# SALT

## Salt Long Short Fund Fact Sheet – June 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 June, 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 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 30 June 2023

| | |
|---|---|
| Application | 2.3027 |
| Redemption | 2.2934 |

### 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 2023

| | |
|---|---|
| Long positions | 56 |
| Short positions | 40 |

### Exposures at 30 June 2023

| | |
|---|---|
| Long exposure | 103.87% |
| Short exposure | 60.12% |
| Gross equity exposure | 163.98% |
| Net equity exposure | 43.75% |

### Investment Risk to 30 June 2023

| | |
|---|---|
| Fund volatility[1] | 6.40% |
| NZ50G / ASX200AI volatility[1] | 13.81% |
| NZ50G / ASX200AI correlation | 0.076 |

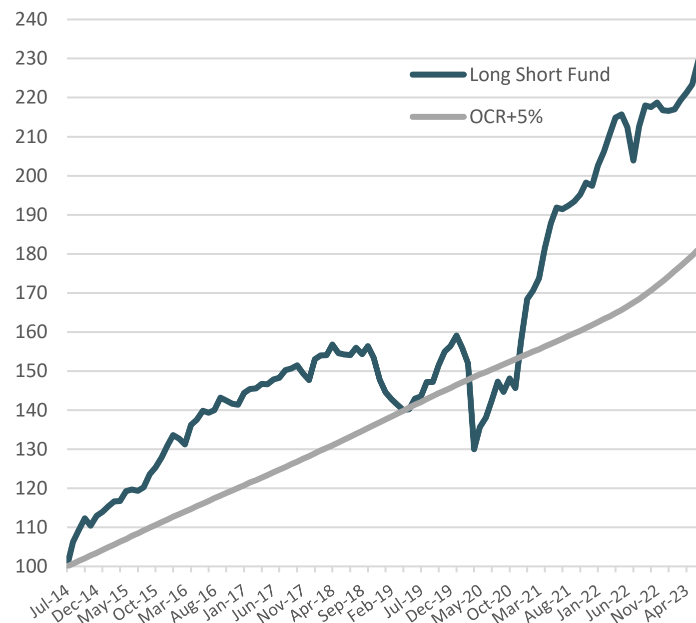
1. Annualised standard deviation since fund inception.

### Fund Performance[2] to 30 June 2023

| Period | Fund Return | OCR+5% Return | NZ50G/ASX 200AI Return[3] |
|---|---|---|---|
| 1 month | -0.05% | 0.82% | 1.32% |
| 3 months | 3.66% | 2.47% | 0.64% |
| 6 months | 5.90% | 4.80% | 4.20% |
| 1-year p.a. | 12.48% | 9.02% | 12.11% |
| 2 years p.a. | 9.45% | 7.41% | 0.30% |
| 3 years p.a. | 17.19% | 6.68% | 6.78% |
| 5 years p.a. | 8.28% | 6.52% | 6.82% |
| 7 years p.a. | 7.38% | 6.60% | 8.75% |
| Inception p.a. | 9.66% | 6.92% | 8.90% |

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 30 June 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 | Fortescue Metals Group |
| Global Data Centre Group | Goodman Property Trust |
| Lynch Group Holdings | Brambles |
| Monash IVF Group | Meridian Energy |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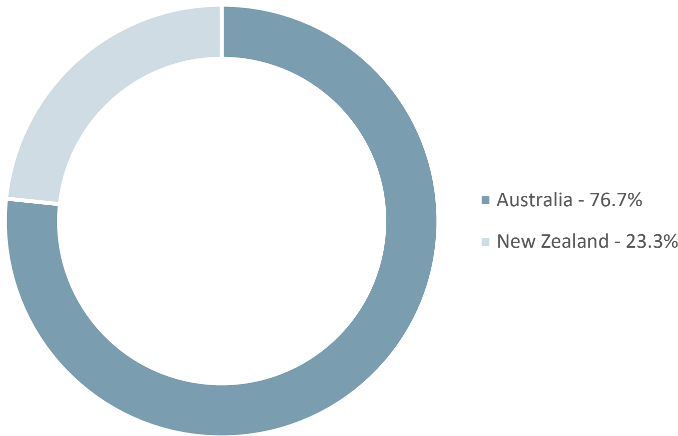
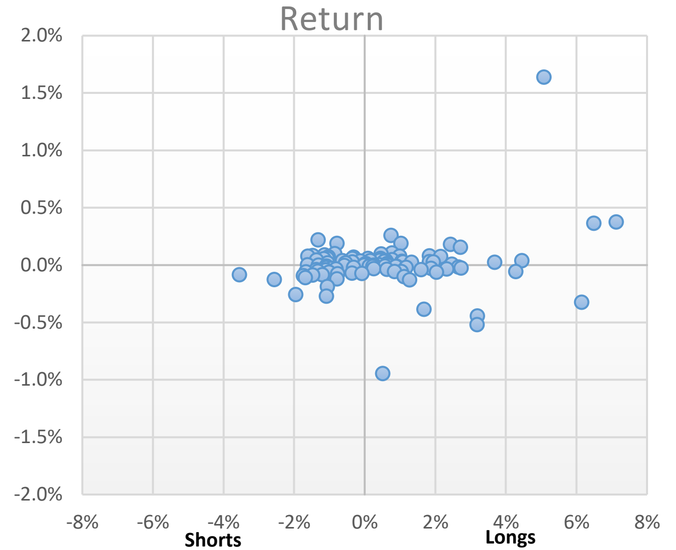
**Country Allocation at 30 June 2023 (Gross Equity Exposure)**




