Salt Long Short Fund Fact Sheet – October 2019

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 31 October 2019

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$115 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 October 2019

Application	1.5565
Redemption	1.5502

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 2019

Long positions	71
Short positions	43

Exposures at 31 October 2019

Long exposure	88.25%
Short exposure	-52.27%
Gross equity exposure	140.17%
Net equity exposure	35.64%

Largest Longs	Largest Shorts
Tower	Auckland International Airport
Marsden Maritime Holdings	BWP Trust
Graincorp	Fortescue Metals Group
QANTM Intellectual Property	Ryman Healthcare
Spark	Orica

Performance[1] at 31 October 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%	1.74%	-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%			**7.21%**

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	5.30%	1.48%	-0.77%
6 months	10.55%	3.12%	7.67%
1-year p.a.	1.01%	6.52%	20.70%
2-years p.a.	1.86%	6.63%	11.41%
3 years p.a.	3.06%	6.68%	13.15%
5 years p.a.	7.02%	7.13%	11.11%
Since inception p.a.	8.71%	7.22%	11.27%

[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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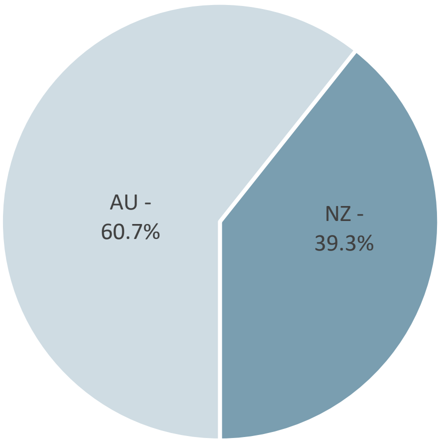
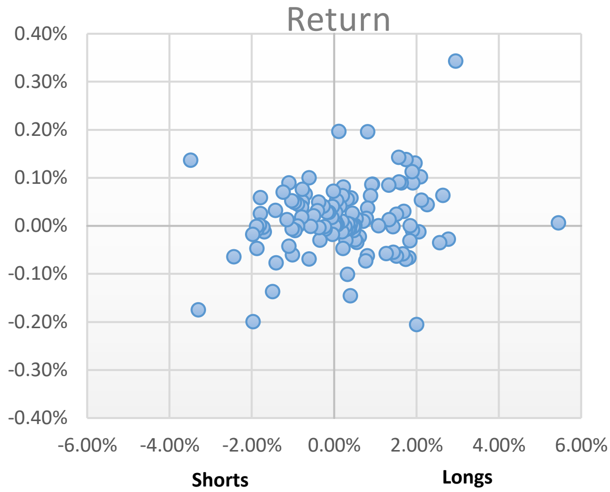
Country Allocation at 31 October 2019 (Gross Equity Exposure)



October 2019 Individual Stock Contribution



Fund Commentary

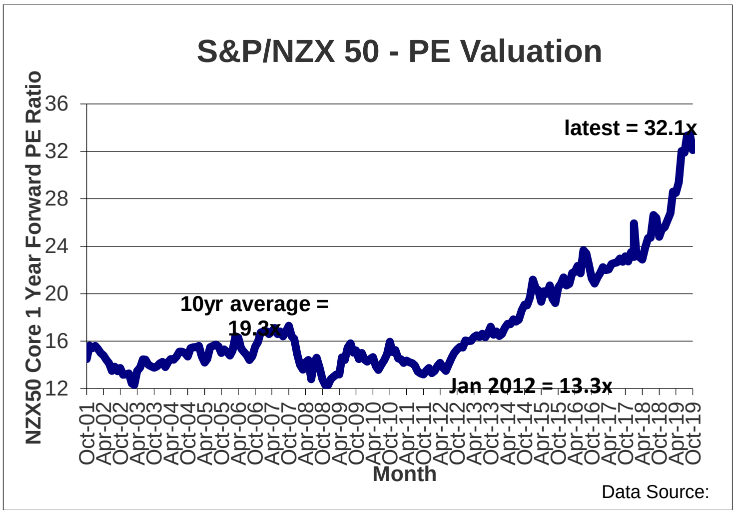
Dear Fellow Investor,

The Fund continued its run of strong recent performance in the month of October, with a pleasing return of +2.34% after all fees and expenses. Since inception, the Fund has returned +55.0% after all fees and expenses.

In contrast to recent months, this performance occurred against a more mixed backdrop for the NZ and Australian markets, which posted October returns of -1.3% and +1.2% respectively. Critically, even though the Fund finished the month at a superficially long net position of +36%, the strong recent returns have not been driven by abandoning our cautious view of markets and jumping on the bull market bandwagon.

