Salt Long Short Fund Fact Sheet – March 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 March 2020

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$88 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 March 2020

Application	1.3053
Redemption	1.2999

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 March 2020

Long positions	58
Short positions	38

Exposures at 31 March 2020

Long exposure	89.14%
Short exposure	-49.73%
Gross equity exposure	138.88%
Net equity exposure	39.41%

Largest Longs	Largest Shorts
Tower	Technology One
360 Capital Digital Infrastructure Fund	Ryman Healthcare
GDI Property Group	Breville Group
Elanor Commercial Property Fund	Goodman Property Trust
Marsden Maritime Holdings	Fisher & Paykel Healthcare

Performance[1] at 31 March 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%
2020	-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%										-18.29%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	-18.29%	1.42%	-17.35%
6 months	-11.67%	2.94%	4.03%
1-year p.a.	-7.16%	6.27%	16.86%
2-years p.a.	-8.95%	6.51%	11.43%
3 years p.a.	-3.95%	6.59%	12.10%
5 years p.a.	2.18%	6.96%	9.85%
Since inception p.a.	4.67%	7.12%	7.50%

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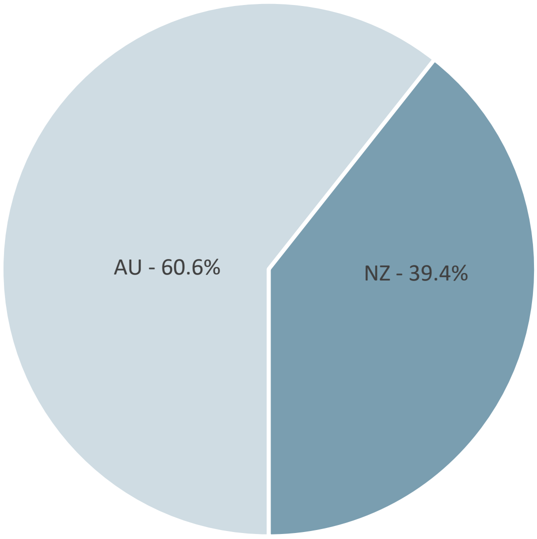
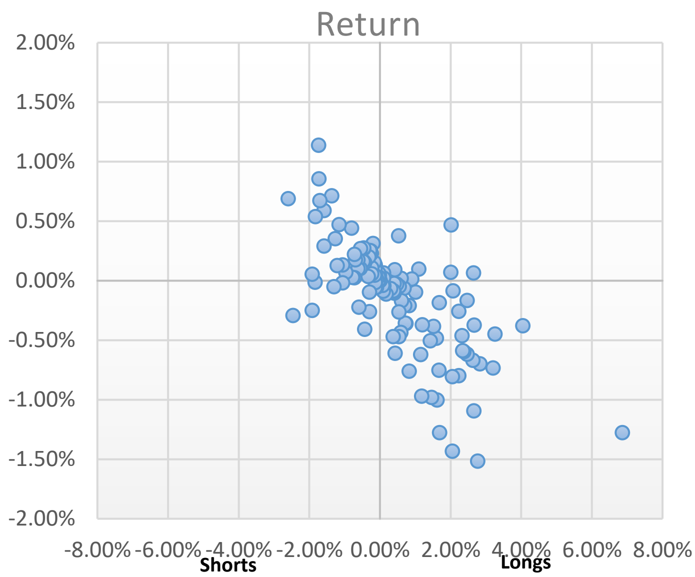
Country Allocation at 31 March 2020 (Gross Equity Exposure)



March 2020 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

In common with many funds globally, the impact of Covid-19 made March a very difficult month for the Fund, with a return of -14.47%. The unprecedented market reaction to a sudden stop in economic activity left very few places to hide. As detailed shortly, several of the sectors that we expected to be solid safe havens turned out to be anything but that. The only slight solace is that our return compared to the -21.6% turned in by the Australian index and -13.0% by NZ (-17.5% ex Fisher & Paykel Healthcare). The NZ mid cap index declined by -19.9%.