**June 2023 Individual Stock Contribution**




## Fund Commentary

Dear Fellow Investor,

The month of June saw a veritable roller-coaster of positives and negatives for the Fund, culminating in the delivery of a return of -0.05%. This lagged the return from NZ equities of +0.9% and Australia of +1.8%.

Looking at the overall June quarter, the Fund's +3.66% return compared favourably to +0.3% from NZ equities and +1.0% from Australia, especially when one considers that it was delivered with far lower volatility and no correlation to long-only equities.

Over the last several months, we sense a significant change in the underlying drivers of markets globally, with a misplaced return to hopium driving a small selection of ultra-expensive technology stocks through the roof to the exclusion of many other companies. Bond yields have generally risen, inflation has peaked but is falling too slowly for central banks to relax, and earnings expectations continue to be downgraded across many sectors and companies.

However, this seems to have been swamped by a delirium of excitement for anything to do with artificial intelligence. This has seen the Nasdaq 100 Index enjoy its strongest ever first half of the year, rising by +39% in a flurry of breathlessness. Meanwhile, boring cashflow generating companies have been quite weak, with the S&P500 High Dividend Index falling -6.4% in the first half. These relative movements set the scene for markets everywhere and one of the factors holding the Fund back a little in the June month was that we have gradually started shorting the bubbliest of the tech names in Australia, which have bobbed higher on the rising tide.

Our macro view remains boringly consistent. Inflation has clearly peaked but it remains too deeply intertwined with wage and service sector inflation for central banks to ease in the foreseeable future. Indeed, some further hikes may occur. Markets are still too optimistic in their timing about rate cuts, with this being a key risk to equity market performance.

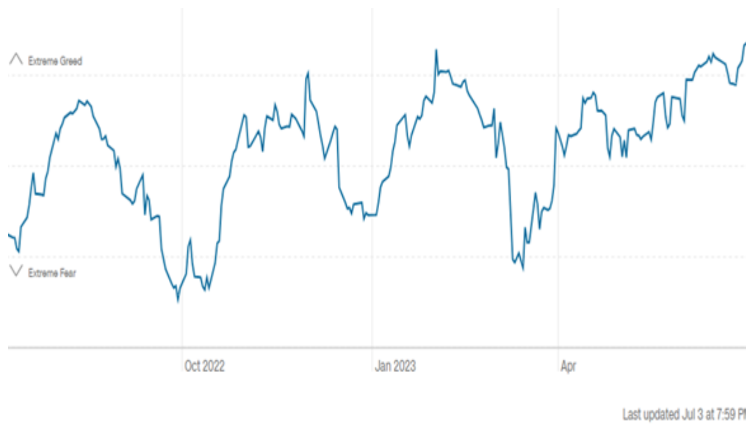
While the RBNZ appears to be firmly on hold until at least the October election, the RBA surprised with a 25bp rate hike to 4.1% on 6 June, accompanied with a bearish statement focusing on the upside risks to inflation from areas such as rental and wage inflation.

By mid-month, the Australian yield curve inverted for the first time since 2008. We find it hard to believe that Australia could have a recession but perhaps it may do so on a per capita basis. Late month saw a headline CPI at "just" 5.6% YoY versus expectations of +6.1% but this was driven mainly by volatile segments such as travel and food, with underlying inflation remaining very sticky. Early July saw them keep rates unchanged but further hikes are clearly possible.

