

SALT

Funds Management

Salt Long Short Fund Fact Sheet – December 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 31 December 2018

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	\$241.0 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 December 2018

Application	1.4518
Redemption	1.4459

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 December 2018

Long positions	75
Short positions	35

Exposures at 31 December 2018

Long exposure	75.42%
Short exposure	-42.29%
Gross equity exposure	117.71%
Net equity exposure	33.13%

Largest Longs	Largest Shorts
Centuria Metropolitan REIT	National Storage REIT
Tower	BWP Trust
Unibail-Rodamco-Westfield/CDI	Goodman Group
Bingo Industries	Spark NZ
Investore Property	Technology One

Performance¹ at 31 December 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%	-0.21%	-0.11%	1.20%	-1.06%	1.37%	-1.88%	-3.71%	-2.16%	-5.50%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI ²
3 months	-7.56%	1.66%	-6.99%
6 months	-6.17%	3.35%	-6.19%
1-year p.a.	-5.50%	6.75%	-1.24%
2-years p.a.	0.05%	6.75%	7.43%
3 years p.a.	2.68%	6.89%	8.42%
Since inception p.a.	8.54%	7.36%	8.65%

¹ Performance is after all fees and before PIE tax.

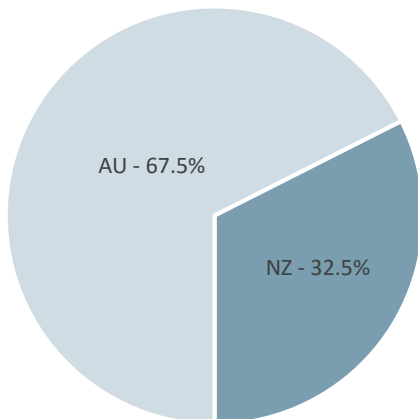
² NZX 50 G/ASX 200 AI is a 50/50 blend of the S&P/NZX 50 Gross Index and the S&P/ASX 200 Accumulation Index and is for comparison purposes only.

SALT FUNDS MANAGEMENT

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Country Allocation at 31 December 2018 (Gross Equity Exposure)



Fund Commentary

Dear Fellow Investor,

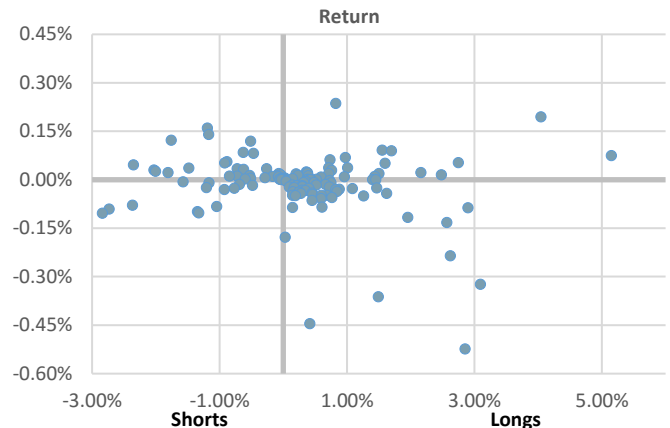
The Fund finished 2018 with another weak month, returning -2.16% after all fees and expenses in December. This return compared to the S&P/NZX 50 Gross Index return of -0.14% and the Australian S&P/ASX 200 Accumulation Index decline of -0.12%. The S&P 500 Index fell by -9.2%. Equity markets remained extraordinarily volatile around the world both between days and during days, with the apex of this volatility perhaps being seen in the S&P 500 Index on Dec 26, which experienced a 5.1% move over the course of the day. These are not normal times.

The Fund has fared well during previous market sell-offs but this time around our reliance on valuation as a defence mechanism was ineffective, our sectoral positioning has not worked yet and we stood on several “land-mines” during the quarter, with one more left-field hit occurring in the December month. These were not offset by the usual handful of major winners.

The only market sector that really rose in the period was very expensive defensives as investors flocked to safety irrespective of price. We became increasingly net short this area on a valuation view. This is why the NZ market held up relatively well compared to most markets globally. A slight sell-off late month in these stocks actually saw the Fund lift by around 1% off its lows. Contrastingly, cyclical equities were brutally discarded as fears gathered about their earnings outlook. We built longs in a number of higher quality names in this broad segment. This caused considerable short-term pain but we obviously like the prospects for longer term gain. Oddly, commodity stocks held up relatively well despite a plethora of signs that China is slowing sharply and we used this to build our shorts in this area.

