# SALT

## Salt Long Short Fund Fact Sheet – November 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 November 2020

| | |
|---|---|
| Benchmark | RBNZ Official Cash Rate +5% p.a. |
| Fund Assets | $47.8 million |
| Inception Date | 31 July 2014 |
| Portfolio Manager | Matthew Goodson, CFA |
| Associate PM/Analyst | Michael Kenealy, CFA |

### Unit Price at 30 November 2020

| | |
|---|---|
| Application | 1.5841 |
| Redemption | 1.5776 |

### 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 November 2020

| | |
|---|---|
| Long positions | 47 |
| Short positions | 34 |

### Exposures at 30 November 2020

| | |
|---|---|
| Long exposure | 101.64% |
| Short exposure | 49.02% |
| Gross equity exposure | 150.66% |
| Net equity exposure | 52.61% |

| Largest Longs | Largest Shorts |
|---|---|
| Tower | Napier Port Holdings |
| Vitalharvest Freehold Trust | Premier Investments |
| Marsden Maritime Holdings | Meridian Energy |
| Shaver Shop Group | Wisetech Global |
| Pacific Edge | IDP Education |

### Performance[1] at 30 November 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% | -1.67% | 8.31% | | 1.16% |

| Period | Fund | Benchmark | NZX 50 G/ASX 200 AI[2] |
|---|---|---|---|
| 3 months | 9.07% | 1.28% | 9.41% |
| 6 months | 14.24% | 2.62% | 18.02% |
| 1 year p.a. | 0.86% | 5.48% | 9.21% |
| 2 years p.a. | 3.32% | 5.96% | 17.54% |
| 3 years p.a. | 1.83% | 6.41% | 12.16% |
| 5 years p.a. | 2.64% | 6.57% | 10.82% |
| Since inception p.a. | 7.36% | 6.92% | 11.48% |

[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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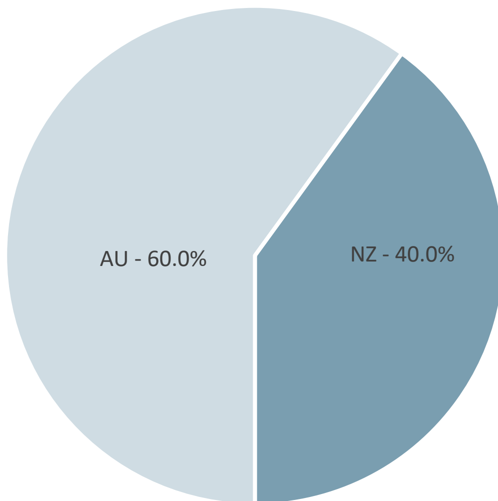
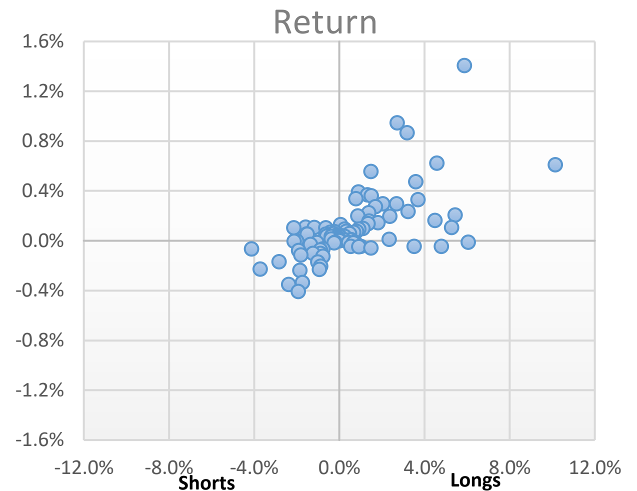
**Country Allocation at 30 November 2020 (Gross Equity Exposure)**




**November 2020 Individual Stock Contribution**




**Fund Commentary**

Dear Fellow Investor,

November was something of a watershed month for the Fund, with a record performance outcome of +8.31%. There were three key drivers behind this.

Firstly, stock selection was very strong, with the key highlight being a takeover bid for our large holding in the formerly very cheap Vitalharvest Trust (VTH, +24.4%). More on this and other key holdings shortly.

