al.

Inflation is most assuredly coming and the US Employment Cost Index for the March year rose to 2.7%, the largest increase since 3Q08. Even in Germany, that pillar of price stability, a large public sector wage agreement gave workers a 3.2% increase. Years of remarkably loose monetary policy are finally beginning to work.

There is no question that the Goldilocks era of low yields and steady growth is over. The most interesting question for investors now lies in the direction that the inflationary dyke breaks. If it does so in a stagflationary manner, then the next few years will be very sticky indeed for equity markets. However, if we see a more conventional reflation cycle, then higher bond yields across the curve will be accompanied by stronger earnings. This historically hasn't been too bad an environment for equities until inflation gets to the 4% type region.

While earnings growth is strong right now, some worrying signs of stagflation are popping up. Cost-push pressure from oil is the most obvious concern. Combine that with massive US fiscal deficits for decades into the future and memories of the 1970's come flooding back. Another sign was the Citi Economic Surprise Index in March, which sagged from readings in the +20-30 regions to -2. This was particularly evident in Europe, where the stronger Euro and widening credit spreads have seen a slowdown, with this in turn putting the ECB's consideration of ending QE on hold until July. What will they do if inflation is strong and the economy is weak?

To summarise our macro diversion, we believe we are at an inflection point where Goldilocks is over and bond yields are rising thanks to higher inflation, huge bond supply from wider US deficits and less demand as QE gradually and spasmodically transitions to QT. This scenario points to being wary of bond-proxy equities, equities with leverage to housing markets that may fall when financing costs rise and to high growth stocks, whose valuations are very sensitive to the NPV of forecast growth in 2025 and 2030. This is how we have tilted the Fund.

Amongst this yield-sensitive tilt, we have a sizeable non-consensus net short position in the NZ retirement village sector, chiefly via Ryman and to a lesser degree via Summerset. We thought we would devote a portion of this month's letter to stepping through our thinking here.

The great bull market in NZ house prices and turnover is finally coming to an end as several factors converge. Falling prices will have a major valuation impact on the sector. When an inhabitant passes away after an average of around 7 years occupancy, the operator re-sells the unit at a far higher price thanks to 7 years of accumulated house price inflation and retains 20-30% of the sale price as a deferred management fee. Bullish analysts and property valuers then project this process of sales and resales to continue alongside many decades of unbroken house price inflation so that this fee becomes an extremely large number indeed.

Aside from the myth that house prices never go down, these house price inflation projections also typically run well above household income growth. This implausibly means that housing affordability will worsen every year forever from its current record-high level of house prices relative to incomes. Unfortunately, history shows that real NZ house prices fell by over 40% in the early-mid 1970's as interest rates rose, immigration slowed, planning laws were eased and global economic shocks hit – sound familiar?

However, this is only the half of it. The real crunch will come when there is a sharp slowdown in turnover. This is already occurring in Auckland, where we calculate that REINZ data shows housing turnover per capita has fallen back to its 2009 lows. At some point, an inability to sell a vacant village unit to incoming occupants will affect the inventory turnover of retirement villages. We have already heard several anecdotes of deceased estates waiting many months for payment in Auckland.

The problem is that the villages' capital structure consists of a dash of equity, a modicum of bank/bond debt and a vast amount of zero-cost occupier advances. This is a formula for Croseus-like riches in a rising market but what happens when an occupant passes away and the unit cannot be resold? Where does the money come from to repay the estate when the equity base is such a small part of the capital structure? It was this problem that saw the Metlifecare share price fall from $8 to $1 in the aftermath of the GFC when the NZ housing market slowed for a year or two and they had great difficulty selling units in two of their key villages.

We have high confidence that this conceptual outlook for retirement villages will play out at some point but the theory won't be tested until the housing market actually tips over. How are we looking on that front?

1. The latest data shows a picture of house prices falling slightly in Auckland, rising at a slowing rate in the provinces and turnover being especially weak in Auckland.
2. Immigration has been a key driver of demand (albeit largely offset by people per house rising). The latest

numbers for the year to March showed a gradual slowdown to a still very high level of 68,000 net immigrants compared to a peak of 72,400 back in the year to July 2017. So, immigration is not tipping over just yet, but government policy is clearly tilted to lowering the number further.

3. A Treasury study that the NBR reported on during the month showed that Auckland's population growth has been well overstated. Official data shows Auckland's population rose from 1.49m to 1.61m in the three years to 2016 but analysing internal migration movements using a wider data-set shows the rise was only half that. Moreover, the arrivals have a skew to being single and on temporary visas, while the departures have been families moving out of larger homes. Not only is immigration slowing but its impact on the narrative that Auckland house prices must keep rising forever has been misplaced.

4. A Select Committee is currently receiving submissions on the proposal to ban foreign buyers, with an outcome likely later this year. Westpac economists point out that Toronto house prices fell by 6% in a six-month period after a 15% stamp duty was imposed on foreigners. A UBS case-study showed that a 5% stamp duty would only see 50% of Chinese intended property purchasers follow-through, while this drops to only 10% of purchasers at a 20% stamp duty. A foreign buyer ban will likely have a similar impact.

5. RBNZ lending data shows that loans to first home buyers have been quite solid of late and that loans to investors have recovered to the levels of a year ago as LTV lending restrictions have been eased. However, investor loans are still a good 40% below the levels of two years ago. We expect further pressure on investors as mooted policy changes see the removal of negative gearing and the capital gains Bright Line test being extended from two to five years. Westpac also expects the Tax Working Group to recommend some form of capital gains tax on properties excluding the family home and they highlight their past analysis that such a tax could reduce house prices by 15%.

