SALT

Salt Long Short Fund Fact Sheet – October 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 October 2022

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$64.8 million
Inception Date	31 October 2014
Portfolio Manager	Matthew Goodson, CFA

Unit Price at 31 October 2022

Application	2.1958
Redemption	2.1869

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 October 2022

Long positions	42
Short positions	33

Exposures at 31 October 2022

Long exposure	86.51%
Short exposure	43.67%
Gross equity exposure	130.17%
Net equity exposure	42.84%

Investment Risk to 31 October 2022

Fund volatility[1]	6.44%
NZ50G / ASX200AI volatility[1]	14.05%
NZ50G / ASX200AI correlation	0.085

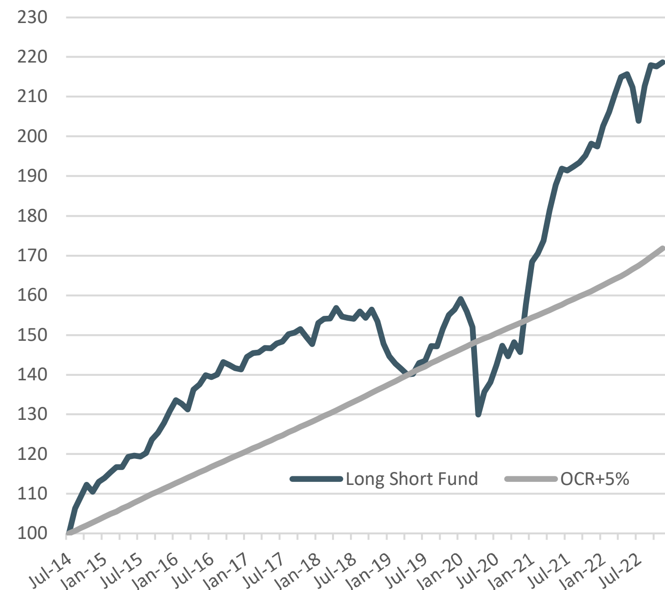
1. Annualised standard deviation since fund inception.

Fund Performance[2] to 31 October 2022

Period	Fund Return	OCR+5% Return	NZ50G/ASX 200AI Return[3]
1 month	0.50%	0.69%	4.25%
3 months	2.82%	2.01%	-0.46%
6 months	1.37%	3.73%	-5.07%
1-year p.a.	10.33%	6.70%	-7.92%
2 years p.a.	22.53%	5.97%	4.99%
3 years p.a.	12.15%	5.82%	4.59%
5 years p.a.	7.92%	6.14%	7.27%
7 years p.a.	7.97%	6.40%	9.12%
Inception p.a.	9.84%	6.71%	8.82%

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 October 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	National Storage REIT
Monash IVF Group	BWP Trust
GDI Property Group	Breville Group
Australian Vintage	Technology One Ltd
Lynch Group Holdings	Amcor Ltd

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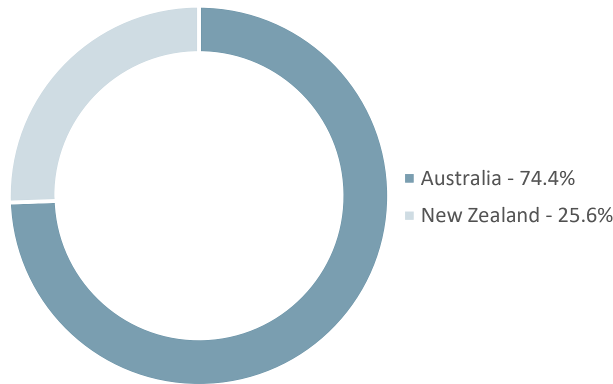
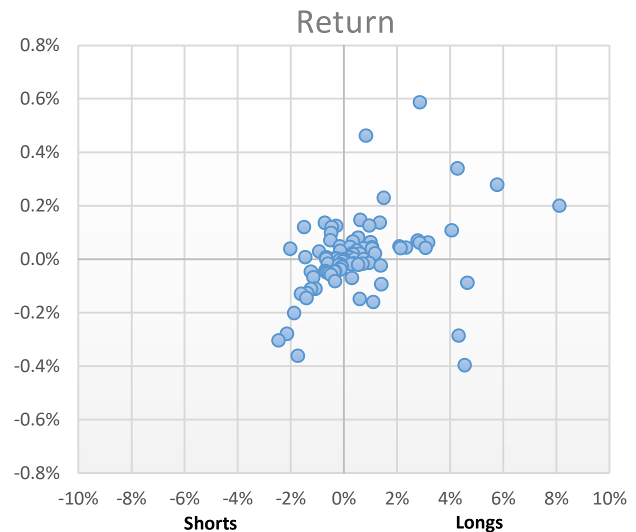
Country Allocation at 31 October 2022 (Gross Equity Exposure)