The Fund remains true to its mission of aiming to provide positive returns irrespective of the direction of equity markets. This can be seen in how the Fund was actually up on eight out of the nine down-days on which the 50/50 NZ/Australian index fell into the red during the month. On average, long only equities fell by -0.72% on those days, while the Fund was up +0.21%. This shows how we are delivering our returns with far less volatility and no correlation to equities and gives confidence that the Fund will do its job as part of a diversified portfolio in the event of a sharp market sell-off.

While the Fund appeared to end the month moderately net long on a risk-adjusted basis at 36%, we would not overplay this. 2.5% is held in QMS Media which is now a cash proxy given it is subject to a takeover bid and we took advantage of several attractive equity raisings to dramatically lift our net length in low-beta property stocks. We see Kiwi Property as a very interesting trade post-raise as it will be gradually upweighted in a bevy of indices and will soon be cum a 3.5cps dividend that it normally carries quite quickly. The massacre of the NZ gentailers in response to Rio Tinto's negotiating tactics with the Bluff aluminium smelter saw us move from net short to net long what is normally another very low beta sector. We have not abandoned our generally bearish tilt on markets.



As shown above, the NZ PE actually declined a little in October, moving from 33.4x to a mere 32.1x. However, we would not overplay this as it was driven by special and likely temporary circumstances in the gentailer sector, while 10 year bond yields rose from 1.10% to 1.29% in the period. Excluding the gentailers, most stocks actually became even more expensive relative to bond yields. Interestingly, the median PE rose from 18.8x to 19.4x, with small-mid caps staging a rare bout of outperformance versus their passively driven large cap compatriots. This helped the Fund's performance given our general tendency to be long what is cheap and short what is expensive.

To be crystal clear, we remain strongly of the view that most large cap and growth-style equities are unconscionably expensive, while pockets of opportunity remain in a number of small-mid cap stocks which haven't been propelled into the stratosphere by forced passive buying. With careful searching, it is still possible to find stocks on PE's of 10-15x with low risk 5-15% earnings growth and this strikes us as rather attractive when bond yields are just 1.3%.

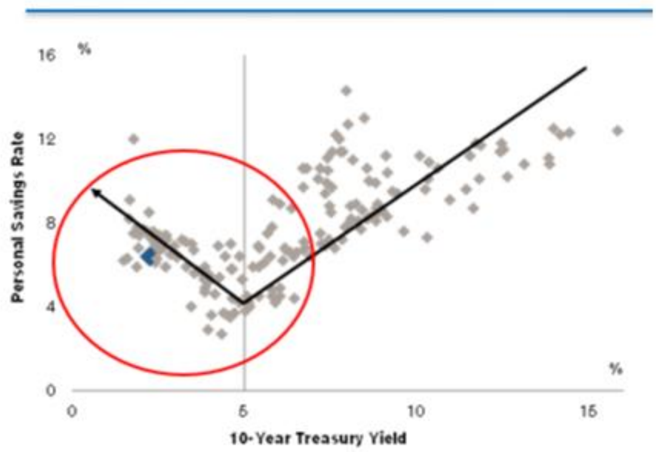
The current market set-up was brilliantly encapsulated in a quote by the head of quantitative strategy at Sanford C. Bernstein: *"…equities are quite fully valued, credit is pretty expensive, sovereign bonds are expensive, private equity is really, really expensive, maybe the only cheap thing I can go buy is value…with the enormous caveat that it's very important that I have absolutely no clients at all."*

A classic example of the remarkable expansion in large cap growth company valuations came when our Xero analyst, Tristan Joll conducted a post mortem of his numbers from several years ago. Back in October 2016, he forecasted 2020 revenue of $766m and FCF of $45m. His latest forecasts for the 2020 year are revenue of $740m (-3%) and FCF of $11m (-76%). Meanwhile, the share price has risen from A$16.31 then to A$68.99 at end-October. Down is up, black is white and I clearly don't get it in that space (to recall my favourite saying from 1999). Alternatively, as an exemplar of such companies, it could just be a tad overpriced.

We currently have no position in Xero but are certainly short several over-hyped, over-priced names in the conceptual growth space. We had thought the WeWork debacle might act as a more generalised wake-up call in these names but to date the impact of this burst bubble appears to have been largely confined to unicorns without earnings rather than those valued at a mere 100x earnings or 10x revenues. It is a time to be very wary of the stale valuations that all such names are being carried at both in private equity funds and increasingly in some listed equity funds that have been desperate to get a piece of the pre-IPO action.

Failing IPO's such as WeWork are a classic sign of late-cycle market froth and Australia similarly saw a number of mooted floats quietly pull the pin during the month. Names included Latitude Financial, Property Guru, Retail Zoo, MPS Kinetic and Onsite Rentals. The market has by no means shut, with other names such as Carbon Revolution getting up, but it is fair to say that a cautious and sceptical eye is being cast across the many opportunities that are being presented. Some factors in the failed deals included difficult industries, private equity sellers having high price expectations and projected numbers that were being cast in a particularly favourable light.

