SALT

Salt Long Short Fund Fact Sheet – January 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 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 2023

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$68 million
Inception Date	31 December2014
Portfolio Manager	Matthew Goodson, CFA

Unit Price at 31 January 2023

Application	2.1785
Redemption	2.1697

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 2023

Long positions	42
Short positions	31

Exposures at 31 January 2023

Long exposure	81.27%
Short exposure	43.27%
Gross equity exposure	124.54%
Net equity exposure	38.01%

Investment Risk to 31 January 2023

Fund volatility[1]	6.42%
NZ50G / ASX200AI volatility[1]	13.95%
NZ50G / ASX200AI correlation	0.079

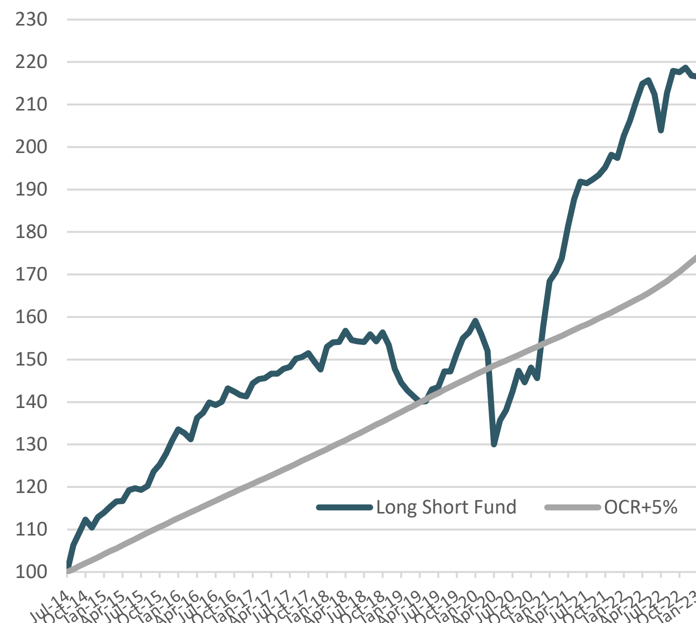
1. Annualised standard deviation since fund inception.

Fund Performance[2] to 31 January 2023

Period	Fund Return	OCR+5% Return	NZ50G/ASX 200AI Return[3]
1 month	0.19%	0.78%	5.27%
3 months	-0.79%	2.20%	7.59%
6 months	2.01%	4.26%	7.10%
1-year p.a.	5.23%	7.52%	6.29%
2 years p.a.	12.80%	6.45%	2.95%
3 years p.a.	11.65%	6.07%	3.99%
5 years p.a.	7.09%	6.26%	8.14%
7 years p.a.	7.28%	6.45%	10.31%
Inception p.a.	9.44%	6.78%	9.48%

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 January 2023

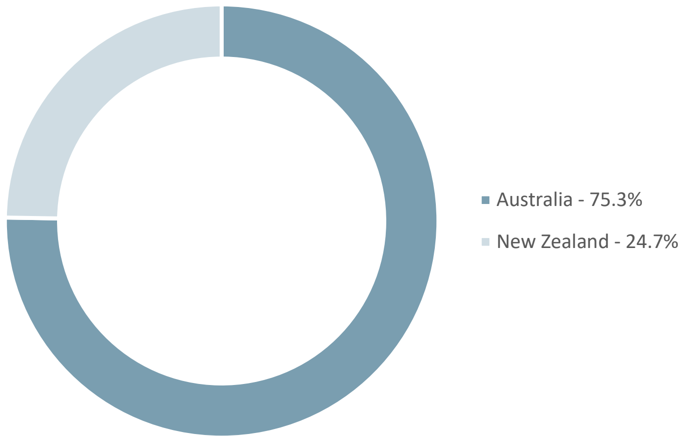


Fund performance has been rebased to 100 from inception.
Past performance is not a reliable indicator of future performance and no representation or warranty, express or implied, is made regarding future performance.

