SALT

Salt Long Short Fund Fact Sheet – June 2022

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 2022

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$58.9 million
Inception Date	31 October 2014
Portfolio Manager	Matthew Goodson, CFA

Unit Price at 30 June 2022

Application	2.0472
Redemption	2.039

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 2022

Long positions	42
Short positions	36

Exposures at 30 June 2022

Long exposure	98.26%
Short exposure	49.10%
Gross equity exposure	147.69%
Net equity exposure	49.48%

Investment Risk to 30 June 2022

Fund volatility[1]	6.44%
NZX50G / ASX200AI volatility[1]	14.04%
Fund correlation to 50/50[2] (daily)	0.088

[1] Annualised standard deviation since fund inception.

Fund Performance[1] to 30 June 2022

Period	Fund Return	OCR+5% Return	NZX50G/ASX 200AI Return[2]
1 month	-4.00%	0.56%	-6.33%
3 months	-5.12%	1.61%	-11.04%
6 months	0.64%	3.04%	-13.25%
1-year p.a.	6.50%	5.82%	-10.26%
2 years p.a.	19.63%	5.53%	4.21%
3 years p.a.	12.41%	5.64%	3.62%
5 years p.a.	6.58%	6.07%	7.39%
7 years p.a.	7.95%	6.40%	8.48%
Inception p.a.	9.31%	6.66%	8.50%

[1] Fund performance is after all fees and before PIE tax.
[2] NZX50G/ASX200AI 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.

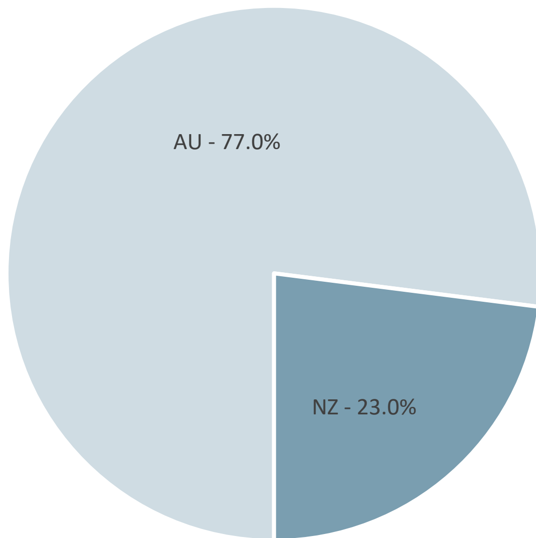
Cumulative Fund Performance to 30 June 2022

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.

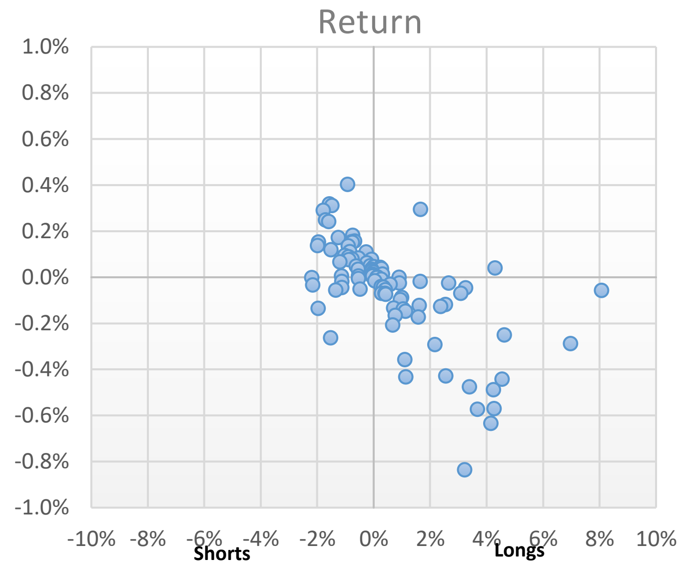
Largest Longs	Largest Shorts
Tower	BWP Trust
Dalrymple Bay Infrastructure	Endeavour Group
Australian Vintage	NIB Holdings
GDI Property Group	ASX
Shaver Shop Group	Ryman Healthcare

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 2022 (Gross Equity Exposure)



June 2022 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

The month of June saw the Fund finally succumb to the widespread selling pressures that were pervasive across global markets. Our return of -4.00% was disappointing and a little frustrating in that we did not own a single company which delivered a negative update. Indeed, several guided ahead of expectations but after an initial pop ended up well down – such was the highly correlated selling pressure across stocks.

