Salt Long Short Fund Fact Sheet – July 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 July 2021

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$53.2 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 July 2021

Application	1.9315
Redemption	1.9237

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 July 2021

Long positions	58
Short positions	36

Exposures at 31 July 2021

Long exposure	97.92%
Short exposure	49.42%
Gross equity exposure	147.34%
Net equity exposure	48.50%

Largest Longs	Largest Shorts
Tower	Reece
Dalrymple Bay Infrastructure	Sonic Healthcare
Shaver Shop Group	Xero
Monash IVF Group	Cochlear
Marsden Maritime Holdings	Goodman Property Trust

Performance[1] at 31 July 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%	-0.23%	0.48%						12.81%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	2.42%	1.28%	2.35%
6 months	12.81%	2.58%	4.62%
1 year p.a.	30.59%	5.22%	19.65%
2 years p.a.	14.31%	5.47%	9.80%
3 years p.a.	7.25%	5.88%	12.11%
5 years p.a.	6.56%	6.24%	11.01%
Since inception p.a.	9.68%	6.76%	11.39%

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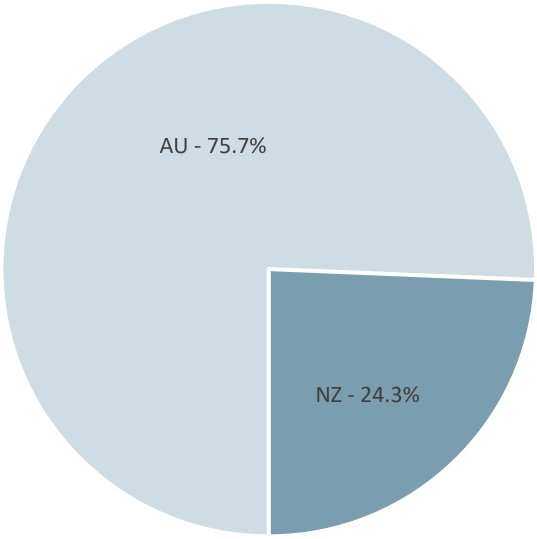
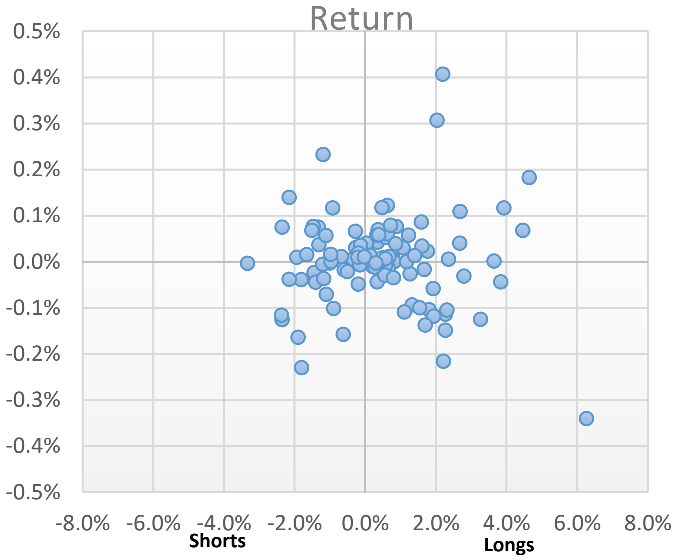
Country Allocation at 31 July 2021 (Gross Equity Exposure)



July 2021 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

The month of July saw a satisfactory performance from the Fund with a return of +0.48%. It was a funny month for equity markets, which raised more questions than answers for investors.

How serious is the Covid-19 delta strain? Is the sharp lift in inflation in most countries transitory or not? Will central banks continue to move at a glacial pace if inflation evidence tightens? How hard will the RBNZ have to go? The earlier clear-cut outperformance by cyclicals has faded as yield curves have flattened and July was a month which was driven by individual stocks rather than any over-arching styles or sectors.

The Fund's net length rose from 44% to 48% but much of this happened into market weakness towards the very end of the month. Our gross position declined from a relatively high 156% to a more normal 147%.

We still view our positioning and style as being market-neutral and despite the net length, we added value on down-days for the 50/50 index of NZ and Australia. There were an unusually high eleven negative days for the market in the month, with the average return being -0.36%. We were up on seven of those days, with an average return of +0.16%.

The Fund is continuing to provide equity-like returns with no correlation to equity markets and less volatility than them. While our overall returns have been satisfactory, they have not really stood out against the backdrop of an endless bull market for long-only equities. One day that backdrop will change and we will continue to aim to grind out positive returns with less volatility and no equity market correlation.