Our key issue was that we began March with net length of +55.6% in response to sharp weakness in the back half of February, global monetary policy easing and as we took heart from a number of countries such as Singapore, South Korea and Taiwan coming through Covid-19 with what seemed like only a short term blip to economic performance. A complete economic lock-down of NZ and partial lock-down of Australia was not our expectation.

Our short book performed very well but it was dominated by our overall net length, even though this was concentrated in a variety of seemingly defensive yield names, which had previously underperformed despite a sharp rally in bond yields in February. Some low beta "defensive" stocks proved anything but that in March, with the S&PASX200 A-REIT Index declining by a staggering -35.9% and the NZ property index falling by -20.7%.

Our property holdings were generally concentrated in non-retail, conservatively geared vehicles with solid tenants. Indeed, three of the largest positions are embarking on sizeable buybacks. However, this mattered little in the very short term as our "defensive" longs merely performed less badly than their peers.

We topped up our holdings at the lows and expect many of our names to perform strongly as we come out of the crisis. Conversely, we have shorted defensive names which are overpriced, have major exposure to the shutdowns and/or have high gearing. These worked well but the net position dominated.

Another key factor which caught us out in the short term was "size". Small-mid cap stocks sharply underperformed large cap stocks in a dramatic flight to liquidity, which occurred irrespective of all the normal factors an investor might look for in a downturn such as business franchise strength, balance sheet strength, financial leverage, operational leverage et al. This was particularly frustrating as several of our key smaller caps such as Shaver Shop (SSG,-53%) and Redcape Hotels (RDC, -44%) had earlier rallied sharply following outstanding results in February. Their balance sheets are strong and they will survive to have their day in the sun again.

This size factor is obvious in hindsight but coming into March we had already seen a record valuation dispersion between large cap and small/mid cap stocks. This widened yet further in March, with NZ for example seeing the S&P/NZX Large Cap Gross -8.4%, Mid Cap Gross -19.9% and Small Cap Gross -26.3%. On the ASX, the average high-to-low move of the 20 largest stocks was -37.6%, for numbers 101-200 by size it was -49.6% and for 201-296 it was -57.7% (yes, they carelessly lost four companies). We have clear memories of the climb out of the GFC when this size factor was very much reversed.

Where are we now? Is this the purchasing opportunity of a lifetime or are we in for a grinding bear market that lasts many years as projected by luminaries such as Jeff Gundlach and Jim Rogers. We can only outline the numbers as we see them.

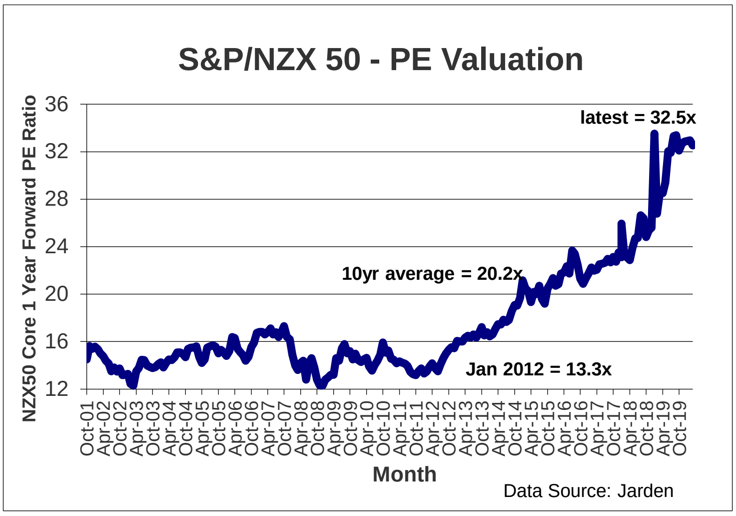
Firstly, any sensible discussion of the market outlook depends on the economic outlook and that depends on the end-game for Covid-19. All projections suggest a reliable vaccine is at least 12 months away, so the question for NZ and all other countries is when does the lockdown loosen and how economically disruptive will lesser social distancing measures be?

NZ has taken robust measures relative to most countries, with the cited goal being to "flatten the curve" to ensure the health system can cope. Overseas experience would suggest that eradication is implausible in the absence of a vaccine, so a certain number of cases will continue to occur. The longer the lock-down goes on, the greater the economic risks although progress so far in terms of new case numbers has been encouraging.