Since inception on 30 June 2014, the Fund has now returned +44.6% after all fees and expenses, with thirty-four of the fifty-four months having had positive returns. While our overall volatility

December 2018 Individual Stock Contribution



remains low and our correlation to extraordinary equity markets remains zero, the last two and a half months have clearly been very disappointing.

We have had tough periods before and comfortably recouped the losses in subsequent periods, so we will be striving our utmost to do the same again. We will stick to our simple and historically successful philosophy of seeking to buy companies when they are cheap relative to their free cashflow generation and short sell them when they are expensive and preferably with catalysts that can be identified. In addition, we will continue to seek opportunities that are created by the vicious rotations between different equity market sectors that NZ and especially Australia experience.

Prior to digging into what drove performance during the month, we have used past December newsletters to reflect on what we have seen during the year and what may occur in the year ahead – particularly when our thoughts differ from current market expectations.

One of our key calls as we started 2018 was that economies would reach full capacity, with this generating wage and price inflation and thence higher bond yields. This view was correct for much of the year but reversed sharply in October, which was when our performance travails began. Investors are now rushing out of almost any stock with cyclical characteristics on a view that a sharp economic slowdown is ahead – this applies to the USA, Australia and NZ. Business outlook surveys are relatively weak and a Duke University survey of US CFO’s showed that half expect a recession by end-2019 and 82% by end-2020. Conversely, government bond yields have declined and equity investors are buying perceived defensives at almost any price, despite companies’ cost of funding being under pressure from expanding credit spreads.

The key question for 2019 will be whether this current market view of slowing economic growth and declining inflation/bond yields proves correct. As this piece is being written, Fed Governor Powell sparked a furious rally on 4 Jan by going all wobbly on the likelihood of interest rate increases in 2019 – “*we are listening sensitively to the message that markets are sending.*” After reacting like a petulant child to the rate hike in December, the market has clearly interpreted his comments as meaning that the “Fed put” is back in place.

Markets are very focused on slower growth and are assuming that it necessarily implies less inflation. The risk we see is a stagflationary scenario of weaker growth and higher inflation. The US labour market is extremely tight and Deutsche Bank is pointing out that wage inflation has hit 3.1% and is trending up as it takes a record 31 days to fill a job versus a low of 15 days in 2009-10 and a past cyclical peak of 23 days back in 2006. NZ and Australia are less pronounced but the theme is similar as economies run out of capacity after many years of expansion. In addition, oil has just moved from a 12-month high to a 12-month low in a record period of time but this deflationary impulse could easily reverse as Saudi production cuts take effect and shale producers struggle to fund themselves in difficult junk bond markets.

On top of inflation risks, it seems bold to be charging head-long into bond yield proxy equities when expanding US fiscal deficits are requiring record issuance and when the era of QE is largely over. The Fed is shrinking its balance sheet at \$50bn per month (unless they wobble on that), the ECB has finished with its QE programme and Japan’s commitment is unclear. We argued through most of last year that this end to QE would lead to higher bond yields and we were correct until being swamped by the massive risk-off trade of the last two months.

Prior to digging into the key swing factors that we see for the year ahead, let’s examine the ten factors that we pin-pointed last year. We were largely on the money until the end of October when everything changed.

1. “Bond yields will rise globally thanks to Fed QT, ECB tapering and possible BoJ tapering.”
Correct. US 10-year bond yields rose from 2.39% to a peak of 3.24% in early November before plunging to 2.56% as this piece is being written. Fear has triumphed the realities of quantitative tightening, large fiscal deficits and inflation threats that are still present.
2. “Inflation pressures will see the Fed hike by more than the 2-3 times expected by the market.”
Correct. The Fed hiked four times although the market now believes that no more hikes will be forthcoming in 2019. However, the logical implications of this call did not work at all as the year progressed. Being long cheap cyclicals that would benefit from improving economies and pricing power versus shorts in expensive defensives and over-priced growth darlings worked moderately well until October but poorly afterwards.

