Salt Long Short Fund Fact Sheet – February 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 29 February 2020

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$107 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 29 February 2020

Application	1.526
Redemption	1.5198

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 29 February 2020

Long positions	61
Short positions	38

Exposures at 29 February 2020

Long exposure	90.93%
Short exposure	-35.90%
Gross equity exposure	126.83%
Net equity exposure	55.03%

Largest Longs	Largest Shorts
Tower	InvoCare
Kiwi Property Group	Ryman Healthcare
360 Capital Digital Infrastructure Fund	Commonwealth Bank
Oceania Healthcare	SEEK
Marsden Maritime Holdings	Wesfarmers

Performance[1] at 29 February 2020

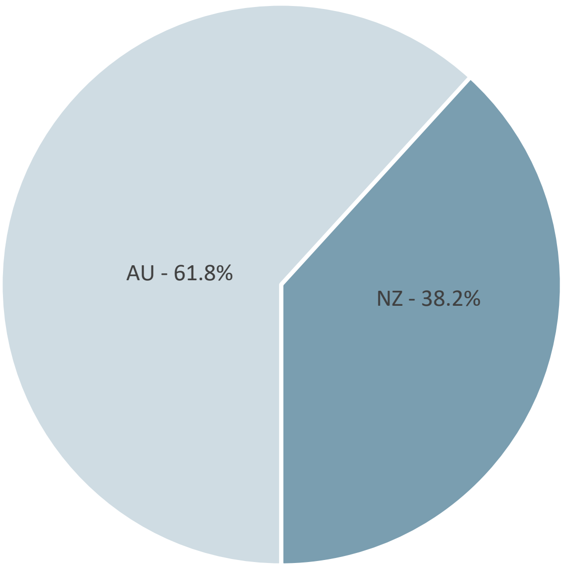
Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2014							6.28%	2.85%	2.74%	-1.67%	2.27%	0.89%	**13.96%**
2015	1.28%	1.07%	0.04%	2.17%	0.38%	-0.28%	0.75%	2.84%	1.34%	2.04%	2.37%	2.04%	**17.21%**
2016	-0.67%	-1.08%	3.81%	0.92%	1.72%	-0.39%	0.50%	2.26%	-0.51%	-0.57%	-0.20%	2.19%	**8.14%**
2017	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%											**-4.46%**

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	-2.84%	1.46%	-0.93%
6 months	3.27%	2.94%	4.03%
1-year p.a.	7.50%	6.27%	16.86%
2-years p.a.	-0.69%	6.51%	11.43%
3 years p.a.	1.44%	6.59%	12.10%
5 years p.a.	5.43%	6.96%	9.85%
Since inception p.a.	7.67%	7.14%	11.17%

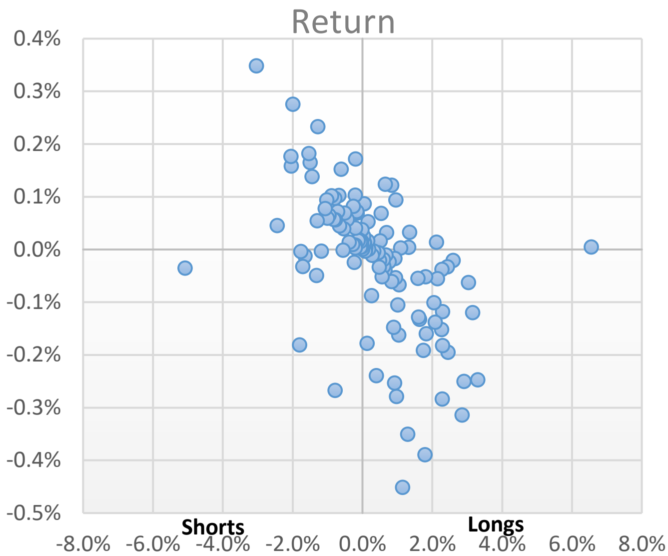
[1] Performance is after all fees and before PIE tax.
[2] NZX 50 G/ASX 200 AI is a 50/50 blend of the S&P/NZX 50 Gross Index and the S&P/ASX 200 Accumulation Index and is for comparison purposes only.

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 29 February 2020 (Gross Equity Exposure)



February 2020 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

February was a tough month for the Fund, with markets gyrating violently on evolving news and views regarding the spread of the Covid-19 virus. Our return of -2.51% after all fees and expenses was disappointing but it did at least provide a degree of shelter from the -3.9% turned in by the NZ index and -7.7% by Australia. Since inception, the Fund has returned +52.0% after all fees and expenses.