The hope is that as new cases wane, the government response may shift to a strategy like Taiwan, where extensive contact tracing and testing occurs. Any calibrated re-start will necessarily accept trade-offs between a certain number of cases and economic outcomes and it may even see steps back to tighter measures as has occurred in Singapore. As an investor trying to navigate through this maze, it is a case of continually calibrating new developments and what their economic impact might be.

In the face of this risk, our old standby chart below suggests that the valuation of the NZ market has not become even remotely cheap. Share price declines have been roughly matched by earnings downgrades, leaving the forward PE at 32.5x. This does not scream "bargain" and indeed makes us very cautious as there are numerous downgrades still to come. Analysts always move with a lag. EPS will fall not only due to lower earnings but also due to an increase in share bases as a companies need to raise equity. Interestingly, the median forward PE is just 14.5x – a remarkable divergence to 32.5x, illustrating why we have been irresistibly (and wrongly to date) drawn towards small/mid cap names from the long side.

A plausible counter-argument is that the market is partially trying to look through the crisis and is pricing off possible earnings a couple of years out in 2021/22. However, remember that there are many NPAT downgrades still to come and much EPS dilution from expanded share counts.



The chart below shows how bottom-up analyst forecasts tend to lag in real time and thus the 32.5x forward PE above should be very much regarded as a best case. As an example, the top-down estimates by Goldman Sachs for the S&P500 Index for 2020 stand at -33%, whereas consensus bottom-up analyst estimates sit at -1%. Hmm. We expect estimates are falling like a stone as this is written. We doubt the dispersion is this great in NZ and Australia but the picture should be clear.

Exhibit 1: GS top-down vs. consensus bottom-up estimates of 2020 EPS growth

Source: I/B/E/S, Toyo Keizai, MSCI, Goldman Sachs Global Investment Research

We are arguing that the sudden sharp bear market has not made equities cheap because earnings forecasts have also fallen sharply and indeed have further to fall. However, what say the fall is temporary and everything turns into sunshine and roses from 2021 onwards? This is the bull case and seems to still permeate the view of many investors. The complacency on show was exemplified on CNBC.com with a classic quote, "all of us agree that the market will be substantially higher by the end of the year." This doesn't sound like despair at the depths of a bear market to me.

According to Barrons, the S&P500 tumbled into a bear market at the quickest speed in history, falling -20% in just 19 days. It then proceeded to spend a mere 11 days there before a +20% gain in 3 days wiped out the theoretical bear market. This 3-day move did have a historical parallel to 6-8 October 1931 but unfortunately the ultimate market bottom was then reached 60% lower in 1932.

This historical parallel is both interesting and frightening but it doesn't mean we are similarly doomed to the deepest of bear markets. History may rhyme but it doesn't necessarily repeat. This time around we have governments who are easing fiscal policy apace and central banks who will do whatever it takes, including perhaps the morphing of fiscal and monetary policy, as they increasingly purchase the bonds that are issued by their own Treasuries. This was certainly not the case in 1932 although one factor that did help end the Great Depression was a debasement of currencies when the UK moved off the gold standard.

One of our key fears regarding the response to Covid-19 is that while central banks have eased massively, this may be trapped in the "financial economy" as opposed to feeding through to the "real economy". It is all very well having 0.25% interest rates but if a bank has no deposit growth and rising bad debts, a positive credit cycle is hardly going to kick in. Similarly, consumers who have lost their jobs are hardly going to spend up large. A collapse in interest rates and flooding the economy with money is fine but it will not help the real economy if the velocity of money collapses. This is an argument for "helicopter money" and it will be fascinating to see if any central banks move down that path.

Our thesis suggests one should own high yielding stocks that benefit from ultra-low rates but which aren't badly affected by the travails of the real economy. It lies behind the Fund's positioning in interest-rate sensitive defensives but to date, fear that utilities and REIT's are not so defensive after all has seen very poor price action. We initially pulled the trigger too early a couple of months ago as a Wuhan-style lock-down in NZ and Australia seemed extremely unlikely. From here though, we see a significant opportunity in selected names, even allowing for cap rate expansion. However, we remain wary of permanent structural change seeing large valuation declines for retail malls.

