Funds Management

Salt Long Short Fund Fact Sheet – June 2018

Fund soft closed to new investors

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 June 2018

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$274.7 million
Inception Date	30 June 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 30 June 2018

Application	1.5473
Redemption	1.5410

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 2018

Long positions	84
Short positions	44

Exposures at 30 June 2018

Long exposure	80.06%
Short exposure	-49.65%
Gross equity exposure	129.70%
Net equity exposure	30.41%

Largest Longs	Largest Shorts
Centuria Metropolitan REIT	Ryman Healthcare
Bingo Industries	National Storage REIT
Turners Automotive Group	ARB Corporation
IVE Group	ALE Property Group
Ingenia Communities Group	Goodman Group

This Fund is actively managed. Holdings are subject to change daily.

Performance[1] at 30 June 2018

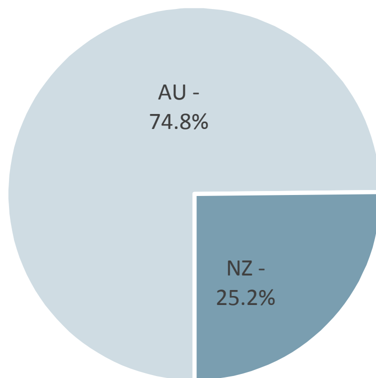
Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2014							6.28%	2.85%	2.74%	-1.67%	2.27%	0.89%	13.96%
2015	1.28%	1.07%	0.04%	2.17%	0.38%	-0.28%	0.75%	2.84%	1.34%	2.04%	2.37%	2.04%	17.21%
2016	-0.67%	-1.08%	3.81%	0.92%	1.72%	-0.39%	0.50%	2.26%	-0.51%	-0.57%	-0.20%	2.19%	8.14%
2017	0.68%	0.12%	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%	1.76%	-1.40%	-0.21%	-0.11%							0.71%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	-1.72%	1.64%	3.14%
6 months	0.71%	3.29%	7.86%
1-year p.a.	3.93%	6.75%	15.12%
2-years p.a.	5.17%	6.81%	13.72%
3 years p.a.	8.89%	7.08%	12.51%
Since inception p.a.	11.42%	7.42%	11.54%

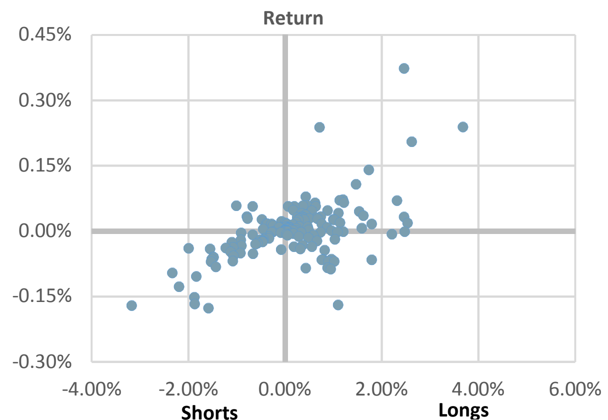
[1] Performance is after all fees and before PIE tax.
[2] NZX 50 G/ASX 200 AI is a 50/50 blend of the S&P/NZX 50 Gross Index and the S&P/ASX 200 Accumulation Index and is for comparison purposes only.

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 30 June 2018 (Gross Equity Exposure)



June 2018 Individual Stock Contribution



Fund Commentary

The Fund battled into continued headwinds in June, with outperformance of "price momentum" factors relative to "valuation" factors seeing vertiginous rises in our ultra-expensive shorts more than outpace some strong pieces of stock selection from the long side. This combination resulted in a return of -0.11% after all fees and expenses. This compared to the S&P/NZX50 Gross Index and the Australian S&P/ASX200 Accumulation Index both advancing by +3.3%.

