SALT

Salt Long Short Fund Fact Sheet – April 2020

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 April 2020

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$86 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 30 April 2020

Application	1.3621
Redemption	1.3565

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 April 2020

Long positions	58
Short positions	32

Exposures at 30 April 2020

Long exposure	89.06%
Short exposure	49.17%
Gross equity exposure	138.23%
Net equity exposure	39.89%

Largest Longs	Largest Shorts
Tower	Ryman Healthcare
360 Capital Digital Infrastructure Fund	TechnologyOne
Marsden Maritime Holdings	Goodman Property Trust
GDI Property Group	Sky City
Elanor Commercial Property Fund	Breville Group

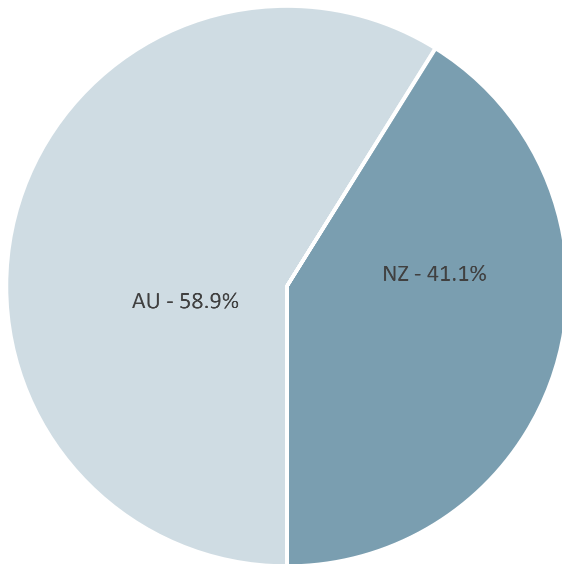
Performance[1] at 30 April 2020

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%	1.74%	-1.40%	-0.21%	-0.11%	1.20%	-1.06%	1.37%	-1.88%	-3.71%	-2.16%	**-5.50%**
2020	-1.26%	-0.97%	-0.96%	0.14%	1.94%	0.42%	2.56%	-0.03%	2.93%	2.34%	0.90%	1.70%	**10.02%**
2020	-2.01%	-2.51%	-14.47%	4.35%									**-14.73%**

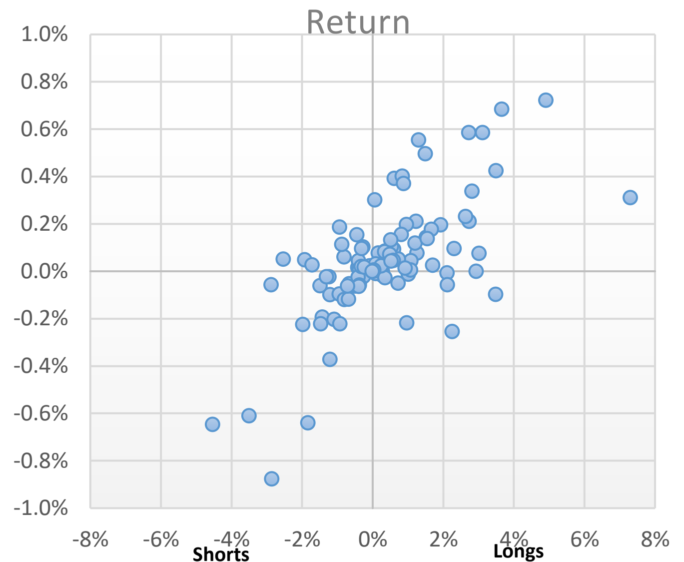
Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	-12.98%	1.35%	-15.26%
6 months	-10.45%	3.35%	-8.00%
1-year p.a.	-3.26%	6.06%	-0.14%
2-years p.a.	-6.33%	6.40%	5.45%
3 years p.a.	-2.57%	6.52%	6.91%
5 years p.a.	2.61%	6.86%	7.90%
Since inception p.a.	5.37%	7.09%	8.84%

[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.