To play defence during March, investors piled en masse into select large cap healthcare, information technology and telecommunications stocks. According to Credit Suisse, price momentum is more overbought globally as a factor than it has ever been by a multiple of 2x.

We have seen this in NZ with the dramatic outperformance of Fisher & Paykel Healthcare (FPH, +17.8%) which is now on a Mar21 PE of 54x. Their respiratory humidification business is clearly in the right place at the right time and the weak NZ$ is helpful but the sleep apnea business could face real disruption. We were also whip-sawed by our short in Cochlear (COH, -9.7%), which is experiencing major earnings downgrades due to non-essential surgery being cancelled but rose dramatically post a placement at $140 to finish the month at $187.45, putting it on a Jun21 PE of a mere 57x. Call me old-fashioned but PE ratios above 50x do not feel particularly defensive.

Given the above arguments, how can we have any confidence that we have seen a bottom in markets? Is the sharp bounce off the March lows the beginning of something bigger or is it a dead cat that has just about reached its apogee? A framework put forward by the Goldman Sachs global strategy team proposed that there are four requirements for a bottom and struck us as potentially being useful:

i) *Has there been sufficient policy intervention?* A = possibly. The RBNZ has eased rates sharply to 0.25%, has begun to engage in QE and has given strong forward guidance. On the fiscal front, the government has eased by 4% of GDP although this still seems relatively modest versus the size of the economic shock.
ii) *Has the infection rate peaked?* A = yes, this is likely occurring in NZ and Australia right now.
iii) *Are there signs the economic slowdown is slowing?* A = no, it's only just begun with a vast range of quite frightening estimates as to how bad it will be.
iv) *Are valuations cheap?* A = no, they have not moved at all in large cap land and while they look very cheap in the small/mid cap sphere, downgrade risk is considerable.

Put all this together and it's hard not to remain cautious. While a number of names have likely seen their lows, the next few weeks and months will prove volatile as information evolves. Passing the peak of new Covid-19 cases in North America, Europe and NZ/Australia is critical, however, the economic cost of achieving this should not be under-estimated.

The market will doubtless respond positively to any steps to re-start economic life but then the harsh reality of just how deep and permanent the economic hit has been will be a heavy counter-weight. A torrent of equity raisings will be an opportunity but also weigh on markets.

We reiterate our view from last month that as the impact of Covid-19 peaks and passes, what will be left behind will be a Japanese-style scenario of lower for longer interest rates. This will be awful for banks but wonderful for any security that promises a modicum of sustainable yield. These stocks generally performed poorly in March, especially on indiscriminant fears in the property sphere but we used this weakness to lift our holdings.

More concerningly, this backdrop could see high multiple momentum stocks have yet another surge once the current state of investor fear passes. We have been conscious of this in considering our short positions but see large cap healthcare names (eg F&P Healthcare and Cochlear) as being heavily over-bought as they are not even safe havens in some instances.

In addition to discussing our key performance contributors and detractors shortly, we thought it would be useful to highlight some of our larger individual names and sectoral positions.

Our view that monetary policy would ease sharply saw circa 3% of our net length being put into gold company investments but these performed disappointingly. The correlation of gold companies to gold prices and to general equities gyrated viciously all over the spectrum. We traded these names aggressively on strength and weakness to add a little value overall, exiting Saracen Minerals (SAR ,-2.7%) into strength near month-end, while retaining a small holding in Resolute Mining (RSG, -20.6%). We had hoped these would be multi-bag winners that provided solid portfolio insurance but this proved to be far from the case.

One factor that does concern us with gold and indeed all mining companies, is what happens to their hedge books in the event they can't deliver into them due to Covid-19 related production disruptions. This could be problematic for gold companies where hedges are typically out of the money. Similarly, one feels for poor old Air NZ here, with all those oil hedges at far higher price levels for flights that will now never be flown.

We see house prices and related equities as being particularly vulnerable in the period ahead. Housing bubble naysayers have long ago been burned at the stake and we have mentioned the sector little over the last two years and we had covered our net shorts in the closely related retirement sector. However, we have firmly put these on again as the outlook could not be more difficult in our view, with a multi-decade bull market in house prices having seemingly lulled forecasters into a state of suspended disbelief.

