Salt Long Short Fund Fact Sheet – June 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 June 2020

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$77 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 30 June 2020

Application	1.4306
Redemption	1.4248

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 June 2020

Long positions	52
Short positions	39

Exposures at 30 June 2020

Long exposure	93.05%
Short exposure	54.84%
Gross equity exposure	147.89%
Net equity exposure	38.21%

Largest Longs	Largest Shorts
Tower	Ryman Healthcare
Marsden Maritime Holdings	Netwealth Group
Vitalharvest Freehold Trust	Port of Tauranga
QANTM Intellectual Property	BWP Trust
Elanor Commercial Property Fund	Fortescue Metals Group

Performance[1] at 30 June 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%							**-10.44%**

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	9.61%	1.28%	16.69%
6 months	-10.44%	2.72%	-3.55%
1-year p.a.	-0.74%	5.86%	2.46%
2-years p.a.	-3.84%	6.28%	6.89%
3 years p.a.	-1.32%	6.43%	9.57%
5 years p.a.	3.61%	6.76%	10.23%
Since inception p.a.	6.08%	7.04%	9.97%

[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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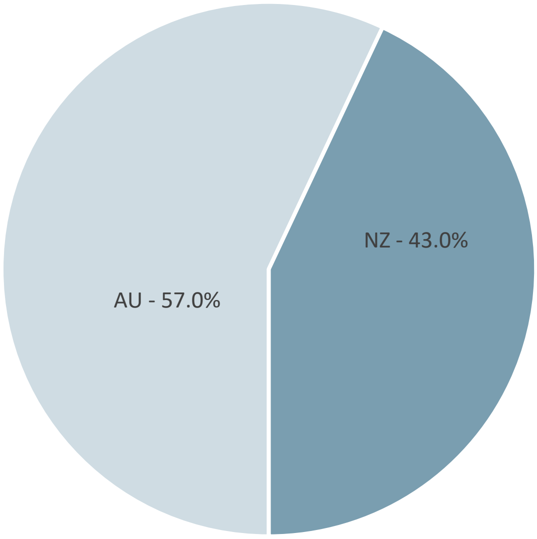
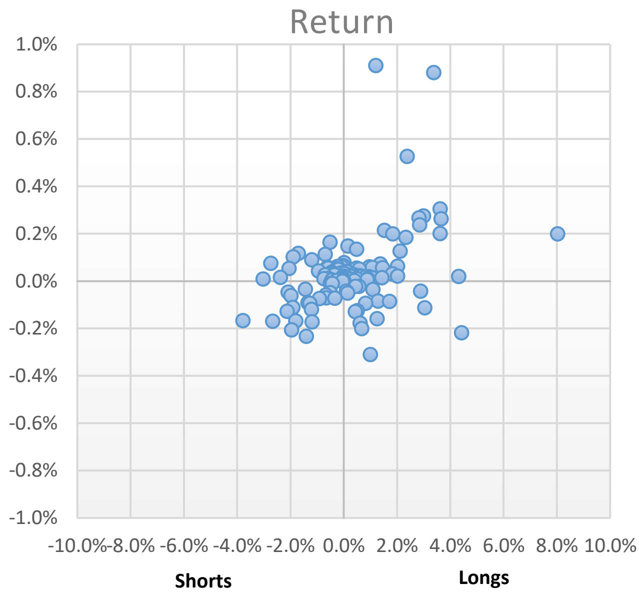
Country Allocation at 30 June 2020 (Gross Equity Exposure)



