Salt Long Short Fund Fact Sheet – February 2021

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 28 February 2021

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$49.2 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 28 February 2021

Application	1.7446
Redemption	1.7376

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 28 February 2021

Long positions	49
Short positions	31

Exposures at 28 February 2021

Long exposure	90.31%
Short exposure	-34.11%
Gross equity exposure	124.41%
Net equity exposure	56.20%

Largest Longs	Largest Shorts
Tower	Blackmores
Shaver Shop Group	Property for Industry
Marsden Maritime Holdings	Reece
Emeco Holdings	IDP Education
T & G Global	Lovisa Holdings

Performance[1] at 28 February 2021

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%
2019	-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%	1.80%	3.18%	3.39%	-1.81%	2.41%	-1.67%	8.31%	6.76%	5.88%
2021	1.24%	1.90%											3.16%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	10.14%	1.24%	-0.60%
6 months	20.13%	2.54%	8.76%
1 year p.a.	14.33%	5.25%	9.58%
2 years p.a.	10.86%	5.76%	13.16%
3 years p.a.	4.08%	6.09%	10.81%
5 years p.a.	5.15%	6.45%	13.40%
Since inception p.a.	7.75%	6.83%	10.67%

[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.

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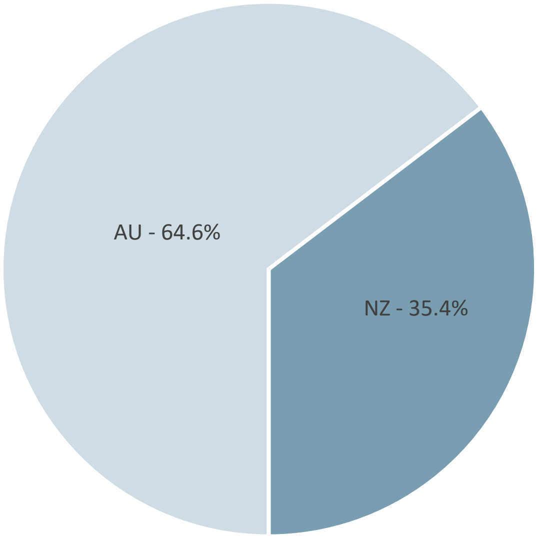
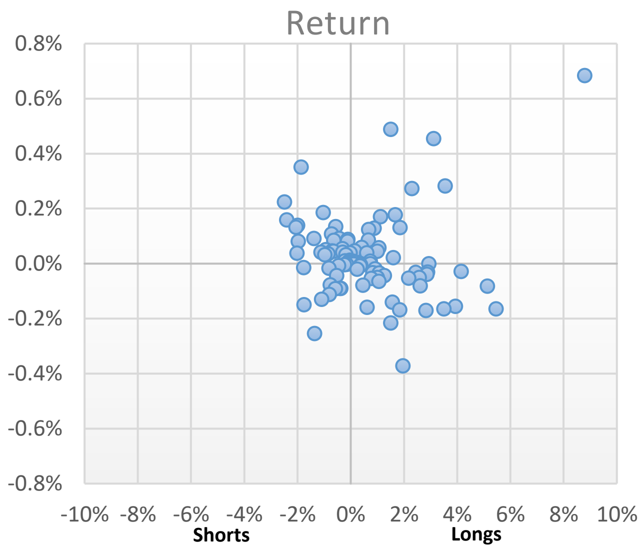
Country Allocation at 28 February 2021 (Gross Equity Exposure)



February 2021 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

February saw a continuation of the recent run of strong performances by the Fund, with a pleasing return of +1.90%.

Markets were volatile during the month, with the NZ index trading in a wide 10% range, with this disguising even greater inter-sector movements. Unusually, Australia was somewhat more staid, with a 4% range. The Fund used these movements to lock in profits from a number of successful positions and to reduce overall risk. Our gross positioning fell from recent levels of 150%+ to an unusually low 124% at month end. We expect it to gradually rise from here especially as opportunities arise from the short side in what remain bubbly markets.

