SALT

Salt Long Short Fund Fact Sheet – December 2022

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 December 2022

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 December 2022

Application	2.1743
Redemption	2.1656

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 December 2022

Long positions	44
Short positions	29

Exposures at 31 December 2022

Long exposure	79.29%
Short exposure	35.29%
Gross equity exposure	114.58%
Net equity exposure	43.99%

Investment Risk to 31 December 2022

Fund volatility[1]	6.43%
NZ50G / ASX200AI volatility[1]	14.00%
NZ50G / ASX200AI correlation	0.079

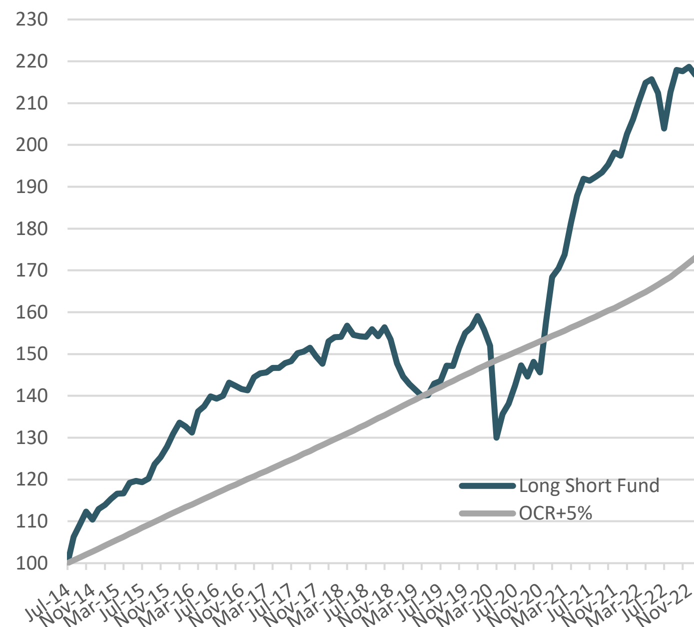
1. Annualised standard deviation since fund inception.

Fund Performance[2] to 31 December 2022

Period	Fund Return	OCR+5% Return	NZ50G/ASX 200AI Return[3]
1 month	-0.10%	0.73%	-1.94%
3 months	-0.48%	2.12%	6.55%
6 months	6.21%	4.03%	7.59%
1-year p.a.	6.89%	7.20%	-6.67%
2 years p.a.	13.39%	6.26%	0.49%
3 years p.a.	10.83%	5.97%	4.06%
5 years p.a.	7.19%	6.21%	7.04%
7 years p.a.	7.15%	6.43%	8.88%
Inception p.a.	9.52%	6.75%	8.92%

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 December 2022



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	Ebos Group
Monash IVF Group	Meridian Energy
GDI Property Group	Amcor
Global Data Centre Group	Auckland International Airport
Kina Securities	Carsales.Com

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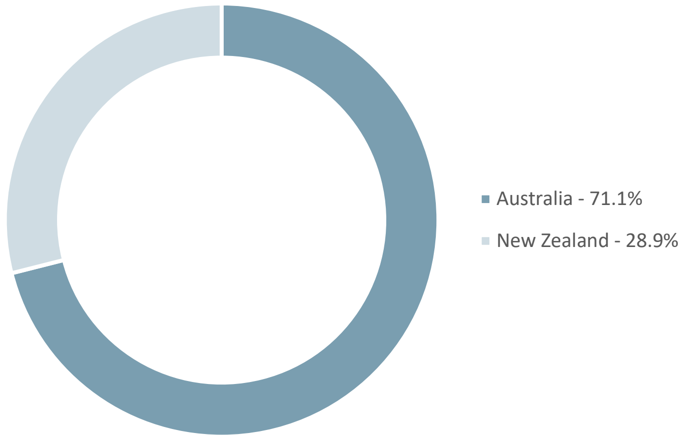
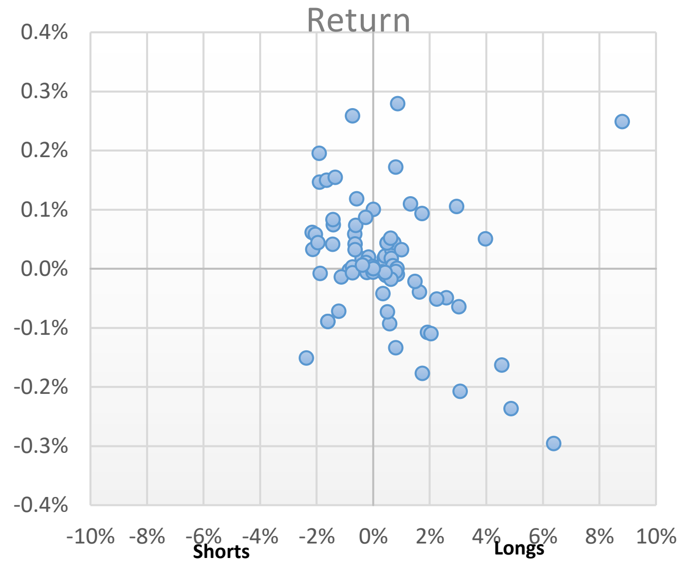
Country Allocation at 31 December 2022 (Gross Equity Exposure)



