Salt Long Short Fund Fact Sheet – September 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 30 September 2020

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$55.5 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 30 September 2020

Application	1.4873
Redemption	1.4812

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 September 2020

Long positions	48
Short positions	29

Exposures at 30 September 2020

Long exposure	94.00%
Short exposure	46.83%
Gross equity exposure	140.83%
Net equity exposure	47.18%

Largest Longs	Largest Shorts
Tower	Netwealth Group
Marsden Maritime Holdings	Napier Port Holdings
Pacific Edge Limited	Goodman Property Trust
Vitalharvest Freehold Trust	Precinct Properties NZ
Templeton Global Growth	Auckland Airport

Performance[1] at 30 September 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%	2.41%				**-6.89%**

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	3.96%	1.30%	1.07%
6 months	13.95%	2.59%	17.95%
1 year p.a.	-2.22%	5.59%	0.34%
2 years p.a.	-2.69%	6.09%	7.00%
3 years p.a.	-0.74%	6.50%	9.34%
5 years p.a.	3.40%	6.62%	11.48%
Since inception p.a.	6.49%	6.97%	9.74%

[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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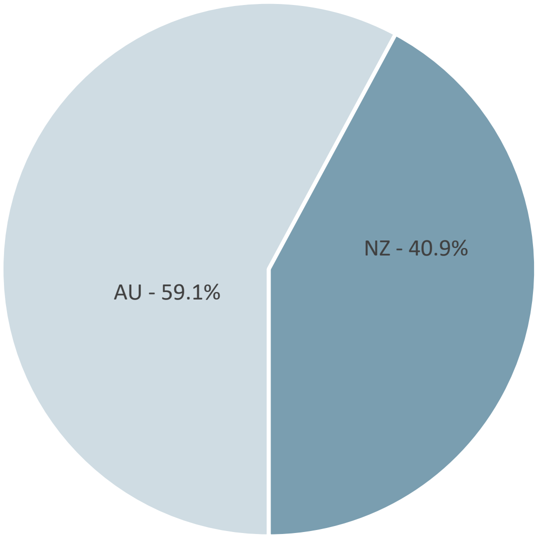
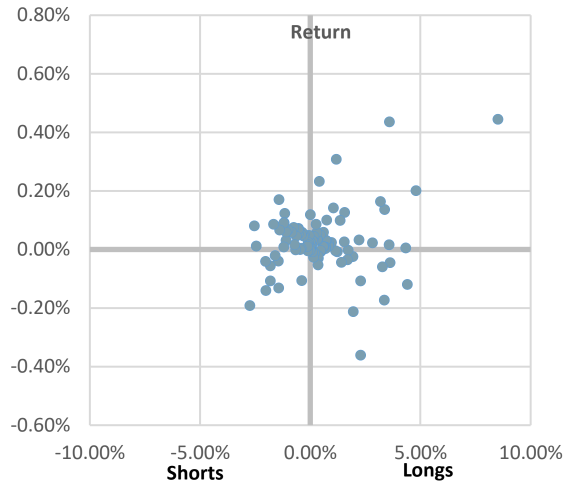
Country Allocation at 30 September 2020 (Gross Equity Exposure)



September 2020 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

The Fund delivered a pleasing return of +2.41% in the month of September. This came despite running relatively high levels of net length in the mid 40% to low 50% region in a month that saw very weak performance from long-only equities in Australia (-3.66%) and even the teflon-coated NZ market (-1.40%) fell somewhat. Interestingly, our longs added considerable value over what was a negative month for markets, while our shorts also worked well.

We continue to deliver returns that are truly uncorrelated to equities. While September delivered a modest and possibly temporary entrée, this will really matter again when the seemingly endless bull market does eventually end. Regardless of whether markets rise or fall, the Fund will march to the beat of its own drum and be up, down or flat. Importantly, our history and style suggest we tend to do a touch better in falling markets than rising ones and we did provide strong protection on the numerous down-days in September.

