SALT

Funds Management

Salt Long Short Fund Fact Sheet – June 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 30 June 2019

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$120.8 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 30 June 2019

Application	1.4412
Redemption	1.4354

Investment Limits

Gross equity exposure	0% - 400%
Net equity exposure	-30% - 60%
Unlisted securities	0% - 5%
Cash or cash equivalents	0% - 100%
Maximum position size	15%

Number of Positions at 30 June 2019

Long positions	71
Short positions	43

Exposures at 30 June 2019

Long exposure	86.23%
Short exposure	-57.60%
Gross equity exposure	143.83%
Net equity exposure	28.63%

Largest Longs	Largest Shorts
Tower	Auckland International Airport
Pacific Current Group	Ryman Healthcare
Turners Automotive	BWP Trust
Spark NZ	Genesis Energy
360 Capital Total Return Fund	NIB Holdings

Performance[1] at 30 June 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%	-0.97%	-0.96%	0.14%	1.94%	0.42%							**-0.73%**

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	2.51%	1.59%	7.97%
6 months	-0.73%	3.24%	19.58%
1-year p.a.	-6.85%	6.69%	12.18%
2-years p.a.	-1.61%	6.72%	13.64%
3 years p.a.	1.00%	6.77%	13.20%
5 years p.a.	7.50%	7.28%	11.67%
Since inception p.a.	7.54%	7.28%	11.67%

[1] Performance is after all fees and before PIE tax.

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

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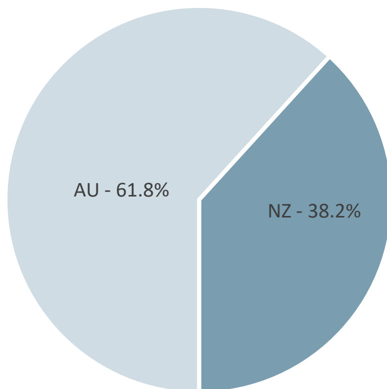
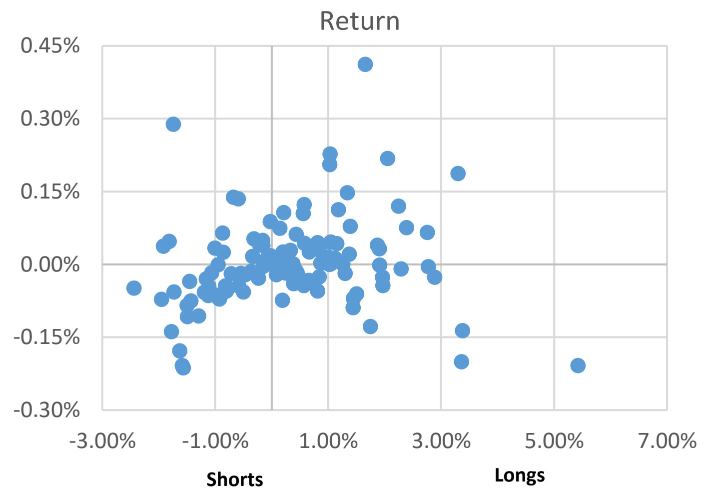
Country Allocation at 30 June 2019 (Gross Equity Exposure)