December 2022 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

Against a backdrop of volatile and somewhat negative equity markets, the Fund was near flat in the month of December, with a return of -0.10%. This moribund net outcome disguised a number of positive and negative movements under the hood which we will look at shortly.

Overall, calendar 2022 was a satisfactory year for the Fund. We had some sparkling successes and made some frustrating errors but on average we were right more often than we were wrong. This was reflected in our return after all fees and taxes of +6.9% compared to -12.0% for NZ long-only equities and -1.1% for Australia.

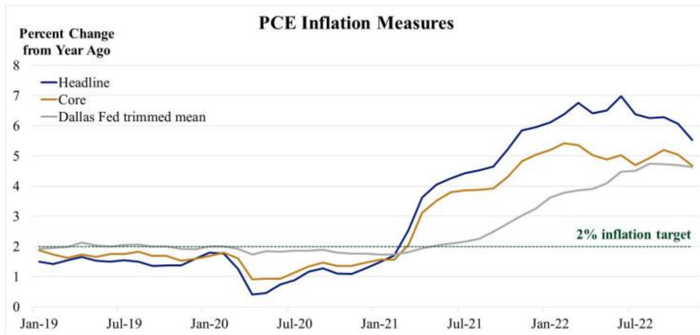
What is 2023 likely to hold? For some years, we have used this December write-up to look at the year ahead and consider what some of the left-field risks might be.

At first glance, the chart below sourced from The Macro Compass via twitter does suggest that forecasting markets is an exercise in futility. It takes the year-ahead forecast from a number of key Wall St banks in recent years and compares it against subsequent actual outcomes. There are four key takeaways – i) About 90% of forecasts are for positive returns; ii) The co-efficient of return versus forecast appears to be slightly negative; iii) Wall St has almost never forecast a bear market and been correct; iv) Markets tend to rise more often than they fall.

This exercise is perhaps slightly unfair as events unfold over the year that could not have been foreseen but it does illustrate the importance of thinking through what these events might plausibly be and how one's investments are positioned for them.

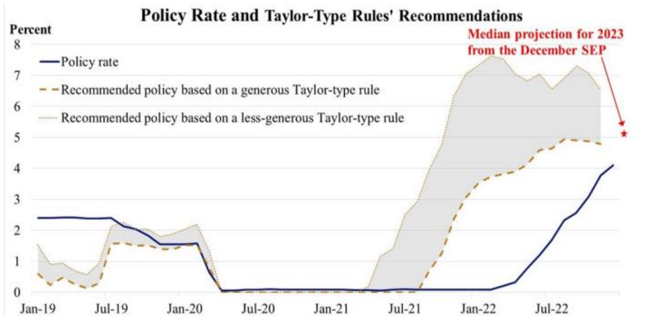
Right now, our basic outlook for economies and investment markets is consistent with the view that we have propounded for most of 2022. Inflation is clearly peaking or has peaked and we are seeing some prices that adjust quickly such as shipping costs, lumber et al fall sharply. However, services sector inflation, which is closely linked to labour costs, is proving far stickier and will likely continue to be so given unemployment rates of circa 3.5% across NZ, Australia and the USA.

A key question for 2023 revolves around how persistent inflation will be. We do not see how core inflation can fall back to the 2%-3% region targeted by central banks any time soon. Two charts below from St Louis Fed Governor, James Bullard outline the US situation. While headline inflation is starting to cool quite quickly, sticker core inflation measures are still far above the Fed's 2% target.