October 2022 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

October was a positive but relatively mediocre month for the Fund, with a return after all fees and taxes of +0.50%.

The month was volatile, with there being ten down-days for the combined NZ and Australian equity benchmark. However, the positive days were strong and NZ ended +2.5% and Australia +6.0%. The panic over the political shambles in the UK subsided and markets began to tease out whether we may be getting closer to a central bank pivot. This occurred particularly in Australia, where the RBA is following a high-risk dovish strategy by only hiking gradually in the face of inflation outcomes that are surprising to the upside.

The Fund had been up over 1.0% for much of the month but the last day of October saw the NZ index rise by an egregious +1.88% as passive funds appeared to be unusually aggressive in investing their poor investors' money. Australia was up a more moderate +1.15% but it did not make for an easy day for the short book.

End-of-month price movements have become a clear anomaly in the NZ market. We think this may be due to the rise of passive funds and the perverse incentives they face on the last day of the month. For the 22 months from January 2021 to October 2022, the NZ index has returned -13.39%. The aggregate return on the 22 last days of each month has been +9.53%. Something is rotten in the state of Denmark. Needless to say, we tend to sell/short on that day and cover/buy on other days. It is a good source of value-add but it can be very frustrating in the short term.

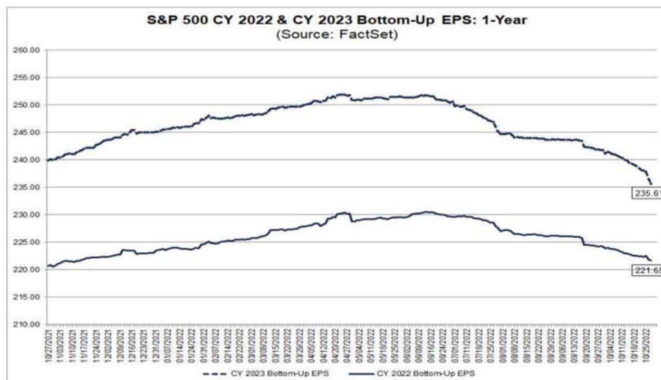
October was a strange month in many ways. Markets globally rallied hard on a view that tightening may be near an end, that inflation may decline quite quickly and that earnings may hold up as many economies somehow manage to avoid recessions. We see this Goldilocks-style view as premature at best and flawed at worst. An aggressive Fed hike of 75bp as this is written confirms this.

We think the rally was all about short-term tactical positioning around the idea of a potential pivot. This saw a slight easing in financial conditions. The chart below is of the Goldman Sachs Financial Conditions Index for the last five years. It has risen from a historic low of 97 to just above the long term historic norm of 100. However, during October, it eased from 101 back to 100 despite a continuation of rate hikes and the Fed finally getting serious on QT.

We therefore attribute the market rally to a slight easing in this broad measure of financial and liquidity conditions, with most risk markets rallying accordingly. However, early November has seen equities sell off sharply as the Fed confirmed it is not for turning. This lined up with our view that any easing cycle is still some distance into the future and it is premature to pre-position for it at this point.

A further problem is that an earnings downgrade cycle is beginning to get underway. We were surprised at how well the US market did in October when there were major earnings misses from bellwether stocks such as Amazon, Google and Meta. What will happen when monetary policy lags feed through and economic growth really starts to slow?