June 2019 Individual Stock Contribution



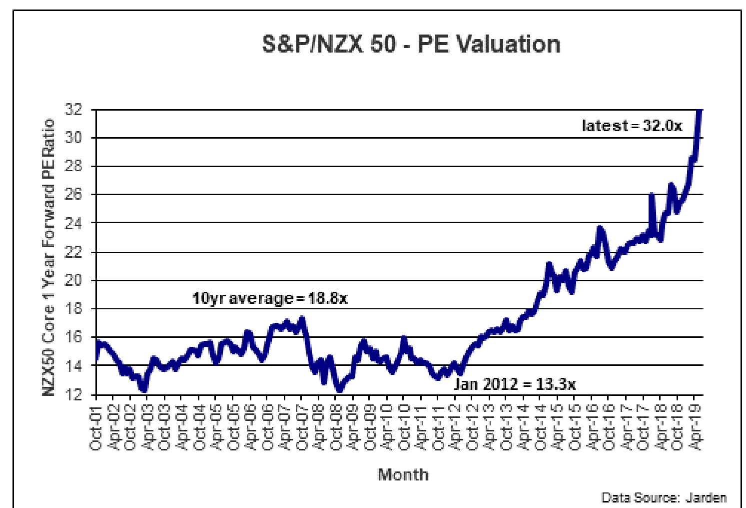
Fund Commentary

Dear Fellow Investor,

The Fund delivered a satisfactory return of +0.42% after all fees and expenses during the month of June. A number of pieces of bottom-up stock selection worked well although our overall performance was held back by inexorable advances in a number of our large cap short positions. These rose particularly sharply in the last 15 minutes of the quarter and have long since ceased to have any fundamental valuation crutch. This does however leave us well placed to add value from the short-side when the inevitable reversal arrives.

The Fund returned +2.51% in the June quarter, meaning we have had only three negative quarters since inception on 30 June 2014. The Fund has now returned +43.5% after all fees and expenses, with thirty-six of the fifty-nine months having had positive returns. Our correlation to what can only be termed an equity market bubble remains zero and our volatility remains below that of balanced funds. This Fund provides a true alternative, seeking to grind out positive returns irrespective of the direction of equity markets. Current performance may look meagre relative to long-only equities but this could change quickly when the market turns. In a world where so many investment classes are expensive, we will continue to stay true to our mission.

As shown in the chart at right, the advance of the NZ equity market has accelerated over the last several quarters, with the PE multiple expansion going into hyper-drive to hit 32.0x. Hyperbolic share prices combined with earnings downgrades have been a high octane combination. One year-ahead earnings forecasts now sit 11% below the peak they reached back in April 2018. This is a measure that normally rises over time due to inflation and due to companies reinvesting retained earnings (except that many NZ companies overpay dividends given the current market reward for this).



Low bond yields explain a portion of the advance but we would suggest that a flood of passive money that simply has to purchase stocks based purely on market cap rather than on fundamentals is a key reason. Other drivers include an onslaught of yield-chasing money from bond market refugees and a late-cycle surge of money into growth and momentum funds which is particularly marked in Australia relative to globally.

Mercury rose by 21% in the June quarter and there weren't any upgrades, while Auckland Airport shrugged off small downgrades and slowly gathering regulatory headwinds to rise by 13%. We understand that AIA now features in over 100 separate ETF's of various hues. As another small example, Meridian Energy and Contact Energy are now more than 10% of a global clean energy ETF that has US$230m in FuM and appears to be growing quickly.

JP Morgan analysis of the US equity market estimates that 60% of shares are now owned by passive funds, while another 20% are in the hands of quant funds. Aggressive share buybacks funded by rising corporate debt levels are also a large part of their landscape. This leaves only a small portion of the market in the hands of active investors who are dedicated to price discovery and are actually trying to put a valuation on the future cashflows that a company will generate.

We do not know the passive percentage for NZ but would observe that it has been rising rapidly from a low base. Analysis by Macquarie Bank points to a staggering 35-40% of NZ daily trading activity occurring in the 15 minute closing match – this being the period when passive funds invest. More normal levels in other markets are 20-25%.

The state of affairs with the trend to passive was brutally summed up in a widely circulated blog post from the "Reformed Broker":

"*There are no asset managers who represent their strategy to clients as "We buy the most expensive assets, and add to them as they rise in price and valuation." That's unfortunate, because this is the only strategy that could have possibly enabled an asset manager to outperform in the modern era. It's one of those things you could never advertise, but had you done it, you'd have beaten everyone over the ten-year period since the market's generational low*."