3. “The NZD will retest the \$0.63 lows it hit in September 2015.”
Correct. We were near enough, with the NZD moving from \$0.74 to a low of \$0.64 and being circa \$0.67 currently. The drivers of a dovish RBNZ versus a hawkish Fed were on the money but the investment implications did not play out, with obvious NZD-sensitive longs such as Scales, Sanford and NZ Refining all delivering negative returns.
4. “Auckland house prices will fall by a further 5% and wider NZ will join in.”
Wrong. Auckland was flat and the rest of NZ continued to rise outside of Christchurch. We held a similar view regarding Australia and this worked for the wrong reasons where a significant credit crunch and physical supply response saw prices fall sharply. However, after a sharp run up into September, being short the NZ retirement village sector worked well. Conversely, our large Ingenia long (now largely sold) worked well in Australia thanks to corporate interest.
5. “The crypto bubble will crash.”
Correct. Hopefully that’s the last we’ll hear of the mania. Sadly, we could not find a good way to short it.
6. “2018 will be another large year for M&A.”
Correct. We argued that funding costs and credit spreads will likely rise but the key driver will be the unusually large spread that remains between the valuations of large cap versus small/mid cap companies. We didn’t do as well out of this theme as we had hoped but some names such as MYOB and Methven were winners here while we avoided any from the short side.
7. “Oil prices will stay above \$60 for much of 2018.”
Correct. WTI ran from \$57 to a peak of \$75 before plunging to a low of \$42 at year-end. We largely exited in time with very good gains but did take a hit from FAR Limited which made the cardinal sin of drilling a dry hole. We have recently begun to rebuild oil holdings on the view that contracting supply means we are at/near a bottom.
8. “The Republicans lose Congress in the 2018 mid-terms and US equities sell off.”
Correct. However, we were not short enough and the sectoral nature of the sell-off did not meet our expectations.
9. “Iron ore and coal have a tough year as China emphasises financial risks over economic growth.”
Wrong. China did indeed pay lip service to financial risks but despite a sharply slowing economy, iron ore and coal ended up doing far better than base metals. We are even

stronger on the view this year as expanding supply meets ebbing demand.

10. "ETF's will again have inflows and will cause a shock at some point in 2018."

Correct. We navigated the February, and initially the October, sell-offs very well but were caught thereafter.

So overall, we were correct in 8/10 of our macro swing factors but this frustratingly did not translate through to performance as markets reacted to them in a very different manner to our expectations. Conversely, we were correct in 5/8 on 2017 and 7/11 in 2016 but the Fund performed relatively well in both those years. What are the key swing factors that we see for 2019?

1. "Auckland house prices will fall by 5% and wider NZ will flatten out."

This makes a return appearance and perhaps we will finally be right this year as one of the most expensive housing markets in the world begins to crack. Drivers include spill-overs from the bank lending crunch in Australia; anticipation of tighter NZ bank capital requirements; the application of AML legislation to realtors and lawyers for the first time; new restrictions on the use of negative gearing; a likely capital gains tax to be signalled; a ban on foreign buyers; a modest slowdown in immigration; supply continuing to expand, with Australian builders aiding this; and an overestimation of demand where an increase in people per household means not as many houses are needed as thought. To play this, we remain net short NZ retirement village stocks although less so than previously given their sharp falls in the last couple of months.

2. "Australian house prices fall by a further 5-10% but the declines abate by year's end."

Signs of current weakness abound as a sharp tightening in bank lending conditions, pre-election uncertainty and a large physical supply response are leading to record low auction clearance rates. CoreLogic data shows the 5-city average price decline in December was a sharp -1.3% and Sydney prices are now -11% from their seasonally adjusted peak, while Melbourne's fall is -7%. Sydney's rental vacancy rate has increased from 2.1% to 3.2% over the last year and rents have fallen by 2.7%. This clearly points to oversupply. Another 10% price fall would be a record decline and our thinking is that strong population growth continues and that an easing in credit conditions and perhaps RBA rate cuts will see a bottom tentatively found towards year-end. APRA has already made modest changes to interest-only lending. Cyclical exposures (both housing and more generally) have performed hideously in the last several months but the equity market will look to sniff out a bottom at some point post-election.

3. "Oil prices will test \$60 and likely move to a \$50-60 range for much of the year."

This is similar to last year's view when WTI ran from \$57 to a peak of \$75 before plunging to a low of \$42 at year-end. Despite demand risks, we see this as a very attractive buying opportunity given sharp supply cuts led by Saudi Arabia (who reportedly need an unlikely \$80/bbl to balance their budget), limited OPEC spare capacity and sizeable risks to shale oil supply, much of which is unprofitable at current levels and has to contend with a far less friendly junk bond market for financing. We have recently purchased Woodside and Senex and retain a small FAR holding.

