SALT

Salt Long Short Fund Fact Sheet – May 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 31 May 2020

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$82 million
Inception Date	31 July 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 May 2020

Application	1.3865
Redemption	1.3809

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 May 2020

Long positions	56
Short positions	37

Exposures at 31 May 2020

Long exposure	90.50%
Short exposure	54.20%
Gross equity exposure	144.70%
Net equity exposure	36.30%

Largest Longs	Largest Shorts
Tower	Ryman Healthcare
360 Capital Digital Infrastructure Fund	TechnologyOne
Marsden Maritime Holdings	Breville Group
GDI Property Group	Goodman Property Trust
Elanor Commercial Property Fund	Restaurant Brands NZ

Performance[1] at 31 May 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%								-13.19%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	-9.14%	1.31%	-6.60%
6 months	-11.72%	2.79%	-7.47%
1-year p.a.	-3.39%	5.90%	2.29%
2-years p.a.	-5.39%	6.32%	6.49%
3 years p.a.	-2.25%	6.47%	8.67%
5 years p.a.	2.90%	6.80%	8.57%
Since inception p.a.	5.61%	7.06%	9.41%

[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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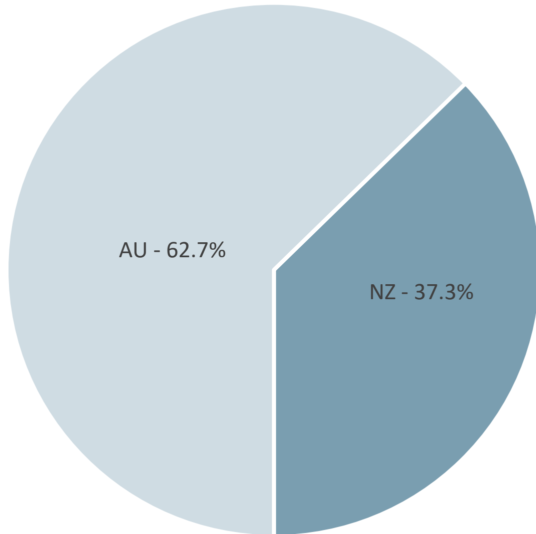
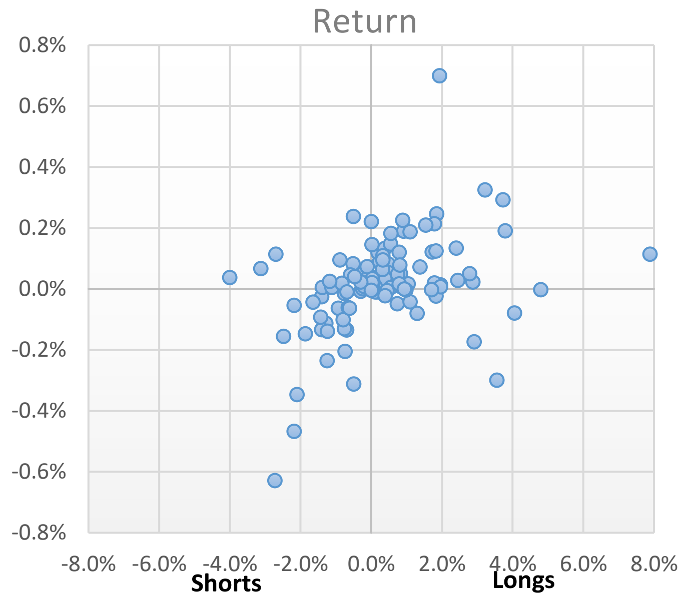
Country Allocation at 31 May 2020 (Gross Equity Exposure)