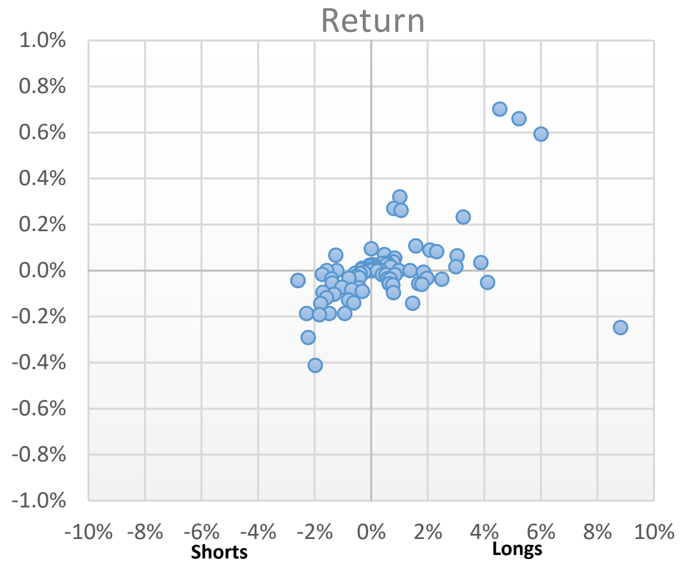
Largest Longs	Largest Shorts
Tower	Reece
GDI Property Group	Meridian Energy
Global Data Centre Group	Auckland International Airport
Monash IVF Group	Pro Medicus
Australian Vintage	Carsales.Com

SALT FUNDS MANAGEMENT
Level 3, The Imperial Buildings, 44 Queen Street | PO Box 106-587, Auckland 1143
P: +64 9 967 7276 | E: info@saltfunds.co.nz | www.saltfunds.co.nz

Country Allocation at 31 January 2023 (Gross Equity Exposure)



January 2023 Individual Stock Contribution



Fund Commentary

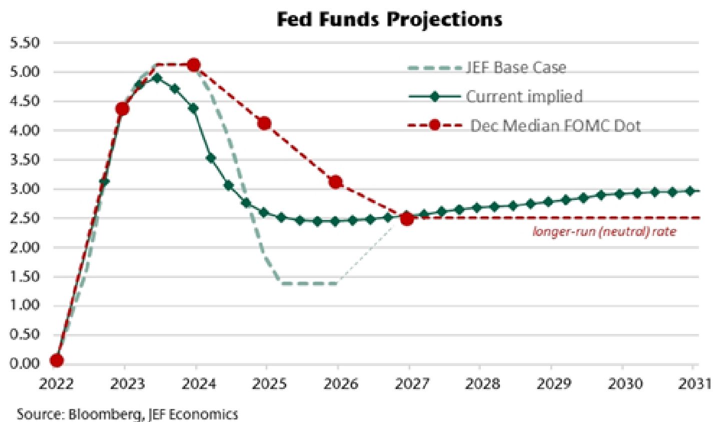
Dear Fellow Investor,

The Fund delivered a modest positive return of +0.19% in the month of January, continuing our pattern of near flat returns in sharp contrast to a backdrop of volatile markets which have gyrated both up and down. This pattern has been the case since end-August and reflects a mix of low gross exposure to markets and our long and short books counteracting each other. Under the hood, there continue to be a number of positive and negative movements – it is just that they are offsetting each other for now.

As this piece is being written in early February, markets are continuing their run from January and reacting euphorically to the 25bp Fed rate hike to 4.5%-4.75%. The focus appears to be on comments from Fed Governor Powell that "the disinflationary process has started" and a seeming lack of concern over looser financial market conditions, rather than on the Fed's expectation of "ongoing" rate hikes and that "it's premature to declare victory over inflation."

The market reaction is also notable for a rotation out of Covid-winning sectors into technology and REIT's. Junk technology has led the way as exemplified by a +40% run in the ARK Innovation ETF so far in 2023. It's now back to $44 versus its $156 peak. However, when something falls by 80%, it has to rise by 500% to get back to where it started.

As shown in the chart below, the US market is now pricing in a peak Fed funds rate of just below 5%, with 50bp of rate cuts by early 2024 and a return to a Goldilocks nirvana of 2.5% rates in early 2025.



