SALT
Funds Management

Salt Long Short Fund Fact Sheet – September 2019

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 September 2019

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$113 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 30 September 2019

Application	1.5210
Redemption	1.5148

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 September 2019

Long positions	68
Short positions	39

Exposures at 30 September 2019

Long exposure	85.99%
Short exposure	-57.57%
Gross equity exposure	143.55%
Net equity exposure	28.42%

Largest Longs	Largest Shorts
Tower	Ryman Healthcare
QANTM Intellectual Property	BWP Trust
Turners Automotive	Auckland International Airport
Marsden Maritime Holdings	REA Group
360 Capital Total Return Fund	Commonwealth Bank of Australia

Performance[1] at 30 September 2019

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%	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%				**4.77%**

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	5.53%	1.56%	3.20%
6 months	8.18%	3.17%	10.76%
1-year p.a.	-3.15%	6.58%	14.10%
2-years p.a.	0.00%	6.67%	13.73%
3 years p.a.	2.07%	6.70%	12.00%
5 years p.a.	6.17%	7.17%	12.05%
Since inception p.a.	8.23%	7.23%	11.63%

[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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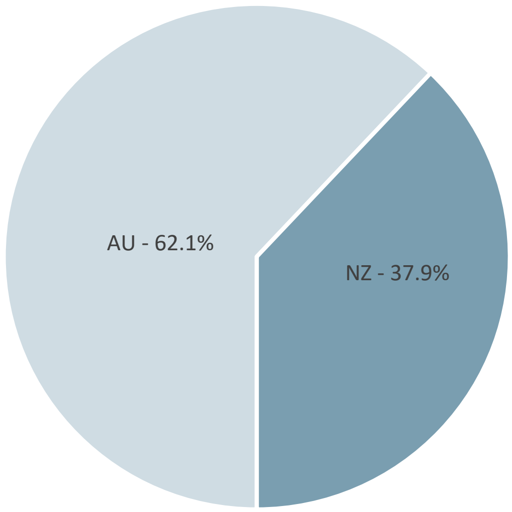
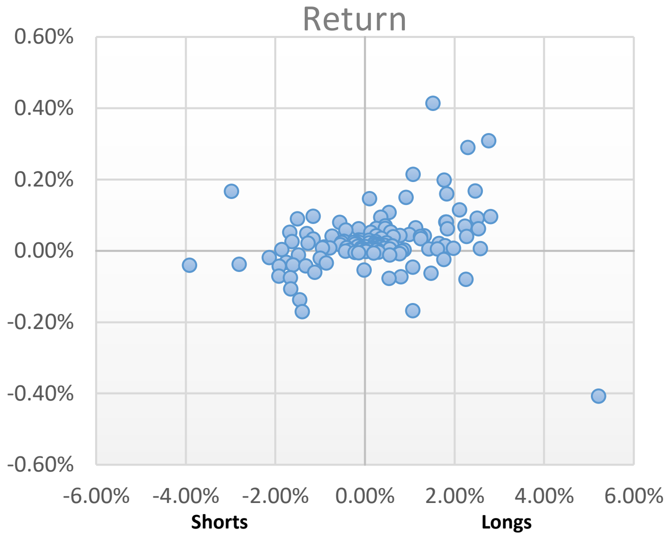
Country Allocation at 30 September 2019 (Gross Equity Exposure)