May 2020 Individual Stock Contribution



Fund Commentary

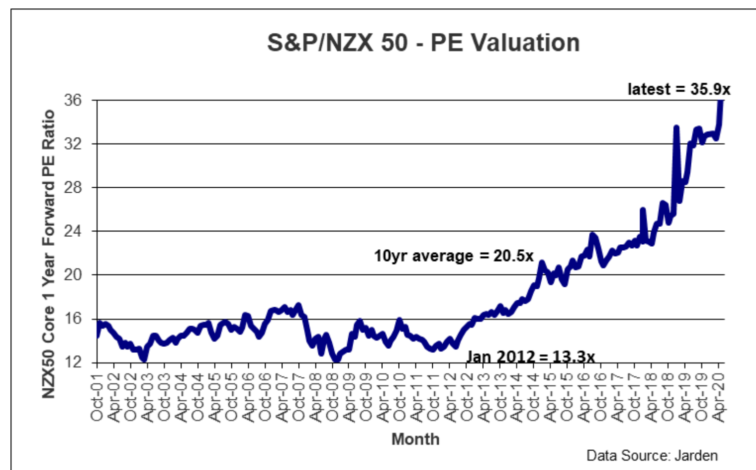
Dear Fellow Investor,

The Fund experienced another solid month in May with a return of +1.80%. This performance came despite sizeable levels of hedging via our high beta, highly priced short book and several of our key longs being relatively moribund. We are sceptical of the sharp market rally in recent weeks given it appears to be dependent on an enormous infusion of monetary and fiscal stimulus which will need to taper at some point. We have gradually moved net length down from around 40% to the mid-30% region, finishing the month at 36.3%. As always, we will continue to manage this as bottom-up opportunities present themselves.

The Fund again performed very well when the 50/50 index of NZ/Australia had negative days. There were just six negative days in the month, with an average return on those days of -0.89%. Contrastingly, we were up on five of those six days and had an average return on them of +0.39%. May 1 was particularly noteworthy, with Australia being -4.95%, NZ falling -0.79%, yet the Fund being up +0.37%. Given these sorts of numbers, we think we are very well placed for when extraordinarily priced equity markets descend back to earth.

Equity markets surged again during May on a mix of FOMO (fear of missing out) and TINA (there is no alternative). Valuation seems such a quaint old-fashioned concept but we will stick to our knitting as the long run evidence in its favour is clear.

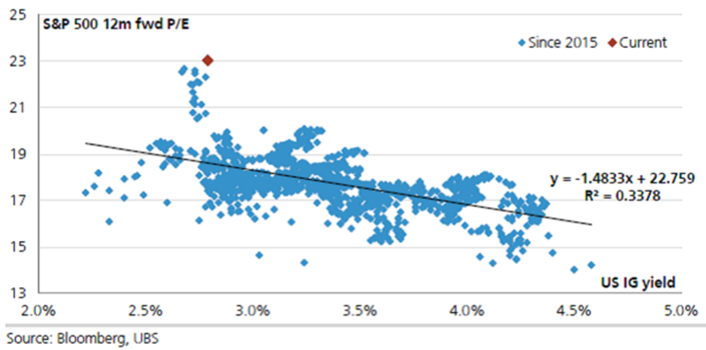
We have again included our long-running chart of the one year forward PE for the core NZ market (ex-property, Infratil, Air NZ) as the worst effects of Covid are beginning to pass into the rear-view mirror on this forward-looking basis. The PE of 35.9x speaks for itself. Maybe the market is looking three years out but even then, we estimate the PE to be 32.0x. In reality, there is just an enormous pool of liquidity looking for a home at any price.



The obvious counter to equities being expensive is that central banks have pushed bond yields to sub 1.0%, leaving little alternative. After all, a PE of 35.9x still gives an earnings yield of 2.8% with some future growth, compared to the NZ 10 year bond yield of 0.8%. The problem with this is that risk-free bond yields are low for a reason and that equity risk premia and credit spreads have deservedly blown out given the extreme uncertainty re companies' balance sheets and earnings outlooks. This was illustrated starkly in the US context by UBS in the chart below, which shows how equities

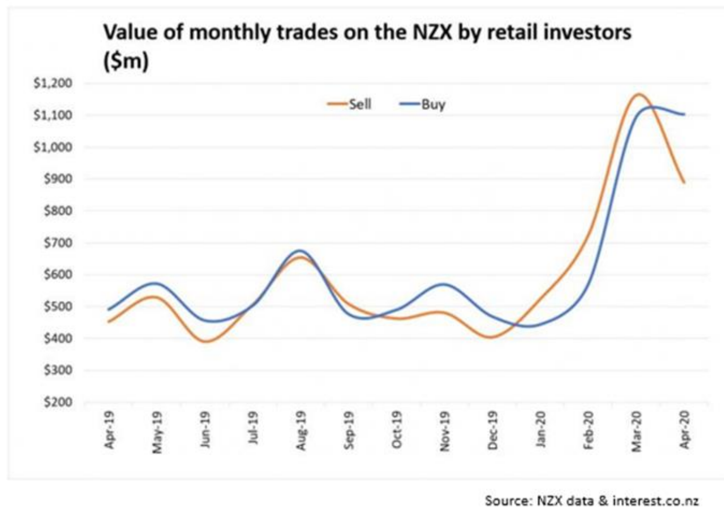
have departed far from their normal relationship with investment grade bond yields.

