Salt Long Short Fund Fact Sheet – December 2019

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 December 2019

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$116 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 December 2019

Application	1.5972
Redemption	1.5908

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 December 2019

Long positions	64
Short positions	34

Exposures at 31 December 2019

Long exposure	89.49%
Short exposure	-51.93%
Gross equity exposure	141.42%
Net equity exposure	37.56%

Largest Longs	Largest Shorts
Tower	Ryman Healthcare
Kiwi Property Group	National Storage REIT
Contact Energy	Fortescue Metals
Marsden Maritime Holdings	Fisher & Paykel Healthcare
QANTM Intellectual Property	Carsales.Com

Performance[1] at 31 December 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%	1.74%	-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%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	5.02%	1.48%	2.93%
6 months	10.83%	3.06%	6.23%
1-year p.a.	10.02%	6.39%	26.27%
2-years p.a.	1.96%	6.57%	11.67%
3 years p.a.	3.27%	6.63%	13.38%
5 years p.a.	6.90%	7.04%	11.69%
Since inception p.a.	8.81%	7.18%	11.66%

[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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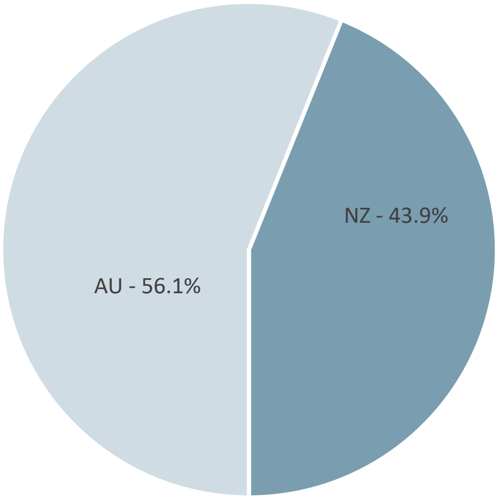
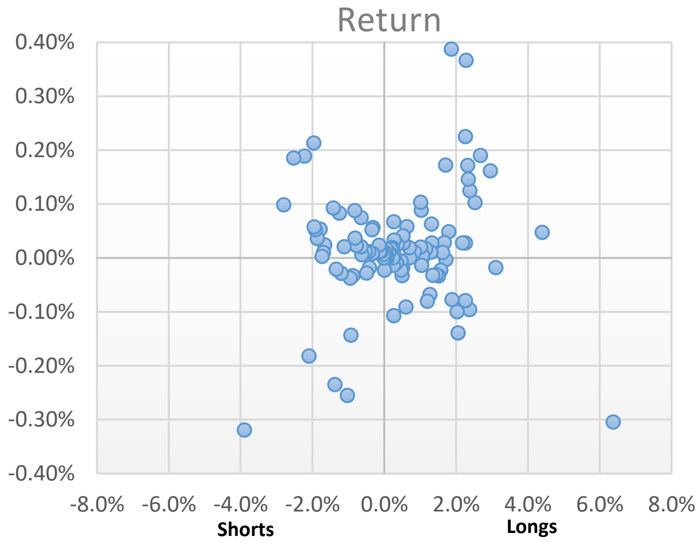
Country Allocation at 31 December 2019 (Gross Equity Exposure)



December 2019 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

The Fund delivered a strong performance in December, with a return of +1.70% after all fees and expenses. We had gone sideways for much of the month but experienced a very strong final three days in contrast to the sharp sell-off in the NZ and Australian markets. Since inception, the Fund has now returned +59.0% after all fees and expenses, with this representing an all-time unit price high.