Country Allocation at 30 April 2020 (Gross Equity Exposure)



April 2020 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

The Fund experienced a sharp rebound in the month of April, with a return of +4.35%. Pleasingly, this did not occur from simply taking on risk to chase the bounce in markets. As we will detail shortly, we question whether April's central bank driven sugar-rush in markets can be sustained and we have positioned the Fund accordingly, with net length generally being in the high 30% to low 40% region and comprising a variety of defensive names.

In common with many non-short biased hedge funds, we had struggled mightily in the month of March. Analysing what happened then, we concluded that the strategy was correct but the tactics were flawed.

Our strategy had been to position for a major economic hit from Covid-19 (correct), which would see central banks cut rates and crank up the printing press (correct), which would spark a boom in high yielding equities such as REIT's which we had become heavily net long (incorrect). Our mistake was that we didn't expect extremely tough lockdowns to be enacted, that rental contracts would be voided in some cases and that a sheer panic for liquidity meant that being long anything other than 50x PE healthcare stocks was a mistake. Despite an environment of plunging real interest rates, even gold stocks struggled to work. The protection that we thought we had in place proved ineffective.

Pleasingly, this protection worked during April. Looking at our performance on down-days for a 50/50 mix of the NZ and Australian indices, we again delivered the sorts of numbers that have been the case in the past. There were seven negative days for the 50/50 index, with an average return on those days of -0.89%. By contrast, we delivered positive numbers on five of those seven days, with our average return being +0.37%. There were some quite remarkable divergences, with April 2 for example seeing NZ -1.98%, Australia -0.56% and LS +0.91%. April 22 saw NZ +0.0%, Australia -1.12% and LS +0.99%. Another takeaway is that volatility has picked up sharply across both markets and the Fund. Interestingly, May 1 saw NZ -0.79%, Australia -5.01% and LS +0.35%. There is a long way to go this month but we feel as though we are once again well placed.

April saw a major switch from stomach-churning FEAR to greed-driven FOMO – the fear of missing out, with quite staggering rallies in some names where solvency remains a serious ongoing question. The apparent willingness of markets to support a veritable gush of equity raisings has seen solvency fears recede for now. Apparently, if you're going bust, you can just raise equity to cover projected losses until a hoped-for V-shaped revival.

As just one example, Air NZ (AIR, +58.2%) spiked on a retail investor driven surge, which almost appeared to be driven by a misunderstanding that the Government is bailing them out as suggested by a prominent radio host. Two of the more prominent DIY retail brokers accounted for one third of all turnover and almost all the net buying at one stage during the month.

Our take on the sombre reality is that this fine airline will survive and perhaps even prosper again in the future but current equity holders may own little of it when it does. No business with high fixed costs can survive a sudden cessation in revenue for long. AIR is burning cash faster than jet fuel and its formerly permanent positive working capital difference is falling sharply as ticket refunds and credits have to be issued. AIR also has significant out of the money oil hedges. Put this together and the onerous Government debt package must surely have a high likelihood of being converted into

equity, heavily diluting current holders. The share price may come under pressure as this possibility becomes more obvious.

A fascinating aspect of the Covid-driven markets of the last few weeks has been a surge in retail activity, not just in NZ but around the world. The presence of Sharesies has become far more noticeable in the NZ market, while all key retail brokers in the USA have been reporting record account openings. TD Ameritrade reported 608k new accounts in the March quarter with two thirds of them opened in the month of March, while E*Trade reported 303k and Charles Schwab 609k. Robinhood also reportedly experienced record activity levels. The number of daily trades on Ameritrade has reportedly risen from just under 1m to just under 3m. All this squares with the observation that we have seen an unusually high number of volatile daily price moves and that they have generally occurred on very light volumes. It is also concerning regarding the sustainability of the April bounce.