September 2019 Individual Stock Contribution



Fund Commentary

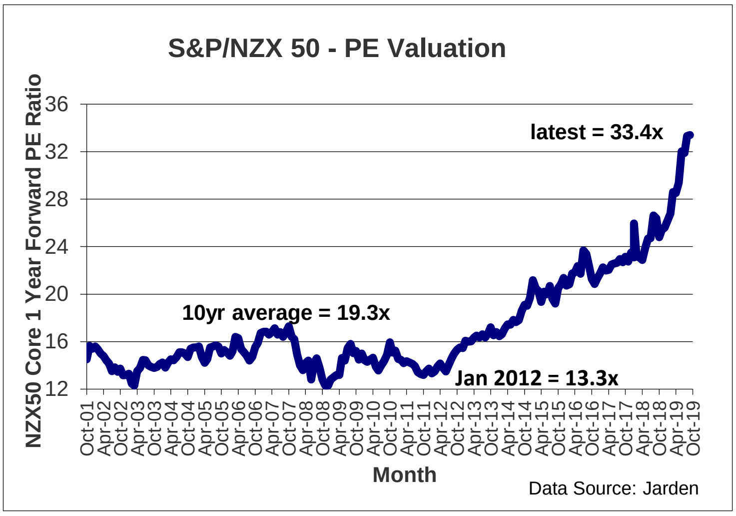
Dear Fellow Investor,

The Fund delivered a very strong performance in the month of September, with a return of +2.93% after all fees and expenses. Since inception, the Fund has returned +51.5% after all fees and expenses.

This performance was pleasing relative to a backdrop of solid equity market returns of +1.6% for NZ and +1.8% for Australia. As an aside, just as the NZ market finished the last day of August +1.67% above its low earlier the same day, so it staged a furious late rally on the last day of September to close +0.86% on the same intra-day basis. This doubled the monthly return and highlights how passive inflows are far too big for our market, with their poor investors getting set at ever higher prices. The deeper Australian market does not systematically see the same unusual end-of-month behaviour.

The Fund's returns were even more pleasing when one considers the relatively heavy "insurance" that we carried, having started and ended the month close to 30% net long but running the Fund in the 25-27% region for most of the period. Risk-adjusted, our style of generally being long cheap stocks and short expensive ones means "market-neutral" sits in the low 30% region.

The impact of this "insurance" can be seen in how the Fund performed on the 9 negative days experienced by the 50/50 index of NZ/Australia during the month. We actually had positive returns on 5 of the 9 negative days, we outperformed on 8/9 of those days and our average return on those days was +0.12% versus -0.31% for the 50/50 index. This illustrates how the Fund is set up to grind out positive returns irrespective of equity market conditions. This has not been a particularly valuable attribute against a backdrop of a raging bull market but we believe it will be extremely valuable when market conditions change. In a world where all asset classes are extremely expensive, this Fund aims to provide a true alternative to what comes next.



As shown above, little has changed over the last month in terms of extreme valuations. The forward PE for the "core market" of 33.4x is flirting with recent historic highs, while bond yields were little changed over the month at 1.10%. A massive size divergence remains in play, with the median PE being a perfectly acceptable 18.8x with +6% forecast earnings growth, whereas the overall market actually has a -4% earnings contraction projected. Thanks to passive, the bigger and more expensive a name, the more it goes up.

A fascinating US milestone was reached in August, when according to Morningstar, the amount of money in US passive stock funds reached $4.4tn to surpass the $4.2tn held in active funds for the first time ever. Vanguard accounts for almost a quarter of the entire market. By definition, passive funds free-ride on active investors for price discovery but there is some unknowable tipping-point at which passive becomes too big and that mechanism breaks down. Passive then sets its own prices, driven by the weight of money. This could see a bubble start to form in the biggest and most expensive stocks which comprise the largest proportion of passive funds. We think we are at this point in NZ.

As we have previously highlighted, when you break the S&P/NZX50 Index into groups of ten by size, the two largest groups are up strongly over the last year, while everything else has fallen. Similarly, there is a record divergence between the average forward PE ratio of 33.4x and the median of 18.8x. Over 40% of the NZ market now transacts in the 15 minute closing auction – the period during which passive funds set their closing prices.

In our view, the valuation dispersion between large and small stocks and the weighting of trading towards the closing match suggests the NZ market has potentially reached a tipping point and could be very vulnerable to a wave of forced passive selling in the event of any left-field shock.

