SALT
Funds Management

Salt Long Short Fund Fact Sheet – May 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 31 May 2019

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$142.6 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 May 2019

Application	1.4352
Redemption	1.4294

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 May 2019

Long positions	65
Short positions	38

Exposures at 31 May 2019

Long exposure	76.00%
Short exposure	-41.24%
Gross equity exposure	117.24%
Net equity exposure	34.76%

Largest Longs	Largest Shorts
Tower	Auckland International Airport
Turners Automotive	Ryman Healthcare
Pacific Current Group	Netwealth
QMS Media	Mirvac Group
360 Capital Total Return Fund	Monadelphous Group

Performance[1] at 31 May 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%								**-1.14%**

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	1.10%	1.66%	6.71%
6 months	-3.28%	3.31%	14.44%
1-year p.a.	-7.34%	6.75%	10.86%
2-years p.a.	-1.67%	6.75%	12.01%
3 years p.a.	0.73%	6.80%	10.76%
Since inception p.a.	7.54%	7.30%	10.91%

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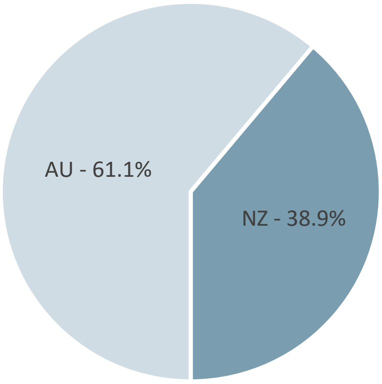
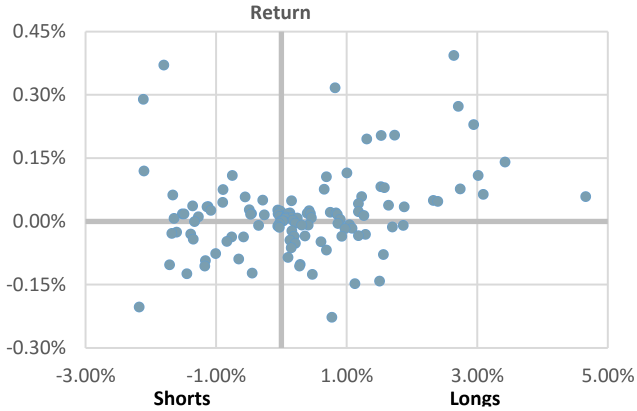
Country Allocation at 31 May 2019 (Gross Equity Exposure)



May 2019 Individual Stock Contribution



Fund Commentary

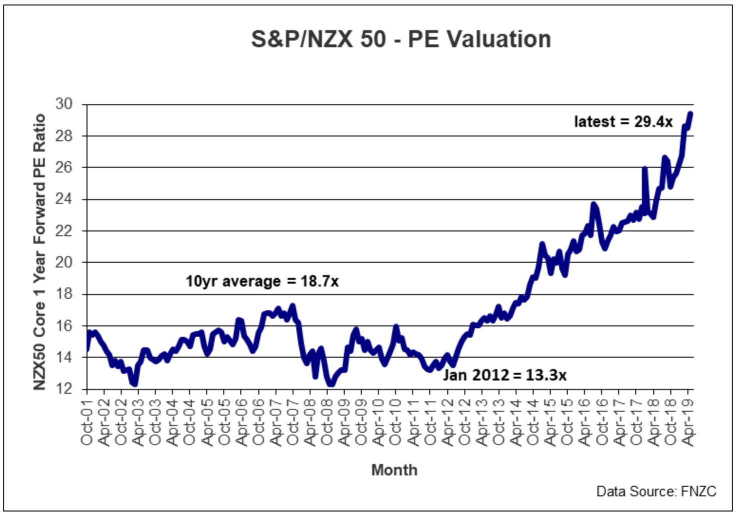
Dear Fellow Investor,

The Fund delivered a strong return of +1.94% after all fees and expenses during the month of May as some of the key factors driving markets began to change. Encouragingly, while the Fund held its own on the sizeable up days, we also delivered positive returns on the handful of days that saw selloffs. In addition, we added value from both the long side and the short side. This is reminiscent of the good old days pre-October 2018 when we delivered positive quarters for four and a half years in a row.

Since inception on 30 June 2014, the Fund has now returned +42.9% after all fees and expenses, with thirty-five of the fifty-eight months having had positive returns. Our volatility remains well below long-only funds and our correlation to the market remains zero. After a tough two quarters to end-March when the most expensive stocks sharply outperformed, markets are changing again and it is most satisfying to return to form. The Fund provides a true alternative to derisory bond yields and equities that are at mind-blowing multiples, especially when markets in Australia and NZ carry considerable earnings risk.

