SALT
Funds Management

Salt Long Short Fund Fact Sheet – March 2018

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 31 March 2018

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$270.3 million
Inception Date	30 June 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 March 2018

Application	1.5743
Redemption	1.5679

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 2018

Long positions	89
Short positions	50

Exposures at 31 March 2018

Long exposure	83.37%
Short exposure	-50.16%
Gross equity exposure	133.53%
Net equity exposure	33.21%

Largest Longs	Largest Shorts
Centuria Metropolitan REIT	Ryman Healthcare
Turners Automotive	CSR Limited
IVE Group	National Storage REIT
Tower	Goodman Group
Ingenia Communities Group	REA Group

This Fund is actively managed. Holdings are subject to change daily.

Performance[1] at 31 March 2018

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%										2.50%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	2.50%	1.62%	-2.40%
6 months	3.53%	3.31%	4.21%
1-year p.a.	6.92%	6.75%	8.92%
2-years p.a.	7.29%	6.87%	11.15%
3 years p.a.	10.35%	7.22%	8.15%
Since inception p.a.	12.75%	7.47%	10.12%

[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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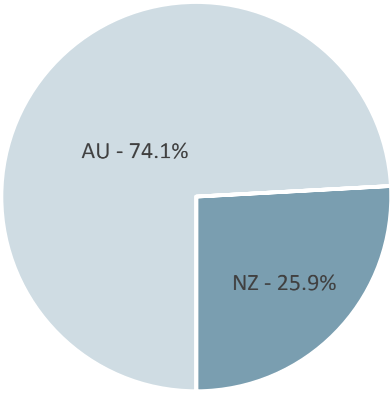
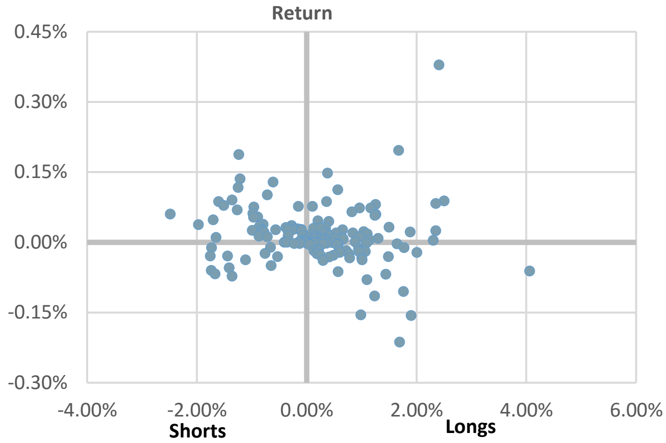
Country Allocation at 31 March 2018 (Gross Equity Exposure)



March 2018 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

The Fund experienced a strong month in March, delivering a return of +1.76% after all fees and expenses. It was extremely pleasing to land these numbers given that we have been battling away for some time with relatively neutral market positioning during a powerful bull market. We wanted to be positioned to still deliver positive returns when that market changed. That happened and we did, with the S&P/NZX50 Gross Index falling -0.65% and the S&P/ASX200 Accumulation Index down -3.77%. With approximately 70% of the Fund currently being in Australia, we were delighted to be on the right side of the buzz-saw that cut a swathe through markets over the month.

Since inception on 30 June 2014, the Fund has now returned +56.8% after all fees and expenses. Thirty-four of those forty-five months have had positive returns, we are yet to have a negative quarter and our correlation to increasingly volatile equity markets remains statistically zero. The Fund aims to deliver equity-like returns with no correlation to equities and much lower volatility. While we are far from immune to rough patches, we are pleased to have delivered thus far.

Looking at the daily returns over March provides a classic example of what we are trying to achieve. Of the 21 trading days, NZ had a range of +1.43% to -1.41% and Australia was +1.18% to -1.96%. By contrast, the Fund's range was a far narrower +0.44% to -0.33%. Our returns were far less volatile and were generally positive on the negative days.

A new-found volatility continued to rule equity markets during March although this was far more evident in the US market than the somewhat more sedate moves down under. The S&P500 Index recently had a record run of 112 days without a 1% decline but February and March saw 21 days with a move greater than 1%. 9 of these 21 moves were negative but the S&P500 fell by 6.5% over the two months due largely to the worst days being far larger in magnitude than the best ones. This is a classic case of negative kurtosis in equity returns, where investors get hit hard on a small number of really bad days.

US moves to impose trade barriers were a key apparent source of volatility, with the market worrying about the stagflationary implications of a trade war. However, analysis by Goldman Sachs suggests that the measures put in place so far affect only about 3% of US imports and will lift the average US tariff rate by less than 1%. A significant escalation by affected countries and then the US into some form of fully fledged "trade war" would seem to be the fear. There is also perhaps a reassessment of the market's view that Trump's policies are "friendly" to it.

