SALT
Funds Management

Salt Long Short Fund Fact Sheet – September 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 30 September 2018

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$275.8 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 30 September 2018

Application	1.5705
Redemption	1.5641

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 September 2018

Long positions	87
Short positions	42

Exposures at 30 September 2018

Long exposure	82.85%
Short exposure	-47.54%
Gross equity exposure	130.39%
Net equity exposure	35.31%

Largest Longs	Largest Shorts
Centuria Metropolitan REIT	Ryman Healthcare
QMS Media	Dulux Group
Investore Property	National Storage REIT
Tower	Auckland Intl Airport
Turners Automotive	Coca-Cola Amatil

Performance[1] at 30 September 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%	-1.40%	-0.21%	-0.11%	1.20%	-1.06%	1.37%				**2.22%**

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	1.50%	1.66%	0.86%
6 months	-0.24%	3.33%	8.79%
1-year p.a.	3.25%	6.75%	13.36%
2-years p.a.	4.79%	6.76%	10.96%
3 years p.a.	7.67%	6.97%	14.57%
Since inception p.a.	11.10%	7.39%	11.05%

[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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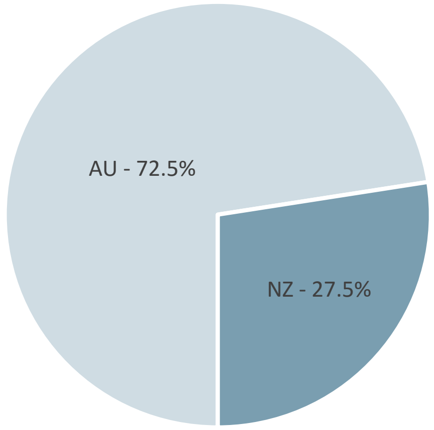
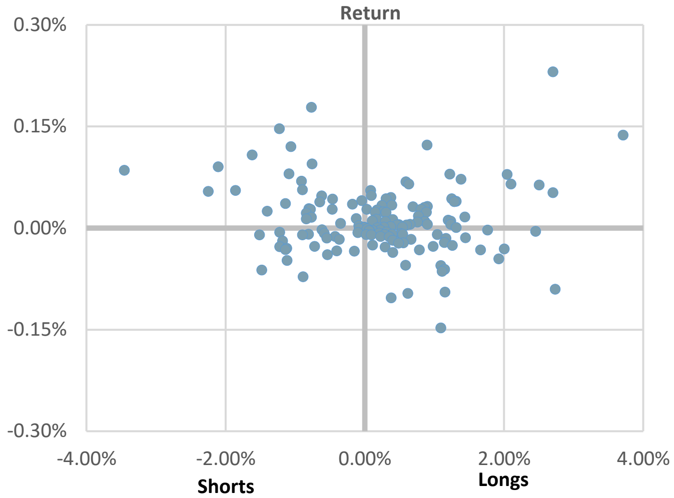
Country Allocation at 30 September 2018 (Gross Equity Exposure)



September 2018 Individual Stock Contribution



Fund Commentary

The Fund experienced a pleasing rebound in September, with a performance of +1.37% after all fees and expenses. This compared to the S&P/NZX 50 Gross Index return of +0.41% and the Australian S&P/ASX 200 Accumulation Index decline of -1.26%.

Since inception on 30 June 2014, the Fund has now returned +56.4% after all fees and expenses. Thirty-six of those fifty-one months have had positive returns, our volatility remains far below long-only equities and our correlation to extremely expensive markets remains zero.

The one year forward PE for the NZ market fell marginally from 26.6x to 26.4x but a modest increase in long term bond yields from 2.54% to 2.65% in September means our market actually remains at the same record distance from fair value that it was at the end of August.

September finally saw a slight hiatus in the wall of buying pervading our markets but it was only slight and NZ finished slightly up thanks to its seemingly obligatory end-of-quarter surge. While less obvious in the deep, liquid Australian market, NZ continues to see a torrent of what appears to be passive index-based purchasing which is skewing market pricing at what we view as unconscionable valuation levels.

To show this skew, let's look at the last few days of September and compare the closing level of the S&P/NZX 50 Gross Index to its level 15 minutes earlier at the end of normal trading prior to the closing auction. At quarter-end on Sept 28, the market rose 29 points; 27th = -13; 26th = +21; 25th = +10, 24th = +9, 21st = +35, 20th = +13, 19th = +16, 18th = +16. See a pattern? Guess what time of day we tend to implement our shorts? The real doozy was on September 11 when out of nowhere, our market rose +1.96% on a day when global markets did little but there was a noticeably large inflow into the iShares NZ fund in the USA. Index funds are nothing more than large cap price momentum investors in drag.