We generally include the one-year forward PE chart for the NZ market in this write-up but have chosen not to this month as its value is rather limited at present. Earnings forecasts are in the midst of being downgraded sharply and investors are focusing further out into a post-Covid world in any case. One year forward multiples currently include part of the Covid cataclysm and part of the hoped-for revival. For the record, the one year forward core PE is a record high 33.8x but the median is only 16.5x using Jarden forecasts. The 10-year bond yield is a heavily repressed 0.79% but risk premia for all assets have blown out sharply, making it less useful as a discounting tool by itself.

This brings us naturally to the first of a series of questions we have about economies and financial markets over the period ahead. As illustrated by the somewhat jarring screenshot from CNBC's "Mad Money" below, will central bank liquidity trump the reality of dismal economic and company fundamentals? Will central banks save Wall St but not Main St? Is saving the former even viable without saving the latter?

Citigroup strategists coined this conundrum of the real economy versus the financial economy as being, "when liquidity meets insolvency". The former triumphs until the latter takes hold.

At an individual stock and sector level, there are clearly areas of solvency concern while there are other areas that will be just fine. As investors, our style means we always find it hard not to anchor to valuation but one can certainly paint a scenario where a gush of liquidity pushes names that are perceived as "safe" up to very extended multiples indeed. Throughout April, markets experienced a very volatile "risk on, risk off" environment, where expensive "safe" names would outperform sharply one day only to give it all back the next as investors sought exposure to oversold cheaper names that will benefit in a post-Covid environment.

Historically, "value" stocks and "small cap" have tended to outperform once the bottom of the economic cycle has been reached as they tend to have the most operating and financial leverage to a recovery….if they make it through. As shown below, they certainly have some catching up to do.

Figure 7. Russell 1000 Value rel Russell 1000 Growth

Source: FactSet and Citi Research – US Equity Strategy

At a broader economic level, debt issuance is ballooning and credit quality is weakening at a time when there is already a huge global debt overhang. Many economists consequently point to the risk of a debt-deflation cycle. The table below from Macquarie paints a sobering picture of just how extended global debt levels are compared to one, two or three decades ago. The world is uniquely vulnerable to the sudden stop created by Covid-19.

Fig 13 Global Debt Level (US$ trillion) (% GDP)

	Households	Non-Financial Corporates	Financial Corporates	Government	Total
US$ trillion					
1990	10	10	7	10	37
2000	17	24	24	21	86
2007	35	43	54	35	167
4Q2019	48	74	63	70	255
% of GDP					
1990	41%	41%	29%	41%	151%
2000	44%	72%	59%	55%	230%
2007	58%	76%	87%	58%	279%
4Q2019	60%	92%	81%	89%	322%

Source: IIF, Macquarie Research, April 2020

NZ is relatively well placed compared to the dismal global picture, with government debt to GDP only being around 20%. This seemingly leaves ample room for massive fiscal expenditure without necessitating tax increases. However, thanks to our long-running hobby of swapping houses with each other at ever higher prices, household debt to GDP is far higher in the 95% region.

So, while the NZ government is planning to aggressively stimulate the economy on behalf of private consumers, there is less overall room than originally meets the eye. What will matter is that the quality of the fiscal expenditure is high and earns a return. Too many "bridges to nowhere" would create an overhang of debt that ultimately needs to be repaid by an indebted private sector, whose own debt levels are rising further due to this crisis. If the fiscal spend-up is unduly large or poorly directed, then an expectation of future tax increases will quickly see businesses and consumers pull back (this is known as Ricardian equivalence).

The dangers of a debt-deflation trap and the difficulties of using fiscal policy alone to lift economies appear to be well recognised by central banks. They have embarked on a veritable orgy of monetary policy easing, with four main prongs.

Firstly, an initial focus on preventing private credit markets from seizing up has succeeded, with credit spreads moving back in somewhat and corporates starting to let go of some of the large credit lines they had drawn down from banks. There has been a torrent of debt and equity issued in public markets. A generalised 2008 style seizure has been prevented.

Secondly, interest rates have been cut to as low as they realistically can be. In the case of NZ, this means an OCR of 0.25%. We expect it to stay at this level for a considerable time but also view a move to negative rates as being unlikely. The problem of deposit flight from banks disrupting their ability to lend appears to be recognised by the RBNZ.