Interestingly, a few cracks began to appear in the momentum edifice at the very end of the month and the Fund managed to finish the period with a strong 1.1% advance off its intra-month lows. As we will argue shortly, this period feels like another re-run of 1987, 1999 and 2007 – memories appear to have faded of those rather distressing episodes. We continue to position the Fund in a cautious manner in the expectation of delivering moderately positive returns when markets do hit the wall. However, we are also focused on not suffering sharp losses from the short side in the interim. A return to sensible valuation norms that have stood the test of time may occur next week or it may be some time away.

Since inception on 30 June 2014, the Fund has now returned +54.1% after all fees and expenses. Thirty-four of those forty-eight months have had positive returns and we have just recorded our first negative quarter. We will strive to make it another four years before we have another one. Our correlation to extremely expensive equity markets remains statistically zero and this remains a key focus given extraordinary market valuations.

The one year forward PE for the NZ market (using FNZC data) continued its untethered (some would say unhinged) advance and reached a reached a new record high of 24.7x at end-June. Justifications such as lower bond yields or rising earnings forecasts are absent – the market simply became even more expensive. Indeed, the monthly ANZ Business Outlook survey at end-June showed firms' own activity outlook fell further from +13.6 to +9.0 and their year-ahead profit expectations weakened from -8.5 to -13.2. This harks back to mid-2009 levels and it does not bode well for the outlook of NZX listed companies with domestic exposure.

An interesting piece from Credit Suisse showed that Australia is marching to a similar drum-beat. The S&P/ASX200 Industrials ex Financials is now on a forward PE of 20.6x versus a long term average of 15.0x. However, one and two year ahead forecast earnings growth is merely at its long term average. Healthcare particularly stands out as being more than 3 standard deviations expensive despite quality and growth measures being around their historical norms. This is a classic example of the momentum trade.

We feel a little like the boy who cried wolf but as in the fable, one day the wolf really will come and eat all the sheep who are investing in this market. The continued bull market surge in NZ (and in the ex-financials market in Australia) has come despite a cluster of warning signals. We have just discussed the risks to future earnings as the NZ economy slows but right now it is fair to say that valuations are not remotely a focus for the market. Without putting too fine a point on it, the "feel" from sitting in the hot seat is that there is too much money sloshing around and it is chasing whatever is going up. However, we would suggest that this liquidity surge is very late-cycle and that there are numerous signs globally of change beginning to occur.

Last month's letter noted how the ratio of the MSCI Australia Growth Index multiple to that of the Value Index had reached extremes last seen back in 2007 and early 2000. This has very much been a global phenomenon, with the ratios of US growth indices versus value indices having surged past their 2007/08 peak to approach where they were at the height of the Nasdaq bubble. Indeed, Citigroup write a piece entitled "*Time For A Growth Stock Bubble*" which argued that this trade looks ominously like late 1999 but that it could continue for a while yet. Down under, this bubble has manifested itself in IT,

healthcare and China-exposed food export stocks – all areas which we have been painfully shorting but which hold rich promise of strong returns when gravity reasserts itself.

In the 18 months to end-June, the S&P500 Momentum Index has outperformed the S&P500 by 15%, a gap last seen in early 2008. So far this year, the Nasdaq has risen +8.8%, while the S&P500 was up a mere +1.7%. Moreover, more than 100% of the advance of the S&P500 has come from the FAANMG stocks. To put the absurd levels of the mega-cap technology stocks in context, BAML pointed out that the FAANMG + BAT (Baidu, Alibaba, Tencent) stocks collectively have a $5.0trn market cap versus the entire Eurozone market cap of $4.9trn (or $4.5trn ex those stocks dual-listed there). Something is rotten in the state of Denmark…

Vast column inches have been devoted to the prospects of monetary tightening in the US and the EU in recent months and June provided further material. The Fed made its seventh rate hike to a range of 1.75%-2% and perhaps more importantly, signalled that there would be four rate hikes this year rather than the three that the market had been pondering. Their "dot plot" now suggests that US rates will reach 4.0% in 18 months' time. It is quite conceivable that the NZ cash rate stays anchored at 1.75% over this period, making the NZ$ implications rather obvious (and we have been stocking up on Sanford, Scales, NZ Refining and other winners on this theme).

