Salt Long Short Fund Fact Sheet – February 2022

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 28 February 2022

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$58.7 million
Inception Date	31 October 2014
Portfolio Manager	Matthew Goodson, CFA

Unit Price at 28 February 2022

Application	2.1146
Redemption	2.1061

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 28 February 2022

Long positions	43
Short positions	26

Exposures at 28 February 2022

Long exposure	86.28%
Short exposure	34.41%
Gross equity exposure	120.68%
Net equity exposure	53.55%

Largest Longs	Largest Shorts
Tower	Arena REIT
Dalrymple Bay Infrastructure	Johns Lyng Group
Lynch Group Holdings	Sims Group
Pepper Money Ltd	Fortescue Metals Group
Shaver Shop Group Ltd	Mercury NZ

Performance[1] at 28 February 2022

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%	0.56%	0.93%	1.52%	-0.39%	2.62%	20.29%
2022	1.76%	2.15%											3.95%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	6.67%	1.43%	-6.78%
6 months	8.87%	2.75%	-4.68%
1 year p.a.	21.21%	5.40%	-0.27%
3 years p.a.	14.21%	5.65%	10.01%
5 years p.a.	7.66%	6.09%	9.93%
7 years p.a.	8.81%	6.50%	8.95%
Since inception p.a.	10.20%	6.67%	10.00%

[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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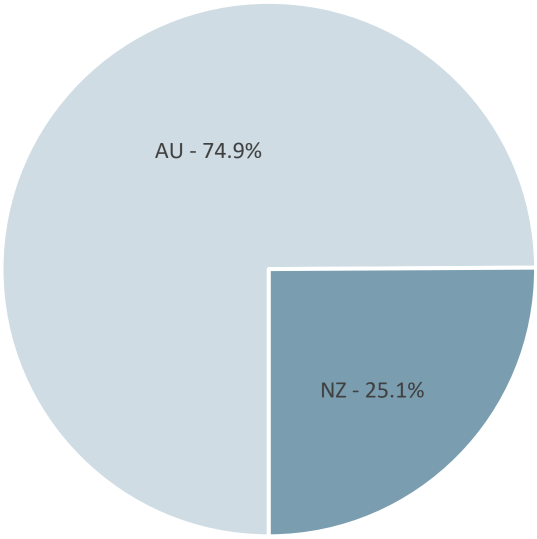
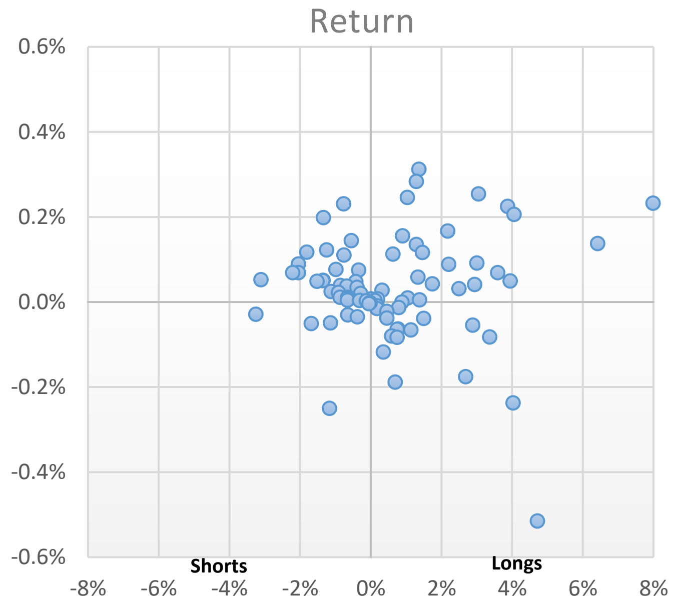
Country Allocation at 28 February 2022 (Gross Equity Exposure)



February 2022 Individual Stock Contribution



Fund Commentary

Dear Fellow Investor,

Amidst further market turmoil and volatility in the month of February, we are delighted to report that the Fund continued to perform strongly, delivering a return after all fees and taxes of +2.15%. This compared to the NZ market advancing by +0.7% and Australia by +2.1%. Markets were extremely volatile amidst the tumult of Russia invading Ukraine, reporting season and ever more evidence that central banks have fallen far behind the curve in meeting their inflation mandates, with NZ being amongst the leading culprits.