Australian equities returned 1.7% during the month as they jumped on an unexpected victory by the Liberal-National Coalition, while the NZ market rose by a mere 1.0% as the RBNZ succumbed to the rate-cutting mania infecting central banks around the world. More on this shortly. These moves defied global weakness which was led by the -6.6% S&P500 Index decline as the prospect of a US/China trade war suddenly became very real. The MSCI World Index fell by -5.8%.

Year-ahead earnings forecasts for NZ were cut during the month and with the market rising, the PE multiple expanded yet further from 28.5x to 29.4x. The decline in bond yields from 1.91% to 1.74% forced ever more investors into equities in a risky search for yield. One day, volatility will return and those owning shares for the wrong reasons will be reminded of the different risk attributes that different asset classes carry. The chart below puts valuations in perspective.



Australia is experiencing a similar story although their headline metrics are disguised by the low multiples attached to the banks and to the very large iron ore companies due to what may prove a temporary surge in earnings. Using Macquarie data for the S&P/ASX 200 Industrials ex financials/property, Jun18 year EPS growth was +1.2%, Jun19 is now forecast to be +0.0%, Jun20 will apparently be +9.5% and Jun21 +8.5%. Spot the anomaly? Investors and sell-side analysts are chasing equities based on a very low bond yield denominator but seem blissfully unaware that the reasons for low bond yields mean that the earnings growth numerator will also be far lower than normal. There are plenty of downgrades to come.

The period from October through March had been very difficult for the Fund as high beta, high multiple stocks outperformed strongly in both the December quarter sell-off and then the March quarter surge. We were slapped on both sides of the cheek. A fascinating piece from Goldman Sachs examined the performance of GASP

(Growth at Stretched Prices) stocks in Australia and concluded that it has the most expensive high PE firms in the world.

Defining “high growth” companies as those which are forecast to grow EPS by >20% over the next three years, Goldman Sachs found that the average such Australian stock rose by a staggering 62% over the year to April and outperformed the average stock globally by 61%. Anecdotally, we have seen a flood of money out of value-oriented funds into the wild-eyed revenue growth brigade and they have invested it as if it’s 1999 all over again.

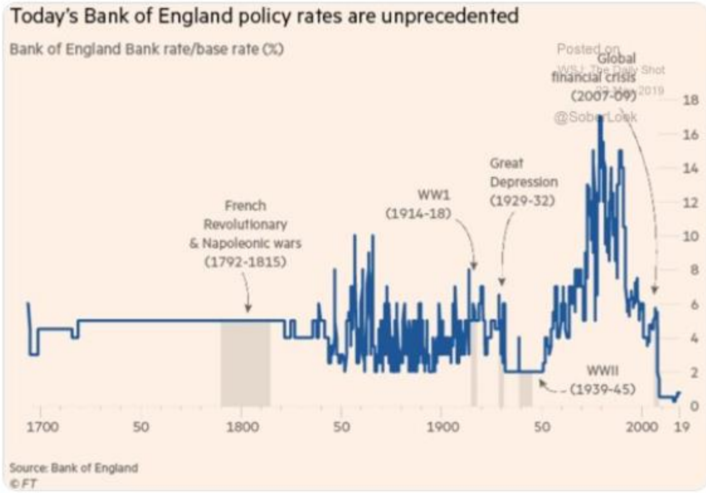
This Australian outperformance saw the median PE of high growth companies hit 38.9x at end-April versus 31.5x for the USA and a global average of 23.5x. Bond yields don’t explain the anomaly as Australia has higher multiples than markets that have negative yields, while there is no “stock shortage”, with there being a similar proportion of such stocks in Australia as offshore.

An example of the mania in Australia came with the listing of Life 360 (360.ASX), which had a day one pop from $4.79 to $5.31 to give a market cap of $764m on $59m of annualised monthly revenue and losses for years into the future. Just as the Uber and Lyft IPO’s were flops, the fact that 360 subsequently closed the month at $3.95 does suggest that the market is beginning to take some sanity pills and that is certainly what the Fund experienced with some of its shorts in this segment finally beginning to work.

JP Morgan looked at the same phenomenon and split the Australian market into a group of “traditional” high PE, high growth stocks and a “new wave” of what they term hyper-PE contenders. Their high PE cohort has underperformed by 3% year-to-date, while the hyper PE stocks have outperformed by a staggering 54%. Within this group of bubble stocks, we are short Netwealth and Hub24 (margin risks and risk to wide cash margins), IDP Education (Chinese student numbers are going backwards), Technology One (their accounting policies strike us as rather aggressive) and Wisetech (dominant cargo software player but numerous acquisitions obscure tepid organic growth and their closed loop system is not liked by clients and is at odds with a world of open API’s).

