SALT

Salt Long Short Fund Fact Sheet – August 2023

Manager Profile

Salt Funds Management is a boutique investment management firm wholly owned by its employees which specialises in actively seeking to maximise returns while managing the risks of the investment.

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 July, 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 August 2023

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$73 million
Inception Date	1 July 2014
Portfolio Manager	Matthew Goodson, CFA

Unit Price at 31 August 2023

Application	2.3167
Redemption	2.3074

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 August 2023

Long positions	58
Short positions	38

Exposures at 31 August 2023

Long exposure	106.48%
Short exposure	57.90%
Gross equity exposure	164.39%
Net equity exposure	48.58%

Investment Risk to 31 August 2023

Fund volatility[1]	6.43%
NZ50G / ASX200AI volatility[1]	13.77%
NZ50G / ASX200AI correlation	0.075

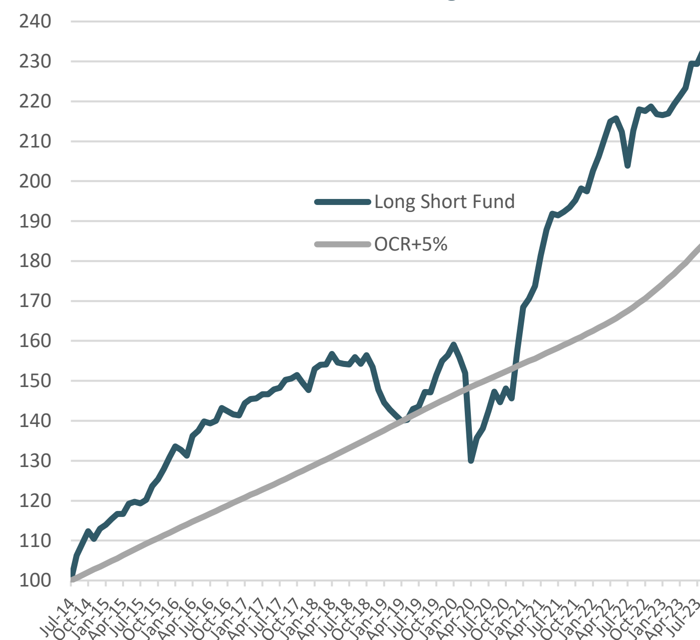
1. Annualised standard deviation since fund inception.

Fund Performance[2] to 31 August 2023

Period	Fund Return	OCR+5% Return	NZ50G/ASX 200AI Return[3]
1 month	-0.85%	0.85%	-2.44%
3 months	0.56%	2.54%	0.39%
6 months	5.24%	5.04%	-0.40%
1-year p.a.	5.86%	9.53%	3.94%
2 years p.a.	9.21%	7.85%	-2.12%
3 years p.a.	16.85%	6.97%	5.14%
5 years p.a.	8.38%	6.64%	6.35%
7 years p.a.	7.06%	6.68%	7.71%
Inception p.a.	9.55%	6.99%	8.62%

2. Fund performance is after all fees and before PIE tax.
3. NZ50G/ASX200AI is a 50/50 blend of the S&P/NZ50 Gross Index and the S&P/ASX 200 Accumulation Index and is for comparison purposes only.

Cumulative Fund Performance to 31 August 2023



Fund performance has been rebased to 100 from inception.
Past performance is not a reliable indicator of future performance and no representation or warranty, express or implied, is made regarding future performance.

Largest Longs	Largest Shorts
GDI Property Group	Reece
Tower	Goodman Property Trust
Global Data Centre Group	Data#3
Lynch Group Holdings	Brambles
Monash IVF Group	Mirvac Group