Thirdly, many countries have moved down the QE path, using this to suppress interest rates along the yield curve. This is why NZ 10-year yields are now around 0.8%, while inflation is around 2.0%. A lesson post World War 2 is that one way to finance otherwise unsustainable debt burdens is by the financial repression of negative real interest rates. This requires a mix of both central bank accommodation and inflation.

The investment implications from this are to own gold (leases rates are marginally positive versus negative real interest rates) and any equities which have sustainable dividend yields in a world where growth and inflation are hard to come by. Negative real rates are also positive for long-dated growth companies, with the value of future earnings being worth more today. The hard part is buying them at reasonable multiples. Europe and Japan show that this is a very difficult environment for banks. Government bonds also appear a particularly poor investment.

Finally, if QE does not do the trick, then the Zimbabwean gambit of money printing is always a possibility. We discussed this at length in a NBR article during the month and Grant Robertson has made mention of it. See https://www.saltfunds.co.nz/post/could-helicopter-money-make-sense. There are two basic possibilities. Firstly, if the central bank never re-sells the bonds it purchases in QE, then it has effectively used newly created money to purchase government debt. One can argue that Japan has followed this script. Secondly, if there is a desire to stimulate Main St rather than Wall St, a good old-fashioned helicopter money drop would be great fun. In practical terms, this would take the form of crediting money to everyone with an IRD number. The one obvious constraint to printing money is that there many disastrous historical examples of inflation subsequently skyrocketing.

Putting all this together, our view is that we will see cyclical disinflation in the short term due to spare capacity, unemployment, pay reductions, plunging oil prices and deleveraging by consumers and firms.

However, if we look out to the post-Covid economy, we have a veritable gush of money creation; a gradual recovery in the velocity of the circulation of that money; a need to inflate huge global debts away; a reversal of globalization lifting costs; less immigration boosting wage inflation and a likely rebound in oil prices as shut-in supply cannot be returned quickly. The thesis is one of disinflation followed by inflation. When the switch occurs, we suspect there will be a sharp switch in performance away from the factors that have dominated equity returns in the last few years.

In the short term, the GDP growth outlook for NZ and almost all economies is ghastly and unemployment will spike sharply once the wage subsidy scheme ends. The chart below is from the monthly ANZ Business Confidence Survey and shows firms' expectations for their own activity over the next year. It tends to be a strong leading indicator for GDP growth and has collapsed to a degree that makes the GFC look like a picnic. Charts for most Western economies are very similar.

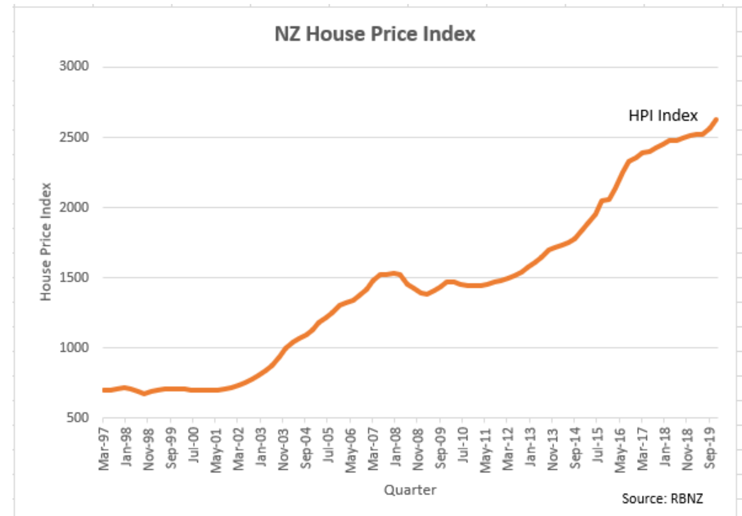
There are as many views over the shape and speed of the recovery from this abyss but a fair projection is that it may take 3 years plus for economic activity to return to its former levels. Quite simply, NZ consumers and firms will have more debt, less income and on average will behave in a way reflecting that we are all a little poorer. Savings will rise and while this is optimal for the individual, it is not optimal in aggregate for the economy. This tough economic reality will gradually filter through analysts' earnings forecasts.