Secondly, and intertwined with our stock selection working well, there was a massive switch in factor performance in markets across the world. Price momentum stocks lagged, while cyclicals and some value stocks caught a powerful bid. This major factor switch was accompanied by bond yields rising sharply. NZ yields rose from 0.51% to a bounteous 0.87%, while the US benchmark rose from 0.68% to 0.88%. They have crept up a little further since.

A key catalyst was positive vaccine news from Pfizer, Modena and to a degree Astra-Zeneca. This has seen a moment in time that is a real sweet spot for markets. The outlook for economic and earnings growth in 2021 is increasingly positive, while central bankers globally are keeping in place unprecedented (and in our view ultimately reckless) levels of monetary easing.

The Goldman Sachs Australia strategy research team picked apart the key market moves occurring under the hood during the month. Their analysis of factors on a long-short basis showed that “momentum” stocks returned -15.6%, “stay-at-home” were -15.0%, “growth” was -12.6%, while “value” was +7.8% and worryingly for some long-short funds, “high short interest” was +4.9%. This combination of drivers spilled over into the NZ market and it was clearly a very favourable backdrop for our valuation sensitive style after months of battling into strong headwinds.

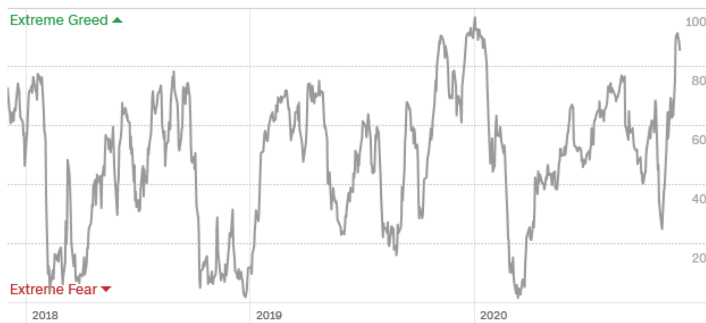
The third key factor for our strong performance was simply that we had lifted our net length into the low-mid 50% region on a view that markets could potentially move into a sweet-spot in a post-vaccine environment. We also recognised that being “beta-adjusted market neutral” required greater net length in the current environment.

Despite this larger net length than we have run historically, the Fund continued to deliver returns that are uncorrelated to equities and it provided a degree of protection on the rare negative days. November saw just seven down-days for the 50/50 index of Australia and NZ, with an average return on those days of -0.29%. The Fund was up on four of those seven days and delivered an average return of +0.06%.

Critically, this shows that the Fund did not simply get itself long equities and ride the bull market, while pretending to be a long-short fund. If we had done that, we would have been clearly negative on the down days.

While markets are currently in a euphoric sweet spot, we are becoming concerned that sentiment measures have reached very extended levels. This is shown below in the CNN Fear & Greed metric, which for the first time since earlier this year has hit extreme greed levels of over 90. This metric is an

amalgam of seven different measures of risk appetite and gives a very useful overall measure of investors' positioning and momentum.




We have found that a reading of extreme fear is almost always a good entry point if one is brave enough to put on the steel helmet and clamber out of the trenches – although it is always far easier afterwards than at the time! March/April 2020 and late 2018 (when everyone feared rising rates) were classic examples.

Readings of extreme greed have been a very useful signpost although they are not quite as infallible in their timing as extreme fear - it seems that in a world of zero yields, the party can rock on at its zenith for a while before it runs out of puff. Nevertheless, it has still been a useful tactical signal and right now, it is flashing crimson red at a reading of 94/100 extreme greed.

There are innumerable anecdotes and stories pointing in the same tactical direction as this Fear & Greed measure. US broker feedback for the week ended Nov 11th was that global equities received $44.5bn of inflows, the largest on record by a considerable distance; US equities saw $32.5bn of inflows, the second largest on record; and the AAII Sentiment Survey had its largest one week jump in bulls versus bears since 2010. Coincidentally, insider selling picked up sharply.

A question you may be pondering given our concerns about this outbreak of rampant greed is how will the Fund fare given that it ended the month at 52.7% net long? Firstly, we have been gradually trimming some of our fewer liquid longs as they hit new highs to lessen our exposure. Secondly, even while net length has been above 50% in the last several months, we have consistently had positive returns on down-days. Thirdly, the Fund is not quite as long as it looks because 6% of it is effectively cash with the Vitalharvest takeover, and 3% of it is effectively cash via the 360 Capital REIT (TOT) which is strategically aimless but at an alluring discount to its NTA which is largely cash.