A 4.0% cash rate also creates clear asset allocation head-winds for equities. Various surveys of investor positioning tend to show near-record high equities exposure (including massive technology overweights), unusually low bond exposure and record low cash weightings. As this is being written, the latest BAML "Flow Show" tracker showed that in 2018, equity inflows were $103bn in the first 5 weeks, +$31bn in the next 5 months but -$30bn in the last 5 days – the second largest weekly outflow ever. However, their tracker still shows their global private client allocations are at 61.1%; not far off the all-time highs of 62.5% and well above the medium-term average in the mid-50%s. Even worse, the beta of the top 20 client holdings is a record 1.1x – everyone is all in on the mega-cap technology names.

It is not yet a done deal that US cash rates will rise to 4% but numerous signs point to inflationary pressure building in the world's bellwether economy. The unemployment rate is 3.8%, core CPI inflation is 2.2%, headline inflation is 2.8% and will feed through to the core as higher oil prices seep into the price of everything. Then there is the stagflationary impact of the Trumpian tariffs, which are small at present but have the potential to spiral in tit-for-tat exchanges. Even worse, huge US tax cuts make no sense at a time when their economy is already at full employment. Ben Bernanke suggested the US economy is having a Wile E Coyote moment – it looks good at the moment but it will go off the cliff in 2020, when the sugar hit from stimulus fades but the fiscal and inflationary impacts remain.

Alongside higher cash rates, the tourniquet from the Fed's quantitative tightening is slowly tightening. Recall that it began at $10bn/month back in October 2017, went to $20bn/month in January 2018, $30bn/month in April, it will rise to $50bn/month from this month onwards and reach its apogee of $60bn/month from October.

The US moves will be added to on a global basis by the ECB's end to QE, where it will move from E30bn/month to E15bn/month from September and zero from end-December. To put the size of the ECB actions in context, UBS estimates that the "shadow" Eurozone policy rate is -5% but by year end, they will merely be left with their official cash rate at 0%.

For all the focus on QT, one aspect that we have been pondering is that the equity market impact is being dwarfed in the short run by the massive size of share buybacks. JP Morgan estimates that Q2 saw $150bn of US share buybacks actually carried out, with significantly more announced. This compares to circa $60bn of QT by the Fed in the same period. UBS estimates that $700-$800bn of buybacks will occur during 2018. As to whether the buybacks are a good idea, we came across a SEC study of 385 recent buyback announcements. They found that a share price typically rises post announcement and that in the first eight days of this period, executives on average sell $500k of stock per day versus $100k normally. Hmm.

The overall extent of the surge in US buybacks is shown by BAML's estimate that since the GFC, US companies have carried out $5trn in share purchases and $14trn of debt issuance. 2019 could be very interesting as QT reaches full speed, while share buybacks wane. In the very short term, July will see 80% of US companies be in a blackout ahead of their June quarter earnings, removing a key prop from the market.

One final macro thought around the US lifting rates and ramping up QT are the implications for emerging markets and China, whose currency is loosely pegged to the USD. The options are either to keep the Yuan stable by tightening alongside the US or to accept a weaker Yuan and inflation by not following US policy. China's actions are complicated by unorthodox policy transmission channels and by their response to US tariffs, but if anything, they seem to have eased slightly. This has seen the USDCNH move from a peak of 6.25 during April to 6.70 as this is written. Will there be a repeat of the 2015/16 fears of capital outflows and a decline in China's forex reserves? At the same time, the Chinese equity market has fallen from a peak of 3550 in January to 2750 today – a 22.5% decline. According to Bloomberg, the average China AA corporate bond yield has risen from 4.7% in mid-2016 to 7.0% today.