The 50/50 index of NZ and Australia experienced thirteen down-days in the month. Our Fund was up on nine of those thirteen days and delivered an average return on them of +0.18% versus -0.82% for the market. We were also up slightly on the nine positive days during September. We repeat last month's comment that the Fund does not provide an infallible backstop when markets fall but on average it is working well.

Market valuations continue to be of little meaning when central banks are aggressively buying every bond that moves. Once upon a time, investors bought equities for growth and bonds for yield but now this is bizarrely reversed. NZ 10-year bond yields finished the month at a scarcely believable 0.46% as the RBNZ aggressively implemented its large QE programme. It is actually one of the few central banks globally whose QE purchases are exceeding new issuance.

Yields at this level when inflation is running well above 1.0% are pushing investors uncomfortably up the risk curve in what is a bar-bell trade of "TINA" and "GAAP". This is a bull market that is being driven by central banks and their repression of discount rates, it is not being driven by economic growth and earnings.

The TINA trade (there is no alternative) continues to be a key driver of the NZ market as investors are aggressively over-paying for equities in a desperate quest for income. The puzzle to us is that they are being far more aggressive in some segments such as NZ listed property and far less aggressive in others such as Spark and Australian property. These look cheap in relative yield terms and we have positioned accordingly.

In our view, the key in an ultra-low discount rate world is not to walk into a buzz-saw with either the capital structure or an earnings downgrade. This is hardly a unique insight but yesterday's low risk stock is not necessarily tomorrow's, particularly if the valuation multiple has become egregiously high.

We are a little bemused that NZ industrial property names such as Goodman Property (GMT) and Property For Industry (PFI) continue to grind higher and are now at 20-30% premia to their geared NTA's. The latest evidence is that industrial rents have peaked, with incentives starting to rise. Stories of ultra-tight cap rates are perhaps to blame but that's simply saying that if someone else is silly enough to pay a 4.5% cap rate for a 30 year-old shed with a leaky roof, then I will too. We have also short-sold a couple of names whose capital structures are over-levered with gearing at well over 40% even at current high valuations.

Over the last few weeks, we have moved to a reasonable-sized net short in NZ property, while we are very long selected names in Australian property and also long Spark, which has a 7.3% gross yield. Similarly, we retain our long in Turners (TRA) which has a 9.4% gross yield and used car prices are booming.

To put some further numbers around this, we estimate a year ahead gross yield from GMT of just 3.3% and from PFI of 4.2%. Conversely, our Eleanor Office Property (ECF) long delivers a 10.7% gross yield to a NZ investor, GDI Property (GDI) will deliver 8.4% and Vitalharvest Trust (VTH) will do 7.6%. These entities are all 20-30% below NTA, while the NZ names are generally 20-30% above NTA. Our longs have reasonable outlooks from their unique sub-sectors. For example, GDI has exposure to the improving Perth market, while VTH has a far better seasonal outlook and we believe may be able to renegotiate their complex lease with Costa Group and generate a sizeable dividend uplift. The TINA trade appears to be carrying all before it, but under the hood, there are still some great opportunities that we have aggressively positioned for.

The other key trade driven by ultra-low yields has been GAAP (growth at any price). After all, if interest rates go negative, then hoped-for profits in 20 years' time are actually worth more than profits today. Mind-bending but true albeit with the huge caveat that it's only true if you have never seen a market sell-off and choose not to apply an equity risk premium – like a Robinhood investor. Our observation is that a variety of all sorts of assorted rubbish has hitched a ride on the growth train alongside the true network monopoly growers such as Amazon and Google.

When you demand a combination of a real business and some vague semblance of valuation sanity, the GAAP stocks been a very difficult area for us to find strong ideas from the long side. That said, our large position in Pacific Edge Biotechnology (PEB) has begun to work very well and we believe has the potential for sizeable further upside if they can execute on the vast US market opportunity that now lies open to them. We would also suggest that our large position in the omni-channel retailer, Shaver Shop (SSG) has a sizeable further growth opportunity but they are making the error of being on a single digit PE (ex amortisation).