The small NZ market is often driven by single-stock factors but our observation is that NZ peers have the same anomalous valuation multiples as Australia without even having the growth. Stand-out examples include Auckland International Airport on 38.5x Jun19 for 1% growth in Jun20 and perhaps 9% in Jun21; Fisher & Paykel Healthcare on 36x Mar20 for 16% and 13% growth thereafter; Vista on 50x Dec20 for 18% growth thereafter; while A2 Milk looks positively cheap with its Jun19 PE of a mere 40x delivering 31% and 25% growth in the two years following. What seems clear is that if you want strong earnings growth at a share price that does not cross the boundaries of sanity, forget about Australia/NZ and go global.

As mentioned earlier, the RBNZ joined the global rate cutting party during the month although at least we still have a positive yield of 1.5% at the short end and we haven’t quite flipped over into a negative yield curve unlike many other markets around the world. We couldn’t resist printing the chart below from the Financial Times which puts some perspective around central bank policies.



We have seen world wars, revolutions, civil wars, the Great Depression of the 1930’s, the Long Depression and outright deflation of the 1870s-1890s, the Global Financial Crisis of 2008/09 and yet apparently the world today is experiencing a far greater deflationary threat than any of those faced in the last three centuries. Gosh things are bad.

An alternative explanation is that central banks may be mistaken in their pursuit of a 2% inflation goal that they have little ability to bring about. Japan has tried for decades and failed, while the case has never been convincingly made for why 2% inflation rather than say 1% or 1.5% inflation is required. It is not a matter of whether central bank policies make any sense but really only a matter of how they will eventually end. As Martin Wolf put it in the FT when he quoted Robert Frost during the month; *“some say the world will end in fire some say in ice.”*

In other words, will it be the “fire” of an outbreak of price inflation when wage inflation from tight labour markets finally feeds through or will it be the “ice” of a deflationary bust as all of those geared-up companies, consumers and asset markets falter as earnings growth turns into deflationary contraction and the real value of a fixed amount of debt rises.

There are many arguments for a world that ends in “ice” and they were nicely summed up in a Deutsche Bank piece late in the month. Yield curves are flattening and inverting everywhere; previous equity market peaks in 1990, 2000 and 2007 occurred around the peak of yield curve inversion; implied inflation break evens are falling; canaries in the coal mine such as semi-conductor sales and South Korean exports are falling; US durable goods orders growth peaked at +10% but is now 0%; IATA data shows global freight tonne km fell by -4.7% YoY in April and this is backed up by other indices; global earnings estimates are falling; the percentage of US companies listing with negative earnings is greater than in 1999; JP Morgan's global PMI for May fell to a contractionary 49.8 which is the weakest reading since 2012; and global CPI forecasts are falling although the stagflationary impact of tariffs may see this start to change.

A key risk is if a contraction interacts with significant financial leverage to create a debt-deflation trap. One obvious area to watch is China. They have moved from a current account surplus to a deficit, which combined with total debt levels greater than 300% of GDP begs the question of how sustainable the USD currency peg will prove under the pressure of trade wars.

A possible canary came when the Chinese regulator stepped in and took control of Baoshan Bank which has approximately US$80bn in assets, while the auditor, E&Y resigned from the Bank of Jiangsu (US$105bn assets) as they couldn't provide documents confirming that the bank's clients could service their loans or were using them for the purposes intended. Whether these issues turn out to be mere blips or portents of something much more dire remains to be seen but remember how the failure of New Century Finance Corp in April 2007 didn't initially raise too many eyebrows.

The arguments for the world ending in "fire" are sparser and centre on labour cost inflation, the lagged impact of previously strong oil prices, the stagflationary impact of tariffs and extremely loose monetary settings eventually leading to inflation in price indices as well as just asset indices. Goldman Sachs estimates that the impact of full implementation of the proposed tariffs would see a peak impact on US CPI of +1.2%.

A final more sardonic contrarian argument for "fire" is that Bloomberg magazine ran a headline article during the month titled, "Is Inflation Dead". As pointed out by several commentators, previous timely headlines included the "The Death Of Equities" by Businessweek at the trough in August 1979 and my personal favourite from Time magazine in 1974 entitled, "Another Ice Age", with one of the arguments being that low temperatures were due to a build-up of carbon dioxide in the atmosphere!

Pulling all these arguments together, it is clear that central banks will keep to their Sisyphean task of trying to generate 2% inflation but the current evidence suggests a greater chance that the world may end in "ice" rather than "fire". This is a long way from the "goldilocks" state for markets that we wrote about extensively through 2016-18.

We have positioned for this by being net overweight property trusts (typically higher yielding smaller ones that haven't been bid up to ridiculous levels by passive ETF's) and moved from a large short in Spark in the $4.20s to a large long in the $3.60 region. Spark's dividend yield is a stand-out relative to its normal relationship to the gentailers and property trusts and we think its earnings outlook has similar levels of certainty amid increasingly rational competitive behaviour.