At an individual stock level, there was some fascinating evidence of the distortions caused by passive during the month. Goodman Group (GMG) fell out of the global benchmark property index (FTSE-EPRA NAREIT) and Blackrock subsequently filed as selling more than 30m GMG shares, taking its holding down from 8.2% to 6.4%. From recent peak to trough, such passive selling drove the GMG share price down -14.1% versus the Australian property stock index ex GMG which we estimate fell by only -5.5% over the same period. Nothing like having a forced seller out there.

We may be seeing another interesting example at present, where Fletcher Building's diminished share price is seeing it flirt with the removal threshold as one of seven NZ members of the MSCI Global Index. FBU announced a $300m share buyback in late June and they are executing this with quite some vigour. For example, it accounted for 47% of on-market volume on 26 Sept, 40% on 25 Sept etc. We may be too cynical and FBU doubtless views itself as undervalued but our observation is that more normal levels for buybacks tend to sit in the 10-20% region. Personally, I'd save my firepower for the tens of millions of shares that will be offer if it does fall out in November.

For so long as current bull market conditions prevail, there is nothing to stop the passive bubble inflating further but we are focused on the systemic risk that is posed in the event of a left-field shock. With passive funds being large relative to the size and liquidity of the underlying assets that they own, it is not hard to envisage a scenario of a shock causing passive outflows, which begets forced selling, which begets more outflows and so on until the spiral exhausts itself at markedly lower price levels. Remember portfolio insurance in 1987 and MBS's in 2007/08? Every good bubble has some form of financial innovation and this time around it is passive funds.

Similar risks and distortions appear to be at play in fixed income markets. According to BAML, there are now $17tn of negative yielding bonds (30% of the total) and $1tn of negative yielding corporate bonds. Who would purchase bonds at such yields? Well, a passive bond fund has no choice.

The Bank Of International Settlements published research during the month that examined how US$1.4tn of leveraged loans have been packaged into Collateralised Loan Obligations (CLO's) and sold off in small pieces. 60% of these loans have net debt/ebitda greater than 5.0x and one-third have net debt/ebitda above 6.0x. The percentage of covenant-lite loans has lifted from 20% to 80%. Even worse, many of the CLO's are illiquid but are held in funds with daily liquidity. As the BIS put it, "*…rapid growth of leveraged finance and CLO's has parallels with developments in the US subprime mortgage market*."

Moodys recently downgraded Ford Motor Company to junk, affecting US$80bn of debt, while according to S&P, the distress ratio for junk bonds rose from 6% in July to 9.4% in August. It might be time to look under the hood of your friendly high-performing fixed income manager.

JP Morgan research early in the month showed US corporate debt hit 17 year highs at net debt to ebitda of 2.5x for all companies ex financials. They do caveat this with the correct observation that plunging interest rates mean coverage ratios are fine for now. Similarly, BAML research shows that US$15tn of corporate debt has been issued since 2009, with US$5.4tn of this being spent on buybacks. Since 2018, they estimate that US companies have spent $114 on buybacks for every $100 they invested. Prior to 2017, this ratio was $60 to $100.

So far in 2019, buyback expenditures are up 20% on 2018 which was itself well up on prior years. Interestingly though, according to "Smart Insider", insider selling has hit US$26bn year-to-date which is the highest since the Nasdaq bubble in 2000. This malign combination of buybacks and insider selling is of far less concern in Australia and NZ but the US market still acts as a benchmark for our own markets.

As another way of measuring the build-up in debt, BAML show that US private sector financial assets are now 5.4x GDP versus previous peaks of 4.9x just prior to the GFC, 4.5x prior to the Nasdaq meltdown and a mere 3.3x prior to the 1987 crash. With debt levels at such an extraordinary high, BAML argues that economies are now driven by booms and busts in financial cycles and that a bond bust could be the scenario to fear. This suggests keeping an eye both on inflation and also on any distress levels, which as mentioned above, are starting to tick up.