The long sweep of financial history points to market innovation as being a precursor to many bubbles. This time around we would suggest that the seemingly unstoppable tidal wave of passive money constitutes that innovation. What will happen when there is a negative catalyst and investors pull their money? What say the liquidity of the ETF's proves greater than the liquidity of the underlying companies that they all invest in? To date, we have had a cocktail of ultra-dovish central banks, passive fund inflows and growth fund inflows which have combined to send markets in one direction, with only the briefest of spine-tingling interruptions.

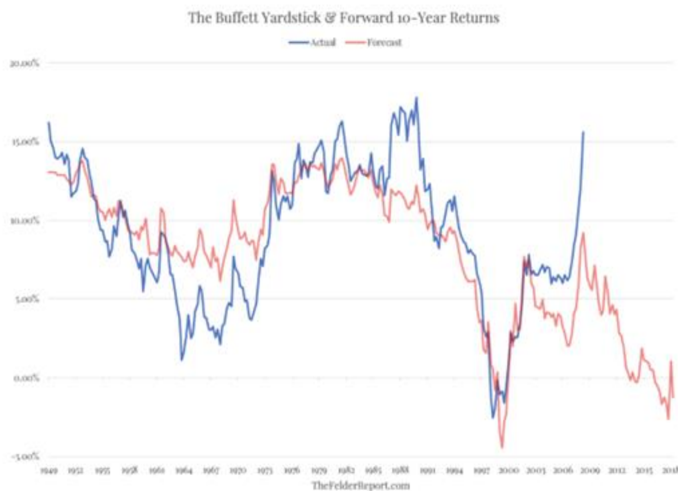
Our fear is that the drawdown that is necessary to bring in fundamental investors to stablise any sell-off could be very significant indeed. As just one little example, we would most certainly be interested in covering our Auckland Airport short but somewhere closer to our valuation in the $6.00-$6.50 region rather than its $9.85 quarterly close. It is easy to forget that AIA was sub $7 as recently as January. For the sake of our market, I sincerely hope we don't get that opportunity but believe that one day we will.

An obvious counter-argument to our fears of a bubble is that interest rates have plunged, so we simply need to use much lower discount rates in our valuations. We make two observations here. Firstly, the market risk premium has expanded to a degree, so discount rates should only fall for low beta stocks and may actually have risen for high beta names. Secondly, in a world that has little apparent inflation, analysts are being too optimistic when they plug in a very low discount rate but have the same old earnings and rental growth projections (which they then gradually downgrade).

Putting some numbers on this, Goldman Sachs looked at the performance of a basket of Australian "bond-proxy" equities over the long term. Over the last 20 years, these delivered an average yield of 6.1% and growth of 4.5%, giving a highly acceptable return of +10.6% per annum. Right now however, these bond-proxies yield 5.4% but only have forecast growth of 1%, making for a meagre +6.4% projected return. Arguments from the sell-side that the current gap of dividend yields to bond yields is at average levels should be put in the dustbin where they belong - the total return gap is far lower than normal. Refugees from the bond market are over-paying for equities.

In last month's write-up, we examined how Australian/NZ growth companies have dramatically outperformed those in other markets and are now easily the most expensive in the world. A piece from the GS global research team examined stocks that trade with an EV/sales multiple greater than 10x and found that they underperform on 1, 3 and 5 year horizons. The composition of this was most interesting. When their profit beats expectations, they outperform by 11% which is the same as the average stock which beats. However, when they miss, they fall by 32%, which is twice the average. There are numerous such stocks peppering the Australian and NZ bourses – better hope they make their numbers.

A slightly left-field way of looking at valuations and subsequent returns is to use the "Buffett Indicator". This is the ratio of the total value of US listed equities to that of US GDP. When the ratio is unusually high, it suggests that the share of profits as a proportion of GDP is unusually high and/or that the market is putting an unusually high multiple on those profits. The chart below has this indicator (inverted) in the red with subsequent 10 year market returns in the blue. Note how well this has functioned as a long term indicator and that it portends very poor returns from here.