The last couple of months epitomise why this Fund exists – it aims to deliver equity-like returns over the long run, with less volatility than equities and with no correlation to them. This combination means it is a true alternative within a balanced portfolio.

Over the 2 months to end-February, the Fund rose by +3.95%, whereas NZ equities fell by -8.10% and Australia declined -4.34%. The daily correlation of Fund returns to those of the 50/50 NZ/Australia index was just +0.11 and over the long term sits at +0.08. Statistically, this is 0 – there is no correlation.

The annualised daily standard deviation of the Fund in the two months was 5.99% versus 11.30% for NZ and a huge 20.82% for Australia – our friends in the West Island tend to be somewhat flighty in their changing daily attitude towards equities. Our Fund is far less volatile.

Put all this together and the Fund has delivered equity-like returns, with no correlation and far less volatility. Make no mistake that there have been plenty of times when we have lagged long-only equities for a period but that is beside the point; we are trying to grind out positive returns irrespective of what equities are doing. Sometimes we have struggled for a few months (typically when high multiple stocks outperform) but it has worked well over time.

Rising equity market volatility has moved hand in glove with a sharp decline in liquidity everywhere, with the NZ situation shown below. Less liquidity at a given price naturally means that greater price movements are needed to execute a given buy or sell trade. As any asset allocator would tell you, greater price volatility means greater risk which means lower risk-adjusted returns.

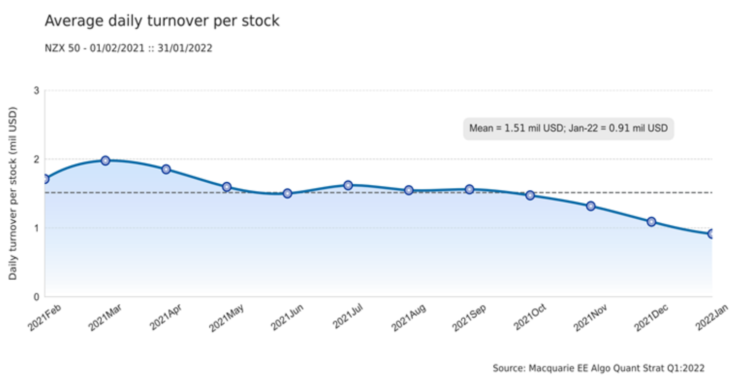


Figure 1. Average daily turnover per stock of NZX 50 between 2021-02-01 and 2022-01-31

One of the most interesting aspects of being a fund manager is the occasional need to become a sudden expert on a field that one only had rudimentary prior knowledge of. Over the last few years, we have grappled with the science of whether the Fukushima fall-out zone would reach Tokyo; whether the UK would vote for Brexit; whether enough "deplorables" would vote for Trump; the science and political response to Covid and its evolving variants; and now we have suddenly become experts on Eastern European geopolitics and Russian military capability.

So, within the confines of this cautionary take on our range of experience and expertise, what might the Russian invasion of Ukraine mean for financial markets and this Fund?

As an overall comment, wars tend to be stagflationary via driving up the price of soft and hard commodities. Ukraine is a massive grain producer and their ports are being shut off to the outside world. This will drive up dairy and chicken prices in particular. Oil and gas prices have obviously spiked, but as an offset, the US appears very close to concluding a deal with Iran. We aren't chasing oil stocks. We may see a glut of apples in Europe with Russia being cut off from massive Polish production, with this impacting NZ. Ukraine is a significant producer of some elements of semiconductors, such as neon gas, with this possibly exacerbating current shortages. I am sure there are many other industries that will also be pressured. Defence spending plans are rapidly being lifted in Europe, with these causing more demand-push inflation.

Contrary to these stagflationary pressures, one of the initial effects of the war has been to raise market hopes that Western central banks might pull back on their plans to tighten monetary policy. For example, 12-month forward Fed funds futures were 1.342% on 1 Feb, 1.828% on 14 Feb but are back down to 1.576% on 1 March and still falling.

This "bad news is good news" reaction only makes sense if one believes that the channels of financial contagion could be quite extreme as Russian banks get cut off from the Western financial system. The potential for sanctioned banks (or their western subsidiaries) to fail is clear. Fortunately for NZ and Australia, there are few obvious links into our financial markets but in a global context, we suspect this financial contagion channel will be a key aspect for equity investors to focus on. The duration of the war is another critical uncertainty.