We ended the month with record net length of +55.6%, with this being particularly concentrated in a variety of defensive yield names, which heavily underperformed despite a sharp rally in bond yields over the month. As an example, the FTSE-EPRA NAREIT global property stock index fell by -8.7% as investors panicked out. Similarly, gold was man-handled lower by 3.5% on the last day of the month (before promptly bouncing straight back post month-end).

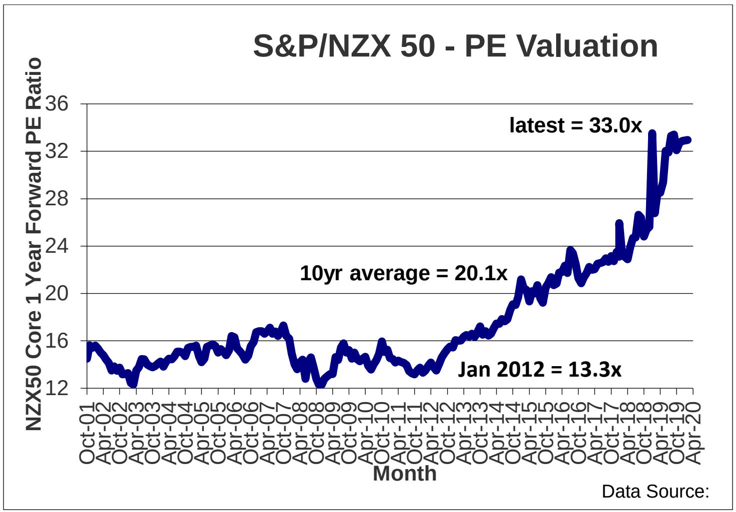
These moves make no fundamental sense and reflect a mad-cap dash for liquidity which we believe will reverse as emergency central bank rate cuts filter through. With Covid-19 posing clear risks to global growth and earnings forecasts, our heavy concentration on high yielding defensives are either unaffected by the virus or benefit from lower bond yields should logically bear fruit at some point.

As Sean Fitzpatrick might say, it was very much a month of two halves. In the first half, ultra-expensive Australian momentum stocks continued their surge from January and spiralled to the upside almost irrespective of whether their earnings season result was good, bad or indifferent. We aggressively shorted when the spiral seemed illogical but in hindsight covered several names a touch early, before the real impact of Covid-19 on markets became apparent. Conversely, our array of low-priced longs generally reported results ahead of our expectations but the market paid little heed to them. Historically, we have been well rewarded for being the only boy marching in step and we will be again.

In the back half of the month, a full-blown panic developed regarding Covid-19 and this saw a dash for liquidity which enveloped anything and everything. Smaller cap stocks gapped down harder than their more expensive larger cap cousins, defensives fell surprisingly hard and even gold stocks came under a heavy counter-intuitive cosh. In NZ, the large cap index fell by -2.0%, the mid cap index was down -6.7% and the small cap index cratered -10.3%. Size rather than underlying business attributes or valuations was all that mattered in the very short term.

The quest for liquidity could be seen in how even the Carbon Fund (CO2.nz) fell by 7% on the last day of the month even though the underlying carbon price was largely unchanged. We do not own CO2.nz in the Fund but we used this panic to lengthen our net exposures in a number of deeply downtrodden defensive names. As Benjamin Graham once put it, in the short run the market is a voting machine but in the long run it is a weighing machine. Patience will prove the key to navigating the current market ructions.

The decline in the NZ index did not provide much relief in terms of forward valuation multiples, with the core PE only declining from 33.5x to 33.0x. Forward earnings estimates were cut by 2.6% but the sharp rally in 10 year bond yields from 1.30% to 1.07% saved the day, leaving the market only slightly over-priced in relative terms. However, the convexity is huge at very low bond yields, meaning that a tiny move in yields leads to a large change in the "fair" PE. We would take it with a grain of salt and also be conscious that revenue and earnings forecasts will also come under pressure as central banks are doing their darndest to turn everyone into Japan.



The clear opportunity that has been created is in small-mid cap stocks. They were hammered on very light volumes during the month to the degree that the median PE fell from 19.5x to just 17.0x. This is stand-out cheap at current bond yields and we are picking our way carefully through the opportunities created by investors who have run for the hills.

