SALT
Funds Management

Salt Long Short Fund Fact Sheet – January 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 January 2019

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$229.7 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 January 2019

Application	1.4335
Redemption	1.4277

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 January 2019

Long positions	70
Short positions	40

Exposures at 31 January 2019

Long exposure	74.18%
Short exposure	- 45.47%
Gross equity exposure	119.64%
Net equity exposure	28.72%

Largest Longs	Largest Shorts
Centuria Metropolitan REIT	BWP Trust
Tower	National Storage REIT
Bingo Industries	Technology One
Investore Property	Goodman Group
QMS Media	Auckland Intl Airport

Performance[1] at 31 January 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%												-1.26%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	-6.97%	1.66%	2.90%
6 months	-8.45%	3.35%	-1.13%
1-year p.a.	-7.31%	6.75%	2.42%
2-years p.a.	-0.92%	6.75%	8.97%
3 years p.a.	2.47%	6.87%	11.24%
Since inception p.a.	8.08%	7.35%	9.36%

[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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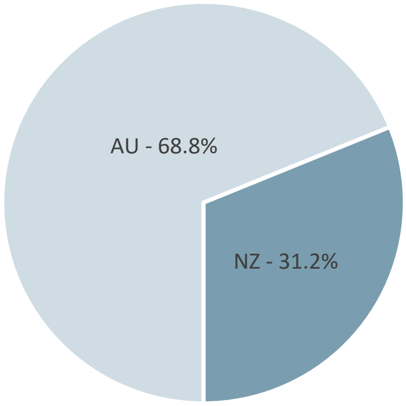
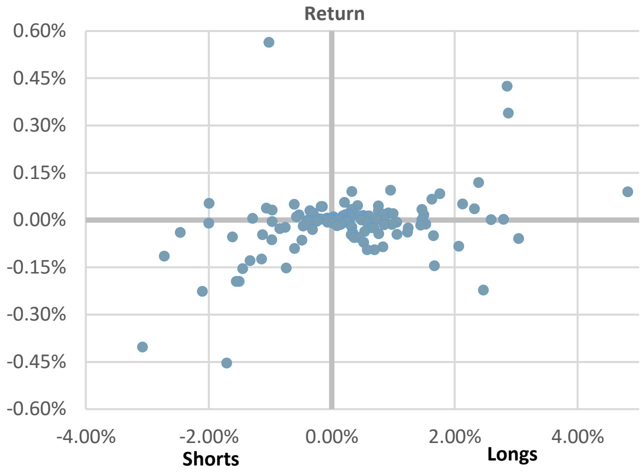
Country Allocation at 31 January 2019 (Gross Equity Exposure)



January 2019 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

The Fund began 2019 with another tough month, returning -1.26% after all fees and expenses in January. Equity markets remained volatile but bounced sharply during the month as the "Fed put" came back into play. This culminated at month-end with a Fed statement that dropped previous language around future gradual rate hikes and introduced a strong element of data dependence around their quantitative tightening program. While US markets soared on this, we believe it will lead to even more volatility over the next few months as markets gyrate according to the next data-point.

Since inception on 30 June 2014, the Fund has now returned +42.8% after all fees and expenses, with thirty-four of the fifty-five months having had positive returns.

The Fund made a number of successful individual stock calls during the month but continued to struggle with the overall positioning and style which has served us so well in the past. Several key aspects stand out:

i) Our heavy emphasis on free cashflow and valuation from both the short and long sides of the ledger is currently being ignored by markets. Very expensive defensives have become the momentum stocks du jour. This will pass.

ii) Our net short positioning in global cyclicals has not worked at all despite clearly slowing global economies. In past episodes, the poor macro numbers that China is currently churning out would have seen iron ore stocks battered but instead they have rallied sharply – partly due to supply disruptions.

iii) Domestic cyclicals have been indiscriminately hammered in Australia and NZ as fears of slowing housing markets and retail sales have taken hold. We are long higher quality structural winners (e.g., outdoor advertising, waste disposal) but these have fallen as sharply as the dross, even as their earnings forecasts have remained intact.

iv) Small caps have sharply underperformed large caps. Given our desire for liquidity from the short-side, we naturally tend to have more small/mid-caps among our longs.