Sources: Bureau of Economic Analysis and Federal Reserve Bank of Dallas. Last observation: November 2022.

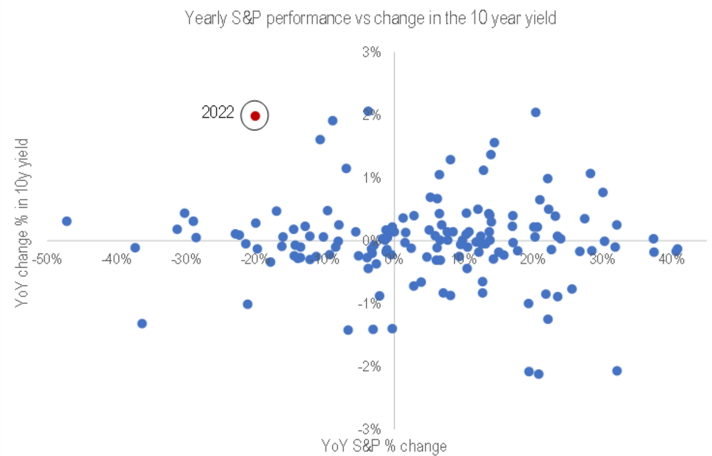
Secondly, the chart below shows that while the Fed funds rate has risen sharply, it is still below levels implied by Taylor-type rules, which used to be how central banks set policy rates.



Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve Bank of Dallas, Federal Reserve Bank of New York, FOMC's Summary of Economic Projections (SEP) and author's calculations. Last observations: November 2022 and December 2022.

The difference today, compared to early 2022, is that this situation is well understood and priced into markets. Two/ten-year yield curves are inverted across most key economies, with the debate being around the nuances of how long it takes inflation to decline. The shock to equity markets last year came from markets repricing from Goldilocks to this situation of durably higher inflation. US 10-year bond yields rose from 1.52% to 3.83%, Australia from 1.67% to 4.05% and NZ from 2.38% to 4.41%. We do not expect this shock to be repeated and think it likely that bond yields may range trade as they respond to actual inflation outcomes.

If we are correct and bond yields do not move materially in 2023, the chart below sourced from Credit Suisse, suggests that equity market movements could be anything. At unchanged bond yields, historic S&P returns have been all over the map.



Source: Refinitiv Datastream, Credit Suisse research

We believe different factors will likely drive equity returns in 2023. These will be "liquidity" as central banks use QT to drain cash from the system and the degree to which earnings forecasts are battered by slowing and potentially recessionary economic conditions.

The chart below shows that it is still very early days in the earnings downgrade cycle.

Source: Topdown Charts, Refinitiv Datastream, I/B/E/S

Research by Credit Suisse suggests that real EPS would need to fall by -12% just to get back to its long-term trend of +4.2%/annum real EPS growth. Further, in a sharp cyclical slowdown, there is nothing to stop EPS falling below trend. It is also possible that trend EPS growth has declined given slowing population growth and the supply-side shocks to the global economy of the last several years. It is interesting that while the US has seen strong EPS growth since its GFC trough, global EPS has been grinding sideways ever since 2008.

The situation in NZ may be worse. RBNZ Governor Orr is clear (for this nano-second) that a recession may be required to bring inflation under control and the monthly ANZ Business Outlook survey has turned in some dire readings. There is no survey in December but firms' year-ahead profit expectations

weakened from -30.2 to -45.1 in November due to a nasty combination of rising costs and slowing revenues. Stunningly, this is even weaker than the -42.9 reading recorded in the grim post-GFC nadir in Jan09.

We have always found consumer confidence readings to be something of a coincident indicator but the NZ chart below portrays a very concerning picture. The performance of many cyclical stocks has been very poor over the last year but this is for good reasons.

To sum up here, our view is that 2023 may be another tricky year for long-only equity investors. However, the fundamental source of the difficulty will likely be very different. 2022 saw the second largest rise in US bond yields in 50 years, but with inflation having peaked, we just can't see that repeating.