Our net length remained optically long at 56% but our shorts are far more volatile than our longs. We have continued to perform well in negative periods for the market. There were eleven down-days in February for the 50/50 index of Australia and NZ, with an average return on those days of -0.61%. The Fund was up on six of those eleven days and delivered an average return of +0.06%.

Hardly stellar but it clearly shows that the Fund is delivering equity-like returns with no correlation to said equities. As bull markets become more volatile in their late middle age, this formerly sought-after attribute of the Fund may perhaps come back into fashion.

The month saw significant global market volatility centred around a reflation narrative. The yield-sensitive NZ benchmark fell by a startling -6.8%, while the more cyclical Australian bourse eked out a +1.5% advance. The major story underpinning everything in February was the global rise in 10-year bond yields. NZ moved the most sharply, with the 10-year benchmark surging from 1.10% to 2.02%. Australia rose from 1.13% to 1.86%, while the US rose from 1.06% to 1.44%.

Markets are starting to sniff out the return of inflation and are testing whether central banks are still providing a Greenspan, Bernanke, Yellen, Powell, Orr put. The answer came just after month end, with the RBA leading the way by doubling their daily dose of QE to signal that bond yields must be suppressed and that equity and housing markets cannot be allowed to fall, no matter what. If the RBA was actually focused on achieving inflation as they proclaim, then surely they would have welcomed the positive inflation expectations embedded in higher bond yields?

While NZ long bond yields have "only" risen circa 1.4% from their lows last September, the magic of convexity means the price move has been huge. If you had bought the 15 May 31's back in September, the chart over leaf shows how your capital losses are in a 15% hole that the 1.5% coupon won't dig you out of. No wonder other long duration assets such as equities have had a speed wobble and central banks are beginning to take note.

On March 1, the Reserve Bank of Australia was the first to join the fray and decided to send a message to markets that it will not abide by the reflation narrative. They upped their QE purchases of long bonds from $2bn to $4bn. Ironically, that same day, Australia had housing data that UBS described as an "up crash". Australian house prices rose by 1.7% in the month of February and the value of January home loans rose by 11% on the previous month, to be 74% above their level at the lows in May. Hmm.

The bubble-blowing risks from the RBA's actions are clear and make Adrian Orr look like an old-fashioned hawk. Indeed, former RBA Governor, Bernie Fraser was quoted in The Australian the next day saying, "*I don't have any confidence in the forecast 3-4 years out that interest rates are going to stay where they are. That's an extremely courageous forecast.*"

The emerging view in Australia is that the central bank will soon need to introduce some macro-prudential measures to keep control of house prices, just like we are doing in NZ. Some readers of this letter may have memories of Muldoon's old wage/price freezes and the cascading market interventions to try to keep them in place. Well, current actions by central banks have an eerily similar feeling as they too engage in their King Canute impersonation to hold back the inexorable tide of the market.

As Macquarie's chief global strategist put it, we are witnessing a clash between state control versus markets. It seems to us that there are four possible scenarios: i) The reflation pick-up is for real and markets win; ii) the reflation pick-up is real but central banks enforce deeply negative real interest rates; iii) the inflation pick-up proves to be transitory and we return to Goldilocks; iv) the opposite of Goldilocks - stagflation. We will adjust the Fund's positioning as the evidence evolves.

Some interesting Bank of America research during the month looked at past evidence of which securities do best in a time of gently rising inflation (1965-68) and which do best when inflation rises sharply (1969-73).

