Salt Long Short Fund Fact Sheet – May 2021

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 2021

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$52.6 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 May 2021

Application	1.9267
Redemption	1.9189

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 2021

Long positions	55
Short positions	35

Exposures at 31 May 2021

Long exposure	94.33%
Short exposure	47.36%
Gross equity exposure	141.69%
Net equity exposure	46.97%

Largest Longs	Largest Shorts
Tower	Cochlear
Shaver Shop Group	Reece
EQT Holdings	Fortescue Metals Group
Marsden Maritime Holdings	Mercury NZ
Graincorp	Xero

Performance[1] at 31 May 2021

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%	-1.67%	8.31%	6.76%	**5.88%**
2021	1.24%	1.90%	4.42%	3.52%	2.16%								**12.53%**

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	10.43%	1.32%	4.59%
6 months	21.63%	2.58%	3.97%
1 year p.a.	38.96%	5.27%	22.71%
2 years p.a.	15.86%	5.58%	12.04%
3 years p.a.	7.55%	5.97%	11.64%
5 years p.a.	6.53%	6.31%	11.27%
Since inception p.a.	9.88%	6.80%	11.24%

[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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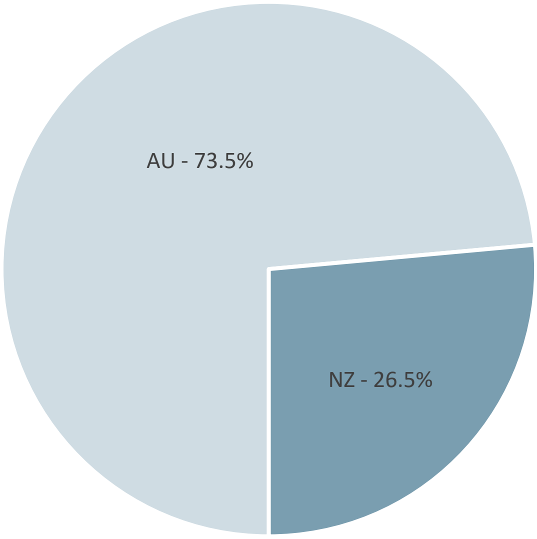
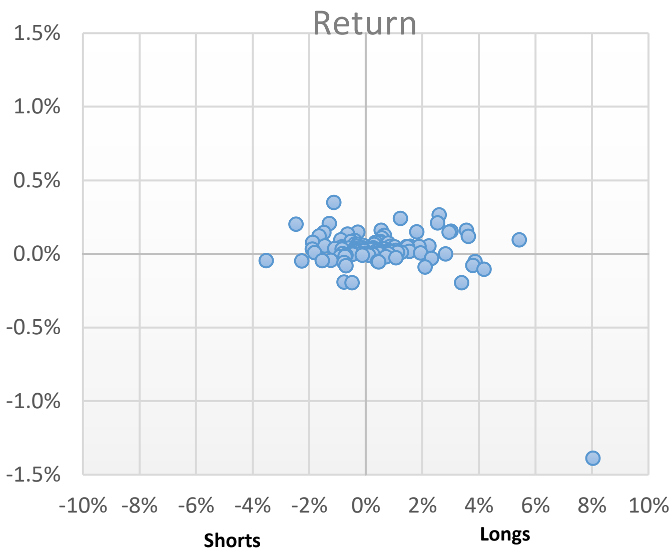
Country Allocation at 31 May 2021 (Gross Equity Exposure)



May 2021 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

The Fund continued its run of strong performances with a pleasing return of +2.16% in the month of May. This occurred against an unusual backdrop of weak NZ (-3.2%) and strong Australian (+2.3%) long-only equity markets. It was by no means the case that every piece of stock selection worked in unison but on average we were right far more often than we were wrong, with our diversification continuing to pay-off.

Stock selection was strong from both sides of the ledger, with both our long and short books performing well. The former was despite a big (but we think passing) headwind from our largest long position. This speaks to the style of the Fund currently intersecting well with what is working in the market, in the face of rising pressures from inflation and bond yields.

The outperformance of cyclicals relative to GAAP (growth at any price) and naïve high-yielding TINA stocks (there is no alternative) has continued in recent months but has become a little choppier rather than being a one-way bet. That said, the month of May did see longer term bond yields generally rise, with NZ 10 years moving from 1.62% to 1.85%. This went hand-in-hand with Technology (-9.0%) and Utilities (-6.3%) sharply underperforming the Australian market advance of +2.3%. NZ was far more stock-specific.