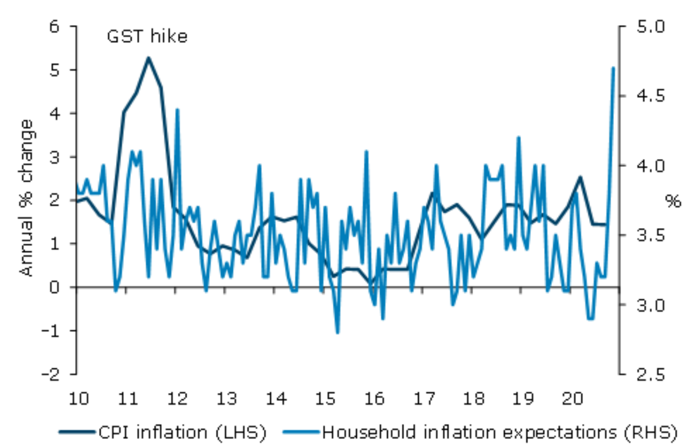
What could change the current euphoria? Aside from the usual bogeymen such as trade wars, North Korea, Taiwan, EU disintegration, Brexit, a Covid-19 mutation et al, the most obvious catalyst would be a re-emergence of inflation. Even though there is no academic research consensus that 2.0% is the optimal CPI inflation target, the reality is that central banks will keep targeting it. Some are even determined to over-shoot given past under-shooting. There is little sign they will change even as political pressure grows due to financial and housing market looking ever more bubbly.

Any re-emergence of inflation would be a major paradigm shift. It would see bond yields rise, equity markets weaken, commodities outperform and a major outperformance of "value" relative to "growth". The last month's experience would be a mere appetiser. There is such a wall of money invested and levered up against interest rates staying low for many years that the reversal potential is immense. Any signs of a move away from clearly ineffective QE policies towards "helicopter money" might have a similar impact.

We are not yet making a major bet on inflation re-emerging but a few early warning signs are popping up which are not congruent with historically low bond yields. House prices and rents are booming; hapless local authorities are looking at putting through rate increases that range from high (5% in Auckland) to outrageous (20% + in Wellington); labour costs are rising due to the minimum wage lifting in April and sick leave doubling; business surveys and much anecdotal evidence is putting to an inventory shortage, with import links being disrupted; and the post-Covid world is showing signs of reversing the globalisation trend of recent years which has seen tradeable inflation of around 0% offset non-tradeable inflation of around 3%.

These warning signs are not being lost on businesses and consumers, with the chart below from ANZ Bank re household inflation expectations really grabbing our attention. The link is admittedly loose but wouldn't it be fascinating if this transmitted to an unexpected lift in CPI inflation?

Household inflation expectations and CPI inflation




Source: Statistics NZ, ANZ Research

Returning to the performance of the Fund in November, we delivered a return of +8.31%. As one might expect in a strong month for markets, our long book's return of +10.4% far outpaced the -2.2% from the short book. Our closely followed "winners to losers" ratio was an extremely strong 69%, with the magnitude of the largest winners being far greater than the largest losers. Some of this ratio was a mix effect of having more longs than shorts in a strong up-month but the ratio within our longs was 83%, while it was still a respectable 46% in our shorts; i.e., 46% of our shorts worked in a huge up-month for the market.

The largest contributor by quite some distance was the large position we had built in Vitalharvest Trust (VTH, +24.4%), which received a takeover bid at $1.00 from a real estate subsidiary of Macquarie Group. In our view, this price is a touch on the light side. VTH will have an exceptional year of variable rentals in 2021 in contradistinction to last year's drought; the market would re-rate VTH sharply if they could renegotiate their variable rentals into a higher fixed rental stream; and the likelihood of moving to a far higher fixed rental stream in 5 years has a lot of value. We hold some minor hopes of a bump but the cause was not helped by the manager, Primewest agreeing to sell its management contract and to sell its shares at $1.00 in the absence of a better bid.

The second stand-out was our long in the mining equipment rental company, Emeco Holdings (EHL, +36.8%) which is the archetypal "dirty" cyclical. Post their equity raising of several months ago, their balance sheet is now unquestionably robust and we were purchasing shares well below both NTA and the raising price. The knock on EHL has been their exposure to the declining coal sector but their numbers suggest this is being offset by the smaller but strongly growing gold and base metals segments.