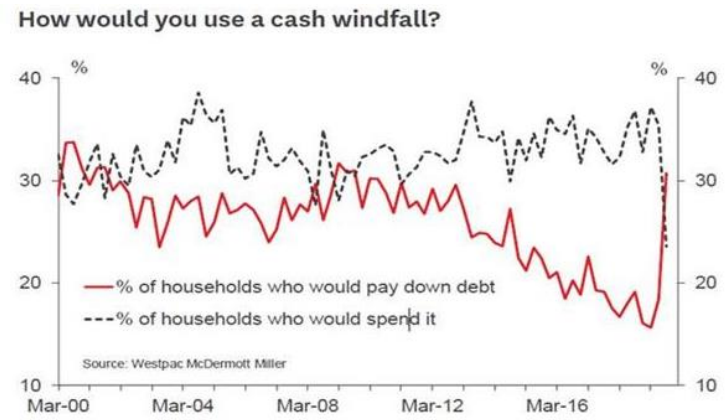
The key macro factor exercising our thinking at present is the apparent failure of monetary policy easing to stimulate economic growth at very low interest rates. Central banks are pushing on a piece of string and when Greek bonds have been jammed down to negative yields, we have moved from a tragedy to a farce.



Source: Credit Suisse – Jonathan Golub, June 2019

The chart above refers to the US and comes from Credit Suisse. It shows how there is an inflection point at very low bond yields where people slow their spending and start to save more. The precautionary motive is likely at play here as the extreme actions of central banks have frightened the daylights out of many firms and consumers. What do they know that we don't? Another factor is that the majority of people typically don't change their mortgage repayments, so borrowers simply repay their debt a little faster, while some savers perversely need to save more to reach their targeted retirement incomes.

This has played out graphically in NZ, where following the RBNZ's surprise 50bp rate cut in August, the chart below shows a massive leap in consumers desiring to save rather than spend a cash windfall in the September Westpac McDermott Miller survey.



Source: Westpac McDermott Miller

This monetary policy failure has three very different investment implications. Firstly, it means the liquidity party may keep on raging for some time yet as many central banks impersonate medieval doctors by prescribing yet another dose of leeches even though the patient is not responding. Bonds are yielding next to nothing and term deposits are little better so where else can one put one's hard saved dollars but into the equity market. The NZ market goes up by 15% a year, so never mind equity risk or a PE well north of 30x, just grab the yield. Indeed, the RBNZ Governor himself has implored investors to take more risk. The dawn massacre of the gentailers in the month of October demonstrated the downside to this utter naivete although we took this opportunity to cover our shorts in the space.

The second key implication is that the equity market's earnings and rental growth forecasts are generally far too high in a world of low inflation and low pricing power, yet we constantly see sell-side valuations which incorporate both ultra-low discount rates in combination with the same old historic rates of growth. You can have one but not both. Investors should be deeply suspicious of the common argument to buy property stocks because their yield is at a normal gap to bond yields – what about the far weaker rental growth that will surely occur over the next few years if the low bond yields are right?!

In NZ this has manifested in year-ahead earnings forecasts peaking way back in April 2018 at 9% higher levels than today. Normally, this earnings measure rises over time due to the reinvestment of retained earnings and inflation. The highly informative monthly ANZ Business Survey shows that a net 24% of firms expect their profits to fall over the next year, which is the worst outcome since mid-2009. With bond yields being so low, by all means use a low discount rate but be very, very careful with carelessly optimistic earnings forecasts.

Downgrades are everywhere and in some highly frustrating cases such as Auckland Airport and Port of Tauranga, the market doesn't even seem to overly care for now but we have heavily skewed our longs to areas where we expect less earnings risk. At times, our fundamental positioning is being overwhelmed by an avalanche of passive flows into the largest names irrespective of their fundamentals but being on the right side of earnings outcomes strikes us as sensible.

The third key implication of monetary policy failure is that the risk-free rate used by investors to discount future earnings is continuing to fall. This driver should theoretically favour low-beta companies whose earnings are at less risk and who are therefore less affected by the accompanying expansion in the equity risk premium. The Fund is comfortably net long such companies. What makes us cringe, and where we think many good shorting opportunities lie, is where higher risk companies are simply valued up with a lower discount rate, while blithely ignoring the greater earnings risk that they carry.

Returning to the performance of the Fund during the month, the return of +2.44% pre fees and tax was comprised of a very strong longs contribution of +2.17% and also pleasingly a positive return from our shorts of +0.25%. The winners-to-losers ratio was a very strong 61.4% and there was a skew to our winners being larger than our losers, with no major problem children.