Clearly, the positioning of the Fund has not worked since late October, when the above factors really started to bite. In thinking about what happens next, four main themes dominate our thinking.

Theme #1 is that despite significant market volatility, valuations remain exceedingly expensive and we are therefore managing our net length carefully. While falling bond yields have helped a little, slightly lower equity prices have been eclipsed by falling earnings forecasts. The one year forward PE for the NZ market (ex-property) now sits at 25.9x, which is the third highest ever and only just below the 26.6x peak at end-August.

A classic example of the contortions that have to be performed by analysts at present was contained in a piece on Ebos (EBO) that took our eye during the month. "*We view Ebos is fairly valued given the trading multiple of 19x PE which is 2x above the long-term average*." The actual one year forward multiple is 20.6x and yes, EBO is a moderate short, as we think the valuation is far too high at a time when grey earnings clouds are gathering.

Year-ahead earnings forecasts peaked back in April, with earnings downgrades more than offsetting the natural upside from rolling forward each month to higher future earnings. Since the April peak, earnings have fallen by 6.1%, the market has risen by 6.4%, while bond yields have fallen from 2.86% to 2.28% - which is effectively the current inflation rate. Even fully allowing for this extremely low discount rate, we model the market as being 18% overpriced. This remains concentrated in the largest stocks, with the dispersion of PE ratios being at a record, as is the gap between the median and the average PE ratio. Australia is similar.

This unusual valuation dispersion is also the case globally. A BAML/ Sanford Bernstein study found that the PE of high momentum stocks relative to low momentum stocks is the highest since early 2000. JP Morgan similarly points out a record valuation spread between "Momentum" and "Value" but also that the stocks that comprise the Momentum basket have switched from being "Growth" to "Low Vol". Just as we have experienced down under, and aided by lower bond yields, investors seem to have bought safety at any price. Worryingly, investors have flocked into such stocks on very low liquidity, with GS pointing out that liquidity for the Russell 3000 Index is just in its 7th percentile in recent decades and is at the worst since late 2008.

Passive funds and a preponderance of quant strategies would seem to be the culprits behind these unusual moves and we retain a strong view that they will ultimately succumb to the gravitational force of valuations. The way in which expensive defensive stocks became the new momentum names was a key factor hurting us in the December quarter and in the January month.

Theme #2 is the capitulation of the Fed to Wall St and the reinstatement of the "Powell Put". Signs of this came earlier in the month as even the more hawkish of the Fed Governors called for a pause. This was capped by the Fed statement at month's end removing the previous language around gradual rate hikes and introducing the idea that future rate movements and the rate at which it shrinks its balance sheet will be data dependent.

Markets have been whip-sawed several times in recent quarters by the Fed's gyrations between dovishness and hawkishness and we see this continuing. Some data releases do suggest that the US economy is slowing but it is unclear whether this is merely a mid-cycle pause or something deeper. At the same time, labour markets are extremely tight and wage inflation measures are exceeding 3%, which is consistent with pre-GFC measures when bond yields were far higher than today. A "shock" high wage or price inflation reading is a key risk for the next few months and would certainly drop all the heavily overbought defensive stocks out of the momentum bucket in very short order.

Theme #3 is that China is slowing sharply and that while a raft of stimulatory measures are now being taken, high debt levels mean there is less room than previously and there is also some doubt about the degree of political will. The official data is heavily red-washed but numerous signs point to a sharp slowing. Cell phone sales are -15% YoY (Apple and Samsung warned); the Caixin China PMI fell from 49.7 to 48.3 in January, the lowest since the scares back in Feb16; Japanese machine tool orders have plunged; German industrial production is heavily leveraged to China exports and fell by -4.9% in December; the median price of a pre-owned home in Beijing fell by -14% in 2018 according to Yicai Global; the Baltic Dry Index tumbled in Dec and Jan as exports to China fell sharply – perhaps most tellingly, Chinese capital outflows are rising in fear of yuan devaluation, as shown by China's imports of precious stones accounting for 69% of all imports from Hong Kong in December.

