SALT

Salt Long Short Fund Fact Sheet – May 2023

Manager Profile

Salt Funds Management is a boutique investment management firm wholly owned by its employees which specialises in actively seeking to maximise returns while managing the risks of the investment.

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 2023

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$72 million
Inception Date	31 December 2014
Portfolio Manager	Matthew Goodson, CFA

Unit Price at 31 May 2023

Application	2.3039
Redemption	2.2946

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 2023

Long positions	55
Short positions	38

Exposures at 31 May 2023

Long exposure	97.45%
Short exposure	46.53%
Gross equity exposure	143.97%
Net equity exposure	50.92%

Investment Risk to 31 May 2023

Fund volatility[1]	6.38%
NZ50G / ASX200AI volatility[1]	13.84%
NZ50G / ASX200AI correlation	0.077

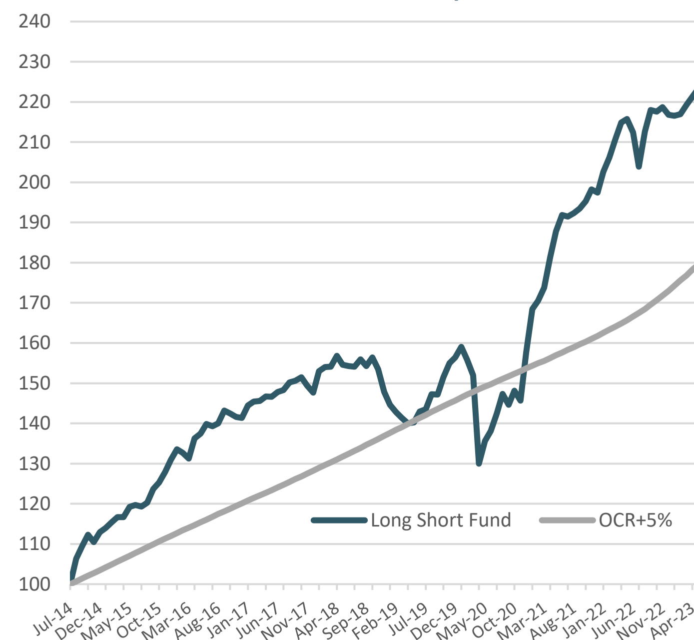
1. Annualised standard deviation since fund inception.

Fund Performance[2] to 31 May 2023

Period	Fund Return	OCR+5% Return	NZ50G/ASX 200AI Return[3]
1 month	2.73%	0.89%	-2.13%
3 months	4.65%	2.44%	-0.78%
6 months	5.85%	4.70%	0.85%
1-year p.a.	8.04%	8.74%	3.65%
2 years p.a.	9.35%	7.19%	0.88%
3 years p.a.	18.44%	6.55%	7.68%
5 years p.a.	8.26%	6.46%	7.21%
7 years p.a.	7.33%	6.57%	8.20%
Inception p.a.	9.76%	6.89%	8.82%

2. Fund performance is after all fees and before PIE tax.
3. NZ50G/ASX200AI is a 50/50 blend of the S&P/NZ50 Gross Index and the S&P/ASX 200 Accumulation Index and is for comparison purposes only.

Cumulative Fund Performance to 31 May 2023

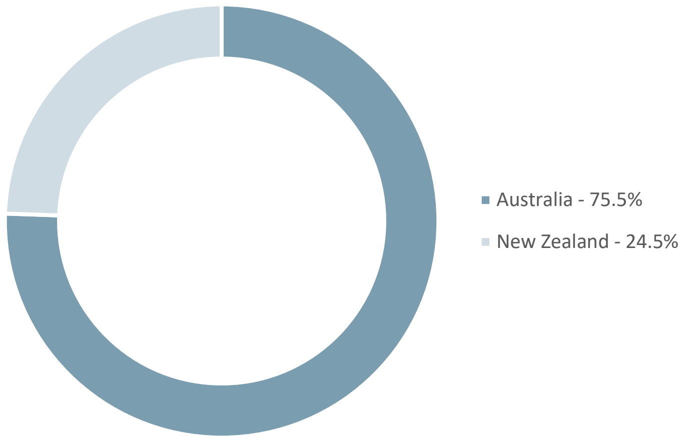


Fund performance has been rebased to 100 from inception.
Past performance is not a reliable indicator of future performance and no representation or warranty, express or implied, is made regarding future performance.