While passive funds may argue that they have to buy at the closing price and are merely investing their inflows, the end outcome has noticeable price impact. Many of these funds will also buy over the day prior to setting their investors at the closing price. What will happen to the NZ market when some sort of left-field event turns these funds into sellers? With valuations continuing to hit new all-time records, it may get very ugly indeed before share prices drop low enough to attract fundamental buyers such as ourselves.

As renowned investor, Howard Marks of Oaktree put it in widely reported comments during the month, *"the seven worst words in the investment world: "too much money chasing too few deals."* Para-phrasing his views, which we have been whole-heartedly arguing for some time, central banks have flooded the world with liquidity and driven risk-free rates to near zero or even negative levels. This has forced investors to move up the risk curve in search of required returns. Examples include cryptocurrencies (oops), emerging markets (oops), FAANG stocks, (no oops yet), corporate credit at record low spreads (no oops yet), a boom in securitised corporate debt (no oops yet), junk bond issuance at record levels relative to investment grade debt and pockets of extremely extended equity valuations in many markets (no oops yet).

At the same time, there has been a loss of generational memory of the impact of the GFC and the dot-com bubble and the Asia Crisis and 1987. This is leaving behind in the dust those who sensibly mitigate risks relative to those who are all aboard the large cap price momentum train.

Having too much money chasing too few deals aptly describes the NZ market, or to be more accurate, the NZ large cap market, with there remaining a record gap between the average PE and the median PE. Similarly, UBS NZ work shows that PE dispersion is at record levels, with the 80th percentile PE being 2.2x that of the 20th percentile. It reached 2.1x in 2008 and bottomed at 1.4x in 2011 and 2013. Australia is similar but less pronounced. Narrowing contributions to an ageing bull market are a classic technical sign of exhaustion.

In line with this dispersion, we are not having great difficulty in finding ideas from the long-side but these are almost entirely in small and mid-cap land, where companies are typically not present in major global indices. We see this as an unusual opportunity and have actually lifted our net length somewhat to take advantage of it. From the short-side, we continue to focus on a mix of GASP stocks (growth at a stupid price) and names where we see unpriced earnings challenges.

We have expounded at length on how NZ equity valuations have extended far beyond levels that can be explained by bond yields or earnings growth. Another way of looking at our experience comes from Deutsche Bank's widely followed annual Long-Term Asset Return Study. For the last five years, NZ has delivered the strongest annual returns in the developed world (+14.7% per year versus a median of 7.8%), while for the last ten years, we have delivered the fourth best returns at +14.1% compound (median is +10.2%). Is there something intrinsic to NZ companies and our economy that makes us special and explains such outperformance or has the rubber band been stretched to breaking point?

Similar drivers are behind booming valuations in the NZ housing market. Across both equities and housing, unusually low discount rates have been capitalised into prices as though they will last forever, while also assuming historic levels of rental growth will continue. Strong rental growth implies strong inflation which implies higher bond yields. The goldilocks combination of incongruent factors will not last. Earnings growth has peaked for equities and rents are peaking for property. The Fund retains a good-sized net short position in the NZ retirement village stocks as a way of playing a reversion to more normal times.

Bloomberg reported on a study by Oxford Economics that showed NZ to be one of the ten riskiest housing markets in the world. Oxford's valuation index looked at overvaluation relative to a long-term average normalised for each country at 100. Hong Kong topped the charts with a reading of 203, NZ won silver at 179, with Canada at 173 and Australia at 160 being the next two standouts. NZ wins gold medal for the rise in real house prices over the last five years, with our 43% increase outpacing Hong Kong at 37% and Canada at 33%. We are "only" the third worst in terms of housing debt as a percentage of GDP, with our 89% comparing to Switzerland at 121% and Australia at 115% but we are doing our very best to catch up.

According to CoreLogic, Sydney house prices are down -5.6% in the year to August. Credit Suisse published a piece late in the month suggesting that Sydney could fall 15%-20% in total from its peak, with arguments including the impact of macro-prudential tightening, a sharp slowing in Chinese buying, housing investors being unlikely to negatively gear into a falling market and housing supply being well above required levels. Further, a likely Labour Government in Australia next year also has policies to clamp down in the use of negative gearing. We are short a variety of plays related to this sector such as REA Group (REA, -5.7%), Domain Holdings (DHG, -2.5%), and Dulux Group (DLX, -2.4%). Our chief long is Ingenia (INA, -0.3%).

Back in NZ, the gloom is gathering rather more slowly. Quotable Value data for end-August showed that the national average house price fell 1.6% from a quarter earlier to $672k, while Auckland was down by 0.4% to $1.05m. Other data has pointed to Auckland falling a little more than that, while the rest of the country (ex-Christchurch) is still rising but doing so at a lesser rate. The spring selling season will be the test and there would seem to be no lack of properties for sale, with realestate.co.nz reporting an 11.7% lift in new listings on a year ago in September, while Auckland is up a worrying +31.9%. Unsold inventory at 23 weeks is the highest since 2012. Median days to sell in Auckland are already at a fairly high 42 days versus a 10-year average of 35 and recent lows of 30. Those who need to sell may need to pull the price trigger.