To paraphrase our economist, our view is that the market is both right and wrong. It is right in the sense that inflation has clearly peaked but it may prove wrong in the sense that there will likely be no rate cuts for a long time to come. Now that price inflation has spilled over into wage inflation, it will be a long hard slog for central banks to return to their targeted ranges in the 1%-3% region. Instead of Goldilocks, this implies a grinding period of potentially recessionary conditions. This carries markedly different investment implications.

This was shown in NZ by the latest ANZ Business Outlook survey for end-January. Firms' own activity outlook bounced

to a still very weak -15.8 versus its previous GFC-like reading of -25.6. However, selling price intentions actually rose a touch from +59.1 to +62.4 and cost expectations went from +84.4 to a scarcely believable +91.3. This feels like stagflation not Goldilocks.

The Australian central bank also appears to have considerable further work to do beyond the tentative baby-steps it took in 2022. Their latest monthly inflation reading in November saw the "core" trimmed mean inflation reading rise to +5.6% from +5.4% previously.

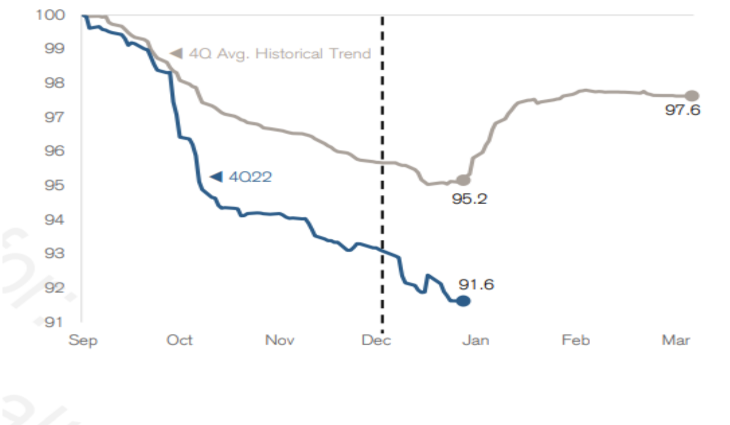
The inflation outlook does appear more nuanced and hopeful in the critical US market. The Citi US Inflation Surprise Index soared from -20 to +85 over an 18-month period to mid-2022. It has since collapsed back to +14. This is still above from the consistent readings of -10 to -20 in the Goldilocks period pre-Covid but it is moving in the right direction.

Within the overall inflation readings, what appears to be happening is a stark and entirely logical divergence between goods and services markets. Destocking post Covid hoarding and falling transport costs has seen core goods inflation fall to +2.1% y/y but core services inflation is running at +7.0% y/y. Services have a high dependence on labour costs. As just one example, Uniqlo's parent, Fast Retailing has decided to lift wages in Japan for the first time in decades – by as much as 40%!

Right across the Western world, we have seen a paradigm shift in unemployment rates into the low-mid 3% region and surging wage inflation. This is the critical factor to focus on in 2023 – it is only once unemployment rises and wage inflation slows that central banks can take their foot off the brake and financial markets can have a more sustainable rally than the speculative fluff we saw in January and early February.

Given our view that central banks have to keep running tight monetary policy, the question then becomes whether this portends a recession or merely a period of slow economic growth. The distinction is perhaps just a matter of degree but there can be little doubt that a difficult period for earnings growth lies ahead across most markets. NZ business outlook measures are very weak and the US Conference Board Leading Economic Indicator Index fell for the tenth month in a row in December and is at levels consistent with past recessions. US M2 growth has now gone negative for the first time since the late 1930's.

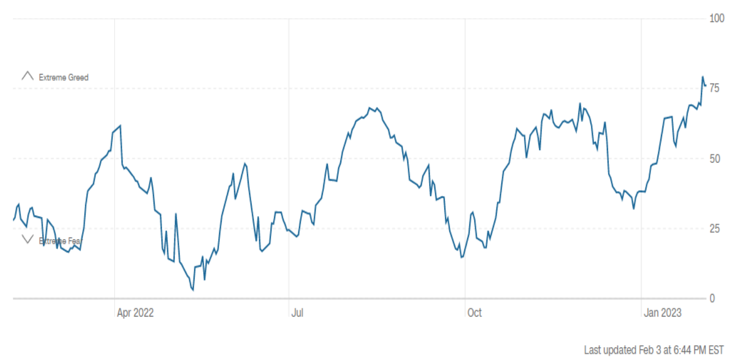
Figure 7: Path of 4Q22 Bottom-Up S&P 500 Consensus EPS