Put all this together and China is a significant macro risk. We have played this for some months by being short iron ore stocks but this has performed dreadfully. We nailed the macro call but the implementation has been dead-wrong. Iron ore company share prices had been creeping up for some time and then surged upon the tragic dam collapse in Brazil at one of CVRD's projects and their announcement that they will phase out the use of the up-river dams that were at fault. While this will superficially remove 40mt of iron ore from the market, it will take time and will be partially offset by spare capacity elsewhere in Brazil. We immediately covered some of our position following the tragedy but will slowly put it back on as the iron ore price spike appears to be an unsustainable knee-jerk reaction.

Theme #4 is that Australian housing is in freefall and the key questions now are how far that spills over to the rest of their economy and to NZ. CoreLogic data for January shows Sydney house prices are now -12.3% from their recent peak and Melbourne is -8.3%. However, they are still +53% and +43% from their 2012 lows, so would seem to have some further room to retrace. Residential building approvals are -23% YoY, with medium density and high-rise being even weaker. Australian consumer confidence fell from 104.4 to a still-neutral 99.6 in January and business confidence likewise fell from +11 to +2 in the latest December reading. The concern is that the declines may have further to run, so we are not yet tempted to invest in the minefield of consumer exposed stocks and have very limited gross and net exposures.

An interesting question is the degree to which this spills over to NZ. We do not have a Royal Commission but there are numerous other headwinds. House prices have only been moderately affected thus far but sales have dwindled, with January's REINZ data showing Auckland sales are down -24% YoY and NZ -13%. Retirement village investors have finally cottoned on to the implications if this weakness worsens and the stocks have been sharp underperformers. We have covered some of our large net short to the sector but retain the directional position.

Moving on from the key themes behind our current thinking, it may also be helpful to work through the thinking behind a number of our highest conviction positions.

Our largest long is Centuria Metropolitan REIT (CMA, +1%). CMA owns non-CBD office properties located chiefly in Sydney, Melbourne and Brisbane. Rents are materially lower than booming CBD rents, meaning these areas are seeing sizeable net absorption and hence valuation and rental growth. They are a classic late cycle play. CMA delivers a gross yield to a NZ investor of 8.5% and models out as extremely cheap relative to Australian peers which are either at the top of the cycle (CBD office) or just beginning a downswing (retail). We expect sizeable NTA upside will come through at the next revaluation round.

A key long for the Fund is Tower Limited (TWR, -2%), which after peaking at 81cps at end-September has been moribund in the low-mid 70cps region. TWR is the third largest general insurance player in NZ, specialising in personal lines of house and motor insurance. It has a strong albeit volatile Pacific Islands business. TWR has travelled a long and winding road ever since the Christchurch earthquakes but the balance sheet trauma has been dealt with by a fulsome equity raising a year ago and we view the remaining provisions as appropriately conservative.

What matters now for TWR is the outlook, with premium growth being comfortably ahead of claims costs and a new IT system set to dramatically lower internal costs, which are well above industry peers. Broker coverage is sparse but our detailed internal modelling has the company on a PE of just 7.8x Sep19 earnings, 6.8x Sep20 and plenty of growth thereafter as costs only really start to fall during 2020. Moreover, TWR has experienced several years in a row of unusual storm activity for which they retain the first $10m exposure. We assume the full $10m hit but there has been nothing thus far in 2019 raising the prospect of a large earnings beat. Bain owns 19.9% and their future intentions will be interesting.