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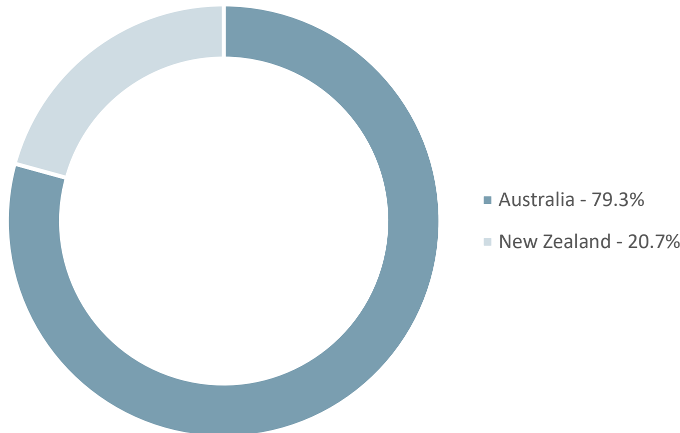
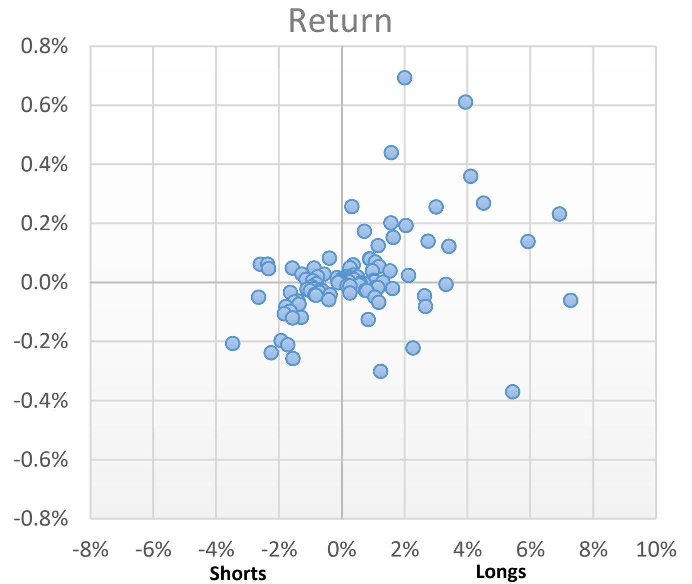
Country Allocation at 31 August 2023 (Gross Equity Exposure)



August 2023 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

The month of August saw a moderately negative return of -0.85%. This was delivered against a backdrop of a volatile and somewhat weak reporting season, which saw the Australian equity market fall by -0.7% and NZ decline a sharp -4.2%.

After the bullishness of July, investors turned rather twitchy in August, jumping at shadows in both a positive and negative manner. Several of our positions in relatively large, liquid companies soared by 10%+ one day and then promptly gave it up the next. Indeed, according to GS research, one out of every eight stock prices moved by more than +/-10% on their reporting day. This was more than twice the historical average despite earnings misses/beats and revisions being only slightly worse than average. This speaks to the uncertainty lurking beneath the surface of the market at present coupled with a tendency to shoot first and analyse later. We felt as though we used this volatility well and are well positioned for the period ahead.

Aside from momentum-junkie investors reacting like two year olds to each trivial piece of new information, share price movements during the month were driven by shifting views on a number of key themes: i) rampant bullish sentiment started to show a few cracks; ii) earnings downgrades were apparent across most sectors in Aus/NZ; iii) valuation multiples expanded but were largely ignored; iv) a view took hold that central banks are largely done but easing hopes were pushed back in time; and v) significant fears emerged re the health of the Chinese economy. More on each of these themes shortly.

Last month, we highlighted/lamented that bullish sentiment according to the CNN Fear & Greed Index had sat in "extreme greed" territory above 75 for every single day of July, bar one. As shown in the chart below, this didn't exactly revert to "fear" in August but some normality did reassert itself with readings dropping into the 44-56 neutral range in the second half of the month.

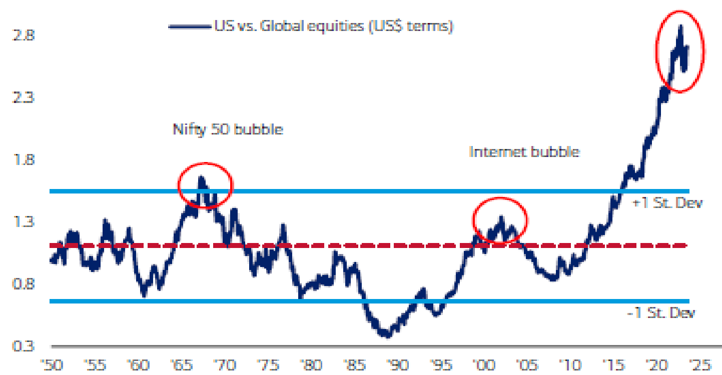
Market views regarding future monetary policy are continuing to wax and wane. What we think is going on is that equity market "liquidity" is still abundant but it is gradually being withdrawn as QT gradually takes hold in US/Europe and Japan's zero-rate policy is in the early stages of changing.