June 2020 Individual Stock Contribution



Fund Commentary

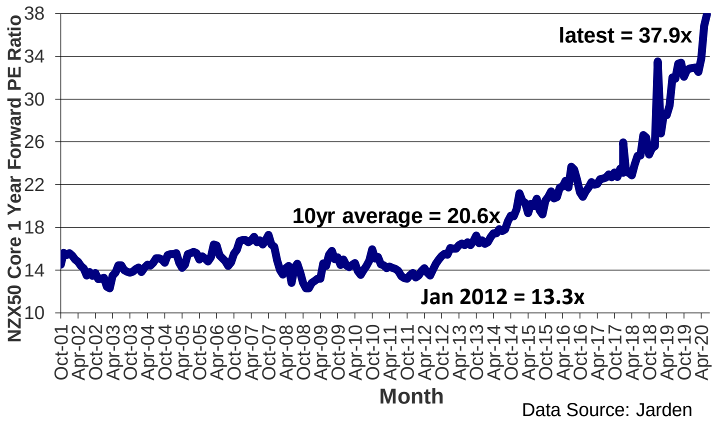
Dear Fellow Investor,

The Fund delivered another strong month in June with a return of +3.18%. Rather than merely riding positive markets, this return reflected a combination of several successful pieces of stock selection from the long side and real resilience on the negative days during what was a volatile albeit positive month. Our net length varied between the low 30% and low 40% region over the month. Our experience is that "market neutral" right now for the Fund is somewhere in the mid-high 30% area.

We continue to closely track our returns when the market declines given that the Fund aims to deliver positive returns irrespective of the market's direction. Pleasingly, the Fund again did well when the 50/50 index of NZ/Australia fell. There were nine negative days in the month, with an average index return on those days of -0.98%. We were up on five of those nine days and had an average return on them of +0.19%. This may not seem particularly valuable when markets only ever go up but we believe we are well placed to provide an alternative source of returns when normality resumes – it will one day.

The one year forward PE for the core NZ market continues to exhaust our vocabulary of superlatives. As shown below, it has now soared to 37.9x. Only a small element of Covid-19 earnings weakness is infecting these numbers given their forward-looking basis. Large cap multiples stand out within this, with Fisher & Paykel Healthcare's 56x forward PE being particularly noteworthy. The median PE is in the 19.0x region, suggesting a large relative valuation opportunity in smaller names. Unsurprisingly, the Fund is finding good opportunities from the long side in this segment.

S&P/NZX 50 - PE Valuation



The key argument for such high multiples is that bond yields have been repressed by central banks to incredibly low levels, with the NZ 10-year yield ending the month at 0.91%. This was actually a sell-off from 0.78% at end- May. The problem in valuing equities at such low levels is that the "convexity" impact on equity valuations of tiny changes in yield is extreme. "Fair" value can be anything you want it to be.

To illustrate this, a naïve non-linear model which simply regresses the forward PE on bond yields derives a "fair" PE of 40.8x at a 0.5% risk-free rate, a 33.4x PE at 1.0% and 25.9x at 2.0%. In other words, if the bond yield was to rise to a mere 2.0%, the fair value estimate for the NZ market has 32% downside.

In our view, investors are playing with fire when equity market valuations require the discount rate to stay at such unprecedently low levels for many years into the future. They are also playing with fire in the implicit assumption that the equity risk premium over risk free rates is unchanged when other measures of risk such as credit spreads have expanded.

What could cause bond yields to rise? One possibility is that inflation lifts as the flood of money from #2 The Terrace moves beyond being trapped in financial markets and eventually feeds through to the real economy. The market view is that the Covid crisis means that any resurgence in inflation is at least several years away. It is hard to disagree too vehemently but Covid has been a shock to both demand and supply. Deglobalisation will surely see a rise in future tradeable sector inflation in contrast to the deflationary force it has exerted for many years.

Another possibility for higher yields is that governments become weary of central banks boosting Wall St rather than Main St and resort to "helicopter money". If every taxpayer received say $1,000 of freshly created electronic funds in their bank account from the RBNZ, would the need for QE, yield curve control and a 0.25% overnight cash rate still be the same? One suspects that investors' longer-term inflation expectations would soar as well. Pre-Covid, we should have been put in a straitjacket if we thought that "helicopter money" was a realistic prospect but an embrace of policies championed by the crimplene suit and Skoda brigade cannot be ruled out in our brave new world.

A final possible driver of higher bond yields is perhaps the highest risk in the short term – namely a convincing treatment or a vaccine for Covid. Giddy headlines about lab rats not being killed in Stage 1 studies have been enough to move markets so far, so imagine the impact if/when something convincing comes out. The charge by investors into cyclicals and out of super-expensive low risk stocks and tech stocks will be a sight to behold.