4. "10-year bond yields end the year higher than the current levels of 2.55% in the US, 2.45% in Australia and 2.3% in NZ."

The fear-trade in the last several months has driven investors head-long into bonds and bond-proxy equities. While markets are perhaps correctly fixated on the idea of a sharp cyclical slowdown, they are ignoring that this could be accompanied by inflation. Labour costs are finally rising around the Western world as very low unemployment and skills shortages bite. The sharp fall in oil prices has clearly been helpful but this could just as easily rebound from current levels. An end to QE and extraordinarily loose US fiscal policy will also reverberate.

5. "China's economy continues to slow and this will hit iron ore stocks hard."

China's December PMI was the weakest since 2008, falling from 50.0 to 49.4. Japanese machine tool orders are a great live-time indicator on China and their November reading was -17% YoY. Chinese car sales fell -14% YoY in November and the list goes on. While tentative stimulus measures are being enacted, the room to manoeuvre is constrained by already high levels of debt. While this inevitably means that iron ore demand is falling, Australian and Brazilian supply is expanding and Chinese scrap usage is structurally increasing. In the short term, the likes of Fortescue and Rio Tinto will ebb and flow with the "risk on/risk off" trade but 2019 could be rather difficult for them.

6. "A disorderly no-deal Brexit will not occur."

We suspect that logic will prevail in the end after the UK tries everything else first and a deal similar to that currently on the table gets supported after initially being rejected. This will see the GBP rally and remove the risk of a disorderly exit from market pricing. We are long names such as Scales and Australian Vintage Group which have significant exposure to that market.

7. “Equity style divergence will be far less marked in 2019, making it a stock-pickers’ market.”

Growth has sharply outperformed value as a style over the last several years and a simplistic contrarian view would be for a sharp snapback in 2019. However, having been burnt on this call last year, it does still feel a year too early for value given earnings risks as economies slow. Value performs best when economies are emerging out of recession. At the same time, while growth has fallen from its end-August extremes, it remains expensive. Obvious defensive stocks have turned into momentum darlings and become very expensive. We suspect that 2019 will be a stock-pickers’ market which does not see one style predominate over another.

8. “2019 will see a dearth of IPO’s but significant M&A activity.”

This will be similar to 2018 and reflects that there continues to be a record divergence between the valuations of large cap stocks versus small to mid-caps. The one caveat is that expanding corporate bond spreads may make large private equity deals (such as the Trade Me takeover) significantly tougher to consummate.

In the short term, we are torn over the direction of markets between the conflicting signs of extreme tactical capitulation versus what could be a very difficult reporting season across the NZ, Australia and the US markets. In particular, firms’ outlook statements may disappoint and a raft of earnings downgrades for 2019 seem likely to ensue. We have already seen Apple warn. Investors have not missed this, with the carnage in many cyclical companies occurring in advance of broker downgrades. Our approach has been to try to maintain shorts in those names which remain expensive and to build longs in hard-hit quality names and segments within the broader cyclical universe. A classic example here has been our painful longs in the outdoor advertising companies, Ooh! Media and QMS which are now at 10%+ free-cashflow yields and have ongoing structural growth even in the face of cyclical headwinds.

Returning to the performance of the Fund in December, the return of -2.16% was comprised of -2.54% from our longs and +0.46% from our shorts. This shows the degree of damage we endured from the long side as many of our value-based names came under heavy pressure. Our “winners to losers” ratio was a weak 48%, with far more of our longs falling than rising.

The stand-out negative for the Fund was our large long in Bingo Industries (BIN, -16%) which has been under extreme pressure since late October, falling from a \$3.20 high to a \$1.72 low. Two things have happened. Firstly, the ACCC amber light to the Dial-A-Dump acquisition creates risk around the sizeable planned synergies occurring if the deal is blocked and pushes them back in time if it ultimately goes ahead. On the plus side, BIN has raised the equity for D-A-D and in the theoretical scenario that they diverted this into a buyback, it would be more than 50% EPS

accretive at current levels. The second issue is BIN has been caught up in the hatred of all things cyclical, even though residential waste only accounts for a moderate portion of their business. It is clearly unhelpful but the ongoing infrastructure boom matters far more. We sold some BIN near the top and we have rebuilt the position in the weakness, with waste and recycling assets being a “river of gold” on a through the cycle basis.