Similarly, after nearly doubling in the two years to late January 2018, the MSCI Emerging Markets Index (EEM) has fallen by 18% since then. Interestingly the S&P500 Index moved in lockstep with the EEM for the last couple of years but the two have diverged sharply since April, with EEM being -10% versus

the SPX +3%. Another fascinating divergence during June was that the GS US momentum index reversed earlier huge outperformance to be -7% in June while the GS Crowded Short Index rose +6% in the month.

Put all this together and we will keep crying wolf. Globally, monetary conditions are tightening and the rising pace is starting to matter. Emerging markets and China have well and truly hit the skids from both this and the nasty potential impact of tariff wars. US markets are flat to down this year except for the impact of a handful of go-go mega-tech stocks. The NZ and Australian markets are priced at forward PE multiples that are at record levels of over-valuation relative to bond yields that are unusually low, while the earnings outlook is difficult as the NZ economy in particular slows. We would love to be bullish but this is a time to tread very carefully indeed.

Returning to the performance of the Fund during June, our return of -0.11% post all expenses was driven by a mediocre “winners to losers” ratio of 52%. Our standout positive contributors were actually larger than our losers but we did not have quite enough of them. Unsurprisingly in such a strong month, our longs collectively contributed +1.79%, while our shorts detracted -1.86%. To some degree, the Fund was a cork bobbing on the ocean and this shows the importance of carefully managing the net positioning in such a strong directional market. This net exposure did lift a touch from +27.7% to +30.5% over the month but it remains noticeable that we do very well on the rare down days, when our low beta longs are relatively unscathed while our high beta shorts are hit hard.

Our largest detractor was a mid-sized short in Fisher & Paykel Healthcare (FPH.NZ, +12.1%). We made good returns from the long side when FPH fell back below $9 in early 2017 but its meteoric rise since then to north of $15 epitomises the absurdity of the current market. Somehow, FPH has managed to catch the price momentum train despite a result in May that was disappointing as their sleep apnea mask product cycle has lagged relative to competitors. This saw earnings downgrades of 3-5% but the share price has since risen 15% to be on a Mar19 forecast PE of a mere 41.3x. We would also suggest that they might be lucky to make this number given recent history. A brief examination of the research published by one leading broking house shows EPS forecasts for the Mar19 year progressing from 41.5cps back in Nov16, to 39.6cps in May17, to 38.1cps in Oct17, to 36.8cps in May18. Forecasts for the 2020 year have similarly waned but valuations have somehow kept up with the share price. The perception of “quality” and the reality of “price momentum” have blinded investors to more difficult recent times in the business – we will stay short.

Our second notable headwind came from one of our favourite frustrating shorts in the form of Ryman (RYM, +5.0%). We have expounded at length on the dangers of their equity-light business model in the event of a dramatic slowdown in the housing market but RYM continues to surf the large cap price momentum wave that is driving this market. We are seeing a classic cycle of rapidly expanding retirement unit supply meeting a slowdown in the housing market. Our concerns appear to not be greatly shared elsewhere at this stage. The Labour-led Government appears determined to act on housing affordability and a raft of measures will play out over coming quarters.

The one long position that detracted from returns was a premature move into the infrastructure and engineering contractor, RCR Tomlinson (RCR, -13.1%) after it had fallen hard the month prior. RCR has a strong pipeline of infrastructure and utility work, with only relatively limited resources exposure. Concerns appear to focus on one of their resources contracts where we believe they are well placed and more broadly on whether the rapidly expanding solar segment (a strength of RCR) can continue to grow at its current pace given pressures on the grid. On a PE of 9.0x Jun19 earnings, we would suggest that risks are heavily discounted already and that RCR is very well placed to benefit from Australia’s infrastructure boom.

Other headwinds came from our short in IDP Education (IEL, +8.6%) which is now on a stratospheric forward PE of 48.5x; a large short in National Storage REIT (NSR, +6.9%) which is extremely expensive in our relative value modelling of the property sector and whose balance sheet has only limited room left to fuel their acquisition model; and a large short in the bumper bar maker, ARB Corporation (ARB, +6.3%) which has become a price momentum darling but is on a forward PE of 33.3x and may have some risks as Australian car sales slow and rising petrol prices likely start to crimp sales in their key SUV segment.