The Fund's net length declined slightly from 48% to 47% over the month although we did run in the low 50% region for much of the period. Our gross position fluctuated around 140%. These levels are relatively normal and consistent with what we consider to be market-neutral given that our shorts tend to be far higher multiple and higher beta than our longs. That this net length is market neutral is shown by the Fund generally adding value on both positive and negative days for the market.

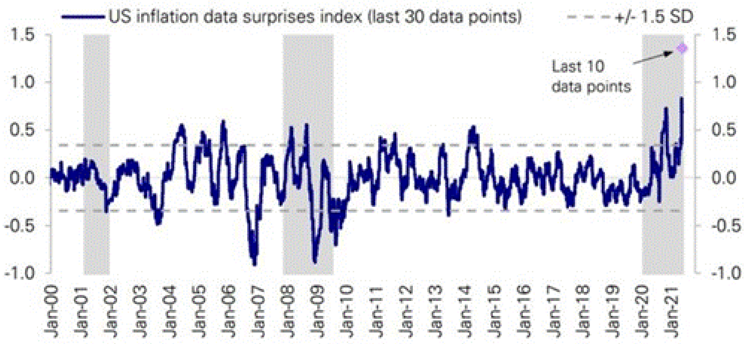
There were nine down days in May for the 50/50 index of Australia and NZ, with an average return on those days of -0.54%. The Fund was up on seven of those nine days and it delivered an average return on them of +0.20%. This shows that the Fund is delivering on its mission of providing equity-like returns with no correlation to equity markets and less volatility than them.

Our current thinking is dominated by rising risks of inflation, potential monetary policy responses to that, what that might mean for the performance of both equities overall and for the performance of sub-groups of equities within the market.

We have argued for some months that inflationary pressures are building and that central banks will start to think about thinking about tapering their quite extraordinary activities. The picture is similar across many markets. It has taken a little bit of time but the inflation evidence is now indubitably coming through. After a 0.6% monthly lift in March, the US headline CPI surged by 0.8% in April versus the +0.2% expected. Core CPI rose by +0.3% and +0.9% in those two months.

In case one thinks the inflation pressure is purely transitory, which is the current argument from central banks, the chart below sourced from DB's global strategy team would seem to put lie to this. Inflation data surprises across a broad range of goods and services are running at the highest level in decades, so there would seem to be a build-up of pressure that has a long way to go yet in feeding through to the official data.

Figure 1: Inflation data surprises are running at the strongest on record



Source: Bloomberg Finance LP, Deutsche Bank Asset Allocation

This very much accords with anecdotal reports from a huge swathe of companies at the coalface. The April ISM Survey reported as this is being written and included an enormous prices-paid number of 89.6. Some individual comments from companies are below and sound more like a lasting impact due to a move away from just-in-time manufacturing rather than a transitory spike:

"*The current electronics/semiconductor shortage is having tremendous impacts on lead times and pricing. Additionally, there appears to be a general inflation of prices across most, if not all, supply lines*." (Computer & Electronic Products)

"*Market capacity in most areas is oversold, with no realistic improvement on the horizon. In fact, it appears that demand will continue to strengthen, leading to more significant disruptions*." (Furniture & Related Products)

"*In 35 years of purchasing, I've never seen everything like these extended lead times and rising prices — from colors, film, corrugate to resins, they're all up. The only thing plentiful at present, according to my spam filter, is personal protective equipment [PPE]*." (Plastics & Rubber Products)

While NZ's last CPI reading for the March quarter was far from panic stations, higher frequency data suggests that NZ inflationary pressures are similar to those in the US and globally. One standout was the April Food Price Index, with restaurant and ready-to-eat food rising by 1.2% in the month alone due to the minimum wage rising from $18.90 to $20 on 1 April.

This wage lift will take time to fully filter through the economy especially as wage relativities are maintained in annual negotiations and firms then lift prices to compensate. This supply-side impost adds to the negative supply-side shock from Covid-19 and is a classic example of how the current economic episode is very different to the pure deflationary pressures of the GFC.

Further evidence comes from the monthly ANZ Bank Business Outlook survey, with the May edition showing that a net 81% of firms expect to face higher costs over the next year but "only" 57% expect to be able to lift their selling prices, resulting in a mere 4% expecting higher profits. Those cost expectations and selling price intentions are the highest in decades.

With all this inflation evidence building, we feel like we are at the end of the beginning in terms of central bank monetary policy settings. Their eyes are slowly opening to the presence of inflation and their assertions that it will prove transitory are beginning to be questioned.