Current economic forecasts have NZ unemployment rising to somewhere in the 10% to 16%+ region. At the same time, the latest NZ house price forecasts from widely followed bank economists seem to be in the range of -3% to -10%. Remember, they rose almost 3% in the aborted first quarter alone. At the same time, net immigration has plunged from 1%-1.5% of the population to 0%; banks will be increasingly credit-constrained by bad debts and no deposit growth; first home buyers' KiwiSaver deposits have suffered a severe short term setback; and building consents hit a 45 year high in February. All this comes at a time when our housing is extremely expensive on any international comparison. The only positive is that mortgage rates are at record lows. Using the House Price Index on the RBNZ website, a -30% price decline would return us to Dec14 levels; -21% would get us to Dec15 and -10% to Dec16.

Retirement villages have a challenged business model in this environment. Firstly, the valuer's house price growth assumptions need to be pruned. We remind investors that this valuer has never been rotated. Secondly, the valuation upside from new developments needs to be slashed. Thirdly and most importantly, there will be a working capital build as normal resident turnover cannot be offset by normal resales. While all the villages could survive a modest short-lived downturn (the current market consensus), their heavily geared capital structures will come into serious question in a more extended downturn. We would suggest this is more likely than not and that a need for sizeable new equity capital could arise. While Oceania (modest long) and Summerset (no position) have fallen sharply, Ryman (large short) has bounced hard off its lows and is both expensive and levered in our view.

Aside from lifting our net shorts in the retirement sector, the other rather obvious play was using fleeting price bounces to lift our net shorts in companies which clearly need to raise equity and/or which have sharp exposure to the economic shutdown. Casinos, retail, airlines and airports figured prominently here and these offset some painful long-term holdings in several names in these sectors. Our longs tend to have strong balance sheets and were trading very well prior to going into the shutdown.

Our largest long by some distance remains Tower Limited (TWR, -17.9%). Bizarrely, TWR slightly underperformed the NZ index during the month despite its highly defensive cashflows. It will be slightly affected by lower short-term interest rates and a likely need for hardship relief for some customers but with no cars on the road, its claims expenses will be collapsing. TWR is on a sub-10x PE with strong double-digit earnings growth for years to come and good earnings certainty relative to the risk that prevails everywhere else.

Our second largest long is very much an off-piste name in the form of 360 Capital Digital Infrastructure (TDI, -13.0%). They trade at $1.35-$1.40 and bottomed at $1.05 during March. Their NTA of $1.96 is comprised of data centre investments and current/incoming cash of $1.22 per share with no debt. We were buying them below cash backing during the month and liquidity will be provided as they are seeking shareholder approval to carry out a 20% buyback.

Our other large longs in the property/infrastructure space have similar qualities of deep value and unusual defensiveness. Vitalharvest Freehold Trust (VTH, +1.8%) owns many of Costa Group's citrus orchards and berry farms. They get paid a mix of fixed and variable rent, with the latter now improving after being hammered by the drought. They are at a circa 30% discount to the NAV of their land and water rights and have a major upward rental re-set in 2026.

360 Capital REIT (TOT, -20%) closed the month at $0.81 and traded as low as $0.61. It has $1.20 of NTA comprising $0.73 of cash and $0.47 of solid first mortgage investments. There is no gearing. It pays a $0.09 dividend, will have a plethora of attractive distressed investment opportunities and is about to embark on a 20% buyback.

We also used extreme weakness to build large longs in a couple of slightly more vanilla vehicles. GDI Property (GDI, -37.7%) has gearing of just 9%, is at a 32% discount to NTA, has a syndication business on top of this, is on a net dividend yield of 8.2% and is starting a share buyback. Elanor Commercial Property (ECF, -20%) is more geared at 35% but has the bulk of its sub-A grade office portfolio leased to government and large corporate tenants and is on an 8.9% dividend yield at a pay-out ratio of just 80%. Our most interesting short in the sector is Cromwell Property (CMW, -28.2%) which has an array of complex property ownership structures but appears to have look-through gearing of circa 46% and a degree of exposure to retail and aged care.