Conversely, we are seeing numerous potential short-selling opportunities in the GAAP space. We are conscious of the risk of being too early, so are being careful not to initiate a position just because the valuation looks extended. Almost all the GAAP valuations look extended. We are also demanding clearly identifiable catalysts and the share price having moved well into over-bought territory on momentum measures. We are still finding it far from easy in this segment as share prices tend to ratchet ever higher until suddenly they don't. Suffice it to say that this segment is our key source of positive performance on down days, so given the beta it provides, we are also being careful with our sizing.

We are entering a fascinating time of year with election season being upon us in both NZ and the USA. This is augmented by the ebb and flow of Covid-19 news and the fluctuating likelihood of a vaccine. There are a range of scenarios that may prove to be market moving in the short term and most of the risks appear tilted to the downside. However, unless the outcomes are particularly dire and permanent, we suspect that the supremacy of low interest rates may reassert itself thereafter.

The US election campaign is a thing of beauty for a political junkie. Federal polls are of far less significance than those in tipping point states. Even if President Trump wins toss-ups such as Florida and Ohio, most analyses point to Pennsylvania being the tipping point. Joe Biden has been consistently ahead there by a moderate but statistically significant high single digit margin.

This leaves the race for the Senate as perhaps being the key focal point for markets. This is far closer but the Democrats do appear to have their nose in front on a consistent basis. So, if we assume that the Democrats sweep the Presidency, the Senate and Congress, what are the market implications?

The pricing of forward-dated volatility already spikes just after the election, so markets have priced a clean-sweep to some degree. However, we would suggest that markets will still stage an initial sell-off on a Democratic clean sweep – it is priced as a possibility rather than an actual outcome.

Looking at specific Democratic policies that are likely to be implemented, two stand out for markets overall. Firstly, a lift in the proposed corporate tax rate to 28% would see a hit of circa 8-9% to S&P500 earnings from several different analyses that we have seen. Therefore, a sell-off of this magnitude would not surprise, to the extent that it is not priced already.

The second key policy to consider is a lift in the capital gains tax rate for high earners to the marginal income tax rate of 39.6%. The obvious response from investors will be either to sell their winners immediately or to hold onto them for at least another four years. We suspect the former effect will dominate. Anti-trust investigations of the likes of Amazon and Google could also be a left-field factor.

The greatest potential risk is however that there is no clear election result for some time. A reasonable hypothesis is that the polls are basically correct and perhaps understate the "shy Trump voter" by 1-2%. At the same time however, vastly more Democrats relative to Republicans plan to vote by mail than in person. In many states, these votes will only be counted in the days and weeks following. Therefore, a quite conceivable scenario is a very close call on election night, followed by massive efforts by each side to prevent or ensure votes are counted afterwards. The cry of "fraud" by President Trump is easily imagined. This would not be pretty for markets.

Closer to home, what seemed a rather boring march to election day, with Labour well in front, has begun to change a little. While Labour is still polling in the high 40% to low 50% region, the momentum has begun to swing, so it is quite conceivable that they end up in the mid-40% region. The Greens seem reasonably solid above 5% although they always underperform their polls a little as young voters don't turn out. Put this together and the difficult scenario for markets of a Labour + Greens coalition becomes a decent likelihood. The market has not priced this and it would clearly spark a short term sell-off.

Returning to the performance of the Fund in September, the estimated return of +2.47% (pre tax and fees) was composed of +1.78% from the long book and +0.68% from the short book. Making money from both sides of the ledger is rarely achieved but is nirvana for a long-short fund. It was particularly pleasing to do well from the long side in a tough month for markets, with 43 out of 62 long positions adding value. Our overall winners-to-losers ratio was an extremely strong 72% and there was no real skew in size between winners and losers.

