

# SALT

Funds Management

## Salt Long Short Fund Fact Sheet – April 2019

*Fund soft closed to new investors*

### 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 April 2019

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	\$154.8 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

### Unit Price at 30 April 2019

Application	1.4079
Redemption	1.4022

### Performance<sup>1</sup> at 30 April 2019

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%	1.76%	-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%									-3.02%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI <sup>2</sup>
3 months	-1.79%	1.61%	8.94%
6 months	-8.63%	3.29%	12.10%
1-year p.a.	-9.30%	6.75%	11.35%
2-years p.a.	-2.22%	6.75%	10.63%
3 years p.a.	0.66%	6.82%	11.41%
Since inception p.a.	7.24%	7.31%	10.80%

<sup>1</sup> Performance is after all fees and before PIE tax.

<sup>2</sup> 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.

### 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 April 2019

Long positions	65
Short positions	34

### Exposures at 30 April 2019

Long exposure	78.20%
Short exposure	-48.49%
Gross equity exposure	126.68%
Net equity exposure	29.71%

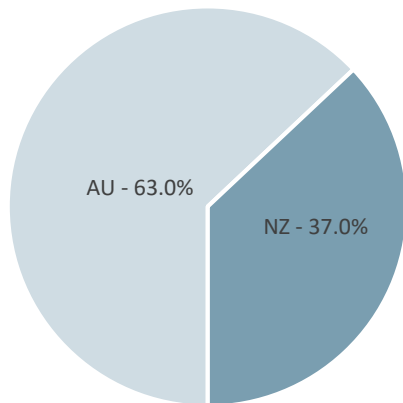
Largest Longs	Largest Shorts
Tower	Ryman Healthcare
Spark NZ	Breville Group
Centuria Metropolitan REIT	Technology One
Investore Property Limited	Dexus Property Group
Turners Automotive	BWP Trust

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 30 April 2019 (Gross Equity Exposure)



### Fund Commentary

Dear Fellow Investor,

The Fund delivered a return of +0.14% after all fees and expenses during the month of April. However modest this may have been, it is something of a relief to turn in a positive number after a run of outs since last October. It could have been considerably better as we were caught by our large short in the late-cyclical Dulux being subject to a left-field takeover bid from Nippon Paint.

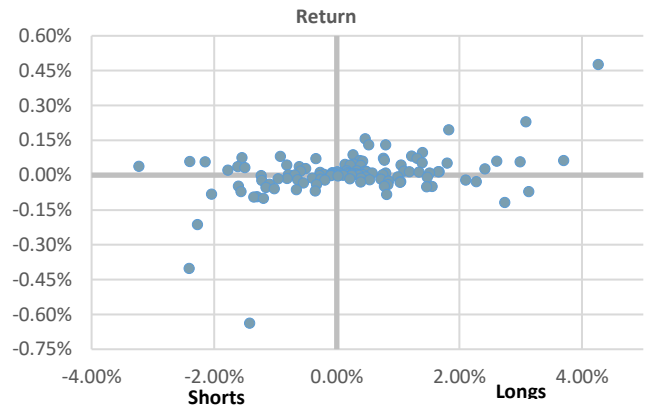
Since inception on 30 June 2014, the Fund has now returned +40.22% after all fees and expenses, with thirty-four of the fifty-seven months having had positive returns. While the last few months have been torrid, the Fund's long-term track record remains solid and we believe we are well placed to benefit when this aged bull market comes to its inevitable end.

The NZ forward PE multiple continued on its merry path to the heavens, closing the month at 28.6x. Valuation will matter again one day but as celebrity US fund manager, Jeff Gundlach put it, "we live in a world where a lot of people are changing the rules."

He was referring to the uniqueness and extremity of central bank actions, the very high levels of government debt that would previously have been viewed as unsustainable, and how the rise of populism is seeing the political rules change across Europe and the US, to the point that he thinks violence could be possible in next year's US elections.

It is not just us. NZ is a mere cork bobbing on the ocean of global bullishness. The Australian market ex financials and resources is also at record valuation levels and US valuations are far more expensive than the often quoted 16-17x PE ratios that you may see. These typically exclude the vast component of stock-based compensation and some calculations also exclude loss-making companies.

### April 2019 Individual Stock Contribution



Other measures point to valuations being at all-time highs. The US market cap/GDP ratio has bounded above its early-2000 Nasdaq bubble highs to sit at circa 1.5x versus the 0.5x it reached post-GFC. This has been a wonderful contrarian indicator for the long-term investor. Similarly, with profit margins being at all-time highs, a cyclically adjusted PE, which moves margins back to long term averages, shows the PE to be in the 1% of its most expensive all-time readings.

Alongside this surge in valuations, equity markets globally have seen dramatic outperformance of "growth" stocks versus "value" stocks. If this continues for much longer, the voluminous academic literature as to why value outperforms over the long run may need to be rewritten.