Other factors such as fears regarding an unsustainable US fiscal path, Facebook's privacy issues, European taxes on global web-based companies and President Trump's detestation of Amazon also played a part in the US declines. We suspect that a rapid unwind of various quantitative strategies also played a role in the volatility, with trend-following CTA funds being stopped out and risk-parity funds having to sell equities as volatility rose. A range of seemingly sophisticated strategies have been shown to be nothing more than momentum funds dressed in drag – when equities fall, volatility rises and they have to sell. Interestingly, it seems that retail capitulation is yet to happen, with one example being that client cash balances in Charles Schwab were at all-time lows of around 10% at end-Feb.

In our view, the key factor for global equity markets over the next few quarters will be monetary policy. Interest rates are slowly rising and QE is slowly ebbing around the world (to a point where it will likely become QT by calendar-year end). As expected, the Fed hiked by 25bp to a range of 1.50% to 1.75% during the month. However, while they lifted their 2019 forecast to four hikes, they did leave ambiguity as to whether there will be three or four moves in 2018 and this appeased markets that had increasingly feared four.

More interestingly, the hawkish Bundesbank President, Jens Weidmann called for a prompt end to European QE to begin a multi-year process of monetary normalisation. The prospect of him replacing Draghi in 2019 could be very interesting for markets. Finally, here, in a highly hedged manner, BoJ Governor Kuroda suggested that inflation may finally reach their 2% target in 2019 and that it would therefore be logical to review their own QE policies. With the US now engaging in QT, the actions from Europe and later Japan will be the keys to watch on a global scale.

Add a sharp rise in US$ Libor rates and it becomes clear that while US and global monetary conditions are still very easy in a historical context, they are beginning to tighten and will continue doing so. For example, the widely followed St Louis Fed Financial Stress Index reached an all-time low of -1.57 in Nov17 and has since tightened to -0.96. However, +0.0 is the long-term average and perhaps we have simply grown used to conditions being unusually loose ever since this remarkable bull market began in 2012. There is plenty of room for further tightening with all the implications that entails for equities and other risk assets.

While it is occurring in a typically opaque manner, China also appears to be on a moderate tightening path, with a greater focus on the quality of growth and a clampdown on shadow banking. The impact on demand can be seen in record iron ore stockpiles and we have played this theme from the short side in recent months with reasonable success in the likes of Fortescue, Mineral Resources and Sims Metal.

There is a major debate as to whether China can successfully and gradually de-gear without a financial crisis and/or sharp growth slowdown. An IMF paper we came across titled “Credit Booms – Is China Different” raises some real concerns. Firstly, non-financial sector credit was stable at 135% of GDP pre-2009 but has since risen sharply to 235% by end-2016. This has taken China’s “credit gap”, the deviation of this credit/GDP ratio from trend, to an alarming 25% of GDP. In 43 similar such cases globally, the IMF has only identified five which did not end in a major financial crisis or growth slowdown and each of those was hardly a walk in the park (e.g., one was NZ in the early 1990’s).

A potential catalyst could be further US tightening putting ever greater pressure on the currency pegs run by China and Hong Kong. They will face bad choices between either tightening or depreciating their currencies and accepting the inflationary pressure that follows. The Telegraph’s Ambrose Evans-Pritchard wrote an excellent article on how any tightening could hurt Hong Kong’s hyper-inflated property market and that Nomura calculates Hong Kong’s “credit gap” to be a staggering 45% of GDP. Amidst all the other current macro noise, it really seems that tightening global monetary policy should be the key focus for investors.

Offsetting our China-driven bulk commodity shorts, we are becoming increasingly attracted to oil plays for several reasons. Firstly, the US appointment of ultra-hawks re Iran to the positions of Secretary of State and National Security Advisor suggest there is considerable potential for the deal that ended Iran’s embargo to be upended at its May review date. As a tail risk, there is clearly some prospect of further conflict in the region. Secondly, reports late month on Reuters stated that OPEC and Russia are close to reaching a 10-20 year agreement on oil production curbs to support prices. Thirdly, Venezuelan production is collapsing. Risks to this trade are that speculative net positioning is already very net long and that US shale oil production continues to rise. However, oil service costs are also rising and debt finance is becoming more expensive.

Our largest play in the general oil space is Speedcast (SDA, -7.2%) which has been an extremely successful investment since we first purchased in the low $3 region. They have grown into a major global supplier of satellite communications services. Satellite input costs have plunged due to a global glut, luxury cruise-liner demand for bandwidth is growing like topsy but SDA’s major oil platform business is utterly in the doldrums – for now. SDA already trades on a very attractive free cashflow yield in the 10% region and they have huge operational leverage to stacked oil rigs being returned to use.

Our direct oil investments comprise an array of small holdings with large potential upside. FAR Oil (FAR, +5.3%) has a sizeable interest in what will become a large Woodside-operated development offshore Senegal. FAR’s angles are that they have interests in a number of “nearology” plays and that Conoco Phillips sold their interest in the field to Woodside without allegedly considering FAR’s pre-emptive rights. This is currently before the International Court of Arbitration and could lead to a major win for FAR (or perhaps a takeout to avoid the complications). Other plays are Woodside (WPL, +0.2%), which appears to be finally corralling the different players with gas field interests offshore WA to provide a rational source of LNG supply into booming Asian markets; Central Petroleum (CTP, +31.6%) has significant stranded gas assets alongside Macquarie in the Northern Territory but these will shortly be connected by a pipeline to the Moomba hub and thence to booming East Coast gas markets; Senex Energy (SXY, +3.9%) which has some drilling risk in its prime Queensland coal-seam gas acreage but will be a standout takeover candidate if successful given the gas shortage for LNG exports; and finally a tiny play in Sundance Energy (SEA, -18.4%) at its lows, which has acquired some US shale oil exposure on what appear to be very favourable terms.