We have long considered Jeremy Grantham as one of the sagest long-term thinkers on Wall St, albeit he comes at markets from a quaint old-fashioned valuation perspective. He called the bottom post-GFC and our eye was taken by widely reported comments that:

"My confidence is rising quite rapidly that this is, in fact, becoming the fourth, real McCoy, bubble of my investment career. The great bubbles can go on a long time and inflict a lot of pain but at least I think we know now that we're in one. And the chutzpah involved in having a bubble at a time of massive economic and financial uncertainty is substantial."

There can be little doubt that we are in a bubble, with there being an array interesting circumstantial evidence. Some of our favourites included:

1. As at 14 April, the US shale oil major, Chesapeake had 216,915 Robinhood shareholders. It filed for Chapter 11 on 28 June. Reminds one of Sharesies in NZ? There can be little doubt that a retail frenzy into a mixture of trash and glamour stocks is having a material market impact.

2. The airline sector has been latched onto in a remarkable way by retail investors, with US Global's JETS ETF rising from $30m of assets in March to over $1bn in June.

3. Hertz provides an interesting example where being bankrupt is no longer sufficient evidence of having no equity value. They filed for Chapter 11 on 22 May; Carl Icahn sold his 39% stake for 72cps on 26 May to realise a cool loss of $1.8bn. By 8 June, Robinhood punters had driven it up to $5.53 on enormous volume, whereupon Hertz's advisor tried to get away an IBO (initial bankruptcy offer) of new stock, with all the proceeds immediately going to bondholders, who would still only be partially repaid. Thankfully, the SEC stopped this.

4. My favourite example of a soaring glamour stock is the hydrogen-powered truck company, Nikola, which soared from $10 in March to a peak of $80 in June, giving it a valuation of $29bn at peak. The only slight issue is that while they have taken pre-orders, they do not actually have a product and there is no hydrogen fuelling network in the event that they ever do have a saleable truck. Nikola is an extreme example but this starry-eyed optimism is being priced across many real growth companies too.

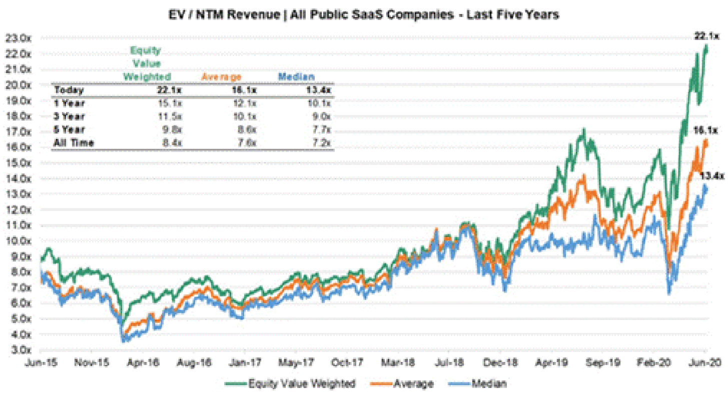
5. Robinhood's ten most popular stocks in June by account ownership were Ford, GE, American Airlines, Disney, Delta Airlines, Microsoft, Carnival, Go Pro, Apple and Aurora Cannabis. A classic combination of trash and commonly recognised names.

6. Many short-sellers were carried out on stretchers during the month, with Citigroup's crowded short index rising by +8.5% versus the S&P500's 1.8% return in June. However, it peaked intra-month at a frightening +52.7% due to a massive short squeeze on trash and over-priced glamour stocks. The retail bubble is beating the pros to a pulp in the short term, but being a bubble, it is reliant on ever more money coming in to keep it going. Mr Ponzi can provide the answer as to how this ends.

7. Market booms tend to generate frauds, with a mix of credulity and greed over-riding obvious warning signs. When a questionable stock rises sharply in price, a certain circularity develops, with investors moving money to those managers who own it and sacking those who don't. Wirecard was a classic of this genre which made the careers of several growth fund managers but collapsed into insolvency as it emerged that E1.9bn was missing from claimed bank balances. An earlier series of exposes in the Financial Times and from short sellers had been brushed off as misguided. While no names in NZ and Australia

obviously fit the Wirecard bill, we do see the odd warning flag in terms of accounting aggression.