Real estate agents are voting with their feet. According to Seek.co.nz, the number of real estate jobs shrunk by 27% in the June quarter, while there was a 30% increase in available candidates. Another interesting picture of what is happening on the ground came from an email that was shared with us by an apartment investor who has just been asked by his agent to drop his asking rent for the third time. Central Auckland has 356 furnished one bedroom and 285 two-bedroom apartments currently vacant – so much for the shortage.

The current distinguishing feature of the Auckland skyline is a veritable forest of cranes. Putting numbers on this, the latest RLB Crane Index showed Auckland with 90 (+7 over the year) and this compares to 36 in Los Angeles, 20 in New York and 26 in the booming San Francisco. Australia is experiencing a similar per capita count, with 346 in Sydney and 158 in Melbourne. The conventional narrative is that Auckland demand is far outpacing supply but we do wonder if this has been over-egged somewhat as rising household size (in a natural response to high prices) and large-scale internal migration out of Auckland are significant offsets. Cycles are created by supply responding with long and variable lags to price signals and that is exactly what we are seeing right now.

It is a similar story in retirement village land. Every player is rapidly ramping up development plans but inventory levels are already showing signs of increasing. Advertising of retirement units for sale is ubiquitous across the media, it is becoming more difficult for incoming residents to sell their own houses and we repeat a tale told by one major player about another major player offering a $20k bonus if prospective residents settled before balance date. We believe that well over 2,000 units per year are being built and this will require a continued sharp rise in penetration rates or inventories will spike. The balance sheets of the retirement companies simply cannot handle rising inventory as they rely on constant recycling of residents' capital – who will repay the estate if the unit cannot be resold? This sector remains one of our highest conviction net shorts.

An obvious catalyst to end the euphoria in financial and property markets is that monetary policy is tightening globally. September saw the eighth increase in the Fed Funds rate, taking it to an upper target of 2.25% and the Fed's "dot plot" suggests one more move this year and three in 2019. Alongside this came jawboning comments such as "financial conditions matter" and "some asset prices are in the upper reaches of historical ranges". The ECB remains on course to end QE by year-end and Governor Draghi commented on, *"a relatively vigorous pick-up in underlying inflation".*

While monetary policy is clearly tightening, the sky is not quite falling yet. Broader measures of financial conditions such as the St Louis Fed's Financial Stress Index, (based on 18 different data series), point to conditions remaining very easy. This is mirrored by contrarian indicator models such as the Citi Panic/Euphoria Model which early in the month hit "euphoria" for the first time since late January. Its level implies a 70% chance of US equities falling over the next year. Similarly, we came across a Bloomberg piece showing record levels of speculative net shorts on a "risk protection" composite of gold, US Treasuries and the VIX Index.

Markets are ignoring the removal of the punchbowl. Perhaps one reason is that monetary policy tightening is being more than offset by other factors. BAML pointed out that since the downfall of Lehman's, US share buybacks have amounted to $4.4tn versus Fed asset purchases of $3.6tn.

At the same time, according to TrimTabs Investment Research, insider selling has reached a new record level of $450m per day. Another egregious example of interests not being aligned was highlighted by Epsilon Theory with regards the darling mega cap Salesforce.com. Since it went public in 2004, CRM has paid stock compensation to employees of US$4.8bn (on top of cash payments) but delivered total NPAT of just $360m. The numbers that Wall St analysts gush over are pro forma, with stock compensation taken below the line! Down under, many sell-side analysts gush over the highly certain 7-8% EPS growth delivered by Goodman Group while ignoring massive below-the-line stock compensation – we are short.

Returning to the performance of the Fund during September, our return of +1.37% after all fees and expenses came from a pleasingly wide range of sources. Our "winners to losers" ratio of 54% was nothing special but we managed to tip-toe through the mine-field without stepping on anything nasty. We also had a helpful skew where our positives were slightly larger than our negatives. In a mixed month for markets, our longs contributed a solid +0.48% and our shorts did very well, contributing +1.02%. This combination where choppy markets can be used to add value from both sides of the ledger is a real sweet-spot for the Fund and makes a pleasant change from the remorseless upward trend of the last few quarters.