The downside was further accentuated by Australian tax-loss selling, where a larger deduction can be claimed if a "loser" is sold prior to the end of the June tax-year. We naturally stood on the other side to try to take advantage of the bargains this created. Indeed, after clawing back some ground in the last week of the month, the first day of July saw extremely strong returns for the Fund as that peculiar selling evaporated.

Our return of -4.0% for June compared to -3.9% for the NZ index and -8.8% for Australia. Worse, the S&P/ASX Small Ordinaries Index plunged by -13.1% in the month. Around 77% of the Fund is currently in Australia as we naturally rotate to where the best opportunities reside. While our shorts tend to be only mid-large cap, our longs range across all market caps. The smaller end of the market really suffered in the month as tax loss sellers ran straight over any buyers brave enough to raise their heads. On that count we won a George Cross but the bounce for the Fund on 1 July suggests that wasn't posthumous.

While June was disappointing, we feel as though we have positioned the Fund for the next chapter in markets, with our key longs being very cheap and having good growth outlooks even in the face of the difficult economic conditions that lie ahead. Our shorts are expensive and/or carrying major cyclical downgrade and balance sheet risk.

Year-to date, the Fund is still in positive territory, being +0.6% versus a painful -16.6% chastisement for NZ equities and -9.9% for Australia. While the month of June was frustrating, we continue to be totally focused on delivered equity-like returns over the long run, with far less volatility than equities and with no correlation to them.

In looking under the hood of the steep sell-off by equity markets over the last few months, a couple of typical factors become apparent. Firstly, small caps have been far harder hit than large caps, with the ASX Small Ordinaries falling by -20.4% in the June quarter versus -11.9% for the ASX200 Index. This reflects smaller companies' typically greater operating and financial leverage to an economic downturn and their lesser liquidity was exacerbated by tax-loss selling.

Secondly, the correlations between stocks tend to rise markedly as investors react to bad macro news and want to sell everything at the same time. Even the Carbon Fund (CO2.nz) fell by -4.6% in June. This meant our net length of c50% hurt the Fund even though we didn't have a single warning amongst our array of holdings. It was the overall

positioning that did the damage. We also couldn't resist some of the bargains that appeared and these are starting to work already.

The sharp rise in correlations between stocks is shown for the US market in the chart over the page. This movement in correlations is a classic problem with modern portfolio theory – diversification doesn't deliver you the reduction in risk that you expect at the very time that you need it. When markets sell off, correlations temporarily start tending towards 1. We thought that many of our longs would be resilient – while their businesses were, their share prices weren't in the very short term. It is only short-selling that provides true protection.

The reasons for the sharp sell-off in equities all originate in rapidly rising inflation. Tightening monetary policy has led to a dramatic reduction in "liquidity" sloshing around the system looking for a home. This will intensify as quantitative tightening (QT) gathers pace. US money supply growth (M2) has averaged +7% growth over the long term but was well over 20% through much of 2020 and 2021, with a peak of +26% in Feb21. The latest data has it back to a normal +6.5%.

The chart above links liquidity explicitly to financial markets via the widely followed Goldman Sachs Financial Conditions Index. This incorporates interest rates, credit spreads, exchange rates and equity valuations. We can see just how loose conditions were through 2H2020 and most of 2021 but that they have now rapidly reverted to the tighter side of what has been normal in recent years.