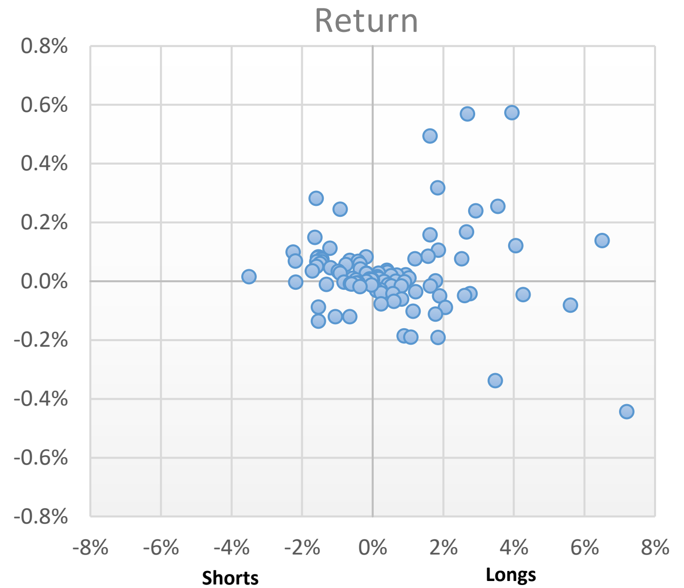
Largest Longs	Largest Shorts
Global Data Centre Group	Reece
Tower	Auckland International Airport
GDI Property Group	Meridian Energy
Monash IVF Group	Stockland
Kina Securities	Brambles

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 31 May 2023 (Gross Equity Exposure)



May 2023 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

The Fund delivered a strong performance in the month of May, with a positive return of +2.73%. This contrasted starkly with negative returns from long-only markets of -1.7% for NZ and -2.5% for Australia. Our long book did surprisingly well in what was clearly a tough month for most equities, while our short book's contribution was satisfactory. The Fund again delivered on its purpose of providing positive returns with no correlation to the underlying equity markets from which those returns were generated.

The key economic and investing themes underpinning our positioning evolved only slightly over the month. Inflation has peaked but remains too high, central banks are starting to diverge in their views regarding further tightening, evidence of an economic/earnings slowdown mounted across many markets and generative artificial intelligence arrived with a bubbly boom on the investment stage, driving sharp movements in a small number of stocks.

Our core view remains that inflation has peaked but it remains too deeply intertwined with wage inflation for central banks to ease in the foreseeable future. Markets are too optimistic in their timing about rate cuts, with this being a key risk to equity market performance.

The month began with a surprise RBA rate hike on 2 May, lifting by 25bp to 3.85%. This sent Australian equities down nearly 2% over 2 days. The tone of the RBA was that while consumer spending was starting to soften, it hadn't done so by enough to return to the 2%-3% target inflation band in a timely fashion. As this is written, they surprised the market slightly and hiked a further 25bp on 6 June.

Late month, the RBA commented that they may need to make further rate hikes unless they can get confidence that inflation will return into their 2%-3% target band by 2025. The April month CPI outcome was released that afternoon and came in at +6.8% for the year versus an expected +6.4%. While underlying inflation did ease in a number of categories, rental inflation soared by 0.76% in the month and by +6.0% in the year. Add a nationwide award wage determination of +5.75%, and +8.6% for the small number on the minimum wage, and we have a recipe for ingrained inflationary pressure that will be very difficult to stamp out anytime soon.

Meanwhile, in NZ, the RBNZ lifted the OCR by 25bp to 5.5% but the tone of the commentary was surprisingly dovish. For the first time there was a split vote (2/7 members wanted no hike) and they seemed quite relaxed about ongoing wage inflation, rental inflation, stronger immigration and the impact of fiscal policy. While the Budget clearly adds to inflationary pressures in the near term, the RBNZ focused on the contractionary impulse further out, which is based on improbably tight future discretionary spending settings. From

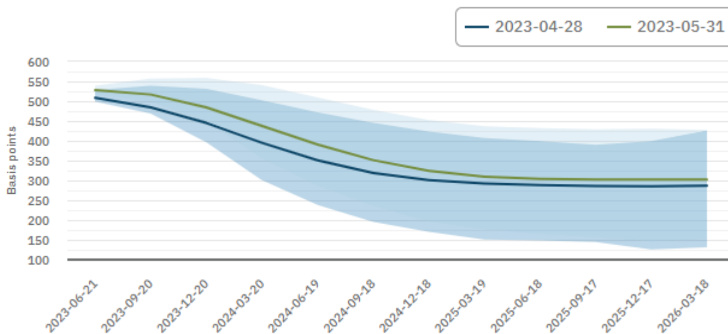
here, much depends on future inflation outcomes. The RBNZ now expects to start cutting the OCR in late 2024 – we think it is very much an open question as to whether inflation is returning below 3% by then.