The strongest tail-wind by some distance came from our large, long-held and oft-discussed holding in QMS Media (QMS, +33%) which received a bid from Quadrant Private Equity at $1.22 per share. This is a long way from the dark days of February through May when we felt like a very lonely buyer in the 70cps region. However, we don't actually view it as a particularly aggressive bid. QMS's multiples are distorted somewhat by the non-cash amortisation of their digital billboard sites over the term of their rental. Strip this out and we estimate QMS is on a "cash" PE of approximately 14x F20 at the bid price with a decent growth outlook thereafter. Little wonder that there has been press speculation that KKR or others may look to bid. We have no insight on this front but would note that KKR owns the other large digital sports advertising business globally.

A particularly satisfying positive came from our large long-held position in Marsden Maritime (MMH, +12%). This has been somewhat risky in the sense that MMH is quite illiquid but we have viewed it as having tail-winds to its business that will ultimately see the liquidity look after itself. MMH owns 50% of Northport in conjunction with Port of Tauranga and owns 100% of significant property holdings and a marina at the port. Northport is somewhat unique in being naturally deep-water and it is also closer to Asia versus Auckland and Tauranga. Its key problem has always been the lack of robust rail and road linkages to the Auckland region. The expansion of Northport has very strong support from the Coalition Government lynch-pin, NZ First which views it as both making economic sense and driving broader development of a region that has lagged for decades. The first obvious steps would be to move the Devonport dry-dock and car imports to Northland, with the latter being able to use existing roads off-peak. Subsequent expansion of the rail and roading network is more controversial but seems more likely than not to happen in our view, particularly given the enormous alternative land value at Auckland and the massive avoided Auckland roading spend. MMH will derive enormous benefit both from the port itself and from the development of its sizeable land holdings all around it.

A third positive came from our largest holding in the form of Tower (TWR, +2.4%) which was simply a catch-up from the pain we had taken in September from its rights issue. October saw the Fund benefit from our proportional rights allocation and from a relatively aggressive sub-underwriting of the rights shortfall. This remains a high conviction holding, with policy pricing still being very firm, the Youi NZ acquisition making sense and the major multi-year cost benefits from the IT project just getting underway. The one negative is the war that the RBNZ is waging on capital requirements across the banking and insurance sectors but TWR has now well and truly dealt with this, while its major Australian peers look a little light in comparison. More capital means lower returns but this will be offset to at least some degree by continued firm pricing.

A final noteworthy contributor falls into the "luck" rather than "skill" camp in the form of a mid-sized long in Ardent Leisure Group (ALG, +24%), which we purchased when it fell sharply upon its removal from the S&P/ASX300 Index. A large line was subsequently crossed at a significant premium to an unknown party, which the press have speculated is Mulpha Group. The main lesson here is you make your luck by playing in the right places.

The largest headwind came from our valuation-based short in Fisher & Paykel Healthcare (FPH, +11%), which rose on a slight earnings upgrade due chiefly to an earlier than expected release of its new mask product and favourable short term forex moves. This has a derisory impact in net present value terms but it excited the algos and the go-go growth funds. FPH is now on a consensus year-ahead PE of 40x and until the last few months has had a track record of steady downgrades to an over-estimated growth path despite its reputation as a high quality company. At these stratospheric multiples, we are wary of strong competition in the sleep apnoea market and of upcoming US competitive bidding changes, which are likely to help those with a high machine sales composition and hurt those with a high mask composition.

The second notable drag came from our large short in Bunnings Warehouse Property Trust (BWP, +5%) which comfortably outperformed the Australian property index for reasons which escape us. It ranks very poorly in our relative valuation model and Bunnings has demonstrated a willingness to act very aggressively at end of lease.

A final modest headwind was our short in JB Hi-Fi (JBH, +8%) which rose in a bout of short-covering following in-line Q1 sales and the reaffirmation of guidance at their AGM. We see Australian retail conditions as being quite mixed and JBH's forward PE of 16.3x appears very toppy relative to the general retail sector and the particular structural challenges that lie ahead for JBH.

Thank you for your ongoing support of the Fund. The strong revival in our fortunes since the lows in February has been both satisfying and something of a relief to both us and I am sure you – our incentives are highly aligned. Importantly, recent performance has not been driven by simply hitching a ride on the bull market, with our consistently strong outcomes on down-days being particularly noteworthy.

While some of our key positions such as QMS Media and Marsden Maritime have worked very well, there are many other high conviction positions where we are still the only boy marching in step. Tower Limited is the stand-out here but there are a number of others where we have strong conviction. In a more general sense, we are tip-toeing very warily through current markets, which we continue to see as being set up for an accident. Valuations are extended, passive funds have become very large and may have difficulty transacting when the tide suddenly turns, high yield debt markets globally appear unusually levered, central banks are pushing on a piece of string and dysfunctional politics in certain countries pose black-swan risks.

Matthew Goodson, CFA