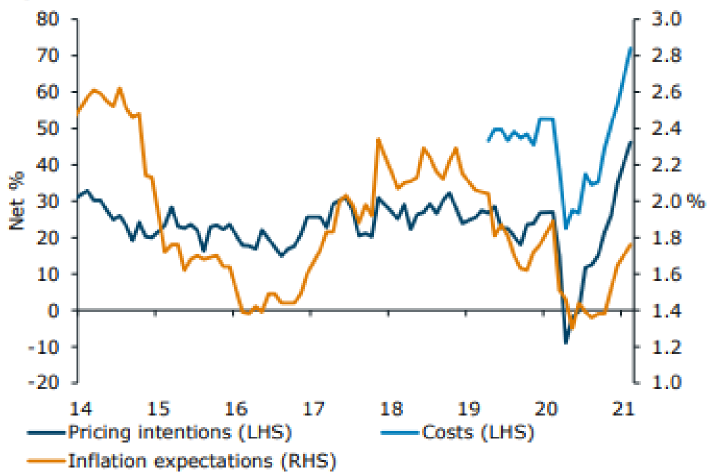
In the former case, small caps, value stocks and growth companies all outperformed. Laggards were REITs, utilities, telcos, bonds and commodities. In the sharply rising inflation scenario, you wanted to be long commodities as the stand-out trade. Small caps, utilities and growth stocks were the key underperformers. Whichever way you cut it, unless the inflation fears are entirely mis-placed, high yielding TINA stocks such as property and utilities may have some hard yards from here.

An important question to ask regarding the sharp rise in long bond yields is how much is real and how much is nominal? If real yields remain anchored, equities are normally a good hedge when nominal yields are rising because that reflects inflation, which also boosts revenue and earnings. This explains the recent outperformance of cyclicals, while GAAP and TINA stocks have begun to lag because their earnings don't lift much but the rate at which they are discounted rises. Last year's rise in yields was chiefly nominal but latterly real yields have begun to rise as well.

Given all the excitement generated by the reflationary trade that is driving markets, an obvious question is whether the market is right. To date, much of the information is anecdotal and survey based but the evidence appears very strong indeed.

In NZ, the chart below speaks for itself and comes from the long-running ANZ Business Opinion survey conducted by their excellent economics team.

Figure 3: ANZBO inflation indicators



Source: ANZ Research

In the US, our eye was taken by the February ISM Survey which was published as this piece is being written. The prices

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paid sub-index was +4 to 86 – it was in the 40's last year. The 64 reading for the order backlog sub-index was the highest since April 2004 (a time which featured a bond rout for the ages). What really took our eye were their selected quotes from survey respondents:

- "Supply chains are depleted; inventories up and down the supply chain are empty. Lead times increasing, prices increasing, [and] demand increasing. Deep freeze in the Gulf Coast expected to extend duration of shortages." (Chemical Products)
- "Steel prices have increased significantly in recent months, driving costs up from our suppliers and on proposals for new work that we are bidding. In addition, the tariffs and anti-dumping fees/penalties incurred by international mills/suppliers are being passed on to us." (Transportation Equipment)
- "Overall capacities are full across our industry. Logistics times are at record times. Continuing to fight through shipping and increased lead times on both raw materials and finished goods due to the pandemic." (Fabricated Metal Products)
- "Prices are going up, and lead times are growing longer by the day. While business and backlog remain strong, the supply chain is going to be stretched very [thin] to keep up." (Machinery)
- "Things are now out of control. Everything is a mess, and we are seeing wide-scale shortages." (Electrical Equipment, Appliances & Components)
- "Labor shortages at suppliers are affecting material deliveries and prices." (Plastics & Rubber Products)
- "We have seen our new-order log increase by 40 percent over the last two months. We are overloaded with orders and do not have the personnel to get product out the door on schedule." (Primary Metals)
- "Prices are rising so rapidly that many are wondering if [the situation] is sustainable. Shortages have the industry concerned for supply going forward, at least deep into the second quarter." (Wood Products)

We would suggest that while the resurgence of inflation is for real, what really matters is whether this proves transitory (the position of central banks) or whether it gets embedded (the fear of bond bears). We will know the answer when we are older.

As mere investors, what are we to make of all of this? It is of little matter in the short term as to whether central banks are right or wrong in their omniscient market interventions. What matters to us is correctly calling such interventions and positioning the portfolio to make money from them. The risk that keeps us up at night is that central banks' desires to run high pressure economies will ultimately see the pressure build up and pop, taking markets with it.