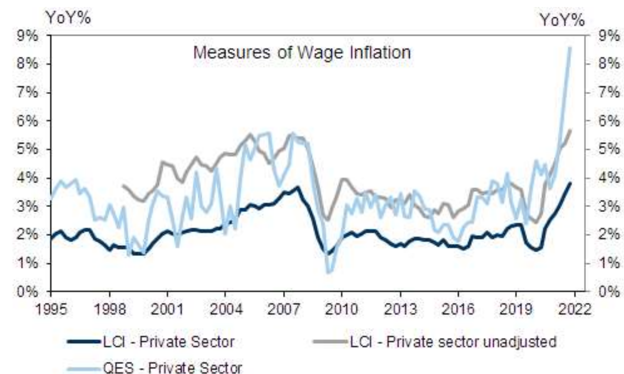
Longer term bond yields may now be getting close to fully pricing in future central bank tightening but the risk to equities then becomes falling earnings forecasts. The chart below for the US market shows this is now getting underway. We suspect there will be more to come and Australia and NZ will not be left out of the trend.



The reason for our suspicion that the earnings downgrade cycle could have some legs is not just a view on the economic outlook. Across many Western economies, the profit share of GDP has never been higher and Credit Suisse research points out that US real EPS for the S&P500 is at near record levels above trend. Earnings would need to fall 12% to return to trend and markets have historically tended to bottom when earnings trough out below trend. We are some distance from this.

Our overall economic and market view remains unchanged. There are a number of helpful signs that inflation has peaked (eg commodity prices falling and global shipping rates plunging) but also significant evidence that price inflation has fed through to wage inflation. This emergence of a wage/price spiral is similar across many economies and makes it most unlikely that inflation will fall back into central bank target ranges any time soon. A "pivot" may occur in 2023 in the sense that we see an end to rate hikes but it is fanciful to think that rates will actually be cut any time soon. There is an awful lot of wood to chop first.

Our view regarding a wage/price spiral is increasingly shared across markets and this is heightening the importance of labour market data. NZ wage inflation for the September quarter is shown below in a chart from Goldman Sachs and paints a very clear picture.



Source: Statistics NZ

Put all this together and our view is that central banks are getting well advanced in their hiking cycles and that long bonds have now priced a lot of this in. The RBA is possibly an exception and may be storing up trouble by moving so slowly. The problem for equities is that QT is only beginning to hit its straps and there is little reason to expect any early pivot.

The bull case from here is that we are surprised by lower inflation readings. This is certainly possible but recent outcomes have surprised to the upside in most countries and there is gathering evidence of a wage-price spiral. We think inflation has peaked but that its rate of decline will be slow, necessitating a continued monetary policy tourniquet. This is so different from the goldilocks era that the average 30-year old growth stock investor has grown up in.

The potential bear case is expounded by Nouriel Roubini in an article on Project Syndicate, "The Stagflationary Debt

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Crisis Is Here". He believes that policy was kept too loose for too long, and that coupled with negative supply-side shocks, central banks will have to force economies into hard landings to get on top of inflation. This in turn will spark financial distress and debt crises, with the world carrying far higher debt levels than during the negative shocks of the 1970s. Roubini has called twenty of the last two recessions, so we sincerely hope he is wrong again. It will come back to how long-lived the shocks proved to be (Ukraine and Covid lockdowns) and how quickly inflation responds to tightening monetary policy.

Fund Performance in October

Returning to the Fund's performance in the month of October, the overall return of circa +0.60% pre fees and tax saw a composition which was very much the reverse of the previous month. As one would hope in a strong month, our long book delivered +2.3% although we may have hoped for slightly better, while our short book detracted -1.6%, with a highly frustrating last day as was previously mentioned. Stock selection was again solid, with a "winners to losers" ratio of 59%.

Strength during the month saw us lower our net length from 49.6% to 42.8%, with much of this concentrated on the last day blip. This also saw us lift the gross from 123.5% to a still relatively low 130%. This is providing ample risk exposure given current volatility and the last few days have seen the Fund have a negative correlation to market movements despite our positive net length. This correlation is anything but stable and will no doubt swing around as the factors that are driving markets change.

The 50/50 index of Australia and NZ had a high number of ten down-days in October, with an average return on them of a negative -0.65%. The Fund was up on four of those ten days but had an average return on them of +0.08%. At present, this suggests gloom is our friend but we are constantly evaluating the Fund's holdings as our aim is to make money irrespective of market movements.