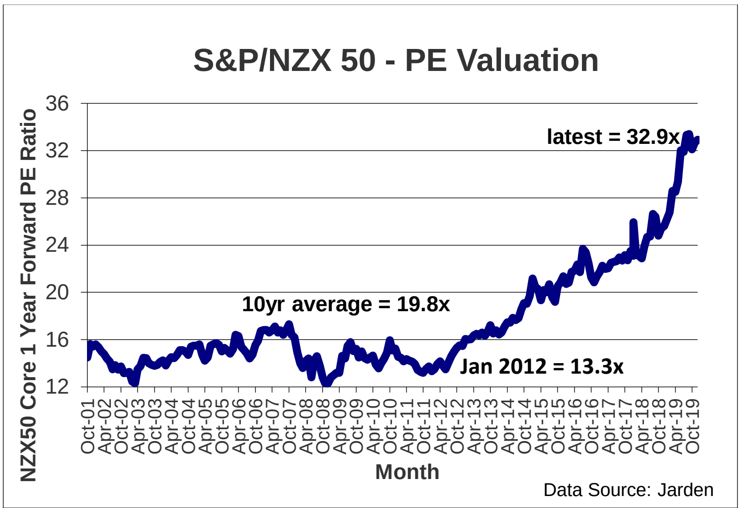
The sources of performance in the month were pleasing. The longs added a strong 1.53% (pre fees and tax) compared to the highly divergent moves of +1.55% by the unending NZ bull market and the -2.17% stumble by Australia. At the same time, our shorts were also positive, contributing +0.29% as a group. This reflects a mix of stock selection, sector positioning and relative exposure to NZ and Australia. We are net longer in NZ than Australia but it is far lower risk.

As a reminder, this Fund is very much in the alternatives asset class and seeks to deliver a positive return irrespective of whether the NZX/ASX indices go up, down or sideways. The aim is an equity-like return but with far less volatility and no correlation to equities. Hence our benchmark is the OCR +5%. To make sure that we are being true to label and not simply being long and riding a bull market, we carefully measure our performance on down days.

In recent months, we have consistently delivered positive returns on those rare days when the 50/50 NZX/ASX 50/50 is down and that was the case again in December. There were eight days where the 50/50 equity index fell and it had an average performance of -0.52% on those days. We outperformed on all eight (as one would hope), we were actually up on seven of the eight days and our average return was a very strong +0.35% on those days. This was despite running net length in the +35-40% region and shows how our shorts are far higher beta (risker) than our longs.

NZ valuations are more stretched than ever. The chart below is our regular update of the “core” PE (ex property, investment companies and Air NZ) using Jarden forecasts. Superficially, the slight lift from 32.7x to 32.9x was nothing to get excited about but NZ 10-year bond yields sold off sharply.

from 1.28% to 1.65% in the month. This saw our estimated “fair” PE fall from 30.4x to 27.8x – a big move given the convexity at very low bond yields. In theory, this yield move should have hammered the growth darlings and the large defensives that dominate our market. It didn’t and we have now reached a point of record over-valuation, with a 16% retreat required to return to fair value. The divergence between the average PE of 32.9x and the median of 19.8x remains as large as ever.



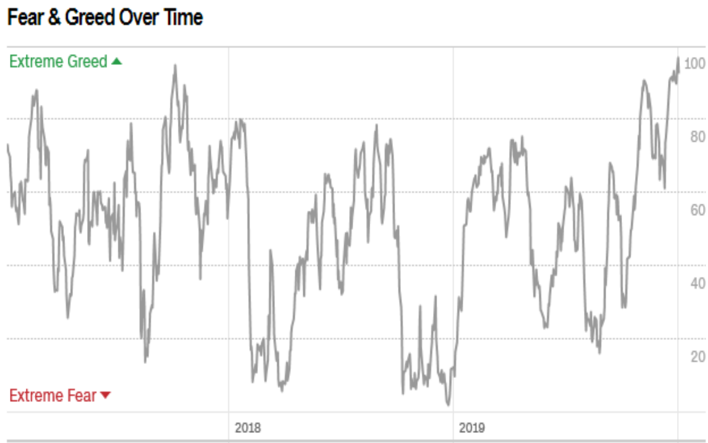
A couple of examples illustrate the extreme froth driving some of our larger cap names. Over the course of 2019, the Port of Tauranga share price rose by +59% but our 2020 forecasts rose by +2.5% for revenue, +3.6% for EBITDA and actually fell -0.9% for EPS. Similarly, the Fisher & Paykel Healthcare share price rose by +71% against a backdrop of revenue forecasts declining -0.8%, EBITDA rising +2.3% and EPS +9.5%, largely due to tax credits.

Similarly, JP Morgan research in Australia highlighted some bizarre divergences between share prices and fundamentals. Healthcare was the best sector with a 43% performance but this was composed of earnings upgrades of just +4% and PE multiple expansion of +10.1 points. Information Technology was the second-best sector at +35% performance but this was thanks to a PE multiple expansion of a staggering +15.3 PE points. It was the second worst sector for earnings revisions, which actually contracted by -13%. Why would such a darling sector bother with mere trifles such as earnings? A final quirk is that Growth outperformed Value by 19% in Australia despite Value having lesser earnings downgrades. This is so 1999 all over again.