We have large longs in the Australian outdoor media companies Ooh! Media (OML, +5%) and QMS Media (QMS, -8%). These were hit very hard in the December quarter on a negative cyclical thematic despite earnings forecasts remaining virtually unchanged. Advertising spending is indeed weakening with the cycle but these businesses have powerful offsetting structural tailwinds due to the digitisation of outdoor and the fragmentation of broadcast TV audiences. The market has consolidated post JC Decaux's purchase of APN Outdoor and OML's purchase of HT1's outdoor business, with there being early signs of rationality. OML and QMS both generate strong free cashflow and have numerous opportunities to reinvest for growth.

Bingo Industries (BIN, +12.7%) has appeared frequently in these pages and remains a key long, which we lifted again when it was hit very hard in the December quarter. There appear to be two concerns. First is the construction cycle but we would note that BIN has only about 15% exposure to residential, with commercial and infrastructure being far more important. Second are the ACCC's issues with the Dial-A-Dump acquisition. BIN has offered up a recycling divestment which makes considerable sense and there is one more area of possible overlap in the landfill space but they are licensed for different classes of waste. We think BIN will ultimately get this over the line, and even if we are wrong, they would have massive firepower for buybacks and investment.

A final long which is large relative to its market cap is a long-held position in Pacific Current Group (PAC, +5%) which we rebuilt during the ugly December quarter. PAC owns stakes in many fund management firms including the rapidly growing GQG but has diversified widely so that the bulk of its holdings are now in alternatives with little equity market exposure. PAC was on a 10x PE with one-third of the market cap being cash (i.e., <7x PE cash-adjusted) and the share price has begun to bounce as it is reinvesting the cash sensibly. Broker price targets are in the high $8 region versus the current $5.70 share price.

A large and unsuccessful short has been Technology One (TNE, +13.1%) and which also rose sharply in the December quarter. They have refashioned themselves as a SaaS company by rejigging their accounting for software contracts but they largely remain a mid-sized business software company that sells and implements IT contracts, with a heavy reliance on middle-ware to connect their legacy software to the cloud. The market cheered their last result but management were large sellers afterwards at much lower prices than today and there were some unusual accounting aspects that raised our eyebrows. TNE reported earned/unbilled revenue of $19.8m in current assets; $26.4m in non-current assets, yet only had a somewhat lower unearned revenue figure of $31.3m in current liabilities. This means they've been paid upfront for $46.2m of work that they've yet to carry out but have only accounted for $31.3m as an offsetting liability – it may be that profits have been brought forward in time. We will take the pain for now.

We have several large property sector shorts to offset our longs in that sector. The largest is Bunnings Warehouse Property (BWP, +3%) which models as extremely expensive in our relative valuation model but has risen for seven consecutive months. Retail sector exposures are just starting to see the first valuation declines as cap rates expand a touch and BWP is very vulnerable at endlease to renewal or departure by Bunnings, whose own business is coming under increasing pressure from the Australian housing slump. The near 30% premium of the share price to NTA is unfathomable but it has clearly caught a momentum bid.

Our short in National Storage REIT (NSR, +2%) is a similar story. It is expensive relative to peers, trades at a large premium to NTA, has a history of disappointing results from the storage centres that is has acquired and has significant risks from the slowing housing sector both in terms of storage volumes and longer-term alternative use potential.

We have also had painful shorts in the listed property fund managers Charter Hall (CHC, +11%) and Goodman Group (GMG, +10%). While we really rate GMG as business operators, we believe the market is far too blasé with regard to the large share-based compensation payments that it excludes from earnings. Both companies also have a large component of performance fees in their earnings and given the late stage of the cycle, we question the repeatability of these. They should have a far lower multiple attached to them than the market is currently paying. We were painfully caught out by their surge in January. They are now at all-time record highs at the cycle peak.