The strongest headwind came from last month's key positive contributor in the form of Lynch Group (LGL, -7.4%). There was no new news and it fell away on light volumes and fears regarding the potential impact of China's continued Covid-zero policy. This policy will not last forever and will hopefully turn around into a tailwind in early 2023 as more of China's susceptible population is vaccinated. The other key headwind for LGL has been transport costs. Our understanding is that air freight is not falling at anything like the same rate as sea freight but that the direction is still downwards. LGL is ultra-cheap and has strong growth on a normalised basis but the market is preoccupied with over-reacting to the next data-point rather than taking a longer view.

The next two major headwinds came from shorts in the two most expensive property stocks in our multi-factor relative valuation model, which has served this Fund very well over time. Bunnings Warehouse Property (BWP, +10.3%) and National Storage REIT (NSR, +17.0%) are exceedingly expensive relative to peers but caught a strong bid as the whole sector rallied. We shorted more into this. There was a partial offset from our longs but our overall property positioning had a rare month of hurting the Fund.

A fourth notable detractor was our long in Global Data Centres (GDC, -5.9%) which has been volatile in recent months. The entire sector has had a sudden fall from grace thanks to higher bond yields and the results of Amazon and Google suggesting that growth is slowing. To our mind, this is disappointing but doesn't invalidate the long term structural growth trend, particularly in the markets that GDC is playing in and the nascent "edge" segment where it is investing. GDC is currently profitable, has strong growth and trades at just half of a very conservative independent NAV. They clearly cannot raise any new equity at their current listed multiple and it is our increasingly strong view that they would be better off being owned by an unlisted player.

Other headwinds came largely from our short book, with high beta "darling stocks" such as Technology One (TNE, +13.7%), Breville (BRG, +9.3%) and Promedicus (PME, +11.2%) hurting in a strong month for markets. Our small long in Pacific Edge Biotechnology (PEB, -14.0%) weighed but we are using this weakness to gradually lift the holding as it is materially undervalued in our view.

The stand-out tailwind came from our large holding in Dalrymple Bay Infrastructure (DBI, +16.0%). Our frequent telling of the story that there was material upside in the

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move from heavy-handed to light-handed regulation was perhaps becoming a little wearying and it was starting to feel like waiting for Godot. Well, Godot finally arrived, with a robust agreement seeing a material lift in fees, with these being indexed to inflation. This naturally saw large uplifts to dividend forecasts and strong share price performance.

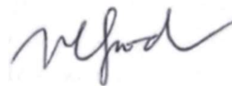
A second notable winner was our moderate long in the gold developer, Tietto Minerals (TIE, +60.9%), which has had some notable share price swings in recent months, which we have largely been on the right side of. They are developing what promises to be an exceptional mine in Cote d'Ivoire and have seen a couple of Chinese players become substantial shareholders.

Other large contributors tended to come from the long side in what was a strong month for markets. Australian Vintage (AVG, +7.4%) and Monash IVF (MVF, +4.4%) both did well and Superloop (SLC, +13.6%) bounced sharply following a strong AGM update and appears to have material further upside potential if they can keep adding traffic to their network.

Thank you for your ongoing support of the Fund. October was an interesting month as markets tried to search out a monetary policy pivot, which saw "hope" priced back in. This was perhaps justified in Australia with the dovish RBA only hiking by 25bp on 1 November but these hopes and dreams were crashed back to earth by a hawkish 75bp hike by the Fed on 3 November our time.

We expect continued market volatility in the period ahead. "Hope" will doubtless return again at some point as it is inevitable that central banks will stop tightening in 2023. However, while inflation is peaking and will fall somewhat from its current highs, the spillovers into wage inflation will make it too persistent for there to be any early easing. An earnings downgrade cycle may add to the pain. Valuation multiples have certainly fallen from their peaks and we can find a number of conviction longs but being wary of earnings risk is critical.

This year has been tough for the NZ equity market (-13.0%), while Australia (-4.1%) has also done it tough with the overall outcome shielded by coal and lithium. While we do not expect a repeat of such negativity, we still see the months ahead as a time to continue to tread carefully. We will continue in our quest to grind out positive returns with far less volatility than equities and no correlation to them.



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