Salt Long Short Fund Fact Sheet – August 2020

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 August 2020

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$69.5 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 August 2020

Application	1.4523
Redemption	1.4464

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 August 2020

Long positions	49
Short positions	32

Exposures at 31 August 2020

Long exposure	88.09%
Short exposure	42.49%
Gross equity exposure	130.58%
Net equity exposure	45.60%

Largest Longs	Largest Shorts
Tower	Goodman Property Trust
Vitalharvest Freehold Trust	Xero
Marsden Maritime Holdings	Precinct Properties NZ
Pacific Edge	Netwealth Group
GDI Property Group	Napier Port Holdings

Performance[1] at 31 August 2020

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%					-9.08%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	4.74%	1.32%	7.87%
6 months	-4.83%	2.65%	0.75%
1 year p.a.	-1.72%	5.67%	4.81%
2 years p.a.	-3.18%	6.15%	8.20%
3 years p.a.	-1.34%	6.35%	10.32%
5 years p.a.	3.19%	6.66%	11.61%
Since inception p.a.	6.17%	6.99%	10.35%

[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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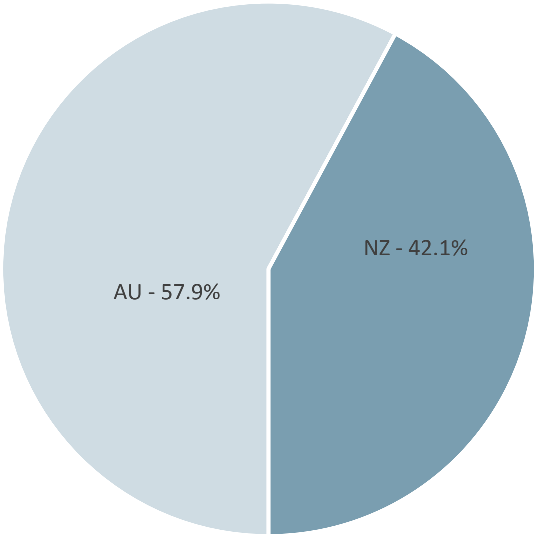
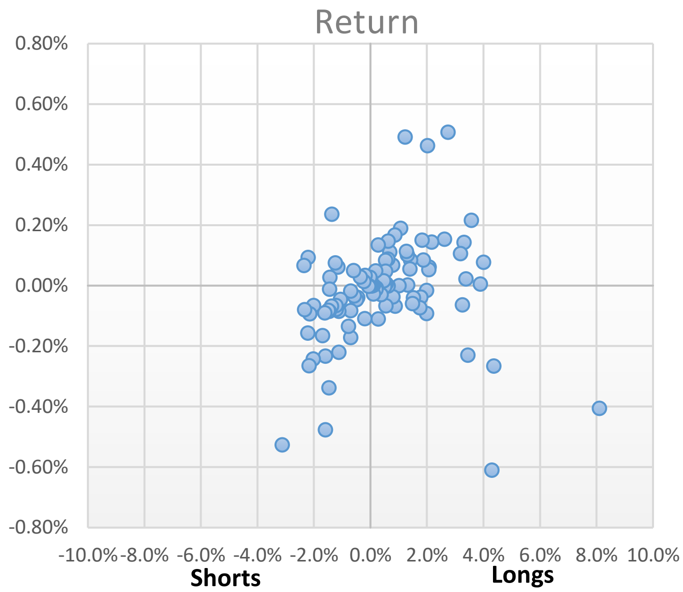
Country Allocation at 31 August 2020 (Gross Equity Exposure)



August 2020 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

After several strong months, the Fund gave some performance back in August with a return of -1.81%. While several of our key stock calls delivered good results, some of our previous winners retraced a little and our generally low beta longs struggled to keep up with what was a buoyant albeit volatile market in August. Conversely, several of our ultra-expensive shorts became even more expensive even though they delivered a mixed bag of results.