Importantly, we suspect the sources of NZ's economic growth may move away from the three-legged stool of export growth, immigration and a housing boom. Exports are clearly in a solid position, with some segments set to do very well but it will take many years for tourism to return to its former contribution. Expecting immigration to return to its 60k+ heyday also looks most unlikely, while housing has a world of worries to deal with.

The net immigration plunge will hurt housing demand, the tourism bust will return short term rentals to the housing stock, NZ housing is hugely expensive relative to almost all other countries, unemployment will spike, bank lending will be constrained by limited deposit growth and concerns re customer solvency, housing supply has finally responded with a long lag and planning laws are set to be loosened.

The one positive is very low mortgage rates and these may staunch some pain. However, these present a classic case of money illusion. By capping them up into the price of a house today, you take on a large mortgage debt whose real value doesn't get inflated away like in the old days. Bulls also point to the RBNZ's high LVR lending rule removal but banks were already lending well under the 20% limit and we suspect the change was simply to stop a breach as house prices fall.

Few people realise that NZ house prices fell by 40% in real terms in the mid-1970's due to an immigration boom turning to bust, an easing of planning laws and major external shocks from both oil and the UK joining the EEC. One difference was high and rising inflation. History doesn't repeat but it rhymes. This time around, house prices have gone up so far for so long that no one seems able to comprehend that they might fall by more than 5-10% before they again begin an inexorable climb. Just like everyone thought in Miami and Phoenix and Madrid and Dublin et al in 2008…. As shown in the chart below, a 20% decline would merely return us to March 2016 levels. The retirement village sector is highly levered to both house prices and house sales turnover. In this environment, the investment implications should be clear.



A key assumption implicit in the April surge in financial markets is that Covid-19 is conquered and that economies will return to some form of normal. A re-imposition of lockdowns in Singapore (due to cramped immigrant worker accommodation) and Hokkaido (due to internal migration of infected people) illustrates that some risks do remain. The hodge-podge of uncoordinated responses and re-openings across US states is surely a risk given the Hokkaido experience. This risk will remain for some time and is one to ponder when considering overall investment positioning.

Returning to the performance of the Fund during April, the return of +4.43% (pre-tax and fees) was comprised of +8.66% from our long book and -4.23% from our short book. The "winners to losers" ratio was an extremely strong 67%, driven in part by having more longs than shorts and markets going up.

Unsurprisingly, our largest winners came from our longs and were chiefly names that had been hard hit in March. The stand-out was our large position in 360 Capital Digital Infrastructure Fund (TDI, +13.9%), which we were buying below cash backing at its lows in March and where our long-awaited catalyst of a buyback of over 30% of the free-float is just beginning to kick in. TDI is a mix of cash, high yielding investments in data centres and it is building a fibre network to connect data centres in Australia.

The second largest tailwind was our old favourite Marsden Maritime (MMH, +20.4%) which is very well placed to be an early beneficiary of "shovel ready" projects to revive the NZ economy. A resumption in log exports will also help and this has seen strength in their peer, Ports of Tauranga.

Our third highlight was more of a fallen angel in the form of our long-standing holding in Turners (TRA, +25.4%) which rebounded sharply

from the beating administered to it in March. There is absolutely no doubt that TRA is being heavily affected by the Covid-19 response, both in terms of car sales and their finance book. We believe they can likely make it through to the recovery without a dilutive equity raising although we wouldn't rule this out. However, raisings that delivers balance sheet surety have tended to be positive catalysts. Ultimately, the crisis will lift their market share and thence future profits but the carnage of Covid-19 has been an unwelcome intrusion on a path that they were well set on already.