Our current answer has a number of different strands:

1. Long bond yields are very important to equity markets. We are unlikely to see a return to the extreme NZ lows of 0.5% at the height of Covid-19 fears. The pre-Covid range of 1.0%-2.5% seems more realistic in an ongoing era of market-buoying monetary policy. Still low but nowhere as low. This favours cyclicals over the GAAP (growth at any price) and TINA (there is no alternative) stocks.
2. TINA stocks will still see some support as conservative investors are being punished by central banks for having the temerity to save. A high-end term deposit rate of 1.0% falls to 0.61% post-tax from April 1. Property stocks may have seen their best days. Our positioning has moved from very long to slightly long by shorting some of the most expensive ones. On balance, they may still do okay but more so in Australia than NZ. Australia is cheaper and physical property prices haven't been driven through the roof by wild-eyed syndicators to quite the same degree. A hard rain's gonna fall at some stage in this highly levered segment and funding costs are beginning to rise.
3. We have de-risked absolute risk levels in the Fund by taking the gross portfolio position down from the 150-160% region to just 124% at month's end.
4. We have slightly reduced the size of a couple of our outlier longs such as Tower (which incidentally is travelling very well), while aggressively lifting those of a number of other positions where we have strong conviction – typically from the long side.
5. We continue to run our net length at a superficially very long 56% but view this as market neutral given the low volatility of our longs relative to our shorts.
6. We continue to see numerous shorting opportunities in egregiously over-priced "story stocks" – think of them as the Teslas of the Antipodean markets. Risk management means we are using volatility to be very light-footed and we are generally keeping the individual position sizes relatively modest. Their ultra-high beta gives us the insurance that we need to protect the portfolio on down days.

7. The battle between the reflation narrative of markets and the bubble-blowing desire of central banks is being caused by the fact that economies are waking up under the dual impulse of free money stimulating them and vaccine rollouts driving realistic re-opening optimism. We are long re-opening plays such as Sky City (SKC), Vista (VGL), United Malt (UMG) and Redcape Hotels (RDC). We are also long cyclicals such as Emeco (EHL), Coronado Coal (CRN) and Turners (TRA). Ironically, the Fund had a very good month in February but it came from eclectic stock-picking rather than from these cyclical names which actually weighed on performance after being strong previously.
8. Signs of excess are everywhere, with a variety of measures showing very extended positioning in equities from mass-market retail, multi-asset funds and hedge funds. This suggests there is a greater risk than normal of a sudden sharp market downturn.

Returning to the performance of the Fund in February, our return of circa 2.10% (pre-tax and costs) featured strong gains from both the long and short books. Our longs contributed +0.75% and our shorts delivered +1.36%. Our overall “winners to losers” ratio was a solid 60%, within which a pleasing 74% of our shorts added value.

After having weighed on us slightly last month for no obvious reason, our large holding in Tower (TWR, +8.0%) was a stand-out compared to the otherwise weak NZ market. They acquired the legacy ANZ Bank insurance portfolio that they have underwritten for many years in what is likely to be a highly accretive deal based on reasonable retention assumptions. Policyholders will slowly switch over directly to Tower as their policies mature over the year ahead and Tower will cease paying commission to ANZ. This is a classic opportunity that Tower has to deploy its capital-rich balance sheet. We would expect further examples of organic and inorganic growth.

Tower reiterated its earnings guidance late month, with the key moving parts being continued weak earnings on its short duration investment portfolio; solid GWP growth despite headwinds from weak Pacific economies; claims cost inflation not being as significant as perhaps feared; excellent progress in reducing their management expense ratio as policies transition to the new IT system; and large claims events from the Lake Ohau fire and Fiji hurricane being a little less than feared. Critically, they stated their intention to pay a 2.5cps interim dividend and target 6cps for the fully year. This is material on a 75cps share price. The TWR holding has certainly been a journey for the Fund but it is finally getting there.