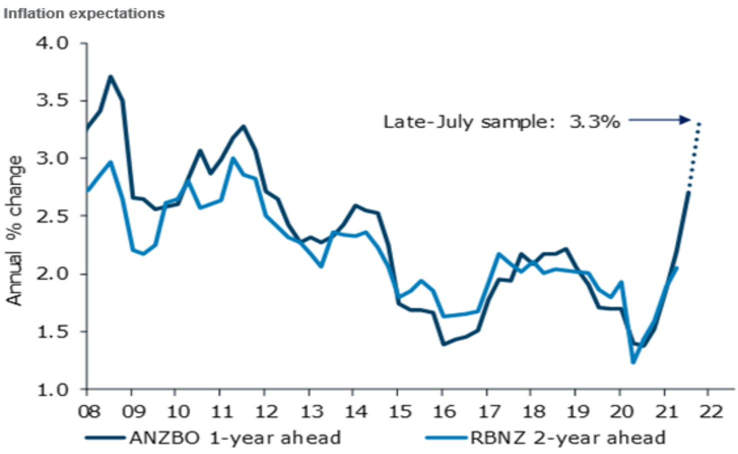
Our over-arching macro view continues to be very clear. Inflation is rising and only a portion of that is transitory. This will require tighter monetary policy and higher bond yields. In turn, equities overall may churn or even decline rather than rise remorselessly. Theoretically, cyclical stocks should do well while quality, growth-at-any-price and there-is-no-alternative stocks should struggle. More on this soon. Our macro view has been spot-on until the last couple of months, but we have seen little to dissuade us from it, so we remain positioned accordingly.

For the last couple of decades, non-tradeable inflation in NZ has run at circa 3% but the overall figure has been held back by the massive deflationary impact of China on tradeable inflation, which has been effectively 0%. This story is over. Covid-19 has changed supply chains forever and China's productivity improvements have ceased to keep pace with its increasing costs in any case.

We now have a situation where non-tradeable inflation is rising more strongly than ever but tradeable inflation has also joined the party – partly transitory due to passing Covid impacts, partly not as supply chains have changed.

The next step is that once inflation moves into the labour market, the risks of a decidedly non-transitory wage/price spiral become considerable. Labour is 60-70% of the cost of everything.

Anecdotal stories currently abound of labour shortages and sharp wage inflation. According to the July ANZ Bank Business Outlook Survey, a staggering 88.2% of firms expect their costs to rise over the next year. Generalised inflation expectations rose from 2.41% to 2.70% and as shown in the chart below, the late-month sample set was running at +3.3%. Shame about the 1%-3% inflation target – the RBNZ has well and truly over-egged the pudding.



Source: RBNZ, ANZ Research

As this piece is being written, the March quarter HLFS Survey came out with the unemployment rate plunging to 4.0% and hourly wage inflation running at +4.5%. Over the next couple of quarters, we forecast the unemployment rate to reach 3.5%. Our economist, Bevan Graham points out that the last time it was this low was pre-GFC and the Overnight Cash Rate then was 8.25%. Different times indeed!

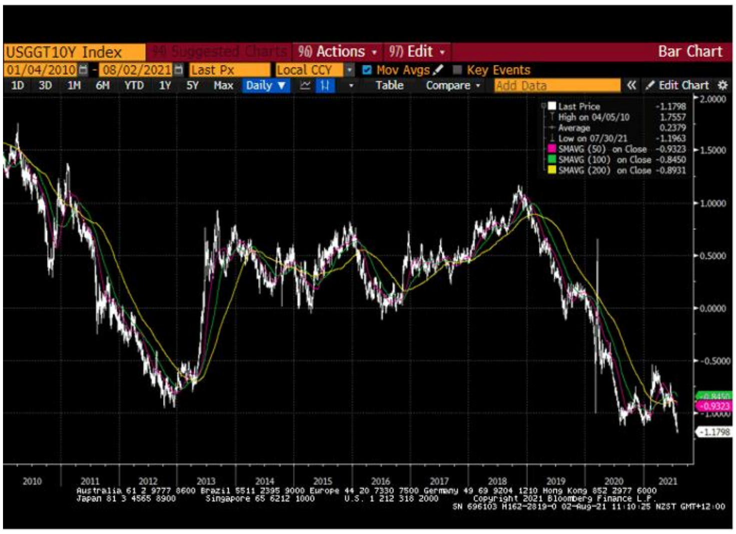
The March quarter CPI was released mid-month and showed a colossal quarterly reading of +1.3%, with tradeable inflation at +1.7% and non-tradeable inflation at +1.2%. At month's beginning, if you'd been told that the RBNZ would end its bond-buying early, that we'd see a CPI reading such as this and that NZ 10-year bond yields would proceed to rally from 1.77% to 1.51%, then you would have been put in a straitjacket.