The concern now is that earnings are far above trend (especially in the US market) and that we could see an earnings downgrade cycle gather pace. There may well be a time to be brave and buy later in 2023 as the cycle reaches its nadir but we are not there yet. Further, central banks globally are tightening the liquidity screws. The direct relationship of the amorphous concept of "liquidity" to equity market performance is not entirely clear but the boom in equity and housing markets in the post-Covid bubble period of "free money" suggests it certainly matters.

At this point, it is perhaps worth referencing the chart back on page 1. We have no reason to believe that our forecasts for the year ahead will be any better or worse than those of other financial market participants. As the saying goes though, all forecasts are wrong but some are more informative than others. What could go right or wrong and lead to dramatically better or worse performance than the mediocre outlook for equities that we have set out?

- NZ house prices fell circa 20% from their peak in 2022 but are still expensive on most metrics versus other countries and their own long-term history. They could fall another 20% and still be above average. This could force the RBNZ to reverse its relative recent hawkishness to avoid a deep recession.
- The NZ election will likely be held in November. Recent polls point to a centre-right outcome but there is an enormous amount of water to flow under the bridge. What if NZ First takes 4.5% from the centre-right vote allowing a hard-left Labour, Greens, Maori Party coalition to come through the middle?
- Inflation and thence bond yields could fall more sharply than our expectations especially if we see China re-open, Covid variants recede and the Ukraine war end. Equities would rise sharply if this occurred.
- Monetary conditions have tightened all around the world but markets have given little thought to financial contagion risks. It is always hard to know where such risks lie but the brief debacle of UK pension funds being Liz Trussed was surely a reminder. We do wonder if "mark to fantasy" by private equity funds coupled with massive leverage and tightening capital standards for bank loans to PE could be an issue. It has been interesting to see a redemption queue build at Blackstone's giant unlisted property fund although we suspect that is more about investors trying to get out at the possibly generous marked prices rather than deeper issues.
- US politics – with the right wing of the Republican party now holding considerable sway in Congress, a major US debt limit battle and potentially extended Government shutdown is quite likely to happen mid-year.
- Ukraine – Russia is stuck and seemingly in a position where they cannot win although they are gradually bringing greater resources to bear. Do we see a year of stalemate, do we see internal Russian political instability, does Western support for Ukraine start to waver?
- Covid – we now have the highly transmissible VXBB15 – what comes next?
- Bank Of Japan – they shocked markets recently with their move to lift their 10-year yield target from 0.25% to 0.50%, with this reverberating through global bond markets where Japan has been a key marginal buyer. Could further moves be in store?
- China – Covid lockdowns are passing into the rear-view mirror and markets are seizing on a re-opening

narrative. However, debt levels are enormous and we could see further concerning sabre-rattling on Taiwan.

Fund Performance in December

Returning to the Fund's performance in the month of December, the overall return of circa -0.10% pre fees and tax was the net outcome of the short book contributing +1.3%, while the long book detracted -1.4%. This was as expected in a month where NZ fell by -0.7% and Australia by –3.2% although we did have some varied performances across the board. The "winners to losers" ratio of 57% would normally be enough to drive a positive month but our losers were larger than our winners.

Our overall positioning changed slightly, with a continued lowering of our overall leverage to a near record low gross exposure of 115%. We will almost certainly lift this in the first few months of 2023 but we do not take risk for the sake of it and will carefully grow our longs and shorts as opportunities present themselves. We suspect results and outlook statements in the February reporting season could drive considerable volatility which we may take advantage of. Our net exposure grew a touch from 42.5% to 44% but this still provides us with a relatively neutral exposure to markets given our investment style.

We continue to have no correlation to long-only equities. The 50/50 index of Australia and NZ had a huge number of 12 down-days in December, with an average return on them of a negative -0.47%. Despite our net length, the Fund was up on seven of those twelve days, with an average return of +0.12%. The Fund's performance has no correlation to what long-only markets are doing.

The strongest headwind yet again was our disappointing and frustrating holding in Lynch Group (LGL, -13.0%). Several large holders appear to have given up and exited at any price. Our approach has been to buy gently on particularly weak days but allow the holding as a percentage of the Fund to decline to a degree. We repeat that the issues affecting this year's earnings are temporary and should turn. Chinese Covid lockdowns have hurt volumes and margins but that country is now opening up at pace; LGL's ultra-expensive partially hedged airfreight prices will fall precipitously; and unexpected issues with a major Australian supermarket's new ordering system will pass. Despite this catalogue of woes, LGL is still only on a PE of 9.7x this year's trough earnings. It is on 5.6x Jun24 and 5.2x Jun25.