The chart above shows this phenomenon for the MSCI World indices and it has largely been driven by relative valuation ratios moving rather than earnings forecast divergences between the two groups. According to Soc Gen, the global price-book ratio for value versus growth stocks now has a spread of -2.25x versus longer term averages in the -1.0x region. These phenomena have also played out in Australia and NZ, with the most expensive stocks massively outperforming the cheapest, even though earnings

revisions are relatively similar across the two. There has also been an added bias to large stocks sharply outperforming smaller stocks in our markets. At end of April in NZ, while the average forward PE was 28.6x, the median was 17.2x on FNZC numbers.

These factors really picked up in the Australian and New Zealand markets in the second half of 2018 and have been a key reason for the difficulties that the Fund has faced since October, after 4.5 years of consistently positive performance. We will stick to our knitting given the extreme divergences that have now been reached.

Unsurprisingly, there have been a plethora of index changes and transition portfolios in the Australian market as short term money flows follow performance and valuation-oriented managers have lost ground to passive and momentum managers. Names such as Pacific Current and QMS Media have been large holdings for us and have been particularly weighed down by these effects, which we think have now largely washed through. Anecdotally, when major portfolio changes such as these occur, we have always found it is five minutes to midnight in terms of a certain style outperforming.

If you woke up from a 20 year coma and were told that GDP growth is modestly positive in the low 2% region, that CPI inflation is at about its 20 year average across the OECD, that US government debt is approaching 90% of GDP, that total Chinese debt exceeds 300% of GDP but that over \$10trn of debt globally trades with a negative yield, you would be popped into a straight-jacket faster than you could say “wibble”.

However, this is the world we live in and the rules have changed for now. The Chicago Fed Financial Conditions Index shown below uses a range of financial market indicators and shows we are at record levels of looseness – this at a time of record low unemployment and economic slack.



The current central bank dogma is that 2% average inflation over the cycle is a good thing and that they have the interest rate and QE tools to make this happen. We are not so sure that the expectations-based models that served central banks in beating down the inflation demon in the 1980's and 1990's work so well in reverse. Japan has had many years of zero and negative interest rates but inflation is nowhere to be seen. Even if we acknowledge that their demographics make this a special case, it is far from clear

that central banks are doing anything other than pushing on a piece of string.

Does the difference between 1% and 2% inflation even matter? They are also fighting into the headwind of technological progress where major “hedonic price adjustments” have kept measured inflation down by allowing for product innovation. For example, according to the US Bureau of Labour Statistics and St Louis Fed, car price inflation from 1994 to 2018 was zero even though the average headline car price has more than doubled! Until or unless wage inflation picks up strongly and feeds through into prices, it seems we will be stuck in this current paradigm.

However, central banks are clearly having an impact in fostering dangerous financial market bubbles in a world where they seem to have a far greater impact on asset prices than they do on inflation outcomes. With central banks seemingly committed to their strategy, and with growth and inflation outcomes being tepid around the world, this looks and feels very much like a soft landing, albeit one that is at very high levels of leverage. For now, this has seen financial markets embrace the re-emergence of goldilocks.

How could this end? Leverage may provide the answer. Deutsche Bank put out an interesting piece arguing that the combination of ultra-loose monetary policy together with greater financial sector regulation post 2008 has seen the transmission channel for leverage move from the financial sector to the wider corporate sector. US financial sector leverage has fallen from 120% to 80% of GDP but non-financial corporate debt has risen from 90% to 120%. This has resulted in more than 50% of investment grade bonds in the US being BBB- rated and therefore just one step from being very sharply sold off in the event of any downgrade. We would note however that this high corporate leverage seems to be much more of a factor globally rather than in NZ and Australia.

Relating all this back to equity markets, investors have now grown confident that central banks have their backs. In practical terms, this means that valuations are implicitly using current levels of ten year bond yields rather than longer term averages. We currently use a 3.7% risk free rate in all our DCF valuation models. If we were to buckle to the idea that rates stay low forever (while revenue and earnings growth is somehow unaffected), moving to a 2.0% risk free rate would see the NZ market PE of 28.6x become “fair”. Personally, I want to be paid a far higher price than that to take equity risk.

In trying to provide uncorrelated returns to booming long-only equities, we are naturally contrarian and have been struggling mightily from the short side as we position for this state of affairs to end. Interestingly, the two major sell-offs over the last 18 months have both been sparked by market fears of a paradigm shift where central banks no longer have investors' backs.

The short-lived sell-off in February 2018 seems to be largely remembered as a time when the quants were lined up against a wall, with those who were shorting the VIX being particularly hard hit. However, the initial catalyst was two unexpectedly strong wage and price inflation readings that sparked fears that the Fed would remove the punch-bowl. Similarly, the somewhat deeper correction in the fourth quarter of 2018 was sparked by the actuality of the Fed taking a much more hawkish stance, only for them to promptly reverse it in January this year. Similarly, the ECB and the Chinese central banks have pulled right back on their former tightening plans.