A fascinating aspect of the month was a lift in volatility, with NZ and especially Australia having several violent daily rallies and sell-offs of greater than 1.5% for reasons that were not obvious. Our sense from being at the coalface was that these moves were driven by ETF flows and that the market tended to close near its highs or lows on those days. This brings us to a key thesis we have been expounding for some time and what we see as a key risk in 2020 – an ever greater proportion of equities is being held by passive or quant strategies that appear to be price-momentum driven. This makes the passive investor look like a rock-star on the way up as they buy ever more of what gets larger and higher in price. However, this rubber-band will reach its limit when there is some left-field event (e.g., Iran assassination) which suddenly flips the flows. Equities are structurally far more vulnerable than they have been to a violent sell-off when something goes wrong.

The volatility "down under" was against a risk-on backdrop globally which saw the S&P500 rally by +2.9%. This was kicked along by the US and China reaching a so-called phase 1 trade deal. However, we would put this very much in the Claytons category as the average US tariff on Chinese goods will only fall from 21.1% to 19.3%, having started the process at 3.1%.

These minor changes are hardly a cause for an equity market boom and we would instead point the finger at good old "animal spirits". We have settled on the CNN Fear and Greed Index as being an excellent measure of investor sentiment, driven by seven different internal market indicators. As shown below, it is now at an ultra-high 93 having almost touched 100. Past peaks have tended to precede subsequent market selloffs although it hasn't been infallible as a signal. Conversely, sentiment lows have been an excellent buy signal and we will pay attention the next time it slips to 20. With markets at record levels of over-valuation and earnings forecasts doing nothing, it seems a rather risky time to be an ultra-bull.



Cross checking the current reading of Extreme Greed, another long-followed indicator has been the Rydex Ratio, which measures assets in the bear fund ETF's provided by Rydex versus those in their bull funds. This ratio is at its second lowest in two decades and is actually weaker than prior to the Nasdaq crash and prior to the GFC. It was only exceeded in early 2018 prior to the sharp (albeit brief) subsequent sell-off. Investors are all-in.

Moving on from the current state of affairs, we have used this newsletter in each of the last five years to set out some of the key swing factors and concerns exercising our mind for the year ahead. Prior to setting them out, how did we get on in 2019?

1. "*Auckland house prices will fall by 5% and wider NZ will flatten out*." Half-correct. That is exactly what played out in Auckland although the rest of NZ continued to rise sharply albeit at a lesser rate and Auckland bottomed late in the year. We tended to run a more balanced retirement village position in 2019, with longs offsetting our large Ryman short.

2. *"Australian house prices fall by a further 5-10% but the declines abate by year's end."* Correct and we made good money in the likes of Peet & Co and Mirvac.

3. *"Oil prices will test $60 and likely move to a $50-60 range for much of the year."* Correct and we have become more bullish late in 2019 as shale's cashflow struggles are becoming more apparent and rising geopolitical risks are crystallising.

4. *"10-year bond yields end the year higher than the current levels of 2.55% in the US, 2.45% in Australia and 2.3% in NZ."* Wrong. We expected that rising labour costs would feed through to price inflation but this was relatively muted and central banks shocked with their willingness to ease aggressively when inflation is essentially at the mid-point of their targets.

5. *"China's economy continues to slow and this will hit the iron ore stocks hard."* Wrong albeit unlucky. We were

roughly correct on China but the CVRD tailings dam disaster led to a supply-led spike in iron ore prices even though demand growth was absent. 2020 will see supply return and Chinese demand growth slow with their economy.

6. *"A disorderly no-deal Brexit will not occur."* Correct although there remains a reasonable possibility of an orderly no deal Brexit. The implications for the Fund were minor.

7. *"Equity style divergence will be far less marked in 2019, making it a stock-pickers' market".* Half-correct. Value made a come-back overseas in the second half but barely made a murmur in NZ or Australia. Size was the factor that became ever stronger over 2019.

8. *"2019 will see a dearth of IPO's but significant M&A activity."* Correct although M&A activity was perhaps not quite as strong as we expected.

So overall, our scorecard was a respectable 5.5/8. What do we see for 2020?

1. *"Central banks will move further away from negative rates but monetary policy will stay very loose."* Emerging evidence on the perverse impacts of negative rates (mainly via the bank channel) will see them consigned to the dustbin of history. However, for so long as central banks remain wedded to their 2% inflation targets (rather than say 1-1.5%), monetary policy will remain very loose even as it pushes on a piece of string.