Right now, the market is pre-disposed to react unusually favourably towards the high multiple stocks that are in fashion. Fashions change but to deliver strong relative performance in August required being long stocks on very high multiples and with strong price momentum.

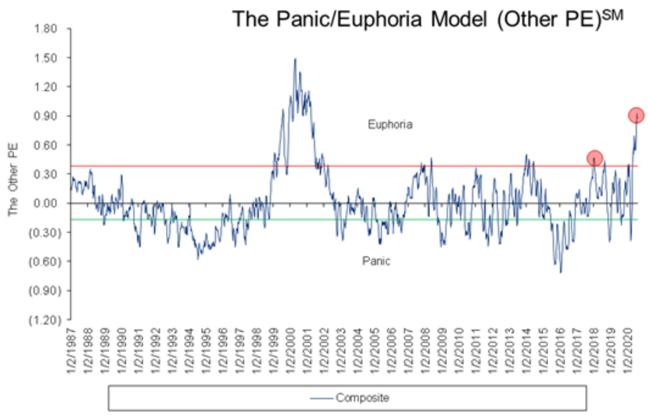
Rampant investor optimism is being driven by ultra-loose monetary policy around the world as central banks drive real interest rates deeply into negative territory. It is clear in hindsight that we should have covered all of our expensive shorts some time ago and jumped on the bandwagon. However, that is not what this Fund is set up to do. There are numerous choices for investors desiring stocks on 20x revenue in their portfolios, whereas this Fund aims to deliver uncorrelated returns in an ultra-low-return world. When markets are up, we may be up, down or flat; when markets sell off, we may be up, down or flat.

Evidence shows that we continue to run this Fund in a truly uncorrelated fashion to long-only equities. Over the Fund's entire existence, our average return on an up-day is +0.012% and our average return on a down-day is +0.045%.

In terms of current performance, we continue to provide strong protection on down-days. We just need more of them for this Fund to shine relative to peers. The 50/50 index of NZ and Australia experienced nine down-days in August. Our Fund was up on five of those nine days and delivered an average return on them of +0.04% versus -0.48% for the market. The Fund does not provide an infallible backstop when markets fall but on average it is working well.

Remarkably aggressive easing by central banks has driven equity markets to nose-bleed levels. With real interest rates moving to negative levels and likely to stay there for years, the market boom has been particularly concentrated in the GAAP (growth at any price) stocks. We will show shortly that there is a certain logic that underpins this, just as there is at the beginning of every bubble, but there can be little doubt that we are in a bubble.

The widely followed Citigroup Panic/Euphoria model is shown below and has now reached levels where the US equity market has historically been lower one year later 100% of the time. As can be seen, the only time it didn't work for a few months was prior to the Nasdaq bubble collapsing. Then it worked. This is also franked by the CNN Fear & Greed Index which has stormed back into "extreme greed" readings.



Source: Pinnacle Data, Haver Analytics and Citi Research - US Equity Strategy

Anecdotal evidence of a bubble fuelled by central bank liquidity abounds. Just some examples:

1. Retail investor account numbers and logins continue to boom and their influence is pronounced. In the US, Jefferies have noted that since April, stocks have rallied on Mondays 93% of the time and that this day accounts for three quarters of the market's positive performance.

2. Stimulus is pouring fuel on this fire. A study by Envest Yodlee in the US of 2.5m US consumers found that those eligible for the $1,200 stimulus payment increased their stock trading by 90%. It would be surprising if NZ and Australia weren't similar

3. In NZ, retail investors have quietened down in Air NZ but are running riot in the medicinal cannabis stock, Cannasouth (CBD) on the mistaken view that the cannabis legalisation referendum might have some relevance. It rose from $0.54 to $1.01 over August, with a high (excuse the pun) of $1.21.

4. Apple and Tesla share prices soared on the announcement of stock splits despite the fact they are value neutral, with the latter having risen from $45.12 last August to $498 this August. Apple's market cap of $2.3trn now exceeds that of the entire FTSE index in the UK.