It is far back in the mists of time since we were last bullish (in 2012 when PE's were 13-14x) but selected small/mid-caps and selected defensives are now stand-out opportunities on valuation grounds.

With thanks to Shaw & Partners, the table below puts a little perspective on medium to long term equity market performance following major negative events. While acknowledging that Covid-19 initially hit at a time of record market valuations and bullish sentiment, it is notable that markets were almost always higher one month and one year later and they were always higher five years later.

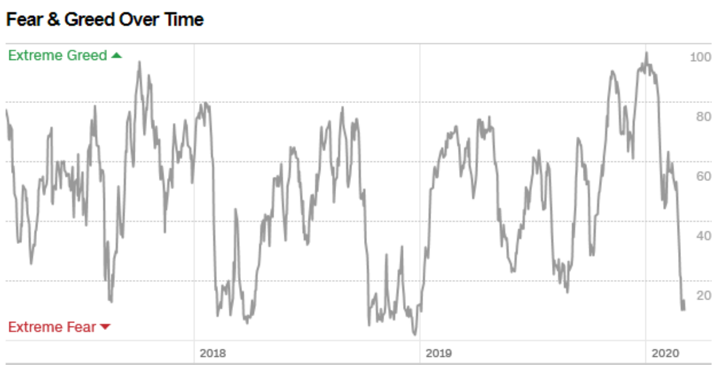
According to Deutsche Bank research, the six-day period it has taken for the S&P500 Index to correct 10% from peak has been the fastest in history, exceeding the previous record in the darkest days of World War One in February 1918. It may not make for a good night's sleep but the pain trade is to be a selective buyer on the big ugly down-days that we are currently experiencing.

Investor sentiment also screams out as being deeply in the troughs of extreme fear. As it is wont to do, the CNN Fear & Greed metric has plunged from record levels of extreme greed in January to the depths of despair in late February.

Event	Event reaction dates	Percent of gain/loss during event	S&P 500 percentage of gain/loss after last reaction date: 1 month later	1 year later	5 years later	10 years later
Fall of France	5/9/40–6/22/40	-18.2	3.1	5.2	15.9	13.2
Attack on Pearl Harbor	12/6/41–12/10/41	-6.9	4.5	16.0	18.1	17.1
Outbreak of Korean War	6/23/50–7/13/50	-11.1	9.5	42.0	27.6	18.4
Eisenhower heart attack	9/23/55–9/26/55	-6.6	0.1	11.8	8.5	11.6
Cuban Missile Crisis	8/23/62–10/23/62	-9.9	15.5	41.1	15.8	11.0
Kennedy assassination	11/21/63–11/22/63	-2.8	7.0	27.8	12.4	7.0
U.S. attacks Cambodia	4/29/70–5/26/70	-15.0	6.4	49.0	9.3	9.3
Nixon resigns	8/9/74–8/29/74	-13.4	-6.8	30.6	14.6	14.6
1987 stock market crash	10/2/87–10/19/87	-31.5	7.1	27.9	17.0	18.9
Gulf War ultimatum	12/17/90–1/16/91	-2.8	17.2	36.6	17.3	18.0
Gorbachev coup	8/16/91–8/19/91	-2.3	3.2	14.5	15.2	14.3
Collapse of Long-Term Capital Management	8/28/98–9/9/98	-2.0	-2.0	35.8	1.8	3.7
September 11 terrorist attacks	9/10/01–9/21/01	-11.6	11.3	-11.1	8.3	3.9
U.S. invades Iraq	3/18/03–3/31/03	-2.1	8.2	35.1	11.3	8.5
Collapse of Lehman Brothers	9/5/08–11/20/08	-39.1	18.3	48.8	21.5	15.8
U.S. debt downgrade by S&P	8/5/11–10/3/11	-8.0	14.9	35.0	17.0	—
2016 Brexit	6/23/16–6/27/16	-5.3	8.5	23.5	—	—

Historical references do not assume that any prior market behavior will be duplicated. Past performance does not indicate future results.

We argued last month that this indicator has a slightly mixed track record at the top but an outstanding track record at the bottom. As can be seen from our net positioning, we are taking note of this indicator and being brave. It is telling us that there is widespread investor capitulation.