A number of other indicators point to this bull market being at a very late phase of its evolution. The gold price spiked from $1280/oz to $1420/oz during June for no immediately obvious reason other than truly enormous speculative inflows; broader measures of share market strength are falling far behind the headline indices, with this seen in NZ in the record-setting gap between the average forward PE of 32x and a median that is "only" 19x; and we are seeing concept stocks such as Beyond Meat trade at 6-7x the price of their recent IPO and attain a $10bn market cap despite there being a plethora of competition in the space.

Meanwhile, back in the real world, yield curves are inverted, business outlook surveys are ranging between mediocre and weak, and earnings are being downgraded. NZ earnings forecasts are 11% below their highs of 2018, while according to Bloomberg, Q2 EPS growth estimates in the US have fallen from +6.8% to +3.6% since January. Cheery Australian analysts still have almost 10% earnings growth for the FY20 year despite the last two years coming in at circa 0% and the economic outlook being weaker rather than stronger – hmm.

A final remarkable feature of the month was the performance of property stocks. The NZ index surged by 6.0%, while Australia was up by 4.2% - held back only by a veritable flood of equity issuance. In no particular order, the last few weeks have seen raisings by Growthpoint $165m, Centuria Industrial $70m, Cromwell $375m, National Storage REIT $190m, GPT $850m, Charter Hall Long WALE $180m, Mirvac $825m, Arena REIT $50m, Investec Australia Property $102m, APN Industria $35m and Dexus $950m. Feed the ducks while they're quacking….

The Fund was generally well positioned for the bulk of these deals and used them to either establish new longs or close off pre-existing shorts. That said, memories of the vast issuance in 2007 and early 2008 came flooding back as bidding interest was fierce. When the cost of equity converges towards the cost of debt, it is perfectly rational for companies to raise. Given our positioning, we are hoping that this will continue.

NZ saw no use made of extremely elevated share prices by the listed property trusts or utilities, with a particular disappointment in recent times being Vital Healthcare Property's decision not to proceed with the Healthscope Property deal. While agitators correctly claimed that it would be EPS dilutive, our analysis pointed to it delivering a much higher quality portfolio and a perfectly acceptable IRR in the 7%'s given the properties had 20 years of 2.5% rental growth locked in.

Returning to the performance of the Fund during the month, the return of +0.48% (pre fees and tax) was comprised of +1.84% from the long side and -1.37% from the short side as we battled into strong markets. The winners to losers ratio was a solid 54% and there was no particular skew in terms of contribution size.

In some ways, it was a minor miracle that the Fund was up for the month given that several of our highest conviction positions were major headwinds. These were led by the large short in Auckland Airport (AIA, +12.4%) which has risen vertically since the end of April despite modest earnings downgrades along the way. It closed at $9.85 versus an absolute valuation that we can torture to $6.50 and a relative valuation that gets to around $7.00. When something changes, there is a large air-pocket before fundamental support kicks in.

The second key headwind was our large long in Tower (TWR, -3.8%), which drifted back randomly on light volumes. Every piece of feedback that we receive on TWR continues to point in the right direction. Premium growth is comfortably exceeding claims cost inflation, claims ratios are low, there is an absence of storm activity, industry feedback suggests Christchurch overcap claims have quietened right down and the IT roll-out seems to now be proceeding successfully, with new business being put on it and existing policies moved over upon renewal. This will drive material cost savings. On our conservative in-house modelling, TWR is on a PE of 10.0 - 11.0x Sep19 earnings (depending on storm costs), with growth averaging 15% in the two years following. That puts it on a third of the market multiple with far stronger growth and Bain owns 20%.

A third laggard of note was our large long in Pacific Current (PAC, -5.8%) which fell on no new news and despite strong equity and bond markets being of clear benefit to its fund management ownership business. PAC has frequently appeared on both sides of the ledger in these pages. The story is unchanged. It is on a Jun20 PE of 8.5x which has the first full year impact of recent acquisitions. Adjust the $220m market cap for approx $40m of net cash and we have a derisory PE of just 7.0x combined with a solid growth outlook.