5. Short interest has collapsed in the US market and hedge funds are running record levels of net length.

6. Pension funds have been placed in an untenable position in meeting their risk versus return requirements, to the point that Calpers announced that it would add up to 20% leverage in its funds. Reminds me of the CDO-squared securities in 2008. They ended well!

Against this bubbly backdrop, the one year forward PE for the NZ market fell slightly in August from 37.1x to 36.9x as the roll-forward to 1 more month of future earnings growth offset rising share prices. The 10-year bond yield fell from 0.77% to an almost unimaginably low 0.61%, at which point valuations can be anything you want them to be. Long duration assets like equities display extreme price sensitivity at such low discount rates.

A different framework is required to think about valuations in this bizarre world that central bankers have wrought. If one believes that equity risk premiums should be unchanged or even compress, then extreme share prices can be "justified" for so long as discount rates stay ultra-low and real interest rates are negative. As an analogy, the NZ housing market is seeing prices move up again as 2.5% mortgage rates get capitalised into house prices as though they will stay at 2.5% for the next 30 years. Conversely, if one believes that the required equity risk premium should expand in this world of extreme earnings uncertainty, then markets are somewhere between expensive and ludicrous.

An obvious question is that if zero bond yields are so good for equities, then why have the Japanese and European markets been mediocre performers in the last several years. As pointed out by Credit Suisse, the answer is that their combination of heavy bank sector weightings (who are obviously hurt by zero rates) and very low nominal GDP growth due to declining populations (and perhaps due to central bank policies) has led to negative real earnings growth that is below their negative real interest rates.

Conversely, the bull case of very high valuations could play out if real interest rates stay negative for some years, if the required equity risk premium does not expand and if real earnings grow somewhat. So, the key investment requirement in this world of central bank repression is to invest in companies with solid earnings growth outlooks. A cheap multiple that comes with structural earnings risk has no appeal whatsoever.

This is how seemingly outrageous valuations in technology and IT stocks can be "justified". All that is required is a network monopoly that can grow its earnings without interruption for the next couple of decades. We would suggest that the lesson of booms past is that a small number of these companies will indeed make it but most will fade due to competitive forces and future structural change. Who today is the next America Online or Global Crossing and who today is the next Amazon? Just look at the decimation handed out to Zip Co and Afterpay in the first couple of days of September due to PayPal entering the space. Who will the winner ultimately be? Will there be further iterations that render the BNPL model obsolete? Current valuations imply that everyone wins forever.

2020 has been all about the technology sector and IT stocks. According to Credit Suisse, the average revenue multiple for the Australian WAAX stocks (Afterpay, Altium, Xero and Wisetech) has risen from 13.0x in Dec19 to 15.4x at Jul20 and 19.2x at Aug20. Many smaller tech names have performed in a similar manner. The Australian IT sector rose by +15.5% in August and it was all about multiple expansion rather than earnings upgrades. This was tough for our modest shorts in this sector.

The chart below shows the Australian IT Index relative to the ASX200 Index over the last year. It did little until Covid-19 hit and has been a rocket-ship ever since, with the furious rally in August also evident. Fund manager performance has entirely depended on whether one surfed this bubble or not.

We have taken care in the Fund not to short any of these names due to valuation alone. As we can see with the ludicrous bubble in Tesla in the US market, valuation need not matter in the short term. We have no position in Afterpay given the sheer scale of its growth opportunity (albeit this is accompanied by competition and under-estimated capital intensity). However, the other three amigos in the WAAX universe are arguably in a weaker business position than they were in December but their price/revenue multiples have risen by 48%. This is a bubble.

We have been moderately short Xero on the basis that they have postponed their July price increase, net small business formation will be very weak once wage subsidies roll off and they are struggling in the US against Intuit which is an essential component for any valuation that gets within earshot of the current share price. We have just covered into a brief pullback given the broader technology sector tailwinds.