Aside from these somewhat amorphous measures of "liquidity", the far purer measure of US 10-year bond yields has risen sharply from 1.4% at the start of the year to a peak of 3.4% in mid-June. This yield is the initial building block of the discount rate for every financial asset. Interestingly, it has rallied sharply in the last few days to 2.8%, with the market starting to test whether rapidly weakening economic conditions may see the Fed over-tighten.

Historically, bond yields have tended to peak about two months prior to inflation peaking, so it certainly feels as though markets are teasing out a repeat of history. Further, according to Deutsche Bank, the median time between the last rate hike in a cycle and the initial rate cut is only about four months. The widespread market rally in late June and early July has clearly been driven by a view that these historical analogues might repeat.

Is the market correct? Maybe but there is some risk that the bounce is a bear market head-fake for two reasons. Firstly, while shadow earnings expectations are below those that are published, the earnings downgrade cycle has barely begun despite a number of nasty forward-looking cyclical indicators. Domestic cyclicals have been hit very hard in recent months and this has now spilled over into commodity stocks, with Dr Copper being down 26% from its highs in March/April.

Secondly, there is the particularly gloomy possibility that economies have suffered from negative supply side shocks (Ukraine, Covid, transport disruption etc), which could mean that a recession doesn't necessarily mean a sharp slowdown in inflation.

Dr Doom, aka Nouriel Roubini examined this in a recent Project Syndicate article, where he naturally argued that the world is on the verge of a stagflationary debt crisis, with this being far worse than the 1970's because at least debt levels were low back then.

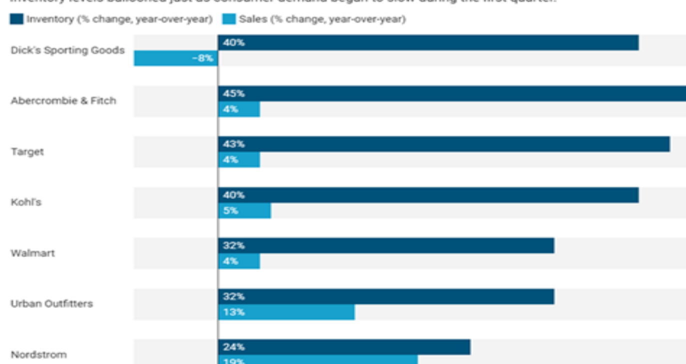
We obviously hope that his conclusion is wrong but his arguments are very interesting. He posits that the current inflation surge is due to a mix of excess demand factors (due to loose monetary and fiscal policy) and also due to negative supply shock factors. His view is that the supply side factors are dominating and that this raises the risk of a hard landing as central banks are forcing to keep tightening into a slowdown. Eventually, he thinks they will wimp out at the damage they are causing and accept a lift in inflation, which at least has the effect of deflating debt in real terms.

We sincerely hope he is wrong and there are a number of reasons to think he may be at least in terms of magnitude. We discussed a "bull-whip effect" last month, where it is a natural human instinct to hoard when there is a shortage, with that hoarding turning into panic-selling when the shortage dissipates. We have seen it with hand sanitiser and are perhaps on the verge of seeing it with gib board.

More generally, freight rates have begun to decline and some comments in the Financial Times by the CEO of AP Moeller-Maersk took our eye:

"Skou said that container shipping could soon be hit by a sharp reversal of the factors that have led to it booming since the end of the first wave of the coronavirus pandemic. He added that there could be a "bullwhip effect" where demand contracts and supply increases, after almost two years of the opposite phenomenon during which shipping groups were unable to respond to a surge in consumer spending. "When it happens, it could go quite quickly," he added."

Similarly, many US retail share prices have been hard hit as evidence has suddenly emerged that they have too much inventory rather than too little. We found the chart below from forbes.com quite interesting.