Overall, despite collapsing risk-free rates, we do expect cap rates in the property sector to expand with rising risk premia and higher vacancies. While hardly a stunning new insight, we are most concerned with retail shopping centres and the rental outlook for trophy CBD office (especially in Sydney which has experienced a remarkable boom). March saw everything sold off irrespective of intrinsic qualities and we took advantage of a range of opportunities, with the larger ones detailed above. In this ultra-low rate world, those vehicles which can keep their properties occupied and which can avoid raising equity will provide very attractive returns from the panic depths reached in March.

Returning to the performance of the Fund during the month of March, the return of -14.89% pre fees and tax unsurprisingly saw highly divergent contributions from our longs (-24.48%) and our shorts (+9.58%). We lowered our net length over the month from +55.6% to a still moderately long +39.5% as we shorted businesses whose geared balance sheets or heavy operational leverage will likely see them needing to raise equity. We also lifted shorts in some names which performed counterintuitively well. Being heavily net long, our "winners to losers" ratio was weak at just 48%. Our main problem is that a number of our longs were hammered, while our generally smaller short positions were hit a little less hard.

The largest negative was our long-standing holding in Turners (TRA, -43.2%), which in common with much of the market withdrew its earnings guidance. Frustratingly, it had been trading strongly prior to the economic shutdown. They are now unquestionably cheap on anything like normalised earnings and will likely dramatically expand their market share once economic activity resumes. Bad debts from their finance book are clearly the key risk.

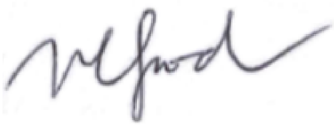
The second biggest hit came from our long in the mining equipment rental business, Emeco Holdings (EHL, -55.5%), which had reported a strong result and bounced hard in February. We were surprised at the extent of the sell-off as their balance sheet is now in decent shape (Fitch upgraded them in the month) and their mining company customers have generally continued to operate through the limited shutdown in Australia. A$ resource prices have held up well with the exception of some base metals, which is a limited proportion of their customer base. There is clearly potential for disruption at some customers but they are on a (downgraded) PE of circa 4x.

Other major headwinds came from names formerly mentioned in Tower Limited (TWR -17.9%), Redcape Hotels (RDC, -43.2%), Shaver Shop (SSG, -53.3%) and GDI Property (GDI, -37.7%). All were businesses that were performing very well pre-shutdown and look poised for a sharp recovery when normal conditions resume.

Our key winners were all shorts, with the largest contribution coming from our large short in IDP Education (IEL, -45.6%). They raised equity at the end of the month but are burning considerable cash as their global educational placement and English testing business is heavily disrupted. They are particularly vulnerable to developments in India. To us, this was a stock that should never have been on a PE of 60x. We covered much of the short at the lows but will reconsider this on any short-lived spikes.

Other notable tailwinds were led by our short in Seek (SEK, -28.3%) whose extremely high multiples do not gel with the negative cyclicality from their job advertisements revenue line nor their somewhat geared balance sheet. Other shorts that stood out were Ryman Healthcare (RYM, -32.5%), Commonwealth Bank (CBA, -24.4%), Invocare (IVC, -25.8%) and Shopping Centres Australia (SCP, -24.6%). One long of note was 3P Learning (3PL, +23.5%) which some investors appear to have picked as a thematic winner from the current disruption to schools globally.

Thank you for your ongoing support of the Fund. This year has been extremely unusual, with the first six weeks seeing a spike in large cap growth and momentum stocks which left everything else behind. This then disintegrated as the impact of Covid-19 struck. NZ and Australia look set to endure deep recessions and we have focused our longs on names which generally have strong balance sheets and which have major upside potential as we came out the other end. The market response when a vaccine delivers good study results will be most interesting. While we have done better than long-only markets, we would have hoped to have done far better in relative terms. We clearly under-estimated the extent of the Covid-19 impact, particularly on small- mid cap names which were already screening as historically cheap relative to large caps. As this is written, the Fund is already 6% above the lows it reached during March and we are confident we will gradually claw back the remainder and then some, irrespective of what lies ahead for equity markets.



Matthew Goodson, CFA