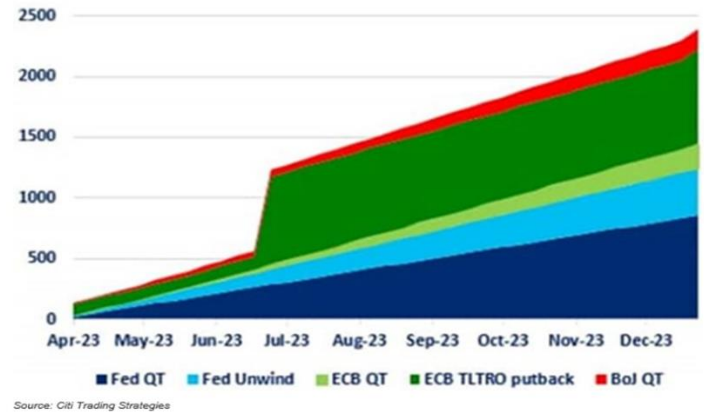
Similarly, US CPI inflation for May came in at just 0.12% but core inflation was sticky at +0.44%. The Fed paused rate hikes mid-month but the accompanying comments were very much along the lines of it being a "bearish hold" and that the July meeting will be "live". The PCE deflator for May saw goods inflation of just +1.1% but services inflation was +5.3%. Forget any cuts any time soon.

Normally, the tech sector is very sensitive to higher yields, as they imply a lower present value of far distant earnings. Instead, hawkishness from central banks was ignored, with the Nasdaq 100 surging +6.5% and the ASX technology sector returning +3.5% in the month and +22.1% in the quarter. What is happening? Should one "fight the Fed" after all?

Our take is that the emergence of Chat GPT has focused equity investors on the transformative potential of generative AI and no one wants to miss out despite profitable use-cases still being early stage. We are reluctant to be a Jeremiah here because no one saw immediate use cases when the Wright Brothers made it into the air. However, what matters is that a potentially transformative technology has grabbed the market's attention at a time when "liquidity" is plentiful. There is plenty of cash just dying to find an exciting home. The CNN Fear & Greed chart below shows we are firmly in "extreme greed" territory.




How can "liquidity" be so plentiful and "extreme greed" be so rampant when central banks have been tightening for some time? One possible answer is that Q1 bank failures across the US and EU saw a flood of liquidity pushed into the system, with central bank assets actually increasing so far this year and thence seeping out into investment markets. This might explain why equities have been so strong and credit spreads have remained very tight in the US despite a sharp tightening in lending standards and a lift in bankruptcies. The chart below suggests this may be about to change.



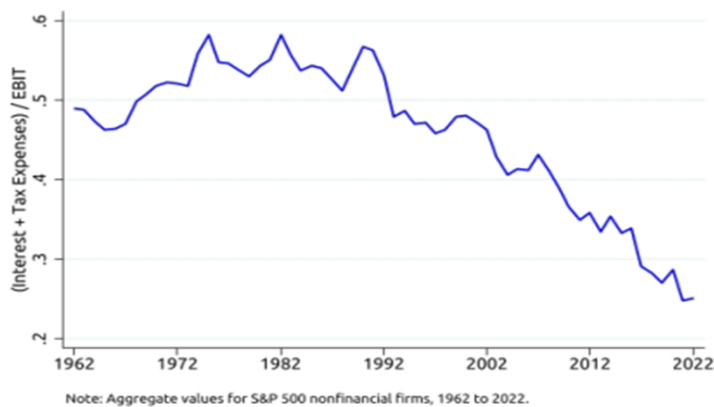

Quantitative tightening will gradually build over 2023 and will be kickstarted in the short term by Eurozone banks repaying EUR477bn of TLTRO loans at end-June. A further large liquidity drain not in the above chart may occur as the US Treasury sells T-bills to replenish its drawn-down accounts now that a debt-ceiling resolution has been reached.

If liquidity factors do reverse, then the two charts below suggest that any recoupling of tech stocks and the broader S&P500 to their normal bond yield relationships may prove rather problematic.