Figure 1: Easy liquidity has already lifted valuations, and by more than historical relationships imply



Who is aggressively buying equities at these sorts of prices? Buybacks have shrunk to a shadow of their former ebullient selves, with corporates having flipped to be huge net sellers of stock as they recapitalise balance sheets.

One answer would seem to be retail investors, who have embraced share investing on a massive scale over the lock-down period, to the point where it has almost been gamified. Mid-month, we examined the activity by Sharesies and ASB Securities and found they have been respective net buyers of $123m and $157m during 2020 and that all of this had come from March onwards. The chart below from interest.co.nz would seem to confirm this point.

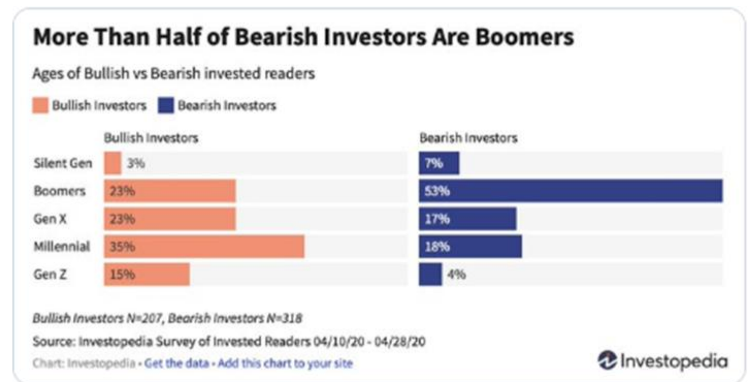


Source: NZX data & interest.co.nz

The data in Australia and the US is similar. The Sydney Morning Herald published a disturbing ASIC report early in the month finding that daily Australian retail broker activity lifted from A$1.6bn to A$3.3bn in late February to early May; that the number of new accounts registered per day has leaped by 3.4x; that on over two-thirds of the days that retail investors were net buyers, share prices declined the next day; that on over half the days that retail investors were net sellers, share prices rose the next day; and that the average holding period was under one day.

The New York Fed survey of consumer expectations carried out mid-month unsurprisingly showed sharp declines in expected earnings, expenditure, job security, house prices et al. However, the mean expectation that share prices would be higher in a year's time rose from 47.7% to 51.8% which is the highest on record. There are numerous other similar indicators pointing to euphoric conditions. During the month, Citi's Panic/Euphoria model moved firmly into the euphoria territory and is at a level pointing to a near 80% chance that the S&P500 declines over the next year.

There is a perception that many of the investors on Sharesies, Robinhood et al are Millennials who have never seen an extended crash and view the Covid sell-off as a major opportunity. This is confirmed by a survey we came across in the US from Investopedia below, which highlights a fascinating age distribution between those who are bearish and bullish in this market. It certainly feels like we are short-selling companies on extraordinary multiples or which have real solvency challenges to Millennials and Gen Z investors who just cannot get enough of them and keep bidding them up in our face.....for now.



Well known US investor, Cliff Asness of AQR published an interesting paper early in May titled, "Is Systematic Value Investing Dead?" What he found was that value stocks are extremely cheap in relative terms but this is due to a massive premium that is being paid for the most loved stocks. It is not due to greater than normal differentials in profitability, investment returns, or leverage between value stocks and other names.

Asness is not wrong about the travails of "value". According to Goldman Sachs, so far in 2020, "growth" has returned +12%, while "value" is -22% and it has underperformed in both the Covid sell-off and in the rebound. These factor performances have been similar globally and also reflect how the advance in most global markets has been extremely narrow, most famously in the US with the "FAANG" stocks totally dominating performance, just as a2 Milk and Fisher & Paykel Healthcare have ruled the roost in NZ. This has turned somewhat since month-end.

The key reason for the surge in equities despite an awful economic backdrop has been an unprecedented easing in both fiscal and monetary conditions. Central banks are forcing investors way up the risk curve if they are to have any hope of a return better than a derisory 2% term deposit rate. This has combined with a perception

that the equity market has been crushed to generate unprecedented retail interest. I have fielded queries from friends ranging from doctors, pharmacists, artists and actors who know little to nothing about equities and who are considering investing for the first time. They perceive the market to have been hit hard (instead of being only 6% off its pre-Covid highs) and the reality of earning next-to-nothing in the bank is hitting home. This is a dangerous period.