The investment implications of this phase have been relatively benign for equities over the last several quarters. Historical studies have shown equities to generally to be a good inflation hedge until around the 3% mark because the numerator of rising revenues and profits offsets the denominator of higher discount rates. Cyclicals have clearly been the place to be in this period.

The next stanza may be somewhat trickier. In our view, we are about to transition from the end of the beginning to the beginning of the end. Monetary policy will actually begin to tighten. With liquidity and speculation still being rampant, equities and other risky portions of the capital stack such as junk bonds may begin to weaken as the reality of the party's end sets in.

As ex-Soros fund manager, Stanley Druckenmiller put it on a CNBC interview mid-month, "*current Fed policy is totally inappropriate …. I can't find any period in history where monetary and fiscal policy were this out of step with the economic circumstances, not one*."

In his view, the combination of very loose monetary and fiscal policies could even create risk to the reserve status of the US dollar. Our take is that at the very least, negative real yields have historically been a great environment for gold as there is no opportunity cost in owning it. For this reason, we have around 2.6% of the Fund spread across 4 of the most interesting Australian gold stocks that we can find.

This view also argues for Bitcoin as an alternative store of value even though it was carved up by 35% in the month of May and it has halved from its recent highs. For what it's worth, our view is that the speculative mania in cryptocurrencies is chiefly an artefact of ultra-loose monetary policy creating liquidity that is sloshing around the system looking for a home. We wouldn't touch any of the plethora of so-called digital tokens with a bargepole but Bitcoin's capped supply makes it more akin to digital gold. The fund has no exposure to such assets and has no intention, so we only make this comment given the incoming interest.

We have frequently been critical of the merry money-printers at No.2 The Terrace but the RBNZ Monetary Policy statement in May saw them join Canada and Norway in signalling an earlier move to tighten policy than some other somnolent central banks (such as the RBA).

This period of tightening monetary policy may prove difficult for equities and corporate bonds even though equities should provide a degree of hedging unless inflation gets out of control. This will naturally see the Fund transition to having less net length overall as we trim some investments and place new shorts on names that may particularly suffer in a higher rate environment. That is the beauty of a Long Short Fund in potentially being able to perform positively irrespective of the market backdrop.

Investors will also need to be wary of changes in the types of stocks that work in the period ahead. We have successfully called "cyclicals" as being a group benefitting from the current reflationary environment and although they have run hard, they may possibly have a little bit of gas left in the tank. We are scouring our universe for examples which still offer value.

We remain wary of the wider group of "value" stocks as they really depend on strong economic growth for their typically operationally and financially challenged models to do well. They tend to be winners coming out of a recession but that does not feel like the period ahead, so we remain shy of structurally challenged dogs.

The surprising group of stocks that could underperform may be the "quality" names that have been big winners in recent years. Who doesn't like a stock with a high ROIC, strong and stable margins and good re-investment opportunities? However, if it was that easy, these stocks would outperform always and everywhere but that is simply not the case.

Such stocks are very attractive in a mixed economic environment because they tend to hit their earnings numbers whereas other companies struggle. At the same time, falling bond yields and a dearth of other solid investment opportunities in recent years mean it has made sense to pay ever higher multiples for the earnings that they generate. The problem is that a 40x PE is now the old 20x and if we enter a period of higher bond yields, the multiple attached to these companies may contract.

Returning to the performance of the Fund in May, our return of circa +2.55% (pre-tax and costs) saw solid returns from both the long book (+0.92%) and the short book (+1.63%). This was particularly pleasing given the choppy nature of markets and the wide differential between Australia (+2.3%) and NZ (-3.2%) market performance. The reason we did well was that the overall "winners to losers" ratio was a record high 77%. This more than made up for a fierce headwind from our largest long. Without that, it would have been a stunning month.

Our large long in Tower (TWR, -16.7%) was the biggest detractor by quite some distance. It followed a modest profit downgrade due to a combination of an unusual number of house fires and a claims cost inflation cycle getting under way. The former accords with data showing house fires to be volatile from period to period and should have a PE of 1x attached to it. The latter is more concerning as it takes time for TWR to re-price its policies as they mature over the year ahead. However, all insurance companies face the same pressures, so while it will weigh somewhat on the year ahead, it will turn around into a tailwind in the future as the cycle runs its course and policies then take time to be re-priced in the other direction.

The basic attraction of TWR remains unchanged. Namely, a balance sheet awash with capital combined with a competitive advantage from their EIS tech backbone allowing them to enjoy strong operating leverage as they grow inorganically and organically. It will take time for their large Australian-based competitors to catch up.