While this short-term valuation dislocation appears extreme, we also came across a longer-term perspective on market valuations in a Federal Reserve Paper titled, "End Of An Era: the coming long-run slowdown in corporate profit growth and stock returns"

www.federalreserve.gov/econres/feds/files/2023041pap.pdf

**Figure 1: Interest and tax expenses as a share of EBIT**




It shows that 40% of the real growth in corporate profits from 1989 to 2019 came from lower interest expenses and lower corporate tax rates. This partially explains the S&P500 rising by 5.5% real per year, while GDP only grew by 2.5% real. The rest of the gap came from an expansion in PE multiples due to a sharp decline in risk-free rates. Well, in recent times, nominal and real interest rates have clearly risen and US corporate tax rates are at record all-time lows at a time of large structural budget deficits.

Unless generative AI truly leads to a step-change in productivity and returns on capital, we are inclined to carefully short the sharp 1H23 rally of select tech names rather than chase it.

## Fund Performance in June

Returning to the Fund's performance in the month of June, our overall return was close to flat pre fees and tax, with the long book (+0.8%) and the short book (-0.8%) almost exactly offsetting each other. These relatively muted overall numbers did however conceal some large movements under the hood which we will delve into shortly. Our "winners to losers" ratio was a fairly subdued 55%, with offsetting single stock highlights and lowlights being the main driver.

The 50/50 index of Australia and NZ had 8 down-days in April, with the average return on them being -0.67%. Our net length over the month fell quite materially from 51% to 44% but ironically, we did not do quite as well on down-days as normal. We were up on only 4 of the 8 such days, with a flat average return on them of +0.01%. So, we still provided some protection but what we found is that positive and negative single stock movements dominated our returns during the month rather than any market correlation.

The biggest winner by a considerable distance was again our large long in Lynch Group (LGL, +37.7%) as it re-rated sharply after a very positive profit upgrade. After being a lead weight on the portfolio for some time, several factors that had hindered them have reversed as we had hoped – mainly, transport costs are falling and the Chinese consumer has returned post lockdowns. We are wary of the Australian retail backdrop but they seem to be defying the broader gloom, with a structural shift from florists to supermarkets perhaps helping. Despite rising by +58% over the last 2 months, we still see LGL as cheap. It is on a mid-teens free cash-flow yield and has significant high returning reinvestment opportunities in China.

The second largest contributor was well behind the first and came from a rebound in our large Tower (TWR, +5.0%) holding. No obvious news drove this unless one counts the absence of biblical floods for a month. An update from the largest NZ insurer, IAG did point to very encouraging trends in rampant 20%+ GWP growth, which supports our thesis that TWR could make extremely attractive profits over the next several years if claims revert to longer term averages. The main headwind which is being more than priced for is sharp reinsurance cost hikes. One further wiggle with TWR is that Pacific National Insurance appears to be creeping slowly up the register and now owns around 3% - they are an associate of Hollard Insurance, which is a top 5 player in Australia.

Another strong tailwind came from our large long in Global Data Centres (GDC, +5.1%). There was no news of any great note but it perhaps benefitted from the general artificial

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intelligence mania washing across markets. It is only a bubble if you aren't long it, so the totally rational price moves in this space are most welcome! On a more serious note, we see GDC as easily being worth well into the mid-$2 region on perfectly sensible valuations and a process is in place to realise that over the next few quarters.

Other wins came from a modest but well-timed long in the uranium miner, Paladin Energy (PDN, +33.9%) as the sector looks set to boom as many countries are turning to nuclear power to meet their carbon reduction targets. The data centre business, Macquarie Technology (MAQ, +14.8%) was another winner for us in the sector; a binding bid by Wesfarmers for our long in Silk Laser (SLA, +6.7%) was thankfully agreed; and our short in Bega (BGA, -20.8%) worked well as they are caught in a nasty pincer between the price they have to pay farmers for milk and the price they receive from the less than beneficent supermarkets.

Despite June being a positive month for markets, our largest detractors mainly came from the long-side and were a mixture of single stock landmines and very aggressive tax-loss selling in Australia, from which we expect a sharp rebound over the period ahead. We also began to short bubbly tech sector names a fraction too early but the pain from this was relatively minor and it leaves us well placed in the event of any market reversal.

By far the largest headwind was the rather tragic demolition of Pacific Edge Biotechnology (PEB, -79.5%). Given the two-sided risks, we only held a moderate position but unfortunately it played out the wrong way. PEB has the leading detection tool for bladder cancer, with this being backed up by an increasingly comprehensive body of research in leading peer-reviewed journals and enthusiastic support from leading US urologists. The quality of the PEB test has been franked by their ability to sign a deal with Kaiser Permanente, the leading US integrated health services company.