We view this liquidity abundance as the necessary fertile backdrop for the "story" of artificial intelligence to take hold

and grow rapidly. There is no doubt that AI is for real but it is also very early days. Use cases and cashflow implications are still unclear outside the most obvious sectors such as specialist chipmakers and datacentres.

However, it is important to curb one's enthusiasm from getting too bubbly. A Financial Times article pointed out that 40% of S&P500 companies mentioned AI on their earnings calls but it only made it into 16% of their regulatory findings. The respective percentages for smaller cap companies would likely be hideous. Beware the spruik! Perhaps the Long Island Iced Tea Company that became the Long Island Bitcoin company will shortly become the Long Island AI company. As shown in the chart below, it is not as though the market has missed the AI theme.

Chart 9: Global stocks massively underperforming US (tech) stocks
US vs Global equities (relative price performance)

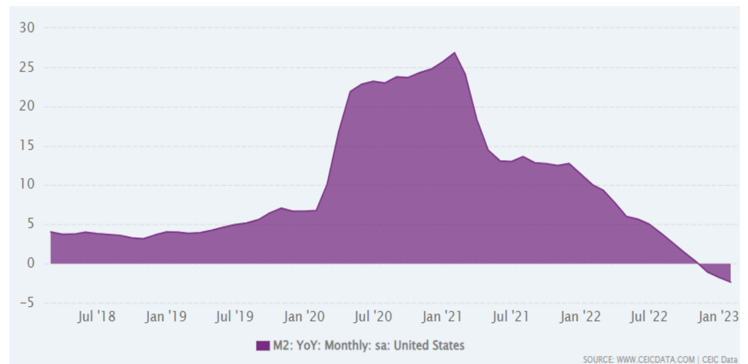


Source: BofA Global Investment Strategy, Global Financial Data, Bloomberg

Our thinking is that AI is the investment theme du jour and it has been enabled by rampant liquidity conditions. These are dangerous waters to be swimming in – pull the liquidity plug out and we'll see who's been swimming naked.

As shown in the chart over leaf, US M2 money supply continues to shrink, declining by -3.7% YoY in the month of June. It has shrunk every month so far in 2023, with these outright declines comparing to trend growth that is more in the 5-6% region. They are the first declines since the Great Depression. However, as dramatic as this sounds, they have to be viewed in the context of the vast 20%+ money supply expansion in the post-Covid response period.

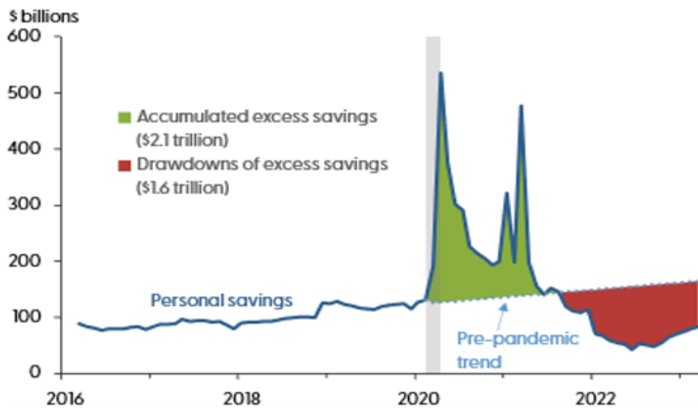
This fits perfectly with our thesis that central banks are removing the punch from the punchbowl via QT but there is clearly still a fair amount of juice left in the bottom. The hard part as an investor is knowing when exactly the liquidity removal starts to impact markets. Maybe just maybe we saw the beginnings of that in August.