As expected, the Fed hiked rates by 25bp on 4 May to 5.0%-5.25%. However, it was a "dovish hike", with a notable softening in the language regarding the likelihood of further moves versus an extended pause. The S&P500 promptly rose by 1.9% on May 5 on a relatively strong non-farm payroll report, which had wage inflation running as expected at 4.4%.

Subsequent evidence over the month and comments by a number of Fed Governors did suggest there is still some risk of further rate hikes. The chart below from the Atlanta Fed shows how rate expectations did indeed move in the direction of "higher for longer". However, the market still prices in rate cuts from the second half of this year – just not as much as previously.

The Expected Three-Month Average SOFR Path

Current target range: 500 - 525 basis points



Despite a shift up in this expected rate path, the S&P500 eked out a 0.4% advance and investor sentiment was notably buoyant. The chart below shows how the CNN Fear & Greed Index remained in "greed" territory and close to "extreme greed" (>75) for almost the entire month. Market leadership was extremely narrow, with most stocks underperforming and we will take a brief look shortly at the emerging frenzy for stocks with leverage to the theme of artificial intelligence.

The second key risk to equity markets is that numerous recession indicators are flashing orange or red around the world, meaning one would need to be brave to trust current earnings forecasts. Berkshire Hathaway's conglomerate of companies give a good window on US activity more broadly. Warren Buffett commented that many of them are faced with an inventory build-up, that the "extraordinary period" of excessive spending post-Covid is over.

It is not just the US that is slowing. Australia may once again be the lucky country but Barrenjoey pointed out that we saw a torrent of mixed comments and earnings downgrades from domestic focused names in the month – Michael Hill, Maggie Beer, Universal Store, City Chic, Dusk Group, Best & Less, Pact Group, AV Jennings and Super Retail. So far in June, we have had Adairs and Baby Bunting. While some sectors such as travel are strong, we suspect that this is because it has a greater exposure to older demographics who have not been hurt by higher mortgage rates.

Early in the month, GS global strategy showed that US equity market returns have historically been negative if a recession emerges after inflation peaks and equities actually underperform the most after the Fed starts easing. If we do end up with persistent inflation and slower growth/recession, equity markets could have some real issues because the valuation start-point is extremely high. The chart below from Barclays Capital shows that the S&P500 is trading at an equity risk premium which has reached its lowest point since the GFC. Likely earnings downgrades would make this even worse.

FIGURE 1. **Equity risk premium is trading 100bps lower than at the outset of the bear market, near post-GFC lows, even as recession risks have increased**

We define Equity Risk Premium (ERP) as S&P 500 Earnings Yield - 10y Treasury Yield.
Source: Refinitiv, Bloomberg, Barclays Research

Another way of looking at market valuations is to look at the corporate bond market, with fixed interest investors often having a more finely honed nose for the future than equity investors.

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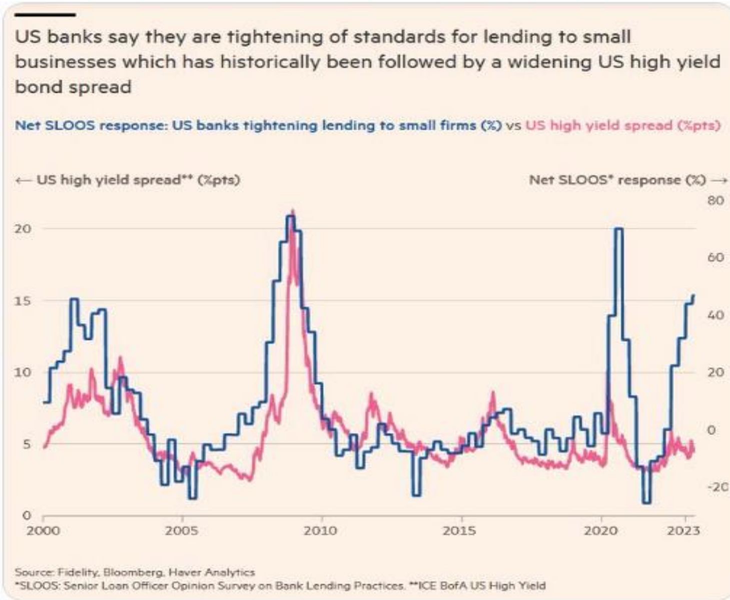

The chart above from the FT shows that US banks have sharply tightened credit standards (blue) and that this is invariably followed by a blow-out in corporate credit spreads (red). If corporate spreads are wider, that obviously hurts the riskiest piece of the capital stack – equity risk premia should rise.