The second key tailwind came from our mid-sized long in the engineering consultant Cardno (CDD, +33.8%) who reported a very strong result. Even with the share price surge, they are on a Jun22 PE of 7.2x and Jun23 of 6.1x, while offering a strong balance sheet and a forecast Jun22 dividend yield of 9.7%. We like growth companies on these sorts of metrics.

Cardno’s former sibling, Intega Group (ITG, -3.1%) also reported a very strong result but aside from a pop on the day did not get the same degree of market affection. ITG is on a Jun22 PE of 6.8x and Jun23 PE of 5.0x and also has a strong balance sheet. Both CDD and ITG are majority owned by Crescent Capital, with the activist investor Viburnum also having reasonable stakes. We have no particular insight as to their future but would not be shocked to see positive catalysts play out.

There were a number of other notable tailwinds, with these being led by a large long in Graincorp (GNC, +4.5%), whose overall performance was only solid in the month but where we altered the holding with good timing. GNC is benefitting from a record Australian grain crop at a time when global prices are high due to difficulties in other countries. We strongly suspect it remains cum upgrade.

A well-timed short on Mercury (MCY, -15.1%) was a strong contributor as it retreated from what we viewed as expensive levels in the face of rising bond yields; our old friend Vitalharvest (VTH, +8.7%) benefitted late in the month from a new takeover suitor; our short in Ryman (RYM, -5.9%) retreated for no obvious reason and we continue to be light-footed in how we position in it; and our long-standing holding in Kina Securities (KSL, +12.8%) rose strongly on a solid result about which investors had clearly held some fears – what could be more cyclical and have greater positive leverage to rising bond yields than a PNG bank?

Detractors from fund performance were notably concentrated in several cyclical names, where we are largely happy to remain long in a world of rising bond yields and re-emerging growth. For various reasons, they just didn’t work this month.

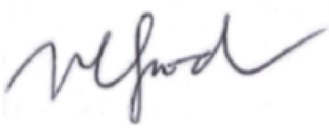
The way was led by a long in Orica (ORI, -17.7%) whose explosives business has been affected to a greater degree than anyone expected by the difficulties in thermal coal. We lowered our holding and may choose to exit entirely given cheaper and less accident-prone exposures elsewhere.

Our long in the coking coal producer Coronado Coal (CRN, -17.2%) did not work at all despite a result that was within a whisker of expectations. We see a cyclical business that has fallen from $3 to $1 and whose commodity has a strong outlook given constrained supply and strong demand from steel production growth. Our long in the mining equipment rental company Emeco Holdings (EHL, -7.6%) also weighed. They are successfully pivoting away from a reliance on thermal coal, their balance sheet is strong, they are generating strong free cash-flow but they are trading at less

A final detractor of note was a mid-sized short in IDP Education (IEL, +18.6%). This provider of English language testing services and global student placements is clearly a re-opening beneficiary but its enterprise value is now well above pre-Covid levels. China's views about students coming to Australia have also been made very clear. The love from sell-side brokers is palpable on a Jun22 PE of 59.8x and Jun23 of 37.7x. We would only note that the cash-strapped Australian universities own 40% of the business via Education Australia and have signalled they are reviewing this. A positive sell-side view would appear to be de rigueur given this backdrop.

Thank you for your continued support of the Fund. As you may gather from the preceding discussion, we are seeking to be nimble and position the Fund to make money regardless of what lies ahead for markets. We think the rise in bond yields back to pre-Covid levels is for real. Rising inflation is also for real but whether it proves transitory or permanent remains to be seen. In the latter scenario, bond yields could have a lot further to rise and equity markets could get very choppy, with cyclical beneficiaries strongly outperforming, while growth darlings lag badly.

We do worry that cheap money continues to permeate everywhere. Retail investor bullishness across equity and property markets is clear to see and positioning is very long. This does raise the risk of a sudden market accident. That is why we continue to keep close track of our performance on negative days and make sure we have some insurance. We continue to see 2021 as being a year where having no correlation to equity markets may pay off.



Matthew Goodson, CFA