Another way to measure the amorphous concept of "liquidity" is to look at the bitcoin price, with a chart from cnbc.com shown below. The price rocketed from 10,000 to 60,000 during rampant money-printing post-Covid but then fell back to the 16,000 region in late 2022/early 2023. The price then almost doubled as the Fed injected liquidity into the system via their discount window to counteract the failures of Signature Bank and SVB. Notice that it has now begun to pull back from recent highs of 30,500 to around 26,000 during August – a 15% decline. Hardly a rout but QT is inexorably removing liquidity from the system and may just perhaps be starting to bite.

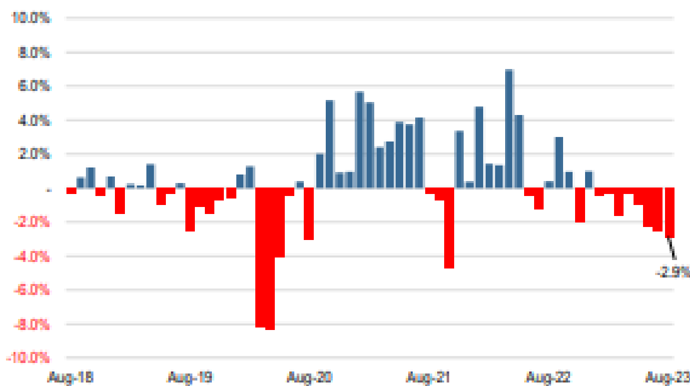
This idea that declining liquidity may start to impact financial markets is closely related to the concept that vast excess household savings are eroding quickly as fiscal giveaways have ceased and monetary policy has tightened. This may impact financial markets directly as retail punters pull back – activity levels have plunged on platforms such as Robinhood, Sharesies et al.

It may also impact markets indirectly as households that were formerly feeling flush are pulling back on consumption expenditure, especially those in the mortgage-holding demographics. We found the chart over leaf from the San Francisco Fed for the US economy very interesting in this context.



One of the surprises of the Australian reporting season was the outperformance of consumer discretionary stocks, whose results were generally better than feared. The sector rose by +5.7% versus the overall -0.7% market decline. We view this as temporary, with very similar forces of exhausted excess savings likely being at play in Australia and NZ.

This brings us to our second theme that earnings downgrades are becoming increasingly apparent across Australia and NZ. The JP Morgan sourced chart below shows the negative path for Australia. In NZ, using Jarden data, one-year forward estimates for the core market saw -6.4% downgrades over the month of August – more than the -4.2% that the market fell by. We would suggest these downgrades have a little further to run before this cycle is over.

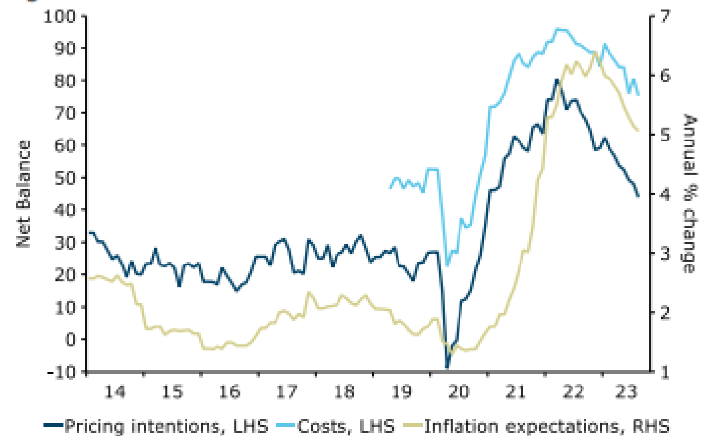


Source: J.P. Morgan estimates, Bloomberg Finance L.P.

Our general bearish slant and short positioning in cyclical plays would quickly change if we saw some downside inflation surprises which allowed central banks to ease policy. However, there was little new news in August to dissuade us from our long-argued and so far correct position that inflation has peaked but that it remains too sticky for central banks to ease any time soon.

The Fed's preferred inflation measure, the core PCE deflator for July was in line with expectations at +3.3% YoY. However, the distinction between goods deflation (-0.5% YoY) and strong services inflation (+5.2% YoY) was stark. This is not an environment that will suddenly see the Fed reverse course and ease. As Governor Powell said at Jackson Hole, "Although inflation has moved down from its peak - a welcome development - it remains too high. We are prepared to raise rates further if appropriate and intend to hold policy at a restrictive level until we are confident that inflation is moving sustainably down toward our objective."