Source: Credit Suisse US equity strategy

We argued in last month's write-up that global and particularly US earnings are far above trend growth and therefore vulnerable to a pullback. As shown in the chart above, we are certainly beginning to see that come through and downgrades will likely continue given the state of leading economic indicators. This was ignored in the speculative fervour of the January rally which went all in on Goldilocks rather than considering falling earnings forecasts, outright declines in M2 growth and a deeply inverted yield curve.

The CNN Fear & Greed Index summaries 7 key investor sentiment indicators and has historically been a very useful contrary indicator. Its recent timeline is shown below and it has entered the "extreme greed" region for the first time in well over a year.



Meme stocks surged with there being numerous examples of 50-100% runs in near-insolvent names, with my favourite being Carvana's (CVNA) 114% spike. It is now back to $14 versus its $360 peak. At the less speculative end, one US broker noted that large cap short covering in Jan23 was the most since Jan21 and was in the 98th percentile versus the past five years.

Put all this together and we see January as an anomaly that leaves our overall market view unchanged. We would be

extremely surprised if the junk-stock led surge in January was to set the tone for the rest of the year.

Don't fight the Fed - central banks are trying to remove liquidity, not add it. Inflation has peaked but by becoming embedded into labour markets, it will force monetary policy to be tighter for longer than markets are currently pricing. This will see an economic outlook across Western markets that is tepid at best and recessionary at worst. This will create ongoing earnings downgrade risks at a point where earnings are well above trend and multiples on these earnings are high.

We expect these fundamental risks to return into focus. Hopefully they will create a good contrarian entry point at some stage but first we need to see markets re-price for weaker earnings and a higher interest rate path, combined with evidence of weakening wage inflation to take the pressure off central banks to do even more.

Despite its housing bubble deflating, Australia looks best placed given its dovish central bank, its leverage to China re-opening and its willingness to entertain strong immigration-driven population growth. The hard part is finding stocks there which aren't fully priced, especially at the larger cap end of town.

Fund Performance in January

Returning to the Fund's performance in the month of January, the overall return of circa +0.22% pre fees and tax was the net outcome of the long book contributing +2.92%, while the short book detracted -2.70%. Our "winners to losers" ratio was a mediocre 52%, the lowest for some time.

We had a number of strong positive contributors from our longs but these were largely offset by almost all of our shorts hurting us in what was a Goldilocks month for the over-priced story stocks that we tend to like shorting. We had been somewhat further ahead until the very end of the month when the heavens opened in a deluge upon Auckland and our large Tower Limited (TWR) position ended up falling -2.8% after being +3.4% earlier.

Should we be concerned about TWR's exposure to the Auckland floods? In short, no. Their Sept23 year guidance incorporates $30m of large event losses. Their exposure to large single events is to the first $11.9m, with reinsurance covering the balance. While the Auckland rains were over several days, we believe the single event definition covers 7 days. So, TWR will certainly pay $11.9m and they now have 8 months left in the year, with $18.1m of large event loss headroom left. This takes away some potential upside and creates more risk for the remainder of the year but that is the extent of the impact. Looking forward, reinsurance costs will undoubtedly rise but so will the insurance premia charged by TWR and all their competitors.

The Fund's positioning changed somewhat over the month as we used market strength and volatility to lift our gross from a record low 115% to a still moderate 124.5% at month's end. Our net exposure declined from 44% to 38% in a natural reflection of finding more short-selling opportunities as markets ran hard. Our style means this is still a relatively neutral exposure to markets but is perhaps now tilted a touch to the downside.

We continue to have no correlation to long-only equities. The 50/50 index of Australia and NZ had a remarkably low number of just five down-days in January, with only one of them being of any magnitude when the ASX fell 1.31% on 3 Jan, when NZ was closed. The average decline on those days was a mere -0.24%. Our return on those five days averaged a derisory -0.02%. The Fund's performance has no correlation to what long-only markets are doing.