8. Finally, here, the chart below was sourced from Wilsons and looks at the remarkable expansion in enterprise value to revenue multiples for SaaS companies in the US over the last 5 years. It has happened in Australia/NZ too. We would suggest some of this expansion is fair given a decline in discount rates but a portion is also due to rampant speculation. The outperformance by the largest names is also interesting and points to the role of passive and the dominance of the FAANG stocks in the US and the WAAX stocks in Australia.



Source: Wall Street Research, company filings and S&P Capital IQ. Market data as of 29-Jun-2020.

The combination of extreme valuations and high-risk market behaviour can leave little doubt regarding Jeremy Grantham's view that we are in a real McCoy bubble. It is a different matter entirely though as to where we are in the bubble. In past versions, examples such as selling out of Japan in the late 1980's and shorting tech stocks in early 1999 proved a very painful and career ending experience for many investment professionals.

Where we are in the progress of this bubble remains to be determined but we can point to a number of potential catalysts for it to end:

1. The current economic recovery reflects pent-up demand rather than a robust outlook, with a "L" rather than "V" recovery crushing earnings forecasts. An extended period of Covid infections would heighten the risk of this scenario and it would see a continuation of the current paradigm of low-risk and high-growth stocks outperforming.
2. A vaccine for Covid would see bond yields rise sharply in expectation of central banks turning off the printing presses. This would see cyclicals dramatically outperform low-risk and high-growth names.
3. The mass market retail bubble will eventually run out of new patsies to keep it going.
4. Upcoming elections may see a dramatic shift in policy settings in NZ and/or the US.

Looking at this latter point, the NZ general election will be held on 19 September. Polls can change but the path for a centre-right government looks rather narrow, requiring both NZ First and the Greens to fall just short of the 5% threshold and a portion of the Labour vote to move to National.

A more likely outcome is that Labour's support weakens a little further from its current 50% levels but holds up somewhere in the mid-40% region. The Greens do seem to have a hard support base of just over 5%, meaning a Labour/Greens coalition without any need for NZ First has to be a realistic scenario. There are few policies to analyse at this point but the risk of a higher income tax rate for the top bracket (lowering the value of imputation credits) and a capital gains tax of some form would have to be high.

Finally, and again with the caveat that polls can easily change, the US election in November could see a clean sweep for the Democrats in both the Presidency and the Senate. Betting markets now point to this. Elements of the US share market have taken notice, with Goldman Sachs pointing out that the post-election November VIX futures are trading at their March sell-off highs and that a planned lift in corporate tax rates would lower S&P500 earnings by 12%.

The current market boom seems disconnected from the November VIX futures. Biden policy proposals include: lifting the corporate tax rate from 21% to 28%; lift the top personal tax rate to 39.6%; lift capital gains taxes for those earnings >$1m; link domestic drug prices to international prices; support a carbon tax; support a financial transactions tax; lift the minimum wage to $15; and enact a massive infrastructure plan. Phew! If the US market is ever to shake off the flood of cheap money pressing it ever higher and focus on these future policy settings, then the bull market might meet its maker.

Returning to the performance of the Fund during June, the return of +3.32% (pre-tax and fees) was dominated by a very strong "winners to losers" ratio of 69%. This was again driven in part by having more longs than shorts and markets going up. Importantly, our longs contributed a pleasing +4.04%, while our shorts were only a drag of -0.72%. There was a strong skew to our key winners being much larger than our worst losers.

Our largest contributor was what began the month as a modest holding in Pacific Edge Biotechnology (PEB, +129%). We have been a small holder of PEB for some time and built it up in the last couple of equity raisings. For some years, we have been strong believers that PEB's molecular diagnostic test for bladder cancer is far more accurate and less intrusive than current market standards. It has strong published research evidence, strong support from key US urological opinion leaders and has been successfully adopted in the small NZ market. However, waiting for its long-promised adoption by Kaiser Permanente and for a Local Coverage Decision by CMS (allowing PEB to be paid for it in the US) was like waiting for Godot. Well, unlike the play, Godot finally arrived. During June, Kaiser approved commercial use of one of the four iterations of PEB's tests and as this piece is being written, PEB's share price has doubled again upon the receipt of a positive Local Coverage Decision. PEB has no broker coverage for the moment but we can model some very interesting valuation scenarios.