Our strongest tailwind came from our large long-held position in the retirement and tourism village company, Ingenia (INA, +14.9%). INA had been a frustrating name for some time as market perceptions of risks in meeting their development target held them back, especially given the difficulties that their peer Gateway had faced in meeting their targets. Our bottom-up village modelling pointed to no major concerns and we also saw the lower end of the Australian housing market not slowing to the same extent as the mid-upper end and inner-city apartments. Moreover, the key value driver for INA is not the one-off development profit from selling a house but the annuity land rental stream that appreciates forever at CPI+. This is a very different model to that in NZ and we always viewed this rental stream as being very cheap at prevailing cap rates of 7.5%-8.0%.

Two things changed in the month. Firstly, they upgraded the settlement guidance number that the market wrongly fixates on and more importantly, their struggling competitor, Gateway (GTY, +32.4%) became the subject of a contested takeover battle as at least two expert global players appear to share our

view on the sector. Fortunately, we also held a medium-sized long in GTY which we had bought after their last warning. We have since exited as the price has moved to what we view the take-out price will ultimately be. It will now be fascinating to see if the unsuccessful suitor develops any interest in INA, either as a target or perhaps as a capital partner. Ingenia and Gateway added 0.61% between them to the Fund.

Our second stand-out was our extremely large long in Centuria Metropolitan REIT (CMA, +6.1%). The Australia property sector has been strong in recent months (excluding shopping centres) as cap rates have continued to contract, office and industrial markets remain strong and corporate activity has crowded investors into remaining names. A touch scarily, I could have written those very words ten years ago. CMA is the cheapest name in Australia on our relative value modelling and suburban office looks to have more puff left in it than most other sub-sectors.

A final tailwind of note was our large long in Turners (TRA, +8.1%) which rebounded from deeply oversold levels and where we had lifted our holding to the limits of our comfort levels. As written about previously, we rate management, we rate their strategy to vertically and horizontally integrate through the car industry and we like how the sheer size and fragmentation of the car industry gives them the opportunity to reinvest for growth for many, many years to come. A solid result appeared to calm some nerves, and while we aren't conceptually in love with domestic NZ exposures as the economy slows, their secular growth combined with a forward PE of just 10.5x sees this remain a core holding.

Thank you for your ongoing interest and support through what was a difficult and at times frustrating quarter. It was our first negative quarter in the Fund's history and rather than any significant individual stock selection disasters, we feel as though we were caught out by a veritable wall of hot money chasing a select group of hot stocks to infinity and beyond. This started to change in the last several days of June, when we had a good bounce from our lows and this has continued so far in July. It is interesting that "price momentum" has suddenly started to struggle as a style globally – except for benighted little NZ. The fundamentals in NZ and Australia ex financials have never looked more stretched and the catalysts of slowing domestic economies, emerging market wobbles and global monetary policy tightening are upon us.

Matthew Goodson, CFA

Disclaimer: The information in this publication has been prepared from sources believed to be reliable and accurate at the time of preparation but Salt Funds Management Limited, its officers, directors, agents, and employees make no representation or warranty as to the accuracy, completeness, or currency of any of the information contained within, and disclaim any liability for loss which may be incurred by any person relying on this publication. All analysis, opinions and views reflect a judgment at the date of publication and are subject to change without notice. This publication is provided for general information purposes only. The information in this publication should not be regarded as personalised advice and does not take into account an individual investor's financial situation or goals. An individual investor should, before making any investment decisions, seek professional advice. Past performance is not a reliable indicator of future performance and no representation or warranty, express or implied, is made regarding future performance. Soft closed to new investors means the Fund is generally only available for investment to existing investors in the Fund and new investors of approved financial advisory firms.