The largest positive contributor was a sharp turnaround in our long-held Global Data Centre (GDC, +14.4%) position. There was no news in the month but GDC did deliver an update just prior to Christmas which provided guidance slightly ahead of our expectations. We retain a clear view that GDC is very cheap and would be a great platform for an unlisted infrastructure investor whereas it is sub-scale in its current listed incarnation.

Another strong tailwind came from a satisfying turnaround in the previously painful GDI Property (GDI, +12.6%). GDI announced two separate sets of positive leasing news which was the catalyst we had been hoping for. Even with its rise to $0.82, GDI remains at a massive discount to its NTA of $1.27, and unlike many names in the sector, we think there could even be a little upside to this given the leasing successes, existing cap rates of 6.6% that are quite conservative (valuer not being pressed by an external manager) and a Perth office market that is clearly stronger than other main cities.

The third positive stand-out was another turnaround from last month in the form of our large long in Monash IVF (MVF, +8.9%). We bought steadily into the weakness which had been for no reason that we could pin down and we lightened a touch into this month's bounce. We retain strong conviction that MVF is a long term structural growth stock as women throughout Australia and Asia increasingly turn to ivf as a natural outcome of having babies at an increasingly older age.

Aside from these large contributors, three of our smaller longs did extremely well in January. Resolute Mining (RSG, +37.5%)

soared following a major increase in gold resources; Helloworld (HLO, +33.6%) rebounded from earlier sharp weakness; and our super-computer company, DUG Technology (DUG, +23.8%) is starting to become a reasonable sized holding as its share price keeps rising thanks to contract success. In our view, it still has sizeable potential upside given how the strong contract momentum and cheap multiples of future forecast earnings.

Headwinds came primarily from our short book, where not a single holding made a positive contribution of any note and only 8 out of 35 did the right thing and declined. The most painful was our long in the ultra-high multiple healthcare technology company, Promedicus (PME, 21.0%). They landed two small contracts with US hospitals that will add $5.4m revenue per year and this was enough to see $1.2bn added to their market cap. PME is now on a forward PE of 121x and we have found with successfully trading it in the past, that it tends to have a very high beta to gloom or euphoria amongst growth stocks. It is a good contrarian play on a return to gloom.

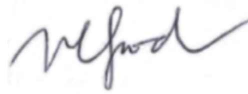
The second key detractor was our large short position in the plumbing supplies distributor, Reece Group (REH, +13.7%). REH has a reputation as a well-run company and we see no reason to doubt this. However, it is running into ever stronger headwinds in the US and Australian markets which seem rather inconsistent with its currently projected PE (on current forecasts) of 26.4x Jun23 and 27.5x Jun24 earnings.

After that, the detractors were smaller in line with the generally smaller position size in our shorts. The movements were broadly correlated thanks to the risk-on rally and featured names such as Technology One (TNE, +10.7%), Breville Group (BRG, +23.2%), Auckland Airport (AIA, +8.8%) and Iluka (ILU, +13.3%). Our large long in Tower (TWR, -2.8%) also weighed a little.

Thank you for your continued support of the Fund. The month saw a continuation of our recent pattern of relatively flat returns with the long and short books broadly offsetting each other. This contrasts with markets that have been sharply up or sharply down. This is consistent with the Fund's aim to generate equity-like returns over time but to do so with far less volatility. January generated a number of opportunities to lift our gross exposure and we expect the February result season to do likewise.

As this is being written in early February, markets are running hard as they take a view that central banks are relatively close to finishing their hiking cycle. This view may prove correct but the spill-over of inflation into labour markets means we think it will be quite some time before any easing cycle can begin in countries such as NZ, Australia and the US. This contrasts sharply with current market pricing and sets us up for a year where markets oscillate between risk-on and risk-off modes in their evolving views around monetary settings.

It didn't work in January but "don't fight the Fed" has generally proven a wise policy. We will continue to run this Fund to be uncorrelated with these swings in long-only equities, while continuing our track record of grinding out positive returns irrespective of the market backdrop. If the market is +20%, we want to be +10%; if the market is -20%, we want to be +10% - that is the goal we will continue to pursue.



Matthew Goodson, CFA

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