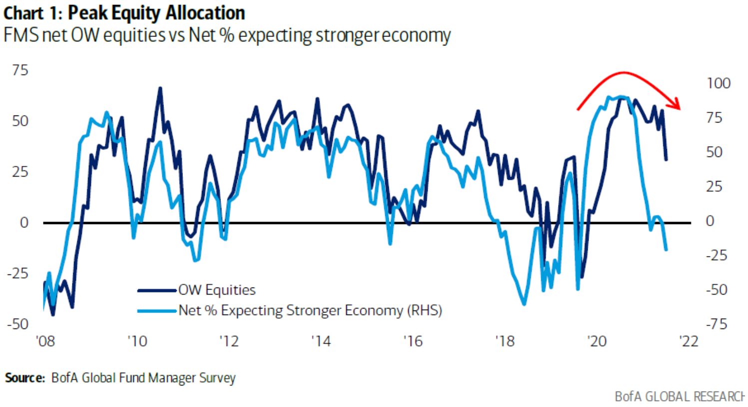
Aside from the Ukraine invasion, the other key factor exercising our minds is growing evidence of inflationary pressures in many Western countries. For example, the US core PCE deflator (the Fed's favourite inflation gauge) rose by +5.2% in January versus the 5.0% forecast and the 4.9% prior. US average hourly wages rose by +5.7%, showing that a classic wage-price spiral may now be upon us. The most hawkish of the Fed Governors is now calling for a 100bp rate hike and the immediate beginning of QT (remember that QE only finishes this month).

The NZ outlook is even more concerning. The end-February ANZ Business Outlook Survey was in their words, "the worst of both worlds". Firms' own activity outlook made a rare foray into negative territory at -2.2 (+11.8 prior); the more nebulous business confidence measure was a nasty -51.8 (-23.2 prior); firms' profit expectations slumped to -32.7 (was -13.1); and selling price intentions soared to +74.1 (was +63.6).

The RBNZ talked a tough game in their February Monetary Policy Statement but opted for a mere 0.25% lift in the OCR to 1.0%. Their earlier dovishness combined with global factors outside their control has left NZ monetary policy between a rock and a hard place. They have little choice but to tighten considerably further even if that pushes the country into the "recession we have to have" – to recall Australia's great Paul Keating.

In our outlook for 2022, we argued that we would see "flation", we were just unsure whether that would be inflation or stagflation. Evidence is currently accumulating towards the latter. We have argued for some time that equities are a decent inflation hedge and that one should own cyclicals, where the nominal earnings upside offsets higher discount rates. We are increasingly pondering if this trade has played out, especially in the NZ market although it may potentially still work well for domestic and global cyclicals in Australia.

We have been gradually repositioning the Fund in line with this evolving view. Our largest longs are generally a group of defensives, insurers, infrastructure and special situations rather than the pure cyclicals that did so well last year. Flattening yield curves bolster the case for growing caution towards cyclicals and our eye was particularly taken by the chart over leaf from BofA global strategy. Positioning is such that there is plenty of potential for an unwind.



Aside from gradually changing our own positioning, we have also used favourable price movements amidst the recent volatility to dramatically lower the leverage in the Fund. While our net length only declined slightly from 53.5% to 53% in the month, our gross position fell from 130% to an unusually low 121% and compares to recent levels in the 150-160% region. We have ample firepower to aggressively take advantage of opportunities in the period ahead.

Fund Performance in February

Returning to the Fund's performance in the month of February, the overall return of circa 2.5% pre fees and tax was comprised of +1.2% from the long book and +1.3% from the short book. In a moderately positive but volatile month for long-only equities, this was an extremely pleasing outcome.

Our overall winners to losers ratio was a very high 72%, with 30 of our 48 longs going up and 32 out of 38 shorts declining – we wish could copy/paste these percentages every month. Rather than any standouts, there were a large number of useful positive contributors and only one large negative.

Despite our seemingly extended net length of 53%, we continued to do well on negative days. There were 6 down-days in the month for the 50/50 index of Australia and NZ, with the average loss for the market being -1.15% on those days. Whilst a small sample, the Fund was up on 3 of those 6 days and delivered an average return on them of +0.03%.