Returning to the performance of the Fund in May, the return of +1.94% after fees and expenses marked a very welcome return to form. As one would expect in yet another month of rising markets, our longs added +1.66% but our shorts did extremely well into their headwind and added +0.28%. Our "winners to losers" ratio was a very strong 58% and there was a strong skew to our winners being larger than our losers.

The largest headwind was our sizeable short in Auckland International Airport (AIA, +10.0%) which rallied sharply on the back of what appeared to be a flood of passive buying. It is hard to classify AIA these days. It is not a "yield" name given the derisory 2.6% gross yield. It is not a "growth" stock given it has consensus earnings growth of just 1% in Jun20. It is not an "earnings momentum" name as forecasts are coming under pressure from weakening passenger numbers. The forward PE of 39x puts it some way away from being "value" so all it has left going for it are the intertwined factors of "size" and "price momentum". Interestingly, according to Forsyth Barr definitions, in the year to May the "size" factor delivered a return of 25.7% far in excess of 19.5% for "momentum", while "value" came in at just 4.0% and "growth" at 1.7%. AIA is a classic example of the impact of passive investments on markets. We have been mistaken in shorting AIA too early based on seemingly irrelevant drivers such as the earnings outlook and valuation but as we have seen in the past in this name, when passive is forced to sell, it really is forced to sell.

The second notable headwind was a modest long in Pacific Edge Biotechnology (PEB, -26%) which fell sharply when its result showed no new progress on the two key potential catalysts. These are a local coverage decision from CMS in the US and hard evidence of a deal with Kaiser. The efficacy of PEB's bladder cancer test relative to current best practice has been thoroughly demonstrated in the leading urology journals so we have virtually no doubt they will eventually get there. It is a matter of grinding through the slow-moving wheels of US healthcare bureaucracy. When they do get there, our current DCF valuation is some multiples of the current share price, with the main risk being further dilutive equity issuance along the way.

Other detractors were modest in nature and were led by our moderate long in the high yielding Unibail-Rodamco-Westfield (URW, -11%) which we had taken down from a very large position into prior strength; our mid-sized long in Metlifecare (MET, -10%) which was largely offset by our Ryman (-5%) short; and a small tail of other random moves in various longs and shorts.

The largest positive was our sizeable long in QMS Media (QMS, +15%) which pleasingly reiterated guidance at its AGM. This came despite pressure on the outdoor media sector due to the

Australian elections seeing companies pull back on branding expenditure and billboards not really being a major political category. We are also long the industry peer Oh! Media (OML, +12%) which reiterated guidance and importantly talked to a pick-up in post-election bookings. The shift to digital billboards is an ongoing structural game-changer for these companies and QMS has the added near term catalyst of probable approval of its deal with Mediaworks NZ, which will give them a stake in a strong NZ platform and release over $40m to return QMS parent debt to less aggressive levels.

The second stand-out was a frequent attendee of these pages via our large short in Technology One (TNE, -19%). We wrote last month how TNE is very much a traditional ERP software business which has repackaged itself in SaaS drag. Their interim result was replete with positive headlines but highly complex accounting changes in the move to AASB15 would require a doctorate in forensic accounting to work one's way through. However, a reduction in retained earnings via large write-downs in earned and unbilled revenue from $115.8m to $13.8m did take our eye. Given TNE's darling status in the hyper-PE group, we covered much of our short into the sharp sell-off but it will very much remain a name on our radar screen.

There were a number of other notable winners, with these being led by our small and previously painful long in Evolve Education (EVO, +38%), which rallied sharply following its recapitalisation. Our large valuation-based short in Breville Group (BRG, -12%) worked well as it returned towards normality after the momentum investors had done their thing. Our large long in Monash IVF (MVF, +10%) continued its recent strong run and our channel checks suggest trading conditions are solid. It is a classic example of a name on a PE of circa 12x offering 10% growth. Other key longs that worked included Investore Property (IPL, +9%), Bingo (BIN, +10%) whose veritable roller-coaster ride continued; and our PNG bank, Kina Securities (KSL, +11%) – we believe the change in government there has had no impact on them to date.

Thank you for your ongoing investment and support of the Fund. It has been an interesting journey in recent quarters but markets are beginning to change again. Valuations are ultra-extended, earnings are being downgraded and only discount rates are supportive. The leadership of ludicrously over-extended hyper PE stocks is beginning to falter and this is already starting to see a marked improvement in our performance. We are sticking to our long-established style and will continue to provide a true uncorrelated alternative to investors who cannot stomach these overextended equity and bond markets for 100% of their portfolios.

Matthew Goodson, CFA