There can be no mistake that central banks are aggressively printing money. While the process of quantitative easing (QE) technically steps around this by buying bonds in the secondary market rather than direct primary issuance, the net impact is the same except for a Wall St clip along the way. Moreover, unless there is any realistic intent by the central bank to one day re-sell the bonds that have been purchased, money has effectively been created out of thin air and interest rates have been crushed to sub-1% along the curve.

Classic monetarist theory would have it that this QE/money printing finds its way into some combination of higher prices and economic activity unless the velocity of the circulation of that money has collapsed. It has. So where has the money gone? Into asset markets. This may change when the economy recovers in a "V" "U" or "W" (my pick). When this happens, central banks will likely take their foot off the printing press a little and the velocity of circulation in the wider economy will pick up. Perversely, this could be when hyper-extended financial markets start to come under pressure.

What equity markets seem to be experiencing is a "Cantillon Effect". When the French engaged in an ultimately disastrous bout of money printing in the 1700's, Richard Cantillon observed that the resultant increase in prices doesn't happen evenly when money is pumped into the economy. Those who were "close to the money" such as the aristocracy benefitted disproportionately from rising asset prices but everyone else suffered a reduced standard of living in real terms due to rising prices. This ultimately didn't end well. While current events in the US pale in comparison, the point is that printing money has distributional consequences and that there is a political limit to how far Wall St can be rescued while leaving Main St in the lurch.

Is there anything to stop the RBNZ and others from continuing to print money for an extended period of time? Examples such as 1700's France, 1920's Germany, Zimbabwe et al would suggest there is. The eventual constraint will be any emergence of inflation. In a small open economy such as NZ, the NZD will fall which will drive inflation higher in a feedback loop unless the central bank rapidly reverses course. This constraint of higher inflation will almost certainly not occur in the near future given the disinflationary pressures of Covid but it will surely occur at some point in the future. As eminent macroeconomist Ken Rogoff put it on Bloomberg during the month:

"So, the probability is, for the foreseeable future, we'll have deflation. But at the end of this, I think we're going to have experienced an extremely negative productivity shock with deglobalization. In terms of growth and productivity, they will be lasting negative shocks, and demand may come back. And then you have the many forces that have led to very low inflation maybe going into reverse, either because of deglobalization or because workers will strengthen their rights. The market sees essentially zero chance of ever having inflation again. And I think that's very wrong."

Turning next to the enormous fiscal stimulus, there are numerous anecdotes about how some people's disposable incomes have actually benefitted in the short term from aggressively front-end loaded wage subsidy schemes, mortgage holidays and a narrowing of the opportunity to spend. Banks are reporting a pay-down in credit card debt and recent updates from Turners suggest that car debt repayments have been surprisingly solid thus far.

In Australia, this fiscal impetus has been heightened by people being allowed early access to a portion of their superannuation. ABC News reported data from Accenture that 40% of those accessing super early hadn't actually experienced a reduction in income; 64% of the super was spent on discretionary items such as clothing, furniture, automotive and alcohol; 11% was gambled; and a mere 14% was used to repay personal debts. This doesn't feel entirely sustainable….

To summarise our current market views, valuations are hyper-extended, driven by extreme levels of fiscal and particularly monetary easing. One manifestation of this around the world has been a surge in retail investors. Markets have been led higher by a small number of highly crowded winners, generally trading at extreme valuations. "Lottery ticket" stocks with questionable balance sheets have also benefitted. Over time, we expect a transition from FOMO to TINA. The reality of difficult economic conditions may see those seeking speculative capital gains run into difficulty, while a chase for low-beta yield names such as the gentailers, Spark, property stocks et al may start to dominate. That is how we are positioned.

The money printing machine may continue for some time yet. The Fed is tapering its QE quite sharply but the RBNZ is showing no signs of tiring of its new-found toy. Ultimately, it will take an economic rebound and a re-emergence of inflation for the current uncomfortable market paradigm that is utterly dependent on central banks to change. Hold onto your hat when it does and that is why we still expect this Fund to provide a very valuable alternative.