6. Another curve-ball is that the Royal Commission of Inquiry into the Australian financial sector may lead to something of a credit crunch in that market, with an inevitable spill over effect in NZ. The key issue is that rather than carrying out individual assessments of a borrower's expenditure, some banks were using an unrealistically low default measure. This meant the borrower's ability to pay was being over-estimated and their mortgage loan is far larger than it should have been. Smaller new loans at the margin will require larger deposits and less demand for houses.

Toronto's experience over the last year may be an interesting analogue for Auckland given a similar dynamic of strongly growing population, strong offshore buying and huge growth in private credit to locals. Well, according to the Toronto Real Estate Board, sales in April were -32% on a year ago, the average price fell -12.3%, while a price index was down -5.2%. Throw that in a retirement village valuation model and see what happens! The lesson is that prices follow volumes and in Auckland, it has only just begun.

Returning to the weak performance of the Fund during April, our return of -1.40% reflected the worst "winners to losers" that we can remember, with it coming in at a very poor 44.8%. Normally, we would expect an outcome in the mid 50% region. There was also a moderate skew to slightly more large losers than winners, but this was a minor factor relative to the simple reality that too many shorts went up and too many longs went down.

The largest negative was our poorly timed foray a couple of months ago into Perpetual (PPT, -13.5%), which came under heavy pressure from two sources. Firstly, the Royal Commission unexpectedly cast a pall over the broader sector even though PPT has not directly come under the gun. Secondly, PPT reported a very weak FUM update early in the month, which featured large $1.4bn net outflows from their Australian equities business. As a value-oriented manager, we have great sympathy with how the current market obsession with darling growth stories is difficult for their style. However, as an investor, we do worry that it can be difficult to stabilise such trends once started. We attribute over half of PPT's value to their private advisory and corporate trust businesses and we have little doubt that PPT is now cheap, but it is the antithesis of the earnings momentum trade that the market is currently chasing. We cut our position in half prior to the worst of the pain.

The second offender was another repeat attendee in the form of our mid-sized long in Eclipx Group (ECX, -9.2%). This vertically integrated car fleet management, equipment finance and auction business has continued to fall steadily for reasons that we cannot put our finger on. Used car market volumes and residual valuations seem fine but perhaps the thematic fear from current US difficulties in this segment is feeding into investors' views. Other possible concerns have been unsourced press speculation that the Grays integration is not going well, (which would be contrary to ECX's AGM update) and a blow-out in funding spreads for the finance business. This could be an issue at the margin, but we understand that ECX fully hedges their book at origination.

The third negative of note was our large short in CSR Limited (CSR, +8.9%) which has defied the peak of the Australian housing cycle with a run of six consecutive up months. High aluminium prices have helped but they do hedge the majority of their production. CSR is now on consensus PE multiples of 13.5x Mar18 going to 16.2x Mar19 and 17.5x Mar20. They also carry the burden of the entire asbestos liability for the former Rinker Group, which blows

the PE out considerably if one adjusts the market cap for this factor.

The final notable headwind was our large short in Goodman Group (GMG, +7.6%). We carry this mainly as a hedge against various longs in the property sector, but it worked appallingly during the month as it defied rising bond yields. GMG has low gearing and makes the promise of steady EPS growth, but the quality has been declining in this late phase of the property cycle, with their last result featuring a low tax rate and below-the-line debt restructuring which lowered above-the-line interest payments.

Our medium-sized short in Clydesdale Bank (CYB, +2.4%) perhaps sums up our month. We view/viewed their reserves for legacy product mis-selling claims as being insufficient and they duly lifted their provision by GBP350m, which swamped the GBP140m indemnity remaining from when NAB exited. This equated to A8.6cps and they are now completely exposed to any further adverse development, but the share price rose. We covered some at the low and re-shorted near the high.

Our strongest positive by a significant margin was our large long in Speedcast (SDA, +15.2%) which has appeared frequently in these pages and has almost doubled since we first purchased it. We have taken a degree of profit into the bounce, but it remains on a free cashflow yield of near 9% and has strong secular growth from its cruise and merchant maritime telephony businesses, while any future oil services turnaround could be material given a very low base and large operating leverage.

Other positives were far smaller in nature, with our long in MYOB (MYO, +6.6%) bouncing from deeply oversold levels, our large long in QMS Media (QMS, +5.5%) finally garnering some attraction as the tom-tom drums of corporate activity start to beat in the outdoor media sector and our smaller remaining long in HT&E (HT1, +23.9%) particularly benefitted from this due to the rejected approach re their Adshel asset from Ooh! Media.

After a strong run by the Fund in the March quarter which defied difficult and volatile equity markets, the month of April saw us come back to earth with a thud. There was no particular issue that we can pin down but rather it was death by a thousand cuts from a mix of investment style and stock selection. In the face of a powerfully resurgent bull market ex-financials, our cheap longs were largely moribund or fell, while many of our shorts rose sharply. High multiple growth stocks have traditionally been amongst the most vulnerable style segments to rising bond yields, so we view this surge as unusual and unlikely to have legs for too much longer. We will stick to our style and look to repeat the solid uncorrelated returns that we have delivered over the last few years.

Matthew Goodson, CFA

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