Close behind PEB in terms of positive contribution was our large long in Turners (TRA, +29.5%) which delivered a March 2020 year result that was in line with pre-Covid guidance despite the end of March being hindered. More importantly, after business dwindling to near nothing during the Level 4 lockdown, they began to experience a recovery during the latter part of the June quarter, with the month of June being ahead of June 2019. The used car market has not experienced the huge post-lockdown bounce of some other segments but Turners is clearly gaining market share. Importantly, we had viewed their finance book as being a risk but their bad and doubtful debt experience has not been problematic. Consensus forecasts have Turners on a forward PE of 9.5x and our long-term thesis of them becoming by far the largest player in the huge and fragmented used car market remains very much intact.

Other tailwinds were headed by our large long in Shaver Shop (SSG, +21.2%), which delivered an exceptional result mid-month and is still only on a cash PE of circa 9x with no debt; our large long in Qantm Intellectual Property (QIP, +8.3%); our large long in the fund management business owner Pacific Current (PAC, +7.5%); and continued recoveries in two of the high yielding property names that burnt us in the March meltdown, GDI Property (GDI, +6.3%) and Elanor Commercial Property (ECF, +6.5%).

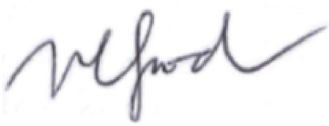
There were no negatives of great note but our modest long in Integea Group (ITG, -28%) fell sharply upon its removal from the FTSE/Russell Small Cap and ASX300 indices. In context however, ITG had risen by 46% in April and 19% in May and we purchased aggressively at the lows off the forced passive sellers. ITG is half of the former Cardno group and is a multinational engineering and testing consultancy which is heavily exposed to the attractive environmental and infrastructure segments. We are a little wary of Covid impacts in the short term but some allowance for this is incorporated in consensus forecast PE ratios of 8x going to 6x.

The second moderate headwind came from our short in Cromwell Property (CMW, +12.5%) which is a partial offset to some of our large longs in the sector. We see CMW as being over-geared on a look-through basis and we are cautious regarding the outlook for some of their property assets such as Polish retail. The corporate machinations involving ARA Group's attempts to lift their ownership could be a risk but alternatively their stake could also turn into an overhang.

Other headwinds came from our long in 360 Capital Digital (TDI -6.9%) which we lightened somewhat while retaining a relatively large position; a slightly premature long in Whitehaven Coal (WHC , -21%) whose share price has been crushed on weaker coal prices but where we see a bottom beginning to form as high cost capacity is being shut; and a short in Domino's Pizza (DMP, +10.2%) where optimism around Covid sales is reflected in the 42x forecast PE, while higher costs and the need for franchisee support have perhaps been overlooked.

Thank you for your ongoing support of the Fund. The gush of money pouring out of central banks globally is continuing to support remarkable performance by long-only equities but valuation multiples are extreme and various potential future risks are lurking. We particularly identify any inflation re-emergence lifting bond yields; Covid either disappearing or proliferating; unusually large policy risk from upcoming elections; and a veritable bubble in mass-market retail investing which has been concentrated in trash names and glamour stocks. This will surely run its course as a bubble needs ever more money from new patsies to refresh itself.

The Fund will continue to follow the same strategy and aims to grind out positive returns irrespective of market direction. We were hit hard by the Covid shock in March but are recovering strongly. Importantly, we are doing so in a manner that is not correlated with the rise in long-only equities – we are not 70% net long and posing as a long-short manager. We continue to carry sizeable protection from the short-side and this can be seen by our generally positive returns on down days. We believe we are well-placed in the event of another market reckoning.



Matthew Goodson, CFA