Another sign of excess that may signal a market top is the Wework debacle. The sheer gall of "community adjusted EBITDA" (also known as profit before costs) will be sorely missed. In the space of just 30 days, Wework went from a $40bn unicorn that was about to IPO to a distressed asset that has had its credit rating cut to B- and has $47bn of future lease commitments versus $4.3bn of committed rent from tenants (many of whom are no doubt of a unicornish persuasion themselves). Alongside this, other high profile listings have bombed, with Peloton -23% in three days, Uber down more than 34% from its IPO, Lyft down 40% and Smile Direct Club down -48% after up-pricing its IPO. Beware of the banker in shiny shoes with a shiny smile and shiny new shares to hand out.

Aside from a surprise re-emergence of inflation or the spread of financial distress, another potential catalyst to keep a close eye on is politics. Using oddschecker.com, Elizabeth Warren is now at $2.05 to win the Democrat nomination versus $5.50 for Joe Biden. A Democrat President is at $1.88 versus a Republican President at $2.10. Investing legend, Leon Cooperman was perhaps a tad extreme when he stated that the US market would not re-open if Warren is elected but it is safe to say that the reaction would not be positive. Investors' minds are just starting to turn to policies such as the return of Glass-Steagall for the banks, a huge minimum wage lift, a large increase in upper-end income taxes, a lift in corporate taxes and the banning of fracking to name a few. We are passing no judgement on the policies – we are merely noting them in terms of their market implications. Political twists and turns in 2020 will be interesting to put it mildly and there is no risk premium priced in right now.

Returning to the performance of the Fund during the month, the return of +3.05% (pre fees and tax) was comprised of +3.01% from the long side and +0.04% from the short side. We were particularly chuffed with the latter given that markets rose during the month. Our "winners to losers" ratio was an unusually high 66% and we cannot actually remember a better outcome than that. We also had significantly more medium-sized winners than we did medium-sized losers, with only the odd flesh wound from one or two of our shorts in what was a relatively positive month for markets.

The largest headwind came late in the month from our large high conviction long in Tower (TWR, -8%). They pre-announced earnings for the Sept19 year which saw a solid beat as we had hoped. However, they accompanied this with a 1:4 equity raising at a relatively deep discount. This raising will be used firstly to buy Youi's NZ insurance book. We view this positively as it takes an aggressive competitor out of the market and the obvious operational synergies make it highly accretive. Our own numbers agree that the company's estimated $4.3m NPAT impact is conservative and we cannot fathom how one broking analyst who loosely covers the stock believes it to be $1m.

The second reason for the raising was a modest negative in that the RBNZ will no longer allow TWR to count their EQC receivable as part of their solvency capital. It changes nothing in terms of TWR's battle with the EQC for this money, where they carried out land and house repairs on their behalf. It was always likely to be a court battle between different engineers' models and the receivable is highly risked already. A gross $150m is in dispute with about 25% being land which is highly likely to go TWR's way. The rest is buildings which may vary from 0%-100% in TWR's favour. A net $70m has been recognised as a receivable which post $17m to reinsurers, leaves around $53m to TWR. Nothing has changed around the likelihood of receiving this money but what has changed is that the RBNZ is clearly going to take a more conservative approach to all insurers' capital positions. Over time, this is likely to see higher capital ratios and stronger premium growth than the status quo. On our forecasts, TWR is now on a Sept20 PE of approx. 9x with extremely strong growth thereafter as their costs fall towards those of peers. Patience.

Other headwinds were far smaller in nature, with a modest remaining long in Z Energy (ZEL, -12%) hurting slightly. We had made solid profits in this name having purchased it cum-dividend at earlier lows but overstayed our welcome. ZEL delivered a profit warning as their volume losses have reached a point where they have had to cut margins to stay in the game.