2. *"NZ equities will post a flat capital return in 2020 at best."* NZ last had a negative year way back in 2011. The +30.4% market advance in 2019 was all about multiple expansion on the back of falling bond yields. The NZ year-ahead core PE rose from 25.6x to 32.9x, while bond yields fell from 2.38% to 1.65%. Year-ahead earnings forecasts were largely unchanged as spot downgrades offset the roll-forward in time. Other markets were similar. Forward indicators point to little hope that 2020 will be the year of earnings upgrades, leaving one to ponder whether the valuation rubber band can expand any further – we say no.

3. *"There will be a sharp 10%+ correction in the NZ and Australian markets at some point in 2020, with passive being a key driver."* Pick a shock, any shock and ponder what will happen when the machine says sell. We've had brief dry runs in Feb18 and Oct-Dec18 but passive funds and fellow travelling quant funds are a larger proportion of the market now. In current market conditions, we are observing numerous 3%+ individual price movements in the NZ closing match but the greater concern is what happens when there is forced selling from a shock. We certainly won't be there on the buyside and I suspect few will.

4. *"2020 will see a dearth of IPO's but significant M&A activity."* This makes a repeat appearance. The valuation dispersion between large and small cap stocks, a vast amount of money sitting in private equity, very low corporate bond spreads and lax debt covenants all point to M&A being strong. The Fund did well out of this factor in 2019 from the likes of QMS Media and Metlifecare and the natural style of our longs leaves us well-placed again. Conversely, IPO's will remain difficult, especially in NZ, where the NZX is more focused on its own passive funds business. Unless you are large enough to get in the index or have a very strong growth outlook, it is unclear where the support for new IPO's will come from.

5. *"Iron ore companies will fall."* This makes a repeat appearance, with one of our largest shorts being the high beta play in the area, Fortescue Metals. Brazil is coming back on stream, Australian supply will lift somewhat on a full year basis, Chinese scrap usage will continue its inexorable rise, concern about future growth from West Africa will appear and the Chinese economic outlook appears tepid at best as they seek to trade off continued economic expansion with rising financial risks.

6. *"The gold price will continue to rise."* This is partly a call on the USD having peaked in the face of huge fiscal deficits and a high-risk election year. We also observe that a number of central banks globally have turned into net buyers, that gold lease rates are well above most interest rates of the same duration and that the lagged impact of a previous major downturn in exploration and development expenditure will see tepid supply. We are not gold bugs but are well in the money already from some modest longs.

7. *"The US junk bond market will sell off sharply at some stage and pressure equities."* We have written at length in recent months how junk bond spreads are at record lows even as the percentage of low covenant loans is at record highs and debt/EBITDA ratios are at records. In addition, a wall of securities are on the lowest BBB- investment grade rating and passive funds will be forced sellers upon any downgrades. In the past, junk bond spreads have been a strong leading indicator for equities given they sit one rung up the capital stack. A weak US economy would be the trigger for this to play out.

8. *"Information Technology and Healthcare stocks will underperform in NZ and Australia in 2020."* This may be a quarter early but there is a consensus lovefest in these

names which suggests we are getting close to every last marginal buyer being in and shorts are generally at low levels. As argued earlier however, their massive outperformance in 2019 defied earnings forecast changes that were only moderately positive in the case of Healthcare and downright lousy in case of IT.

9. *"The revenue model will meet a messy end."* This may be a year too early and I'm not quite sure how to measure the success or otherwise of this call but it is closely linked to the projection that IT companies will finally perform in line with their earnings changes – i.e., poorly. A majority of current institutional investors weren't around for the Nasdaq crash but the parallels are alarming. We are now seeing primary and secondary deals pitched on Price/Sales and Price/Gross Profit multiples and sell-side research is using ever more contorted compco multiples rather than fundamental valuations to avoid a sell call. WeWork may be the canary in the coal mine for those companies without a clear path to positive free cashflows.

10. *"Election uncertainty will rear its head in NZ in the third quarter."* This call puts all personal political biases to one side. A return of the status quo would be market-neutral but the market would react very negatively if the polls started favouring a Labour/Greens Coalition. This is quite possible. The flirtation of NZ First with the magic 5% support line will therefore become a key point of interest for the market. Conversely, there is also a possibility that polls show a National/ACT coalition being feasible.