A final large short of mention is Auckland Airport (AIA, +2%) which fell only fractionally over the hideous December quarter. The strong share price action reeked of purchasing defence at any price, with AIA hitting a record premium to our internal DCF valuation. Moreover, we do not actually view AIA as particularly defensive. Tourism and immigration growth are beginning to slow as can be seen by Air NZ's recent profit warning and the reliance on China for both traffic and retail sales growth is uncomfortable given the uncertainties in that economy. AIA is also overcharging on its currently proposed regulated fees for the next five years and is under political pressure to reduce these in the near future.

Returning to the performance of the Fund in January, the return of -1.26% was comprised of +0.65% from our longs and -1.81% from our shorts. We simply did not get enough bark out of our longs in a month when the market rallied sharply. Our "winners to losers" ratio was again disappointing, coming in at an extremely weak 44%, with there being a large number of moderately sized detractors.

We actually had three notable positives, with the stand-out being our large short in Costa Group (CGC, -25%) which delivered an earnings warning based on a number of factors but chiefly driven by lower prices for berries and avocados. We could never understand how CGC became a 30x PE darling stock when it has significant financial leverage from leases and bank debt, coupled with major operational leverage across its produce categories. While CGC does have some varietal advantages in berries, supply has expanded rapidly across their key categories which is never helpful when you are supplying the major supermarket chains. The stock did frustratingly bounce 25% off its lows but we covered half the position near the bottom. CGC remains on a forward PE of 23x.

That compares to the likes of our large long in Scales (SCL.NZ) which owns most of its orchards and we estimate will be on a low-teen PE post the reinvestment of its cool-store sale proceeds.

The second winner came from an overdue rebound in our large long, Unibail Rodamco Westfield (URW, +15%). While sentiment towards retail is clearly awful, the ultra-premium positioning of URW's malls will act as a strong defence mechanism. We took the top off our position given the magnitude of the move but it continues to model out as very attractive in our relative valuation modelling.

The third tailwind was another rebound – this time from our large long in the aforementioned Bingo Industries (BIN, +13%) whose share price is absurdly volatile relative to its business.

The stand-out negative for the Fund was our mid-sized short in Fortescue Metals (FMG, +35%) which we put on too early as the share price began to rise. The fundamental reasoning was sound in that the Chinese economy is slowing and most experienced commodity forecasters saw a significant iron ore production surplus this year. However, the apple-cart has been well and truly upset by the tragic dam collapse of CVRD in Brazil which has seen a sharp spike in spot prices. We do not believe this will last given the likelihood that there will still be a surplus but it made for a painful hit.

The second notable headwind came from our large short in Goodman Group (GMG, +10%) which we discussed above. We did take advantage of a major sell-down by a large holder to cover some of the position on weakness. Other headwinds were more moderate in size but collectively added up to a sizeable impost. These included ultra-expensive high beta shorts in Technology One (TNE, +13%), Wisbech Global (WTC, +20%) and IDP Education (IEL, +15%) which all rose sharply on no new news.

Our long in QMS Media (QMS, -8%) has proven painful to put it mildly. They continued to decline on a negative cyclical thematic despite having attractive ongoing growth from both their outdoor advertising and their digitised sports media businesses. Following their spike earlier in the year on M&A activity in the sector, the market now appears very wary of the acquisitive nature of management as they aggressively build a presence in the latter segment.

Thank you for your ongoing investment and support of the Fund. The experience has been painful ever since late October, at which point we were up 0.3% against markets that were down 5% at the time. The drawdown since then has been greater than anything we have experienced previously, whereas in past market sell-offs, the Fund has delivered positive returns.

Our main issues have been that valuation has not been the shield it has been in former times; that expensive defensives have become even more expensive; small/mid cap stocks have been punished heavily on a flight to liquidity; and we have had an unusual number of problem-children relative to the usual array of major winners.

Our long-term track record remains positive and we are confident that we can recover the drawdown and then some in the months and quarters ahead. We repeat what we said last month in that we will stick to our knitting and be long companies which generate strong free cashflow relative to their market valuation, while shorting those which are expensive and preferably where we can see catalysts.

Matthew Goodson, CFA

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