The largest headwind was our long-held position in the PNG bank and financial services company, Kina Securities (KSL, -14.9%), which fell sharply on a poorly managed equity raising. KSL delivered a solid result in August and is on a forward PE of circa 5x and dividend yield of 12%, with strong growth thereafter. They raised equity both to allow them access larger customers in PNG and to potentially purchase the PNG and Fiji businesses that Westpac is looking to sell. They claim the former alone could be EPS neutral (adjusted for the raising), while the latter would be hugely accretive. The problem is that they raised the equity without any evidence that they will actually execute on either. That said, KSL is well-managed and we expect they will put the proceeds to good use so that the current share price weakness will pass.

Other laggards were smaller in nature but were led by our long in Intega Group (ITG, -10.2%) which fell for no discernible reason. This is the testing services business of the old Cardno Group and it had earlier bounced by 35% in July when it delivered a solid result. It is on a forward PE of 7.2x in the Jun22 year. Headwinds also came from our long in Qantm IP (QIP, -5.2%) and our short in Netwealth (NWL, +8.4%) which continues to defy the earnings risks from falling interest rates.

The largest positive was our large, long-standing overweight in Tower (TWR, +5.3%), which had fallen in the prior two months for no obvious reason and reversed that in September. We believe the Northland floods of several months ago will not impact TWR as they had already reached their aggregate reinsurance limit. In common with many companies, we are hopeful that the earnings guidance they gave at the start of Covid-19 will end up proving conservative when they report in November. Their major IT revamp appears to be performing well in terms of both driving new business and allowing major cost reductions. There are very few companies on PE multiples below 10x with double-digit earnings growth thereafter – Tower is one.

The second stand-out was our position in Turners (TRA, +13.5%) which delivered a solid AGM presentation during the month, including guidance for the Mar21 year that was well above broker expectations. Strength in used car prices and limited finance book arrears are certainly two surprises that we wouldn't dared to have dreamed about 3-4 months ago. We remain attracted to the strength of TRA's market position and the multi-year growth opportunity ahead of them, from a starting point of an attractive valuation.

Other notable drivers included a well-timed long in Sky City (SKC, +16.9%) although we have since exited as it has moved to a full and fair valuation; a similarly well-timed move into Coronado Coal (CRN, +54%) as the bottom of the coking coal price cycle appears to be well and truly in; and a somewhat random lift in Marsden Maritime (MMH, +4.3%) following earlier random weakness – it remains cheap versus port peers and has clear catalysts for upside from property developments and cross-party political support for moving the dry-dock there from Devonport. One notable short that helped in the month was Wisetech Global (WTC, -8.5%) which remains on an egregious valuation in our view and had rallied sharply in the prior month for reasons that made little sense (an earnings "upgrade" due to greater cost capitalisation).

Thank you for your ongoing support of the Fund in what are challenging and highly unusual times. We are remaining focused on core valuation disciplines, seeking to short sell expensive names with identifiable catalysts and be long companies that are cheap, either on current multiples or relative to the growth opportunities that they have in front of them.

The month of September saw a slightly sterner test for some of the conceptual darling stocks, and as a result, the relative performance of our Fund suddenly emerged from hibernation. We will continue to stick to our disciplines against a backdrop of what famed ex-Soros investor Stan Druckenmiller describer during the month as, "*an absolute raging mania.*"

This mania has clearly been caused by central banks slashing interest rates and driving real discount rates deeply into negative territory. In our view, the single-minded focus on an inflation goal that they have never shown to be optimal is a policy mistake. Further, the experience of Europe and Japan suggests that extended periods of low and negative rates do little to help the real economy. However, it is what it is and as investors we have to adapt to the reality that is in front of us.

Our adaptation is to run with greater net length than normal, while concentrating a fair degree of that in segments of the TINA trade that have been left behind. We are also sizing up those names which we see as cheap and on which we also have strong top-line confidence.

We think markets will be very volatile in the next few weeks as election outcomes could drive sharp but ultimately temporary sell-offs. We hate to say it but the pre-condition for ending the raging mania is a tightening of monetary policy and that appears some way away. This means any sell-off may ultimately end up being confined to those names which are clear losers from political changes.

Matthew Goodson, CFA