11. *"WTI oil will break through its massive $65 resistance level in 2020."* This call is less bold than it was 5 days ago but we held the view then too. The downside is protected by the travails of US shale oil which is struggling from declining marginal well productivity and very low gas prices from huge oversupply. Less friendly debt markets will also weigh. We are attracted to the diversification and optionality of further major events in the Middle East which would see markets sold off hard but oil stocks rally. The key risk to this call is weak demand.

Returning to the performance of the Fund during the month of December, the return of +1.83% pre fees and tax had relatively balanced positive and negative outliers. What really drove the good performance was a record "winners to losers" ratio of +71%. By number, 50/73 longs were winners, while a very high 33/44 shorts also worked.

The largest headwind was a holdover from November in the form of Ryman (RYM, +8.2%). As discussed then, their H1 result was actually quite weak. A notable uptick in inventory leaves them facing a tough task to sell the major development deliveries that they have planned for the second half. However, this mattered little in the face of a perception that NZ and Melbourne housing is turning up and a takeover bid for Metlifecare which put a rocket under the entire sector. Never mind that the MET bid was at book value, whereas Ryman trades at 3.4x book value. Better hope their developments keep getting delivered and sold. Our scepticism regarding book values in the sector is long-standing given that they bear little relationship to the free cashflows generated in the individual village accounts.

The second worst performer was our very large long in Tower (TWR, -4.6%). The main news was that the highly regarded CEO, Richard Harding will return to Australia in a year's time. While we would have preferred him to stay, the hard work in resetting the business is now largely done in our view. A small positive was RBNZ approval and closure of the Youi NZ acquisition pre-year end, avoiding any undue delays to its earnings contribution. This remains a high conviction long. We are suckers for a stock on an underlying PE of 11x with strong double-digit earnings growth for years to come.

There were few other notable headwinds but the largest were moderately sized shorts in the ultra-expensive Napier Ports (NPH, +23.1%) and Restaurant Brands (RBD, +17.2%), which both rose vertically in very thin market conditions. NPH is likely to enter the S&P/NZX50 Index when Metlifecare exits but this could be at least several months away and it peaked at almost double our base case DCF valuation.

While Ryman was an annoying detractor, the Fund did very well out of the NZ retirement village sector thanks to the large longs we had built up in Oceania Healthcare (OCA, +22.2%) and Metlifecare (MET, +17.0%). We had bought these when they were somewhat friendless in the June to September period, with MET trading in a range of $4.30-$4.50 compared to the somewhat fortunate takeover bid that came in at $7.00 during the month. The two lessons from this were that you make your luck by playing in the right places and that these names were very weak when the Auckland housing market had only slowed down slightly, with the rest of the country still being strong. Woe betide the sector when there is a sustained housing pullback and the premium multiples attached to the rapid developers, Ryman and Summerset, come under scrutiny. That is not our near-term expectation and we are not positioned for that, but that day will surely come.

A left-field winner for the Fund was our long in Millennium & Copthorne Hotels (MCK, +10.2%), where we helped clear a line that had been overhanging the stock for some months. We are wary of the limited liquidity but the $2.80 share price compares to an NTA of $5.10 (ex a deferred tax liability that would only crystallise on hotel sales). This NTA is ungeared. The outlook for the hotel component of the business is only moderate thanks to new supply in some cities but the residential land development business is set to bounce back strongly in H2. We are mindful that the Malaysian parent took over their UK subsidiary last year and it is unclear what purpose is being served by having MCK.NZ sitting on the NZ bourse in an unloved and unfollowed state.

There were a large number of other mid-sized winners, with these led by the short in Technology One (TNE, -9.8%) which retraced some of the surge that had hurt us last month. Other standouts were longs in Turners (TRA, +7.3%), Eureka Group (EGH, +10.1%) and Kina Securities (KSL, +6.4%). Shorts were led by Orica (ORI, -7.6%) and Bunnings Warehouse Property Trust (BWP, -5.9%).

Thank you for your ongoing support of the Fund. After a decidedly rocky beginning to 2019, the last three quarters of the year were very strong indeed, with the Fund delivering in its aim of providing equity-like returns but with far less volatility than equities and no correlation to them. We believe this absence of correlation will prove very important in 2020 as markets begin the year at historical levels of bullish sentiment and overpricing. We aim to provide a true uncorrelated alternative regardless of what the year ahead brings.

Matthew Goodson, CFA