Contributors

The largest positive was our sizeable long in Tower Limited (TWR, +8.7%). There was no new news but we believe their business is tracking very well, with strong premium growth in excess of claims cost inflation. Following their raising in late-2017, balance sheet risks have been put to bed. There remains some residual risk from EQC receivables but our analysis suggests they have been treated with conservatism in the balance sheet and that TWR has a very strong position given their bottom-up modelling of the claims that they paid out on behalf of the EQC. We would also note that the escalation clause attached to Bain's purchase of 19.9% from Vero at 80cps expires on 8 December. Sell-side coverage is now very sparse but on our internal forecasts, TWR is on a Sept19 PE of 9.4x and Sept20 PE of 7.4x, with strong growth in this latter year as TWR benefits from a major step-down in costs as old systems are closed thanks to current heavy IT investment.

The second stand-out was a mid-sized short in Blackmores (BKL, -18.5%) which we initiated near its peak in late August when the stock had what we viewed as an unjustifiable spike following a middling result. It subsequently saw broker recommendation downgrades and risks emerge from potential changes to Chinese cross-border e-commerce regulations.

Other winners were led by a short position in Fisher & Paykel Healthcare (FPH, -8.2%) which we traded aggressively to add returns over and above what may have been expected from the position as it gyrated due to volatile offshore flows. FPH is an excellent company which has a long runway of growth from its hospital respiratory humidification business but the sleep apnoea business is competitive and patent litigation costs are rising. A forward PE of 42x is too aggressive in our view for a business that has actually seen a series of consensus earnings downgrades over the last several years.

Final contributions of note came from our large long in Centuria Metropolitan REIT (CMA, +3.4%) which was the subject of vague press speculation regarding interest by Charter Hall; our modest long in Australian Vintage Group (AVG, +11.0%) which is very much the poor cousin in the wine sector but is making solid strides improving its business; our short in Cochlear (COH, -7.0%) which had risen bizarrely in August following a soft result; and a short in REA Group (REA, -5.7%).

Detractors

There were no headwinds that particularly stood out but a few low-lights are inevitable in a diversified fund such as this. They were led by a modest holding in Evolve Education (EVO, -12.5%) which continued to weaken despite the highly successful Australian investor, Chris Scott taking a 19% stake. We spent a considerable time with the relatively new CEO, Roseanne Graham and can only describe ourselves as impressed at how quickly she is getting to grips with a company that has been under-managed.

since IPO. We bought into this business too early as a potential turnaround but do believe that a turnaround is achievable. The industry suffers from over-supply but a series of sensible initiatives that are well within EVO's control should be capable of driving occupancy up from the current 77% region into the low 80% region, with sizeable operating leverage through to the bottom line resulting.

Other laggards included a modest new long that we are slowly establishing in the retirement village developer and operator, Aveo Group (AOG, -14.0%). This came under heavy pressure from the surprise announcement of a Royal Commission into aged care in Australia. While AOG has only very modest aged care facilities and shouldn't be directly affected by the Commission, it may potentially cast a pall on the broader sector and affect AOG's sales. This matters given their sizeable pipeline of units that have been delivered but still need to be sold. The reason we own AOG is that the share price of $2.03 is at a massive discount to the NTA of $3.92 – while we think this number is very optimistic, it is formed by independent valuers using industry standard metrics. The catalyst is that AOG has appointed BAML to conduct a strategic review to examine options to close the valuation gap – just getting halfway would do us nicely.

Another headwind came from a medium-sized long in Monash IVF (MVF, -7.7%) which fell despite an acceptable result in late August. We have been in and out of this name for several years and are taking advantage of the current weakness to rebuild it. We see IVF treatments as having modest but dependable structural growth and although MVF has had doctor-specific travails, these are more than encapsulated in the earnings forecasts that the market is placing a lowly 12x PE ratio on. Final low-lights were a newish holding in the gold producer, Resolute (RSG, -12.6%) and a very small holding that is left in the old mistake, Incentiapay (INP, -22.0%).

The Fund finished September with net positioning of +35.5%, which would seem to suggest we have grown more bullish. This is definitively not the case and fear continues to trump greed in our investment calculus. The current historic divergence of a number of hideously overpriced stocks from a parallel universe of cheaper mid-cap stocks has created a real opportunity. We would also highlight that 1.2% is coming from a long in our old friend Propertylink (PLG, +4.2%) which is subject to a takeover bid and a collective 1.4% comes from three gold company longs that we are carefully establishing into weakness. We are not gold-bugs but we see several tactical arguments in favour of the barbarous relic. Very low real interest rates make for low holding costs; speculative net shorts are at record levels; the USD advance may perhaps falter at some point when the market looks away from interest rate differentials and towards their huge fiscal deficit; and Barrick's proposed merger with Randgold may set off a round of corporate activity.

Thank you for ongoing investment and support of the Fund. The last 12 to 18 months have been a battle as we have stuck to our investment disciplines in the face of remorselessly positive trending markets that have reached unprecedented valuation levels. We are pleased to have delivered a solid month with contributions from both our longs and our shorts against a choppier market backdrop.

Matthew Goodson, CFA