We are also short Wisetech (WTC, +36%) as their growth has slowed sharply, their ability to arbitrage public multiples by buying small private business on tiny multiples has seen large write-downs and their "guidance beat" during the month was simply driven by a greater capitalisation of costs than had previously been forecast. Insiders have also been selling.

This is a market that simply wants to believe and it is very forgiving of certain companies such as these. One day, that will change. As one Australian analyst's headline put it, "Buy The Business Not The Multiple."

The Fund is not oblivious to which way the wind is blowing and we have sized our short positions carefully in the go-go growth sector and manage them in a very light-footed manner. Moreover, we manage the Fund's net length with a view to the dominant trend driving the market. Hence our net length has drifted up into the low-mid 40% region. Even with this, the nature of our longs means we tend to deliver positive returns on down-days – there just aren't enough of those days for now.

Our approach from the long side in the Fund has not been to chase "growth at any price". We have also largely steered away from deep value where structural risks are apparent. Instead, we have looked for the sorts of company where we have made strong returns in the last few years such as Restaurant Brands and Scales.

We are looking for growth at a reasonable price. Some of these have worked really well, with examples such as Pacific Current (PAC), Shaver Shop (SSG), Eureka Group (EGH) and EQT Holdings (EQT). We have frequently bought too early but have ended up being right in the end. Current examples of this genre include Tower (TWR), Marsden Maritime (MMH), Qantm IP (QIP) and Australian Vintage (AVG). They are performing perfectly well as businesses but the market doesn't care – for now. If a stock is cheap and growing, the market always cares in the end. It is noticeable from this list that we have been somewhat pushed down the market cap scale but larger names such as Ebos and Infratil still feature in the Fund.

A key theme running through our larger longs is that besides being very cheap and having solid growth outlooks, they are generally relatively insensitive to the economic outlook. We are wary that the impending end of wage subsidies could see something of a "K" shaped recovery. Those who have jobs and investments will be just fine thanks to record low interest rates, while many people will be badly affected.

In the case of Tower, home and motor insurance has little cyclicality and they have major internally driven cost out and customer growth from their IT-enabled direct to customer model. Our view is that their Sep20 year result in November will be fine and their F21 guidance will be strong. Marsden is far cheaper than its port peers but may have a better future growth profile as Northport grows from a low base and this leverages demand for their huge land holdings – it feels like Tauranga 20-25 years ago; Infratil has major cost-out opportunities with Vodafone and huge growth from their data centre business; Ebos has delivered steady growth in a difficult environment and has plenty of balance sheet room for further bolt-ons.

Qantm IP delivered a sound result. Once you have an IP client, you have the patent filing, trademarks, litigation etc for decades. They also have a strong potential Asian growth path as many of their global clients will follow them as they expand. This stock should be on a higher PE than 10x in our view. Australian Vintage (AVG) delivered a cracking result as they have done an excellent job at building brands in the UK market. Growth should be strong from both the top line and from lower costs on a more normal vintage.

Aside from overlooked, under-priced growth, we are playing two other key themes at present. We have an unusual weighting to high-yielding Australian property stocks to play the TINA trade in a search for under-valued income. We have avoided retail shopping centres and Sydney/Melbourne office where the outlooks are difficult.

The stocks we own are still down some 20-40% from their pre-Covid highs but have solid outlooks. We are particularly interested in Perth office (through GDI and ECF) as it is trading well below replacement cost and occupancy will respond with a lag to booming gold and iron ore markets. Conversely, NZ property stocks have been chased up to nose-bleed levels at a time when their rental outlooks have become rather mixed in terms of Auckland office, retail, and non-logistics industrial. We have used a couple of these as partial counterbalances from the short side.

The other theme running through the Fund's long book is that of post-Covid turnaround stocks, particularly where the balance sheets are in order and which are trading on cheap multiples of stabilised earnings. Examples here include Vista (VGL) which has begun to work well as cinemas re-open; Sky City (SKC); and United Malt Group (UMG) which was formerly regarded as a high multiple, strong free cashflow generative business but has been hit by pub closures – the latest data points to them starting to re-open around the world.