Other headwinds were more modest and came from two slightly premature shorts and one long. The first short was Corporate Travel (CTD, +12.7%), whose enterprise value is now above where it was pre-Covid. Current consensus forecasts have earnings recovering to a PE of 43.5x in Jun22 and 22.6x in Jun23 but our observation is that there has been a permanent change in business travel activity. A structural shift has occurred towards using high quality video applications such as Zoom, so we suspect that the forward forecasts may be too optimistic.

The second short weighing on us was Hub 24 (HUB, +6.1%) which rocketed 18% in the last week of the month for reasons that are not obvious. The one positive that makes us a little wary of shorting HUB is that they have a positive exposure to rising short term interest rates but it may be at least a couple of years before these start rising in Australia. Meanwhile, our observation is that the competition between new and legacy platform businesses is becoming ever more fierce and the forward PE path of 59x Jun22 and 48x Jun23 feels far too aggressive. We prefer being long the trustee business EQT Holdings (EQT, -1.3%) which is on a PE of 20x and has many years of growth ahead as funds under supervision gradually grow over a largely fixed cost base.

The final headwind of note was our long in Emeco Holdings (EHL, -5.3%). We have been focused on how this mining equipment rental business is gradually transitioning its client base from the headwinds of the coal sector to the booming segments of base and precious metals. Further, we have seen coal prices turn up sharply in recent weeks which will likely feed through to equipment demand in time. The new headwind that has sprung up has been several companies reporting labour shortages, particularly in Western Australia. This could affect EHL given a reasonable percentage of their business is “wet hire” but they did provide earnings guidance as recently as 6 May. They are now on a PE of 6.6x Jun22 and well below NTA which strikes us as attractive, particularly given a recovering coal segment. In addition, their balance sheet has now improved to a point where they are considering capital management.

On the positive side of the ledger, there were a large number of mid-sized contributors without there being any stars. The most notable was a mid-sized short in Costa Group (CGC, -27%). We viewed their PE multiple in the mid-20’s as being well over-cooked given the variety of agricultural risks that they always face. As it turned out some of those risks transpired in the avocado and mushroom segments in particular.

The second stand-out was our long-held long in Turners (TRA, +10.8%) whose horizontally integrated motor vehicle business is enjoying a golden combination of circumstances. TRA delivered a very strong result in the period and stated that Q1 trading is running well ahead of the pre-Covid comparative period. TRA’s vehicle sourcing advantages relative to their fragmented competitors have positioned them well in the current unusual period of car shortage, while their finance book is enjoying unusually low levels of bad debts. These circumstances won’t last forever but when normality does perhaps return in a couple of years, TRA will have offsetting upside from greater car sales seeing greater attachment of finance and insurance sales. In addition, their debt collection business will hopefully move out of the doldrums. Meanwhile, TRA is generating strong free cashflow and investing part of that for growth, while using the remainder to pay a high and growing dividend yield. It is still only on a Mar22 PE of 12.7x.

The third winner of note was a new long in OFX Group (OFX, +18.3%). We purchased this non-bank forex business on weakness when it fell out of the S&P/ASX300 Index. Their long-established licences give them a competitive edge in a world of tightening regulatory oversight. In addition, the previous plethora of new entrants are now finding it difficult to get banked in a world of zero interest rates – banks have deposits coming out their ears already. OFX has a strong and geographically diverse growth pipeline from corporate and large enterprise clients, with there being a huge opportunity both due to their pricing and banks pulling away from a tougher regulatory backdrop. OFX is far cheaper and is a far stronger business compared to the old days when it basically engaged in a google ad-words price war to win retail clients.

Other winners included our long in Australian Vintage (AVG, +7.5%), who’s free cashflow generation saw a large off-market buyback announced and shorts in Ryman Healthcare (RYM, -7.6%), Mercury NZ (MCY, -5.6%) and Wisetech Global (WTC, -10.2%). Other strong longs were Spark NZ (SPK, +3.0%), Resolute Mining (RSG, +25.8%), Redcape Hotels (RDC, +5.0%), Irongate Group (IAP, +5.8%) and Qantm Intellectual Property (QIP, +5.5%).

Thank you for your continued support of the Fund. We are pleased to have repaid it with strong performance that is less volatile than long-only equities and which is uncorrelated to them. The comparative attractions of the Fund have been somewhat swamped for now by one of the strongest bull markets in history.

However, we believe we may be on the cusp of a profound change as monetary policy finally begins to tighten and markets react to this. The overall performance of equities may begin to get choppier and what works within the equity market will most likely change. Having alternatives such as this Fund may be a very useful counter to the risks that lie ahead.

Matthew Goodson