The second key headwind came from standing on a land-mine via our medium sized holding in IOOF (IFL, -25%). They plunged given unprecedented court action taken by APRA to disqualify key directors and management from running superannuation assets. The issues are historical and it is remarkable that a \$1.6m reimbursement issue from a unit pricing error by an outsourced provider has turned into a potentially company-wrecking debacle. IFL believed they had been in dialogue with APRA and had this issue and several others under control. While we see a reasonable chance that IFL ultimate prevails in Court, the problem for IFL is that this will cause massive reputational damage and it will highly likely prevent the final consummation of the ANZ Wealth acquisition. Given the unforecastable risks, we exited.

The third stand-out problem was the long we built up in the major outdoor advertising operator, Ooh! Media (OML, -21%) which fell despite retaining a key contract following their acquisition of Adshel. We had sold much of our holding in \$5.20 region but it is now back to \$3.40 on full blown cyclical fear. With broadcast TV being in structural decline, we are positive on digital outdoor media structurally growing as it provides a key way to reach a mass audience. Both OML and the similarly punished QMS Media (QMS, -8%) are on free cashflow yields above 10%. We are clearly taking cyclical risk in the short term but even the latest dismal SMI advertising data for November showed that outdoor continues to experience growth.

Number four on our wall of worry was the large long we have built up in Unibail-Rodamco-Westfield (URW, -12%) which was hammered on a mix of general retail fear, ASX index down-weighting and a degree of concern about their gearing levels. URW owns a set of extremely high-quality malls across Europe, the UK and the US which are destination in nature and highly defensive in the context of the obvious industry headwinds. URW is selling property above NTA to address the temporary balance sheet expansion post the Westfield takeover and it offers a yield to a NZ investor of over 10% - remarkable for assets of this nature. URW stands out by some distance in our relative property valuation model.

Winners were fewer in number and of a smaller magnitude. The largest was a modest position in Methven (MVN, +33%) which after years of sitting at the altar finally received a takeover proposal from GWA Group. We think this makes sense all around as MVN has developed a series of highly innovative products but has lacked the distribution networks to sell them at the sorts of margins that should be achievable from scaling off someone else’s network.

The second notable winner was a moderate long in Resolute Mining (RSG, +22%) which has large scale, low cost gold mines in Mali and Australia. The market appears to be perceiving operational risk from their sub-level caving ramp-up in Mali but to date, everything appears to have gone as it should have. With current global volatility, we are also attracted to the A\$ gold price outlook.

The third tailwind was our mid-sized short in Netwealth Group (NWL, -12%). NWL are clearly a quality player in the investment platform space but they trade on a huge multiple which may perhaps be vulnerable if their earnings do not scale under the pressure of weaker markets, intense price competition between platforms and what appears an unsustainably high fee that is charged on cash balances.

Other smaller positives of note included shorts in Wisetech Global (WTC, -10%) which trades in a highly speculative absurdly volatile fashion; Ryman Healthcare (RYM, -7%) where investors are finally worrying about their vulnerability to housing markets in Melbourne and NZ; and Magellan Financial Group (MFG, -10%) which is a partial offset to our long in the far cheaper cash-rich diversified fund management investor, Pacific Group (PAC, -6%).

The Fund ended the month with net length of 33.3% which would seem to belie our fear that 2019 might see a combination of slowing growth and rising inflation. However, about 3.5% of this length is in merger arbitrage plays such as Restaurant Brands and Methven which offer an attractive annualised return from here.

We have reduced risk across the portfolio by lowering the number of names and lightening the size of a number of more speculative smaller cap holdings. Rather than doubling down, we have also lowered the gross positioning to just 116% but will not hesitate to use the current volatility to lift this again as opportunities arise. We have been caught by our sectoral positioning in the last couple of months, being net long a number of higher quality cyclicals which have been brutalised, while being short a range of expensive defensives which benefitted from the flight to safety. Better performance came in the last few days of December when this latter group came off its highs.

Thank you for your ongoing investment and support of the Fund. We have historically done well in negative markets and that was again the case until late October, when everything changed, with valuation being no protection against a flight to safety at any price. The drawdown since then has been deeper than we have experienced in the past but together with some positioning changes, our track record suggests we can recover that drawdown and then some in the months and quarters ahead.

2019 may be a difficult and volatile year across asset classes and investment styles as the great bull market comes to an end and markets gyrate in their views towards earnings risk, inflation risk, liquidity risk et al. We intend to 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