PEB's test has different sub-tests but in short, it provides exceptionally accurate negative predictive value for bladder cancer tests. If it says you do not have bladder cancer, you almost certainly do not. It is far more accurate than the existing FISH test and it is far cheaper and less invasive than the gold standard cystoscopy, which is carried out with a scope.

Being reimbursed by Medicare is crucial and this is determined by an outsourced assessor (Novitas), who issues a Local Coverage Decision (LCD), with this then applied nationally. Their evaluation process is quite distinct from Kaiser's. PEB was given LCD coverage by Novitas in July 2020. Then, in June 2022, Novitas surprisingly issued a draft decision for many diagnostic tests that linked coverage to third party knowledge bases (such as cancer treatment guidelines) that PEB is not yet part of. A further draft in July 2022 explicitly excluded PEB's test from coverage. PEB received clear advice at the time that this exclusion was unprecedented, would be most unlikely to hold up in a final decision and would be unlawful under the 21st Century Cures Act.

On 3 June 2023, Novitas issued a final decision upholding their draft. This was a major surprise. What we missed was the apparent desire of Novitas to defund a number of diagnostic tests, of which PEB was just one. Interestingly, the FISH Test has also been defunded leaving only the expensive invasive cystoscopy to be used. Why would Novitas do this and leave an unmet medical need? One possibility is that by cutting costs, they improve their chances of being appointed by Medicare to assess more regions – we underplayed this rather cynical and speculative risk. From here, there is some possibility of legal action or otherwise it will be a long, hard graft of further positive studies over the next two years to prove PEB's test at a level where it must be used.

The second key detractor was our long-held position in Australian Vintage Group (AVG, -14.0%), which delivered a moderate earnings warning. In short, while AVG is doing exceptionally well in delivering what they can control in terms of premiumisation and low/no-alcohol wine, we had underestimated just how difficult the entire wine industry is at present. We are also surprised that they are not seeing greater benefit come through from plunging shipping costs and a GBPAUD exchange rate that has moved in their favour. Just after month-end, they announced a strategic review and effectively put themselves up for sale. Their NTA of 97cps compares to their month-end share price of 40cps and recent EPS of 8.6cps in the June22 year. There is clearly potential for material upside.

A third notable headwind came from our long in Superloop (SLC, -12.1%), which had been a strong contributor the prior month. There was no news, so we can only surmise that it fell victim to aggressive tax-loss selling. Our thesis remains unchanged. We see SLC as having a strong balance sheet, generating solid free cashflow and having a competitive advantage in the highly competitive retail broadband/voice space due to having a lot of their own infrastructure and highly efficient marketing and customer management systems.

Other detractors came from a moderate holding in the Carbon Fund ($CO_2$, -21.3%) where the Government's dithering and policy confusion led to a loss of confidence in the Emissions Trading Scheme despite materially higher carbon prices being necessary to meet NZ's climate goals. GDI Property (GDI, -8.5%) continued to be a dead-weight on performance despite continued solid leasing progress – it appeared to be a victim of tax-loss selling. Shorts in the online furniture retailer, Temple & Webster (TPW, +23.8%) and the iron ore miner, Fortescue Metals (FMG, +15.4%) also weighed. We are very wary of the iron ore outlook. Strength in the month appeared to come from financial investors rather than end-market fundamentals. The Chinese property market is in some difficulty and material new sources of iron ore supply from West Africa are getting ever closer.

Thank you for your continued support of the Fund. June was a slightly frustrating month in that we made several very good stock calls but offset these by stepping on a couple of landmines. That is why we practise disciplined diversification. The quarter overall was highly satisfactory, with solid returns delivered with low volatility and no correlation to long-only equities.

Our macro view is unchanged. Inflation has peaked but markets have priced in central bank rate cuts far earlier and more aggressively than will occur. There is simply too much lingering inflation pressure in the labour and service sectors. Central bank comments and bond movements during the month accorded with this view but large segments of global equities blithely ignored this amidst large cap technology euphoria. With animal spirits being at extremes and liquidity likely to dwindle, we fear the risks to global equities from here. We have lowered our net positioning and have carefully begun to short a barbell of names that may be vulnerable to earnings downgrades and any technology sell-off.

Matthew Goodson, CFA

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