One final way to think about current market valuations is to consider the composition of its performance. Narrow leadership is a classic sign of a bull market top. Well, year-to-date, the "7 horsemen of the apocalypse" have seen Nvidia +168%, Meta +126%, Tesla +75%, Amazon +49%, Alphabet +43%, Microsoft +40% and Apple a mere +38%. At the same time, the S&P500 is +16.3% (largely due to those 7 names) and the Russell 2000 Index is actually -0.6%. A long-term ratio of the Nasdaq Composite to the Russell 2000 Index is back to its early 2000 "never-to-be-repeated" Nasdaq bubble highs. This feels dangerous as the Fed keeps removing liquidity.

The Fund only invests in NZ and Australia, so we can safely report that we are neither long nor short the world's newest trillion-dollar company, Nvidia, which rose 36% in May as they reported exceptionally strong sales and forecasts for their GPU chips, which are heavily used in generative artificial intelligence. This theme of AI surged as the new, new thing in investing.

We do not intend to write a moderately informed dissertation on the implications for stocks in Australia and NZ but some potential impacts do need to be considered. One obvious sector to focus on is datacentres, where AI could be a source of demand that is many times larger than current CPU-based computing. However, it is not entirely clear that all existing data centres will be able to handle or provide the massive power loads and cooling that will be required. The thinking seems to be that hyper-scalers will be best placed. Regardless of nuances, Next DC (NXT, +11.7%), Global Data Centres (GDC, +2.0%) and Infratil (IFT, +4.7%) were among those to benefit.

Contrastingly, it is very hard to know what the implications will be for other sectors. What does it mean for online marketplaces and those dependent on the use of google ad-words and old-fashioned search? We would be a little nervous if we owned names such as Carsales.com and REA Group, whose share prices depend on many years of projected growth and an assumption of unending dominance. We are moderately short the latter and began to lift our shorts across other Australian "tech" names which are fellow travellers rather than clear beneficiaries of the sudden focus on AI.

It is rather early to call AI-driven share price moves a "bubble" but the excitement around the theme is such that one can certainly see it driving some extreme share price movements. The Fund did particularly well from our super-computer company, DUG Technology (DUG, +16.1%), while GDC's more modest advance was enough to see it just overtake Tower and become our largest holding. As a reminder, GDC is in gradual wind-up mode, with management heavily incentivized to get $2.50+ versus the month-end price of $1.57 and the last reported "NAV" of $2.32. We believe their stake in the hyper-scaler Airtrunk could have material upside, especially in an AI-besotted investment world. It's only a bubble if you're not invested in it!

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Fund Performance in May

Returning to the Fund's performance in the month of May, the overall return of circa +2.8% pre fees and tax was driven by very pleasing returns from both sides of the ledger. As one would hope in a negative month for markets, our short book added +1.6%, while strong stock selection saw our long book defy markets and return +1.2%. Our "winners to losers" ratio was a strong 63% and there was a notable skew to our key winners being bigger than our notable losers.

The 50/50 index of Australia and NZ had an abnormally high number of 13 down-days in April, with the average return on them being -0.43%. Our net length over the month rose sharply from 41% to 51% but we continued to do very well on the negative days. We were up on 10 out of 13 of them, with an average return of +0.22%, with this actually being our entire positive return over the month. We largely broke-even on the up-days.

The biggest winner was our large, long-held and previously long-suffering holding in Lynch Group (LGL, +14.9%) which rose steadily ahead of a very positive profit upgrade that was delivered after month-end and has driven another +20% since then. In short, most of the factors weighing on them over the last several years are reversing as we had hoped. Air transport costs are falling, the Chinese consumer is returning post Covid, improved labour availability is reducing expensive overtime, the category management issues with a major Australian supermarket chain have improved, and Australian sales are defying wider retail gloom and are likely being driven by an ongoing florist to supermarket switch. As this is written, LGL has risen from $1.65 at end-April to $2.27 but is still only on consensus PE ratios of 9.7x Jun24 and 8.3x Jun25. It is on a cash PE of more like 6x.