Now all we need is some combination of China continuing its fitful re-opening from Covid-19 lockdowns, the Ukraine war to end and house prices to continue falling at the recent rate of 2% per month for inflation to well and truly starting receding. Further, the share prices of semiconductor companies have started to plunge as chip shortages are starting to disappear.

Put all this together and our current suspicion is that inflation is close to peaking and will decline but sufficient disruption remains that inflation will generally remain at or above the top end of central bank target ranges. Spill overs into wage inflation will be a key driver of this. We may therefore have seen the worst of the increase in long term bond yields but they have merely risen to levels which makes sense in terms of inflation and normal levels of real interest rates.

This implies something of a middle path for equity markets. Inflation is far too high and may take too long to come down for central banks to wimp out just yet. At the same time, some of the negative supply-side drivers are already beginning to fade, which hopefully means Roubini's stagflationary debt crisis will not occur.

Interest rates and liquidity conditions have returned to normal levels from their all-time historical lows. We are not going back there, so the days of 20x revenue growth companies being dime a dozen are gone forever. We are positioning for an extended period of economic torpor which central banks can't respond to with low interest rates because inflation is still at the top end of target ranges. This means we are long very few cyclicals and are focused on owning a range of special situations whose businesses are highly defensive or which have strong secular growth outlooks (at cheap valuations of course). Key names include:

- Tower (TWR) – higher short rates boost earnings and the insurance cycle will turn where they now price for very high repair costs which may start to fade.
- Dalrymple Bay Infrastructure (DBI) – long term take-or-pay contracts with all their shippers and on the cusp of deregulation upgrades.
- GDI Property (GDI) – Perth office property has a solid outlook, now at a 30% discount to a conservative NTA; comes with a successful syndication business with embedded performance fees for free.
- Shaver Shop (SSG) – defensive small-ticket retailer which delivered a strong business update during the month. Re-opening beneficiary.
- Australian Vintage (AVG) – strong branded wine growth and industry-leader in the secular growth segments of low/no alcohol wine.
- Global Data Centres (GDC) – trading at close to half their mark-to-market NAV and secular growth for many years to come.
- Kina Securities (KSL) – very cheap, strong capital position and highly levered to the improving outlook for PNG.
- Monash IVF (MVF) – secular growth in IVF procedures as populations age and policy change in NSW to subsidise more of procedure may be copied elsewhere.
- Lynch Group (LGL) – strong flower industry growth outlook and big re-opening beneficiary.

SALT

Fund Performance in June

Returning to the Fund's performance in the month of June, the overall return of circa -4.0% pre fees and tax was composed of a gale-force headwind from our long book of -7.8%, partially offset by +3.7% from our shorts. Our long positions tend to be larger and normally lower beta than our shorts, with this typically working well for us. However, we very occasionally get temporarily hit when correlations go to 1 and everything gets sold. June was one of those months.

Our overall "winners to losers" ratio was just 50% but the skew of our negatives was much larger than our positives because of the larger position size. The indiscriminatory nature of the sell-off was shown by how only 9 of our 48 longs went up, while just 8 of our 47 shorts went down. The negative returns in the month were all about the size of the net positioning.

There were 14 negative days for the 50/50 index of Australia and NZ during the month which must be close to a record. The average return for the market on those days was a deeply negative -0.89%, while the Fund did provide some protection, being -0.16% on average. This means we also down on the rare up-days for the market, which was disappointing. Digging into this, the heavy impact of tax loss selling on some of our small cap longs becomes apparent.

Headwinds buffeted the great majority of our longs. Emeco Holdings (EHL, -21.2%) was the largest detractor despite delivering an earnings update mid-month which reiterated guidance at the low end of their range. We took this as being well above shadow expectations as the market is very focused on labour cost blow-outs in the resources sector. We have always viewed EHL's equipment rental business as being less labour-intensive than most and so it is proving. However, the market didn't care and tarred it with the same brush. EHL is now on a Jun22 PE of 5.4x and Jun23 of 4.6x – that strikes us as providing a reasonable margin of safety.