The second key name to weigh on returns was our long-standing position in Kina Securities (KSL, -9.4%) which fell on a surprise proposal in the draft PNG Budget for 2023 to lift the tax rate on banks from 30% to 45%. While KSL is still very cheap, this would clearly be a sizeable valuation negative if it happens. Our read on the situation is that there has been major pushback in PNG especially as a key issue they have in their fiscal structure is a massive informal economy that is untaxed and is not connected with the financial system. We will see what happens but KSL's share price is probably stuck until we get greater clarity.

The third lowlight was our large long in Monash IVF (MVF, -4.5%) which pulled back with the broader market for no particular reason. We have a strong view that MVF is a long-term structural growth stock as females in Australia and Asia move to have babies later and later. It has little exposure to economic cyclicality and has a strong balance sheet to fund growth both organically and via acquisition. MVF had earlier been a good winner for the Fund in November.

A final headwind of note came from our large position in GDI Property (GDI, -4.5%), the Perth-focused office property company. Perth has strong relative appeal versus other capital cities as it is seeing positive absorption due to the WA economy being driven by resources and a return to strong population growth now that Covid-driven border closures are over. The share price of $0.75 is at a 41% discount to the last NTA of $1.27, and unlike many of its property peers, the cap rate of circa 6.6% appears reasonable and potentially even conservative. Post month-end, GDI delivered a long-awaited positive leasing update, which the market only noticed to a modest degree amid the holiday slumber.

The largest positive was a small esoteric long in the super-computer company, DUG Technology (DUG, +35.5%). They provide super-computing services to clients who require enormous amounts of computing power such as universities and seismic analysis for oil companies. Their cash position had looked somewhat tenuous but significant recent contract success has seen them work through this and they now have a strong growth outlook from a single digit PE base.

The second key contributor was our short in the property fund management business, Home Consortium (HMC, -18.4%). HMC has aggressively grown their business over 2021 and 2022, and while the leverage in the headstock appears fine, a number of their vehicles in which they have large co-investments have reasonable gearing and have performed

poorly. It is essentially a levered play on weaker commercial property markets, which we hold to offset several of our longs in the sector.

A third tailwind came from our large long-standing position in Tower Limited (TWR, +2.8%), whose share price ground higher for the fourth month in a row. After feeling like a plaintive voice in the wilderness for years, investors are finally twigging that TWR is a rare beneficiary of rising short term bond yields and the insurance cycle may also be about to turn in their favour as premium increases catch-up to and pass claims cost pressures. We would also highlight (with some trepidation around jinxing the company), that there have been no large claim events so far three months into their year. This is a massive swing factor for reported profits and the market bakes in their very conservative $30m guidance. To this end, AON Australia released a fascinating climatic report that the current triple-dip La Nina (bad for large events) is likely to be followed by a decade-long El Nino.

Other positives in the month came from our long in the risky but ultra-cheap gold producer, Resolute Mining (RSG, +25%) and shorts in Carsales.com (CAR, -9.1%), where we are wary of the universally assumed success in their US acquisition as the car market there weakens; The Warehouse (WHS, -11.3%) which delivered a juicy warning; Reece Group (REH, -7.8%) and Promedicus (PME, -7.0%).

Thank you for your continued support of the Fund. We delivered a solid 2022, which was pleasing given the negative returns of the Australian and especially NZ markets. The last several months have been flat to moderately negative for the Fund as several of our key holdings have not worked. However, we have no reason to believe that they won't and many of our largest wins have come after initial drawdowns and many quarters of frustrated waiting. In the face of a particularly uncertain macroeconomic outlook, we have naturally had less conviction in a large number of names, so we have pulled back our risk exposures awaiting greater clarity.

The outlook for 2023 is uncertain. Bond yields may have peaked alongside inflation but liquidity conditions are tightening and we could be in for quite a deep earnings downgrade cycle in some markets. Our current sense is that this could provide good buying at some point but clear-cut buying opportunities for now are rather sporadic rather than broad-based. Markets appear fairly valued on current earnings forecasts which are likely too optimistic. As always, we will attempt to take the opportunities that are provided to us from both sides of the investment ledger and aim to again deliver solid returns that are uncorrelated with long-only equities.

Matthew Goodson, CFA

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