Returning to the performance of the Fund in August, the estimated return of -1.54% (pre-tax and fees) was comprised of +1.87% from the long book and -3.41% from the short book. It was a tough month to be a short-seller, especially one who is valuation sensitive. Our winners to losers ratio was actually in positive territory at 53% but we had a larger number of mid-sized losers (chiefly shorts) than we did mid-sized winners.

Our largest headwind came from what we believe will be a temporary pullback in our large long in Pacific Edge Biotechnology (PEB, -13.3%) which had contributed so strongly in previous months. Even on conservative assumptions for each facet of their growth outlook, we derive a valuation that is materially above the current share price. News flow was quiet in the month, but we expect the success with Kaiser and CMS to help secure further customer agreements in the months ahead. This remains a very high conviction long.

The second key laggard was our short in Netwealth (NWL, +16.6%) which makes a repeat appearance even though we reduced the quantum into fleeting weakness. It has soared following what was a small earnings upgrade due to better than expected earnings on clients' cash, strong transactional revenues and solid platform flows. The latter will continue but fee competition is omnipresent and ultra-low interest rates will be a headwind for years. This does not gel with a forward PE of 69x.

The third notable detractor was a moderate short in our old friend Wisetech (WTC, +36.5%). They delivered a result at the bottom-end of expectations and lifted guidance slightly but only did so by assuming more capitalised costs than previously. Their old public-private arbitrage game of buying small businesses on low multiples has ended with a flurry of write-offs and we are wary of their accounting. We are also wary that WTC is very much a closed loop software package which ultimately creates risks in a world of open API's. We lifted the short into strength.

The largest positive was our long-standing overweight in Shaver Shop (SSG, +18.4%) which delivered a very strong result although it did come back a little off its highs at month-end. SSG moved early to an omni-channel model and this has been remarkably successful for them. Their sale strength has continued post period-end with total sales +27.5% in the first 7 weeks of FY21 yet the share price is still below its listing price several years ago. Adjusting for the amortisation of franchisee repurchases, they are on a sub 9x PE ratio with strong growth and a net cash balance sheet. That is why we remain long.

The second tailwind was a veritable straw hat in winter that we purchased in Vista Group (VGL, +43.0%) in the mid-$1.20 region on the view that cinemas will gradually begin to reopen around the world. With the cinema release window shortening, there could be a negative structural change element to the future outlook but VGL remains a long, long way from its former $6 highs.

A third key winner was our long-held position in Eureka Group (EGH, +23.2%) which delivered a rock-solid result. EGH is slowly cleaning up the detritus left behind by overly aggressive former management and is now largely simplified into owning aged care rental properties. While many of the locations are provincial, a cap rate of over 10% is far too high in this zero-rate world for a government guaranteed funding stream and very high occupancy in a sector that has a dire shortage of rooms. EGH has a major opportunity to grow by redeploying capital on these favourable terms.

Thank you for your ongoing support of the Fund in what are remarkable times. Despite what has been a challenging market backdrop for our style in the last several months, the Fund has hung in there and is well positioned for when markets change. With some minor tweaks at the margin, we are trying to follow what renowned investor Cliff Asness said of Warren Buffett:

"The real magic skill of his is that despite some fairly horrific and none-too-short relative and absolute return periods, he's stuck with his style, and his risk level, like grim death"

We have allowed our net length to rise a little in acknowledgement of current conditions and this has meant we have largely held the Fund together in the last few months. We are most certainly not betting the house on the current bubble collapsing next week or next month as we are not in possession of a crystal ball which tells us exactly when this might occur.

The Fund will continue to follow the same strategy and carry sizeable protection from the short side. It is still doing well on negative days. From the long side, we are avoiding structurally challenged value traps and looking to aggressively position in longs that we feel have solid outlooks and are under-priced. The bizarre aspect of this bull market is that it is not hard to find a number of such names that have been left behind.

Matthew Goodson, CFA