NZ inflation data is far sparser than the US but is gradually moving in the right direction. The ANZ Business Outlook survey at end-August showed encouraging declines in pricing intentions and inflation expectations. The caveats are that they are still at high levels and pricing intentions have been heavily impacted by agricultural sector weakness that isn't reflective of the rest of the economy.



Source: Macrobond. ANZ Research

The area that markets may be mispricing against this backdrop of peaking inflation may actually be long term bond yields. Credit Suisse strategists pointed out that since mid-July, nearly 75% of the rise in US bond yields has been driven by real yields, which have risen from 1.0% to 1.9% on the 10-year TIPS. As shown over leaf, this is actually the highest real yield since before the GFC.

This may signal a long overdue return to normality from the funny money era of central bank money-printing that we have endured ever since then. At the very least, there is now some compensation for owning long-term bonds. The fund is now net long equities that may theoretically be correlated with a peak in bond yields and we are net short cyclicals.

A final theme that drove markets in August was the escalation of significant fears regarding the health of the Chinese economy. The key housing sector is in trouble with players such as Evergrande and Country Garden in all sorts of strife. Very high debt levels appear to be constraining the building of more bridges to nowhere, while private consumption expenditure appears weak. With China being almost unique in experiencing deflationary forces, the obvious solution would seem to be to lower interest rates and accept a weaker currency. We shall see, but in the mean time, our consistent bearish view regarding the iron ore outlook remains very much the case although it will no doubt bounce around on any stimulus announcements.

Fund Performance in August

Returning to the Fund's performance in the month of August, our overall return of circa -0.7% pre fees and tax had divergent contributions from our long book (-1.0%) and our short book (+0.3%). This was unsurprising in a weak month for markets but we would have hoped to have done a little better on both sides of the ledger. Our "winners to losers" ratio was a mediocre 54%, with a skew to larger losers, one of which may be permanent but the other should be temporary.

Welcome market volatility saw our gross exposure remain relatively high by our standards at 165% (was 161%), while our net exposure rose a little from 46% to 49% on market weakness. While perhaps starting to get a touch long, we still see this as broadly being market neutral, with individual stocks driving returns rather than overall market movements.

The 50/50 index of Australia and NZ had an extremely high 13 down-days in August, with NZ being particularly negative. Those 13 days had an average return of -0.42%. Pleasingly, we were up on 7 of the 13 days, with an essentially flat average return of +0.01%. So, despite being net long, we were actually up slightly in negative markets and down somewhat in positive ones. This illustrates how our overall returns are uncorrelated to what long-only equities are doing.

Our largest positive was yet again our highly successful investment in DUG Technology (DUG, +12.9%). It closed the month at $1.80, compared to our average net purchase price of just over $1.00 and our initial entry price of $0.40. DUG reported a strong result and delivered a particularly strong revenue update for the month of July. They are growing very rapidly as they use their supercomputers to process highly complex tasks such as seismic imaging for oil companies and meteorological forecasts. They operate in a highly concentrated market in the geophysics segment and appear to have a technical edge which is seeing them gain market share in an oil market that has also returned to life.

Looking forward, we highlighted last month that they have received Government funding to help build a major new computing campus in Geraldton, with the first data-hall's capacity of 400 petaflops lifting their capacity by 13 times. We don't know what we don't know in terms of how and when they will fill this capacity. However, they appear to be rather well placed in solving the compute bottleneck in this rapidly emerging era of artificial intelligence applications. Putting our AI hype to one side, they are still a real company with real earnings, being on a Jun23 PE of 13.7x going to 11.8x in Jun25, with rapidly growing net cash on the balance sheet.

The second key tailwind came from a mid-sized holding in Paladin Energy (PDN, +15.0%), which has been a solid performer for the Fund in recent months. The uranium price outlook appears extremely positive, with numerous countries looking to add nuclear capacity to lower their carbon emissions from power generation. At the same time, there is a major future supply deficit which will be exacerbated by the Russian situation. There are many small, high-risk players in the sector but we went with PDN as it is relatively low risk with its restart of the Langer Heinrich mine in Namibia.