We find that rental equipment companies tend to have a lifecycle, where at the bottom you can buy them well below replacement cost. Normally this is accompanied by losses but the difference this time was that you were also getting strong contracts and decent cashflows/profits. At some point, if the shift to cyclical stocks really does have legs, we suspect we may be able to sell to momentum chasing investors well above the current share price. EHL moved from 70cps in May 2017, to a peak of $3.50 in mid-2018, to a recent trough of $0.70 and is now back to just over $1.00. These sorts of stocks have enormous leverage both from their earnings and from the multiples that different classes of investing tourists put on them at the top and the bottom. The hard part is being lucky and/or skilful in picking these huge shifts.

In a similar vein, the Fund benefitted to a smaller degree from its holdings in the engineering consultancies Cardno (CDD, +13.8%) and Intega Group (ITG, +7.1%). These both have strong balance sheets, solid outlooks as governments look to spend on infrastructure but are on single digit forward PE ratios. A cheap valuation with growth and structural tailwinds is our sort of investment.

A third major contributor was a large long we built in Graincorp (GNC, +23.5%) on fleeting weakness due to overblown fears following a localised hailstorm. After the difficulties of last year's severe drought, they are on the cusp of a perfect storm of positive news. The East Coast winter harvest is massive, the summer crop planting outlook is very good, West Australia looks weak and the global planting outlook is difficult driving high prices for wheat, corn et al. GNC is still only on circa 5x EV/EBITDA adjusting for their remaining stake in United Malt (UMG).

A fourth sizeable winner was our generally disappointing investment in Qantm Intellectual Property (QIP, +13.6%) which bounced off its lows which had been driven by mandate-loss style selling. We remain deeply frustrated with QIP who seem to view themselves as still being a private partnership rather than a publicly listed company that is run for its shareholders. It should be an outstanding business on a high multiple as sticky patent clients generate highly certain fee streams for decades into the future. However, QIP is on a PE of just 11x and a cash dividend yield of 6.1%. In our view, it should be privatised.

some years. Their 5% profit growth guidance struck us as a little light given their 5% GWP growth expectations and further cost reductions but this likely reflects a mix of lower investment earnings and low-balling. TWR now has an extremely cashed up balance sheet which gives them plenty of capacity for bolt-on growth.

Finally, a mid-sized long in Coronado Coal (CRN, +40.9%) worked particularly well as the cycle began to turn. While their Australian coking coal production is facing some difficulties from the unofficial Chinese import ban, we take the view that it can always find a home elsewhere in what is a fungible market. CRN also has US production which is benefitting from China's actions.

The largest laggards in the month all unsurprisingly came from the short side. They were led by REA Group (REA, +22.8%) which has soared to all-time highs even as earnings are still recovering from post-Covid weakness and the relative underperformance of high multiple growth names might have seen REA be expected to lag.

A second headwind came from some remarkable movements in Meridian Energy (MEL, +21.3%). Whichever way you cut it, MEL is fundamentally very expensive both in itself and relative to its listed peers. However, this has been accentuated by its inclusion in the S&P Global Clean Energy Index with a weighting of around 5%. Two huge clean energy ETF's are benchmarked to this index, with these having grown from US$2.5bn to US$5.5bn since the election of Joe Biden. Never mind that this doesn't have the slightest thing to do with MEL. Broker estimates now suggest that these clean energy passive funds alone hold 7-8% of MEL's free float. Madness.

The final stand-out laggard was our short in IDP Education (IEL, +26.9%) which has soared to levels far in excess of its already-expensive pre-Covid levels. While international student growth will doubtless pick up again, we would expect the level to be below pre-Covid expectations for at least several years to come. Similarly, while IEL will benefit from English language tests moving online, whether this is a net benefit over and above earlier physical testing remains to be seen. We also suspect that Chinese student numbers to Australia may be rather low for the foreseeable future.

The Jun22 forecast PE of 56.5x appears to incorporate a major rebound and then some.

Thank you for your continued support of the Fund. 2020 has been a challenging and volatile year, so it is immensely pleasing to deliver strong outcomes for those who have stood by the strategy. We will continue to stay focused on our disciplines of short selling expensive names with identifiable catalysts or weak business models and being long companies that are cheap, either on current multiples or relative to the growth opportunities that they have in front of them. Looking forward, the market backdrop appears far more promising for our style than it has in some time.

Matthew Goodson, CFA

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