The only other notable detractor was a short we have built up in Fortescue Metals (FMG, +10%) close to its recent highs. They have had the best of times in 2019, with the month-end share price of $8.80 comparing to the adjusted $3.91 that they started the year at. These halcyon days are coming to an end. China is slowing, their proportion of steel made from scrap is growing, Brazilian ore supply is now coming back apace and iron ore is trading way above its cost curve as shown by a number of juniors with superficially attractive projects that they are trying to re-heat.

The largest positive contributor was our long-held and oft-discussed long in Pacific Current Group (PAC, +25%) which continued its stellar recent run. It finished the month 68% above the lows it plunged to back in late-June and not a great deal has really changed since then. The new news was PAC's highly accretive purchase of a stake in Proterra, a natural resources private equity investor but a deal like this was always going to happen given the burgeoning cash on PAC's balance sheet. In our view, it was a matter of when rather than if but clearly the market had been more sceptical. We have been slowly leaking stock but it remains a good-sized position and even now is only on a forward PE of circa 12x.

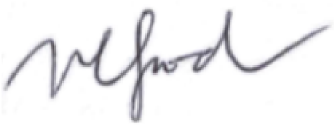
Our second notable winner was another long-held and oft-discussed name in the form of Turners (TRA, +12%) which rallied sharply following their comment that, "*Q1 trading conditions were robust and all business divisions were tracking ahead of budget and ahead of FY19…*" TRA is a name that has little coverage and arguably even less understanding but we are irresistibly drawn to companies that have a PE of 10-11x and an earnings growth outlook averaging 10%+. The new car sales outlook is gloomy to put it mildly but used cars are a steadier business and TRA appears to be picking up considerable market share in a highly fragmented market as low-end players exit. This is also taking the pressure off the prices that they need to pay for used vehicles. The one piece of less positive news was that they withdrew the sale of Oxford Finance as bids were received above book but clearly not at the very attractive prices that they were hoping for. This business does however appear to be performing well so it's a case of simply carrying on.

Continuing the theme of being rewarded for patience, the third stand-out was our long in QMS Media (QMS, +11%). There was no particular new news driving this but following the completion of the QMS NZ deal with Mediaworks, the balance sheet has been de-risked and there is also perhaps a gathering sense that a short term bottom has been reached in the outdoor advertising cycle in Australia. At $0.92, QMS is now 33% above the lows it plumbed in Q1 and Q2 but it remains well below the $1.00-$1.30 range in which it traded from 2016-2018. Ex-amortisation, QMS is still only on a PE of circa 10x Jun20 earnings with solid growth thereafter.

Other notable winners in a month full of them included Shaver Shop (SSG, +20%) whose ultra-low PE and 9% same store sales growth are finally attracting notice; Eureka Group (EGH, +11%) which still trades at a 10% discount to its NTA on elderly rental villages which have a cap rate of 10.2% despite government-funded income streams; Unibail Rodamco Westfield (URW, +6%) as it had been oversold ahead of its removal from a major European index; and a short in Auckland Airport (AIA, -5%) whose passenger numbers have been dwindling in contrast to their remarkable valuation.

Thank you for your ongoing investment and support of the Fund. It is satisfying to turn in an extremely strong month although we have no doubt that there will be more swings and roundabouts in the months and quarters ahead. We will remain diversified and continue in our aim of grinding out more winners than losers from both the long and short sides of the investment spectrum.

Given the Fund's role as a diversifier to long-only equities in a portfolio, we are paying particular attention to our performance on down-days and it is pleasing to report that on average we have turned in positive numbers on those occasions. This gives us confidence that the Fund will more than hold its own when we enter another rocky period for markets. With economies slowing, central banks being impotent, politics being tragi-comic and valuations stretched beyond all reasonable metrics, we continue to believe that markets are set up for an accident. This could be tomorrow or it could be some quarters away – we are walking the tightrope of aiming to provide a safe harbour when that arrives, while keeping our head above water in the mean time.



Matthew Goodson, CFA