Returning to the performance of the Fund during March, our strong return of 1.76% reflected an excellent “winners to losers” ratio of 60.6% and a skew to our positive contributors being larger than our negative detractors.

The stand-out was our large long in Tower (TWR, +19.1%) which rose sharply on the sale of Suncorp’s stake to Bain Capital for $0.80/share. Notably, Bain’s SSH notice outlined provisions to make a top-up payment should they choose to initiate a takeover offer within 9 months. In any case, although TWR’s share price rose from $0.68 to $0.81, our valuation remains well north of this.

NZ home and motor insurance premia have entered a hard cycle, TWR is performing well operationally and is winning share, it is now well capitalised post its rights issue, the dispute with Peak Re has been settled, Christchurch over-cap claims appear to have slowed sharply and the new Government is highly motivated to bring the Christchurch imbroglio to an end. In time, this will hopefully see Tower able to release capital that is tied up in this seemingly never-ending event.

Our large long in Bingo Industries (BIN, +10.0%) was the second standout. There was no major news driving this other than a delayed reaction to their solid result at the very end of February. BIN traded in a very volatile manner mid-month on news that the Queensland State Govt is planning a waste levy on out-of-state waste shipments. While some view this as increasing BIN's cost of doing business, the fact is that they are long landfill and recycling facilities in NSW, so they stand to benefit in the highly likely event that they increase prices up to the amount of the Queensland waste levy. We did take a little profit at its peak.

Our third winner came from the short-side with our medium-sized short in Fortescue Metals (FMG, -14.1%). We discussed our concerns regarding China at a macro level earlier and the obvious way to play this in an Australian context is via the major exporters of iron ore. The appeal from the short side with FMG is that it is relatively high on the cost curve and therefore the most vulnerable of the larger players in the event that iron ore prices keep falling. Further, FMG's balance sheet is not pristine, they have a desire to pay a high dividend and they have sizeable future capex needs. They warned on the basis of even larger low-grade price discounts than expected for their ore. Clearly if our view is wrong, then FMG has the most upside in the sector, with this explaining why we have kept the position to a medium size.

The largest headwind during the month was our large long in Pacific Current Group (PAC, -11.9%). As was perhaps to be expected, this owner of stakes in various fund management companies globally came back hard with the weakness in markets. PAC is a name we have held with varying sizing for quite some time and it has delivered strong returns for us. The interim result in late Feb was solid, PAC's key investments such as GQG and Aperio are growing strongly and PAC has plenty of balance sheet firepower to make further acquisitions which they have stated are under consideration. It is a far simpler and stronger company than has been the case for years, yet it is 27% off its recent highs, so we took advantage of the sharp pullback to lift our holding.

The second notable laggard was our large long in Eclipx Group (ECX, -5.8%) which added to its recent weakness. This vertically integrated car fleet management, equipment finance and auction business has fallen steadily for several months. Their AGM update in February was rock-solid and the only things we can point to are possibly market fears regarding used car sale volumes and funding of the finance business. ECX is now on a forward PE of 12.3x Sep18 and 11.0x Sep19 earnings.

The final detractor of note was a large long in Perpetual (PPT, -10.3%) which we rebuilt a little early, having exited our former holding in February when it rose sharply on a good result. PPT's fund management arm is dealing with structural headwinds but it is performing in a satisfactory manner. The real attraction lies in the strongly growing Perpetual Private and Perpetual Corporate Trust businesses, which tend to get overlooked despite being over 40% of the earnings (and over half the valuation in our view). We bought the position well below the month's highs and we suspect it will wax and wane with the fortunes of markets but a Jun18 PE of 14.7x strikes us as too low for the strong growth prospects.

Weak markets over the last few months have seen us slowly change the net positioning of the Fund from the low-mid 20% region to low-mid 30% levels. Overall, our longs are much lower beta than our shorts, so we view this change as being from slightly net short on a risk-adjusted basis to slightly net long. This does not so much reflect a macro view on markets as the bottom-up opportunities that present themselves. While we are finding an increasing number of longs at attractive prices, this is more the case in Australia than in NZ, and we remain wary of many valuations at this late stage of the bull market when the monetary policy tourniquet is slowly tightening on a global basis.

We are pleased to have delivered a strong March when markets were under real pressure and our net positioning was generally above 30% and ended at 33.2%. We have moved on quite a number of positions where we felt as though our thesis had played out. We feel as though we are starting April with a clean slate of a large number of holdings that are yet to work rather than stale positions that are all tapped out. Thank you for your continued interest and we will do our level best to continue navigating these choppy waters with no correlation and far less volatility than equity markets.

Matthew Goodson, CFA