Typical of the fear being expressed by global strategy gurus, this comment from an investment bank that shall remain nameless shows how we have plunged into extreme fear and why this has created a contrarian opportunity: "We remain cautious on risk appetite in broader financial markets and expect further downside in risk assets, despite occasional risk squeezes." How useful.

One of the many "joys" of being a fund manager is the need to read widely and become an instant expert on the topic du jour, be it Christchurch earthquakes, Fukushima nuclear fall-out, the politics of Brexit and now we have Covid-19.

Being simple equity investors, we note the analogue from SARS that markets bottomed when the second derivative of the infection rate peaked. This peak has well and truly occurred in China. While one cannot but harbour nagging data doubts, it is clear that China is gradually returning to work. Elsewhere around the globe however, we are still very much in the exponential expansion phase as shown by the chart below.

How long will it take to peak? The general view last month was that it would be March /April before we saw a peak in China but this has clearly come a little earlier. It is too early to tell elsewhere but markets will be on a hair-trigger looking to buy the first signs of any peak. One interesting aspect of the virus is that transmission rates in countries where it is winter (China, Italy, Iran) have been far higher than those in hot countries such as Singapore and Thailand. This gives hope that the arrival of more heat and light in the northern summer will sharply lower transmission. With thanks to one expert call, it seems that Covid-19 is an enveloped RNA virus. This means it is enveloped in a protective gel which shields the virus as it spreads around. However, this gel may break down in warmer temperatures and impact the stability of the virus. June can't come soon enough although it perhaps doesn't bode well for NZ /Australia as we are currently registering our early cases ahead of the onset of winter. Wash your hands!

Notwithstanding the fact that Covid-19 is a negative supply side shock that central banks have limited ability to counteract, they have seized the moment and acted with alacrity. Australia cut by 0.25% to 0.50%, the US Fed and Canada both cut by 0.50% to 1.25%, Hong Kong reacted with a HK$10bn handout of helicopter money to everyone aged over 18, South Korea announced a US$13bn fiscal stimulus, Malaysia announced a US$4.7bn package…"I'm turning Japanese, I think I'm turning Japanese, I really think so…."

We expect well-targeted fiscal policy to have more impact than monetary policy. Interest rate cuts will have little impact if firms are producing less and consumers buying less and the velocity of money has collapsed. Moreover, once you get down below a "reversal rate", banks bleed deposits and lend less while those who rely on interest income will need to save more.

However, what lower interest rates and QE-style liquidity provision will almost certainly achieve is another leg-up in financial markets. A quite likely scenario in our view will be for the emergency monetary medicine to persist for a period past the Covid-19 peak, driving markets back to some of their recent extremes.

Signs of excess were everywhere in the first part of the month, to the point that Charlie Munger made the eerily well-timed comment that, *"I think there are lots of troubles coming…there's too much wretched excess*."

Some of our favourite examples included:

1. Tesla has traded in a 230% price range so far this year and turns over its market cap every week;
2. If that is a little staid for you, Virgin Galactic has traded in a 385% price range in 2020;
3. These stocks are so cool that they inspired the ASX to start a technology index (XTX.au) which promptly dropped 4% on day one and is now down 12.5% as this is written;
4. The renowned value investor Perpetual made public comments that they plan to de-emphasise value investing;
5. Over the first two weeks of the month, US options traders bought $16bn of speculative calls, which is 60% more than in any period since 2000;
6. According to Morgan Stanley, in the three months to mid-Feb, the rolling outperformance of growth versus value was the greatest since May 2008;
7. According to JP Morgan, the valuation ratio between low volatility and value stocks was twice as wide as in 2000, while the ratio of tech stock performance relative to energy stocks returned to its prior early 2000 peak.

These anecdotes show how the backdrop was well and truly in place for the fastest ever 10% decline in the S&P500 and other markets globally. However, as the impact of Covid-19 peaks and passes, we strongly suspect that what will be left behind will be a Japanese-style scenario of lower for longer interest rates. This will be awful for banks but wonderful for any security that promises a modicum of sustainable yield. More concerningly, it is also a backdrop that could see high multiple momentum stocks have yet another surge once the current state of investor fear passes.

Returning to the performance of the Fund during the month of February, the return of -2.40% pre fees and tax unsurprisingly saw highly divergent contributions from our longs (-5.42%) and our shorts (+3.02%). We lifted our net length into the weakness over the month to end up at 55.6%, with the large number of longs relative to shorts naturally hurting our "winners to losers" ratio but it still came in at a highly respectable 57%. The problem was that the magnitude of our longs was greater than our shorts and nearly everything fell hard.