A third notable contributor was another name which has been a frequent flyer for the Fund, our very large position in Global Data Centres (GDC, +4.2%). GDC reported a solid result from their various assets and their unaudited NAV rose 20cps to $2.47 versus the closing share price of $1.755. We have significant hope/confidence that their stake in Air Trunk will end up being worth significantly above the current value in the NAV, which should see GDC deliver strong returns from their staged wind-down.

A fourth notable name which we have revisited from several years ago is a long in the intellectual property firm, Qantm IP (QIP, +9.1%). When we previously exited, we were concerned (perhaps unfairly) that the business was being run for management rather than shareholders. It has not been a great performer in the interim. Since then, they have largely

completed a heavy investment phase which will lower costs, they reported a solid result where they continue to win market share, they are a big winner from the weak AUD and they have a rapidly growing AI-driven business to file trademarks called Sortify. They have no analyst coverage but are on a historic PE of 9x with growth.

Other useful contributions came from our long-held position in Superloop (SLC, +6.0%), who reported a strong result and whose planned merger with Symbio may add value; a long in the chemicals distributor, Redox (RDX, +12.5%) which we added to when it fell post-IPO; and a short in Wisetech (WTC, -19.0%) whose result didn't match up to its ultra expensive valuation and which we have since covered on weakness.

The largest laggard was a clear error via a moderate long in the small-cap veterinary company, Apiam Animal Health (AHX, -30.1%), which fell sharply following a disappointing profit update. We are highly attracted to the industry they operate in, with AHX being a combination of companion animal clinics and livestock clinics (including horses, farm animals and feedlots). We are always a little wary of roll-ups but they had delivered solid quarterly updates during the year, only for it all to turn to custard in the last quarter. They clearly didn't undertake sufficient due diligence on some of their purchases, wage inflation is high, we are a little suspicious of just how effective their central management controls are proving and interest costs have obviously risen. That said, they claim to have since cut costs and have taken necessary actions to turn around the problem clinics. Drought conditions will also aid their feedlot services. The share price is now cheap if they can deliver but that is very much an if. We will manage the position closely.

The other stand-out headwind was our highly volatile holding in the litigation settlement fund manager, Omni Bridgeway (OBL, -25.5%). We view it as being materially under-priced given the pipeline of settlements and fee payments that they have in train via their array of managed funds. We have bought and sold the name on weakness and into strength but were a little taken aback by what was clearly an aggressive short-selling attack. We think the apparent thesis that OBL lacks sufficient working capital to cover their ongoing management costs is mis-placed. Positive settlement announcements have always acted as a catalyst in the past and we expect them to do so again, especially as they are on the verge of large waterfall payments from some of their earlier funds now that they are almost through the preferential returns to investors.

Other detractors included our long in Lynch Group (LGL, -6.5%), which remains very cheap but whose in-line result featured a better Australian but weaker Chinese outlook than we had expected; our large long in GDI Property (GDI, -3.8%) whose result was fine and where we remain very confident of strong future returns; a mistaken small short in Altium (ALU, +26.7%) which surprised us by taking off following an in-line result; and a large short in Brambles (BXB, +6.4%), whose result was in-line and whom Australian investors seem to be in love with despite a wholly inadequate free cashflow yield in the 2.5%-3.0% range.

Thank you for your continued support of the Fund. We called many names correctly in the highly volatile August result season but also suffered several minor flesh-wounds, where we were wrong in either timing or substance. Notwithstanding that, we easily outperformed long-only equities and did so with no correlation to them and far less volatility.

August saw the beginnings of the winds of change from the extreme bullishness enjoyed by equity markets in July. Earnings seasons were far from easy in NZ and Australia, and more broadly, we are getting the sense that central bank tightening is finally beginning to get some traction in terms of the impact on market liquidity. From here, we will see more earnings downgrades than upgrades and inflation is too persistent for any early easing. The one sign of light we do see is that long bonds have now priced this in. Real bond yields have risen sharply to pre-GFC levels and perhaps have done their worst since they are now providing adequate levels of return for investors to hold them.

Matthew Goodson, CFA

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