An equally large tailwind came from a holding we have built in recent months in Omni Bridgeway (OBL, +17.5%). This featured in our headwinds list last month but sentiment appears to have approved somewhat from their announcement of several modest settlements. OBL's core business of litigation funding is inherently uncertain in terms of each specific case but they have largely turned themselves into a fund manager, where investors fund the bulk of cases and OBL receives a modest base fee and larger waterfall structure performance fees once investors have received preferential returns. We repeat last month's comment that there is no evidence OBL has suddenly lost their ability to find investors, source litigation funding agreements and convert them into income at an average 15% of the headline figure funded.

A third stand-out was the medium-sized long in OFX Group (OFX, +28.4%), which we have owned on several occasions over the last few years. We bought in when it was hammered on disappointing guidance back in March but they have since reported solid numbers and recovered much of the lost ground. OFX has a powerful competitive position as a non-bank forex player for consumers and businesses and we have found over time that forex volatility and trading volumes go through their strong and weak phases. We like to buy when the market panics at the latter.

There were a number of other notable tailwinds. Our super-computer business, DUG Technology (DUG, +16.1%) turned in yet another strong month and is now up around 2.5x from when we were very lonely and nervous buyers back in 2022. We have taken a little profit but it is still relatively cheap in our view if they can continue on their recent earnings growth path.

Turners (TRA, +7.1%) did well following a rock-solid result into some fairly strong economic headwinds. They are being held back by only hedging 50% of their finance book's funding in a rising rate environment but this will turn into a tailwind when the RBNZ eventually starts easing (although we have no great hopes for this). They are taking significant share in the NZ used car market and we expect their debt collection business will kick back to life after a number of quiet years. The PE of 9x and dividend yield of circa 9% are compelling for a company with a solid albeit somewhat cyclical growth outlook.

Other strong contributors included Superloop (SLC, +7.3%), APM Human Services (APM, +8.9%) plus shorts in the Australian retail sector, where Super Retail (SUL, -15.5%) and Lovisa (LOV, -22.5%) were particularly helpful.

Headwinds were fewer in number and smaller in magnitude but one stand-out was our large long in Tower (TWR, -5.5%). They downgraded guidance early in the month on the back of the plethora of large NZ events and a larger than expected impact (to us) from cyclones in Vanuatu. This also incorporated the costs of reinsurance reinstatements. In what has been a true annus horribilis, they are still actually guiding to a full-year NPAT of $8m-$13m, incorporating $16m of assumed large events in the September half. This speaks to how strongly the underlying business is performing and we see the market as dramatically under-estimating their earnings power in a normal or light claims year. Bring on El Nino…for which the Australian BoM now estimates a 70% chance.

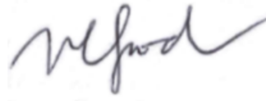
The only other detractor of notable magnitude was our long-standing holding in Australian Vintage Group (AVG, -8.8%) which continued to slip away on no new news. Global wine companies are encountering mixed trading conditions at present, with AVG not being immune given their exposure to the UK market and a hefty inflation-driven increase in excise taxes. However, the AUDGBP has moved in their favour, strong structural upside remains from their dual premiumisation and low alcohol wine strategies, shipping costs are falling quickly and the possible removal of hefty Chinese tariffs on Australian wine would help the entire market even though AVG has little direct exposure.

Other headwinds were relatively modest. From the long-side, detractors included a position in Carbon Fund (CO2, -9.4%) and two modest resource company holdings, Tietto Minerals (TIE, -17.5%) and Strandline Resources (STA, -15.3%). These are both on the cusp of respectively being material gold and mineral sands producers and we see them as exceptionally cheap.

From the short-side, we prematurely established positions in NIB Holdings (NHF, +9.5%) and Wisetech (WTC, +9.2%). We see the former as still benefitting from unsustainably low post-Covid volumes, while the latter may be at risk from a sharp slowing in global transportation volumes and prices but has risen due to a halo effect from the US mega-cap tech stocks.

Thank you for your continued support of the Fund. We were pleased to deliver strong outcomes in May and to do so with no correlation to underlying equity markets. June has begun relatively well, with several strong tail-winds more than offsetting one unfortunate headwind (a small long in Pacific Edge which was hard hit on a shock Medicare coverage decision).

Our net length has edged up to a little over 50% which may seem odd given our continued cautious view regarding the equity market outlook. However, many of our longs march to the beat of their own drum and some even tend to be beneficiaries of rising interest rates. Our overall view remains concern that the market is too optimistic in pricing the timing of rate cuts, that the economic and earnings outlook is difficult and that we have seen a surge in mega-cap tech stocks despite central banks continuing to remove liquidity from the system.



Matthew Goodson, CFA

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