Other winners included Qantm Intellectual Property (QIP, +17.1%) which is on half the multiples of the widely loved IPH Limited but whose core patent business benefits from the weak A$ and is similarly little affected by Covid-19; the mining equipment rental company, Emeco Holdings (EHL, +38.5%) which we largely traded out of into the vertical bounce; our old friend Shaver Shop (SSG, +40.3%); and GDI Property (GDI, +11.8%), which has little debt, is doing a rare buyback and is still on a 20% discount to NTA, giving you a large syndication business for free.

While we own some longs that are heavily exposed to volatile market movements, much of our long book is a collection of cheap and defensive names which should theoretically prove highly defensive to ongoing volatility. We therefore view our net length in the high 30% to low 40% region as being relatively market neutral.

Other key longs include our long-time favourite Tower (TWR, +4.4%) which is on a circa 10x PE with years of strong mid-teen earnings growth ahead. TWR is a rare beneficiary of Covid-19 as cars don't get driven, homes don't get burgled and long-standing Christchurch claimants potentially see the attractions of cash settlement. Yes, a good deal of TWR's claims experience will be shared by rebates to policyholders but it will still lock in a solid result.

Other key examples include: Elanor Commercial Property (ECF, -2.7%) which is on a sustainable low teen dividend yield to NZ investors, with over 90% of its tenants being government or large corporates; Vitalharvest (VTH, +0.0%) which is at a 30% NAV discount and whose partly variable rental stream will recover now that the Australian drought is over and has a huge market review uplift in five years that will deliver a dividend yield well into the teens for a NZ investor; and 360 Capital REIT (TOT, +9.3%), which is still at a 25% discount to $1.20 of ungeared NTA comprising $0.73 of cash and $0.47 of solid first mortgage investments.

Larger holdings in more common names include defensives such as Aurizon (AZJ, +10.9 %), Contact Energy (CEN +9.2%) and Spark (SPK, +8.7%). It is harder to find reasonable pricing in large cap land but we leap at it when we do.

Our short book naturally weighed on returns to a degree but has proven its worth in the beginning of May, with the Fund returning +0.35% on 1 May, when Australia was -4.95% and NZ -0.79%. That said, much will likely change as the month evolves.

Our largest headwind was the short we built up a little early during the month in Sky City (SKC, +42.2%). This business has experienced a sudden stop in its revenue at a time when the balance sheet has a number of calls on it. We also harbour concerns regarding post-Covid trading, with the international high roller business likely shut down for a considerable period, while much of the higher value end of the local grind market will lack the financial wherewithal that they formerly enjoyed.

Our large short in Ryman Healthcare (RYM, +17.6%) also weighed as it bounced with markets. Our view on the NZ house price outlook is clear and we have vivid memories of the moderate housing market decline in the post-GFC period when Ryman's share price halved and Metlifecare fell by 80%. House prices are far more extended now and the economic shock is greater. The key will be to watch the build-up in unsold retirement units, with the enormous leverage in the retirement village model making this difficult to finance. We are conscious of being something of a broken record here but it is only now that we have a clear catalyst for house prices to break that we have moved back to being net short the sector.

Another headwind came from being short one of our former favourite longs in Restaurant Brands (RBD, +48.1%) which experienced a staggering retail investor driven bounce and is now trading at pre-Covid levels despite sharply lower earnings expectations. Finally, we suffered from a bounce in our favourite IT company short, Technology One (TNE, +18.8%), whose unique accounting policies present it as a SaaS business when much of its revenues come from traditional IT implementation. They have not updated for any Covid impacts but it would be surprising if there was not a degree of disruption.

Thank you for your ongoing support of the Fund. We are living and investing in unprecedented times, with markets swinging violently as views change almost daily regarding the depths and duration of the economic downturn, the role of near-zero interest rates, the importance of very extended valuations, whether a vaccine or cure will be found for Covid-19 or whether there will be a second wave. We continue to be frustrated at our drawdown in March but as has been the case following past drawdowns, we will stick to our knitting and expect to claw that back and then some. April marked a strong start along that path.

Matthew Goodson, CFA

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