Put all this together and what it tells us is that valuation ratios are at extreme levels but they don't matter for now. All that seems to matter is central bank policy and the continuation of ultra-low interest rates and the willingness of investors to suspend disbelief and keep assuming that earnings will grow at the same old rate. The common factor behind the two sharp risk-off episodes in 2018 was a fear that central banks would tighten but this does not mean the next war will be the same as the last war. We are certainly wary of central bank policy but we are also wary of other factors such as leverage and disappointing earnings leading to a market reversal.

Returning to the performance of the Fund in April, the return of +0.14% saw our longs do well in a rising market with a return of +1.85%, while our shorts unsurprisingly hurt us, detracting -1.67%. Our "winners to losers" ratio turned around to a highly acceptable 55%, which is what we typically achieved prior to the extraordinary market movements in recent months.

Our largest headwind was extremely frustrating in that we were wrong for all the right reasons with our short in Dulux (DLX, +32%), which surged on a takeover bid at a very high price from Nippon Paint. There is a very robust relationship between house sales and housing renovations that operates with a 12-month lag. House sales have plunged and we view analysts' forward outlook for DLX as being far too optimistic. When do you normally paint the inside and outside of a house? Often, just before or after you buy or sell it. In addition, there has always been a modest danger that DLX has very strong shelf-space in Bunnings and that this could be vulnerable to being chipped away at if/when competitors began to demonstrate a more compelling sell-through. The left-field takeover bid knocked 0.64% from our performance.

The second largest detractor was a relatively large short we have built up in Breville Group (BRG, +18%) which seems to be on the buying list of every momentum and quantitative fund in Christendom. BRG is a solid company with a strong product pipeline manufacturing and distributing coffee machines, juicers and an array of other kitchen appliances. They have interesting upside from their entry into the German coffee market and delivered a good result back in February (when we had no position). However, they have soared 72% since then, despite

earnings upgrades being modest. BRG is now on a consensus Jun19 PE ratio of 35.1x, with EPS growth of 12-13% being forecast thereafter. Their history in recent years demonstrates that while they are a quality player in their segment, they are far from immune to the vicissitudes of product cycles and retail conditions. We shorted a little too early but this is a classic example of just how overbought high multiple companies have become in the current market.

The third headwind of note is a name that has frequently appeared here in the form of our short in Technology One (TNE, +10%). TNE is now on a forward PE of 48x which strikes us as rather excessive for what is a traditional software business which writes and implements IT solutions for enterprises across areas such as HR, financials, supply chain etc. They have changed their reporting to effectively repackage their traditional contracts to be presented on a SaaS basis. In case there is any doubt, the word count for "SaaS" in their annual report came in at 124! For now, investors seem to have bought that superficial change. Management have previously been sellers of shares at far lower levels and we also worry that their accounts show significant services that have been paid for but not yet carried out, with this gap growing sharply over the last year. Whether this reflects true business growth or a possible bringing forward of future sales remains to be seen.

The largest positive contributor was our large long in Tower (TWR, +11%) which rebounded sharply from its weakness in March, when it was removed from the FTSE/ Russell Global Small Cap Index. We have written at length about TWR in the past but see it as being on a PE of circa 11x and offering years of double-digit earnings growth as it dramatically lowers costs and gradually gains market share. In the short term, we view TWR as being on track for a very strong result in late May, while the 19.9% stake of Bain & Co will ultimately be resolved one way or another.

The second largest winner was our long-held long in Turners (TRA, +6%) who pleasingly reiterated FY19 guidance and talked to improved trading during the current fourth quarter. Overall conditions are clearly still not easy but we remain attracted to their leading position in the huge and very fragmented used car market. TRA trades well below our in-house Discounted Cash Flow valuation which cross-checks against a forward PE of 9x with solid medium-term growth.

The third standout was our relatively large long in Bingo Industries (BIN, +10%) whose volatility has made it a frequent flyer in these pages. The world changes for the East Coast waste industry on 1 July with the introduction of the Queensland waste levy, and unlike some nay-sayers, our industry feedback gives us confidence that sizeable price increases will occur for waste disposal in NSW. These will be positive for BIN given their powerful position in recycling stations and landfills. More generally, we expect FY20 to be a very strong year for them as they have a full year of the Dial-A-Dump acquisition, the opening of Patons Lane for all the year

and Mortdale for most of it, and Sydney landfill price increases. We were comfortable with our thesis following a meeting with Bingo at a major Australian investment conference last week (which also explains why this letter is later than usual).

Thank you for your ongoing investment and support of the Fund. Investing on the basis of valuation has felt increasingly old-fashioned in recent months but the explosive outperformance of the most expensive sub-set of stocks feels as though it is beginning to run its course. We are continuing to stick to our style and invest in names whose valuations appear far too low relative to their growth prospects, while shorting companies which appear extended and which preferably have identifiable risks. The Fund remains well placed to perform well if and when this aged bull market inevitably stumbles.



Matthew Goodson, CFA