Our largest headwind was deeply frustrating in that we had purchased a mid-sized long in a name we formerly disliked (at much higher price levels) in the form of Synlait Milk (SML, -32%). Our thinking was that they had been sold down hard to low multiples, that their result would be adequate, that their land dispute at Pokeno will be solved on acceptable terms and that they will remain a key manufacturer for a2 Milk.

As it turned out, they delivered a surprising profit warning due to low prices for the speciality product lactoferrin, lower than anticipated base powder sales to China, with this exacerbated by extra capacity and some contingency for Covid-19 impacts. A2 Milk also suggested they may invest in some of their own manufacturing capacity although we believe it will be long-dated and SML will remain essential to them.

The second problem-child was our long-standing mid-sized long in 3P Learning (3PL, -19.1%), the online educational software company. We have bought and sold this relatively well over the last few years but the move down from the $1.20 mark has been rather painful. Expectations going into 3PL's result were low and they were not too far from the mark but rather than a relief rally, it sparked a further bout of selling. 3PL has turned into a real patience job as they have invested heavily in people and products but the SaaS sales uplift is only gradually coming through. They remain confident they can grow revenue sufficiently in the vast US market to justify their fixed cost investment but the market has run out of patience and is also concerned that their SaaS metrics in terms of revenue versus costs of sales versus churn require improvement.

Other notable headwinds came from a modest long in NZ Refining (NZR, -25.1%) which we bought as a straw hat in winter to get upside from higher refining margins due to shipping fuel regulations but instead ran smack into the impact of Covid-19; a large long in Turners (TRA, -10.7%) which is very cheap, has strong growth and fell for no discernible reasons; our long in Kina Securities (KSL, -11.5%) which delivered an outstanding result but fell hard anyway on concerns regarding PNG – in our view the delay to the major LNG gas project will be resolved as all parties stand to benefit; and our modest long in Oil Search (OSH, -24.2%) which fell on both PNG project delays and the weak oil price.

Our key winners were all shorts, with our large position in Ryman Healthcare (RYM, -7.5%) being helpful. We remain very wary of its extended valuation and its somewhat aggressive profit recognition relative to peers. The retirement village sector has done very well over the last few months as NZ and Australian housing markets have turned up but we do hold concerns as to how long this will last given extended valuations, early indicators such as land sub-divisions appearing to have peaked and bank lending beginning to be constrained by an absence of deposit growth at such low interest rate levels. We are now relatively neutral in our sector positioning.

Our second tailwind came from a short in Meridian Energy (MEL, -13.6%) which we put on near its highs on relative valuation grounds. The upside from this was partially offset by our long in Contact Energy (CEN, -10.0%). As the month progressed, we covered a portion of the MEL short and are now net long the sector in the expectation that a sensible Comalco aluminium smelter outcome will eventuate. We expect this will be either a continuation of the smelter at lower power and transmission prices or a staged exit over a period of time.

Other notable positives came from shorts in Fortescue Metals (FMG, -11.5%) which we partially covered on its sharp Covid-19 related pullback; Bendigo Bank (BEN, -11.7%) which is in a very difficult position thanks to ever lower interest rates; Seek (SEK, -8.9%) which is very expensive, has negative Australian job advertisement growth and has a sizeable negative exposure to China; Wisetech (WTC, -40%) which delivered a doozy of a profit warning; and Technology One (TNE, -8.0%) which is our other favourite tech company short. Mentioning SaaS 147 times in your annual report does not make you a SaaS company just because you choose to account for a good portion of your traditional revenues in that manner. To give them credit, this was up on 124 mentions last year – 19% growth is clearly very impressive!

Thank you for your ongoing support of the Fund. The last two months have seen highly unusual market conditions. The first six weeks to mid-February saw a remarkable surge in growth and momentum stocks to the exclusion of most other names. Large stocks dramatically outperformed smaller stocks in both NZ and Australia. This all then disintegrated in a major burst of volatility due to the macro shock of Covid-19. The Fund was down but it was far less volatile than long-only equities. We will stick to our aim of providing equity-like returns but with far less volatility than equities and no correlation to them. We believe there is value in having this as part of a diversified portfolio and this will shine through when the music eventually stops for longer than the day or two that it did in February.

Matthew Goodson, CFA