Other headwinds included a short in the bubbly dot.com company, Wisetech Global (WTC, +13.8%) which we view as the epitome of extraordinarily overpriced Australian growth stocks, with the added bonus that it only has modest levels of organic growth. Another headwind was our slightly premature short in the health

insurer NIB Holdings (NHF, +12.0%) which we put on after their post-election surge. While the market is clearly correct in viewing the Liberal Coalition as being friendlier to the sector, it remains a very difficult space with continued cost pressure forcing healthier young people to downscope or drop out. A forward PE of 24.5x seems rather aggressive in the circumstances.

The stand-out winner was our large long in Monash IVF (MVF, +18.2%) which continued the very strong run it has staged since January. We felt like the only buyers in the world in the low $0.90 region but we have since lightened a little in its run to the mid $1.40's which is starting to get closer to fair value. MVF has now cycled the disruptive loss of a key Melbourne specialist, low cost competition appears to be abating, their core business is growing nicely in line with its modest structural tailwinds and Asia is going well for them. MVF is a classic example of providing a great buying opportunity when it was butchered by forced transitional selling amidst mandate losses and fund closures in Australia.

The second stand-out was our old favourite Bingo Holdings (BIN, +22.5%) which ran extremely hard ahead of its investor day near month's end. Salt attended this day and while it didn't deliver earth-shattering new information to our mind, investors now seem more comfortable with the strategic value of BIN's landfills and recycling sites and their ability to lift prices in NSW to take advantage of the new Queensland waste levy. Given the stock has nearly doubled from its lows, it is no longer one of our largest holdings.

Further tailwinds came from shorts in the investment platform providers Netwealth (NWL, -15.8%) and Hub24 Limited (HUB, -13.0%). These trade on extraordinarily high PE multiples in expectation of their positive operational leverage to structural change in the Australian financial planning industry. The problems are that the industry funds are the main winners, the retail platform space appears to have reasonable price competition and a sizeable proportion of earnings come from the cash spread on investors' money. This spread will come under tremendous pressure as the RBA cuts rates.

Other winners of note included a position we have built up in the extraordinarily volatile Emeco Holdings (EHL, +14.7%), which had been down by a similar amount in the prior month. The fundamentals of strong demand for mining equipment are no different from when EHL was almost twice its current share price back in September. A final stand-out was our long-suffering holding in Qantm Intellectual Property (QIP, +9.2%). We had sharply lowered this into earlier M&A activity in the segment and then built it back up aggressively when QIP was left at the altar. It now has almost no coverage but is on a PE of circa 12x, with a steady tailwind from gradual patent filing growth and near term potential upside from the weak A$ and possible benefits from the IPH/XIP merger.

Thank you for your ongoing investment and support of the Fund. While we didn't knock the ball out of the park, the June quarter marked a return to normality, where we ground out positive returns in both up markets and in the fleeting period of down markets. We are particularly focused on the latter as current abnormal conditions will painfully normalise at some point and we aim to be a safe harbour for a portion of investors' portfolios in the storm that surely lies ahead. We are sticking to our long established style and will continue to provide a true uncorrelated alternative to investors who cannot stomach these overextended equity and bond markets for 100% of their portfolios.

Finally, I would like to highlight several changes to the Salt investment team which we are extremely excited about. Firstly, welcome to Paul Turnbull as our Chief Investment Officer. Paul has many years of market experience and joins us from Jarden, where he covered a number of sectors and ran a very successful model portfolio. Secondly, welcome to Tristan Joll as a Senior Research Analyst/Associate PM. Tristan also joins us from Jarden and as a former INFINZ Analyst of the Year has long been one of the most respected analysts in the NZ market. Last but not least, welcome to Stephanie Mitchell who joins us in a newly created Head of Data Science role. Stephanie has a PhD in Space Engineering from Cal Tech and gives us market-leading capability to analyse the vast array of large data-sets which proliferate in today's investment world. Alongside these changes, we saw goodbye with gratitude to David Oxley and Andrew Bolland who made important contributions to the growth of Salt and have our best wishes for the future.

Matthew Goodson, CFA

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