The largest headwind by some distance was our large long in the multinational flower grower and distributor, Lynch Group (LGL, -9.8%). We must confess to being bemused by the performance of the stock price which is quite at odds with the performance of the business, which has done relatively well in the face of Covid headwinds.

LGL's overall result was largely as forecast despite their Australian business being some distance behind expectations. The Omicron outbreak saw a trifecta of temporary woe. Labour shortages saw a big lift in overtime and testing costs, demand was affected as customers stayed at home in quasi lockdown and freight rates rose yet further after previous sharp increases. Despite all this, the business was still solidly profitable and their commentary was that by end-February, revenue was back above prior year and labour costs had normalised. Freight rates will remain a problem for at least a few more months yet.

Contrastingly, LGL's China business is doing very well. Despite local lockdowns, demand is blooming with the market only being constrained by supply, especially in the non-summer period. LGL's hothouses can supply all year round and they are now talking to a pre-tax ROIC of greater than 25% on investment in them. So, we have a business on a Covid-impacted PE of 11x, a dividend yield of 4.5%, and large investment opportunities at very high returns in both China and in Australia as their supermarket partners take share off florists. This feels just like the old Scales holding that we used to have in this Fund, which was on a cheap multiple and had high returning investment options. It tripled from its lows. LGL does have a private equity ownership overhang but these things do tend to get resolved.

Other headwinds were of less significance. We were hurt by a poorly timed short in Sims Group (SGM, +28.2%) partly through its rise over the month. They reported a strong result but US scrap prices were starting to fall post period-end in contrast to the share price increase. We were struck by how every analyst seems willing to extrapolate quite an extreme price cycle ad infinitum in their numbers. Then Russia invaded Ukraine…

Longs that hurt were led by the position we have built up in the non-bank lender Pepper Money (PPM, -6.4%), which earns a 25% ROE and is on a PE of just 5.4x. The market seems to be saying that their earnings are not sustainable because mortgage margins are under pressure but this considers only one leg of the stool. PPM made up for weaker housing margins with strong asset finance growth, rising rates mean less refinance activity and weaker margins also mean lower finance cost margins for them. PPM delivered a very strong result due to these factors and the market bounced a little but still seems dubious. As rates rise in Australia and the major bank funding for lending scheme is fully subscribed, margin pressures should abate in any case.

We did not have any single stand-out tail-wind but instead had a plethora of positions that made 0.20%-0.30% contributions to our returns. These were led by our mid-sized holding in Bellevue Gold (BGL, +22.7%) which rallied sharply along with much of the sector. We exited much of the position by month-end on concern that our positive view towards gold has played out to a good degree and that rising real interest rates may soon be a headwind.

Our long in Meridian Energy (MEL, +14.6%) contributed well and has been a position we have consistently bought on weakness and vended into strength over the last few months. Our multi-year position in the PNG bank, Kina Securities (KSL, +7.2%) delivered a solid result at month-end and remains extraordinarily cheap being on a PE of 6x and cash dividend yield of 13% (on which NZ investors pay tax on an assumed return of only 5%)Yes, it has PNG country risk but it is awash with capital to fund growth, is well managed and the outlook for the PNG economy is very strong thanks to commodity price strength.

Other long winners included Genworth Mortgage (GMA, +23.5%) which saw a corporate investor enter the register; Tower Limited (TWR, +2.9%); Australian Vintage (AVG, +5.6%) and Monash IVF (MVF, +3.5%). From the short side, a well-timed position near its peak in Flight Centre (FLT, +6.2%) worked well and Reece (REH, -10.9%) also declined as a solid result was not enough to justify its 34x forward PE for a plumbing retailer that may be near top of cycle.

Thank you for your continued support of the Fund. We have had a very pleasing start to 2022, with strong positive returns at a time when markets have been volatile and weak. The remainder of this year looks difficult. Inflation is continuing to rise, and while it may be close to a peak, it looks likely to settle above central bank target ranges. This will ensure a background of tighter monetary conditions in contrast to the extreme laxity of recent years.

Many investors have drawn the lesson over the last few years of “buy the dip”. Maybe it will work again but we are wary that the monetary backdrop is changing. Investors are now running into the wind for the first time in many years. Add Ukraine and the risks of financial contagion from Russia sanctions on top of this and we see a strong role for a non-correlated fund such as this. We will continue to focus on trying to grind out our benchmark target of OCR+5% - we suspect this may be a good return in 2022.

Matthew Goodson, CFA