Returning to the performance of the Fund during May, the return of +1.94% (pre-tax and fees) was dominated by an extremely strong "winners to losers" ratio of 69%. As in April, this was driven in part by having more longs than shorts and markets going up. Our longs contributed +4.64% (outperforming the NZ and Australian markets), while our shorts were a drag of -2.70%.

Our largest positive by some distance was our long-standing holding in Shaver Shop (SSG, +36.8%) where we kept the faith through the dark days of March. After an excellent result in February, they plunged from a high of $0.85 to a fleeting low of $0.225 in March.

Unlike many retailers they had earlier invested heavily in their online capability and they never had insolvency risk given their net cash position. Despite significant store closures, they delivered a staggeringly good update during the month. In the 18 weeks to 10 May, total sales growth on the same period last year was +17.6%, with online sales growth of 171%! Adjusting for the non-cash amortization of store repurchases from franchisees, they are still on a PE of less than 9x with strong growth to come.

Our second largest winner was a holding we have built up on bouts of weakness in what we view as an undiscovered gem in Vitalharvest Trust (VTH, +10.1%). VTH is Costa Group's landlord for many of its citrus orchards and berry farms. It earns a mix of fixed and variable rentals, with the latter having been hit hard this year due to the drought. This has now ended. There is a major market review uplift in five years that will deliver a dividend yield in the teens for a NZ investor, while the currently depressed gross yield of almost 7% is perfectly acceptable, especially given the uncorrelated nature of VTH's returns. It has ground up from a brief low of $0.63 to $0.76, and in this yield-deprived world, we see no reason for it not to return to its former level in the mid $0.90 region.

Other notable positives came from a short in Sky City (SKC, -8.3%) which we covered off entirely pre month end; a large long in Elanor Commercial Property (ECF, +7.1%) which still offers a gross yield of circa 10.5% with growth; and a long-held position in the high quality trustee business, EQT Holdings (EQT, +14.2%) which we bought aggressively at the lows and have been leaking into strength.

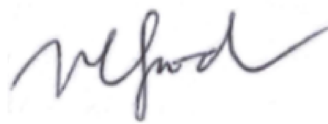
The largest headwind came from the sizeable short we built up into strength in Breville Group (BRG, +27.3%). This maker of kitchen appliances and coffee machines has been operating well relative to competitors such as De Longhi but it does operate in competitive segments. Demand boomed during lockdowns but we expect much of this has been a pull-forward in demand which may leave a hole thereafter. It trades on a scarcely believable forward PE of over 30x and we view it as vulnerable to a sharp pullback as the thematic trade ebbs.

The second stand-out negative was our short in Fortescue Metal (FMG, +16.2%) where we have been too early in projecting the end of the counter-intuitive iron ore price boom. Brazil's Covid woes have delayed a major increase in production from that country, but even on relatively conservative projections from commodity analysts, the market looks set to move from a slight deficit to a chunky surplus in the second half of this year. In our view, FMG has a lot of momentum tourists currently owning it and we retain confidence that we will recoup our losses and then some.

A third laggard was our short in Goodman Group (GMG, +16.9%), which we put on a little early as a hedge to our sizeable property longs. The market reacted very positively to their update to the end of the March quarter and also seems focused on the logistics thematic, which is undoubtedly positive. However, we expect considerable pressure to come on their development pipeline (for example, we have seen speculative builds delayed in NZ), some geographic segments such as Hong Kong will face difficulty and the valuation multiple is very extended when adjusted for management remuneration paid in shares and the low multiple nature of development profits and performance fees. They have ridden a bull market for the last few years which has seemingly led investors to expect the latter two items to be repeatable and have a 26x PE multiple placed on them. Good luck with that when the cycle ends.

Thank you for your ongoing support of the Fund. Long-only markets are extraordinarily expensive and being driven by central bank largesse rather than valuation fundamentals. The boom in low volume retail investors harks back to the 1980's and will surely not end well. Our emphasis on valuation has been deeply unfashionable for the last couple of years but we remind investors that we went many quarters without a negative outcome when this style factor dominated. It will have its day in the sun again.

In the meantime, just as after past drawdowns, we have continued to rebuild from the damage endured in March. We are not perma-bears but view many current share price levels as utterly unsustainable, while there are always cheap opportunities from the long side if one looks hard enough. We are carrying significant levels of protection and our strong performance on down days suggests we are well placed in the event that markets retrace sharply from what we see as unsustainable highs.



Matthew Goodson, CFA

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