The second largest hit came from our long in Global Data Centres (GDC, -14%). We can only put this down to tax-loss selling. GDC should deliver a strong NAV update in coming weeks, with its holding in Airtrunk being worth far more than the price they paid several years ago. We think GDC could be trading at as little as half NAV and it has a net cash balance sheet. It strikes us as being a management platform and set of long-life assets that might be better suited to a pension fund owner.

Other headwinds were led by a long we built too early in Ooh!Media (OML, -12.3%). While this outdoor advertising company has cyclical headwinds, it is a huge re-opening beneficiary and has structural upside as it continues to digitise. Lynch Group (LGL, -11.3%) declined yet again and is now on a PE of 9x the guidance they provided in late-May, with strong growth thereafter. Kina Securities (KSL, -10.6%), Monash IVF (MVF, -14.2%) and GDI Property (GDI, -10.0%) were all large detractors despite their businesses going along just fine.

Another interesting set of negatives came from our moderate holdings in three gold stocks, Resolute Mining (RSG, -18.2%), Bellevue Gold (BGL, -27.3%) and Tietto Minerals (TIE, -29.6%). So much for gold being a portfolio insurance policy. The A$ gold price actually rose from $2,567 to $2,611 over month, so what this reflects is a market that is terrified of rising costs. Never mind that BGL and TIE are not yet operating but have reiterated their capex and cost expectations and have two of the lowest cost mines in the world to come on over the next few months.

Our tailwinds were very much the mirror image of the long positions that hurt us. Pretty much anything that we shorted did well. The largest winner was our short in Sims Group (SGM, -22.3%) which had earlier been defying gravity in the face of weakening scrap steel prices and industry compco's that were falling. Our short in JB Hi-Fi (JBH, -16.3%) was helpful. The thesis is hardly unique but JBH has obvious exposure to a weakening housing sector and was a past beneficiary of purchases for working-at-home, much of which will not be repeated.

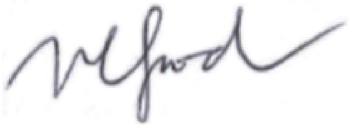
A third short that worked well was Homeco (HMC, -19.5%), which has been an aggressively acquisitive property funds manager. A rising yield environment with slowing commercial property turnover and expanding cap rates is a sombre backdrop for such a player. It is difficult to understand the fundamental reasons why almost every broker has a buy on it. We had been short several other property fund managers but covered these on weakness.

Other shorts that contributed were led by Commonwealth Bank (CBA, -13.4%), where a 20x PE multiple of goldilocks-style earnings forecasts struck us as too optimistic – bad debts will return and credit growth will slow. Charter Hall Long WALE REIT (CLW, -11.7%) worked well. While they have interest rate hedges in place, their gearing in the 39% region is rather high in an environment where cap rates should soon start to expand. A rare contributor from the long-side in June was our holding in the decidedly acyclical litigation funder, Omni Bridgeway (OBL, +5.3%).

Thank you for your continued support of the Fund. When we look at the drawdowns we have experienced over our long history, two sets of circumstances stand out. The first has been when ultra-expensive growth stocks have soared, which is decidedly not the case now. The second has been when our typical net length of 40-50% in lower beta stocks doesn't work for a period because everything gets sold off due to generalised market risk aversion.

This was very much the environment in June but it appears to have passed, with some selectivity returning to individual equity performance and tax-loss selling being definitively behind us. We used the weakness in June to lift our holdings in a number of bargains and this is beginning to work well, with nearly half of June's losses already made back at this early point in July.

We are remaining disciplined, keeping up the size of our short book in names where we see risks from cyclical exposures and extended valuations or balance sheets. From the long side, we are very focused on avoiding cyclical value traps, where the earnings forecasts are at grave risk. Our typical names tend to be special situations where we are the only boy marching in step. We will strive to continue delivering equity-like returns over the long run, with far less volatility than equities and no correlation to them.



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.