The yield curve flattened sharply in the month, with the benchmark funding rate of 3-year swap rising from 1.00% to 1.21%, It was a mere 0.01% in late October. There is little evidence so far but this must surely start to bring an end to the massive cap rate contraction we have seen across all classes of property, be it commercial or residential.

Put all this together and it has been a funny couple of months. Inflation has soared as we expected but the market has counter-intuitively taken long term nominal bond yields lower. In equities, this has naturally seen cyclicals and value lag, while quality and growth have returned to outperforming.

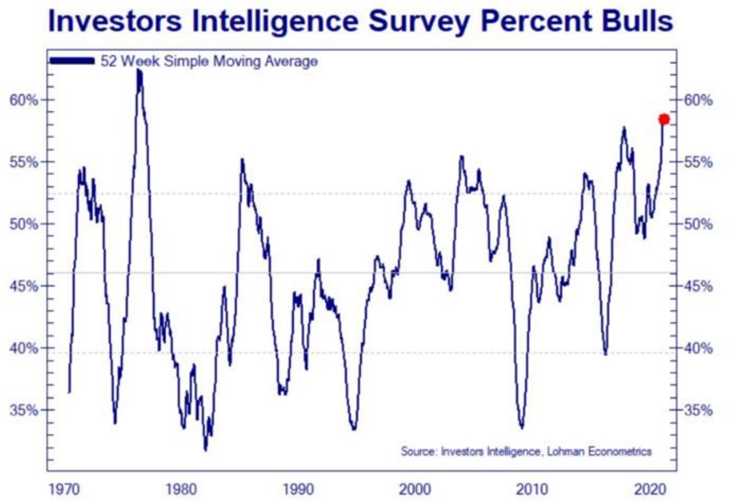
Why have yields fallen? Firstly, there seems to be a greater belief globally than in NZ that inflation pressures are indeed transitory. Along with this, the Fed has been as dovish as it could possibly be in the face of contrary evidence. Further, the ECB has moved to a symmetric inflation mandate of 2% over time, which in practical terms is being viewed as QE forever. With sovereign debt levels soaring, a cynic might think the only way out is to keep interest rates well below inflation – a dangerous game indeed.

The combination of high inflation and plunging bond yields has led to record low real bond yields. This is shown in the chart below for US 10-years, which subtracts expected 10-year inflation from 10-year nominal yields. An investor now has the pleasure of losing -1.17% of their money each year in real terms for the next 10 years. This is financial repression at its finest – this is a time to be a borrower rather than a saver.



This is a wonderful environment for risky assets as investors get pushed up the risk curve to find some form of yield. It explains the persistent strength in equities and the all-time lows in junk bond spreads. With ever more money coming in behind and driving prices to new highs, bulls are operating in a virtuous circle of their obvious investing brilliance as they put more money to work.

For example, the long-followed Investors' Intelligence Survey of newsletter writer opinion has just reached its highest level since 1976. As can be seen in the chart below it has a storied history as an accurate contrarian indicator when it reaches extremes.



So, how are we positioning the Fund in this rather extreme environment? We remain net short GAAP (growth at any price) stocks as they will lag when bond yields rise but we are being light-footed given the wall of credulous money chasing them. We are carefully shorting some quality darling names whose multiples have reached the stratosphere.

We have lowered our net exposure to real estate securities, which may come under pressure as term deposit rates and funding costs lift. We had earlier taken a degree of profit in cyclical exposures as we suspect that inflation will not be entirely transitory but economies could still slow in a stagflationary combination.

So, what do we own and how can we be 48% net long given our fears that central banks have gone too far and that a reality check may occur? What we are finding is a whole range of special situation longs which have fallen off the radar screens of investors. We are having little difficulty getting growth at a cheap valuation multiple. Interesting names and examples include:

- Tower - we have written about TWR ad nauseum so will merely note that the market has put a multiple on a bad claims year, that they have sizeable excess capital to fund growth, and that while it will take time to lift pricing to fully cover claims cost inflation, the outlook for investment yields is improving rapidly for their short duration book.
- Dalrymple Bay Infrastructure, a coking coal export port that is on a >10% gross dividend yield to a NZ investor with growth as they move from a heavy-handed to light-handed regulatory regime. They are not thermal coal.
- Shaver Shop – another long-time favourite but still on a cash PE of a mere 4.0x with no gearing. A degree of this is unrepeatable from Covid but they still have strong future growth from franchisee buy-outs and category expansion.
- Monash IVF – data points to extremely strong IVF numbers in Australia which are well above the 2019 year and they have no debt so have plenty of room for bolt-on acquisitions and capex while still being on a forward PE of 15x, which is cheap for the sector.
- Marsden Maritime – MMH has been moribund for some time after strong gains from our initial purchase. Strong long-term growth potential and we will walk in one day and find that the Devonport dry-dock and/or navy are moving there.
- Genworth Mortgage – trading at a huge 40% discount to NTA on fears regarding their CBA contract but could do a major capital return if they didn't retain it. Positive exposure to the Australian housing boom and reported a very strong result as this is written.
- Australian Vintage Group – has been a great investment and is still only on a PE of 11x for a dominant wine brand in the low-mid price-point of the UK market. AVG is generating strong cashflow and has a good growth outlook.
- Intega Group – positive exposure to global infrastructure expenditure, on a sub-10x PE, have put themselves up for sale and stated that, "Intega is performing well…" when they did so.
- Elanor Commercial Property – ECF offers a gross yield to a NZ investor of 10.5% with quality B-grade office exposures which stand out on relative value grounds versus peers.
- GDI Property – GDI trades at a 10% discount to NTA, with its exposure mainly being to Perth which is trading far below replacement values at a time when investors are clamouring to invest there. On top of this, they have a long-standing syndication business.

Returning to the performance of the Fund in July, our return of circa +0.60% (pre fees and tax) was driven by moderate gains in both the long (+0.29%) and short (+0.27%) books. In a choppy sideways month, it was pleasing to add value from both sides of the ledger. Our overall "winners to losers" ratio was an excellent 62%.

The largest headwind came from the oft mentioned holding in Tower (TWR, -4.7%). It is still our largest position but we had trimmed it back into strength in prior months which gives us some flexibility on current weakness. Three things appear to be going on. Firstly, they have had an ugly claims year with large house fires and natural disasters which have seen their reinsurance protection utilised in full. The market has put a multiple of this. Secondly, there appear to have been some major portfolio transition flows in the month which may have weighed on TWR to some degree. Finally, a claims cost inflation cycle has come through more strongly than expected and it takes time for TWR to lift premia to offset. Looking forward, we continue to see TWR deploying its surplus capital to drive accretive growth, while they are a rare beneficiary of rising rates due to higher yields on their investment book.

The second drag of note was our long-standing holding in Kina Securities (KSL, -7.1%) which fell on the PNG competition regulator making an initial finding to block their acquisition of Westpac PNG. We understand several more stages of the process are yet to play out and it will be a battle between KSL arguing that they will be able to compete more strongly against the hugely dominant BSP, while competing minnows argue it will see a reduction in competition. We obviously hope it is allowed but even if it isn't, KSL is extremely cheap and will have a hugely over-capitalised balance sheet.

Other smaller detractors were led by a small short in what we see as the wildly over-priced Lynas (LYC, +28.6%) where we went a little early; a short in Fortescue Metals (FMG, +6.7%) which rose despite benchmark iron ore prices falling by over 8% from their record highs in the month; and a short in Breville Group (BRG, +7.8%) which is on a forward PE of a mere 48.5x with a fair bit of that being unrepeatable Covid-19 driven earnings. You only need so many coffee machines and blenders but clearly there is no price high enough for true love.

The largest positive contribution came from our previously painful long in Emeco Holdings (EHL, +13.3%). Our thesis remains that they are successfully diversifying their mining equipment rental business, and that meanwhile, coal prices have picked up sharply, meaning activity over the next year or two will likely be robust as EHL transitions. EHL is on a forward PE of 10.7x going to 8.6x in Jun22 with positive earnings momentum.

A second stand-out was our long in OFX Group (OFX, +9.4%) which we initiated at its lows a few months ago when it fell out of the S&P/ASX300 Index – thank you passive. OFX has changed tremendously from the old days when it was basically a google AdWords war between retail forex focused competitors seeking to win business and earn income off the float. Ever-tightening regulatory requirements combined with low interest rates mean competitors are finding it difficult to get banked. OFX has a strong and geographically diverse growth pipeline from corporate and large enterprise clients, with there being a huge opportunity as banks retreat due to a tougher regulatory backdrop.

A final stand-out was our short in Hub Group (HUB, -15.6%) which had hurt us previously and which we covered off on the weakness. Longs in Dalrymple Bay Infrastructure (DBI, +5.7%), Coronado Coal (CRN, +17.9%) and Silk Logistics (SLK, +22%) provided another useful upside.

Thank you for your continued support of the Fund. The major tailwinds we experienced for much of the last year may have passed temporarily but we are continuing to work away and add value in what are choppy and ever more dangerous markets. We repeat last month's comment that we believe we remain well-placed for a pick-up in inflationary pressures, an eventual tightening in monetary policies across many markets and higher long term bond yields. This Fund is well positioned to be a useful diversifier in the event that one of history's great bull markets begins to falter.

Matthew Goodson