SALT

Funds Management

Salt Long Short Fund Fact Sheet – May 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 31 May 2018

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$272.9 million
Inception Date	30 June 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 May 2018

Application	1.5490
Redemption	1.5427

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 2018

Long positions	87
Short positions	48

Exposures at 31 May 2018

Long exposure	78.09%
Short exposure	-50.40%
Gross equity exposure	128.49%
Net equity exposure	27.70%

Largest Longs	Largest Shorts
Centuria Metropolitan REIT	Goodman Group
Ingenia Communities	Ryman Healthcare
Turners Automotive	ALE Property Group
Bingo Industries	ARB Corporation
Tower	Lendlease Group

This Fund is actively managed. Holdings are subject to change daily.

Performance[1] at 31 May 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%								0.82%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	0.10%	1.66%	2.26%
6 months	4.48%	3.31%	4.31%
1-year p.a.	4.36%	6.75%	13.16%
2-years p.a.	5.03%	6.83%	10.71%
3 years p.a.	8.83%	7.12%	9.98%
Since inception p.a.	11.70%	7.44%	10.92%

[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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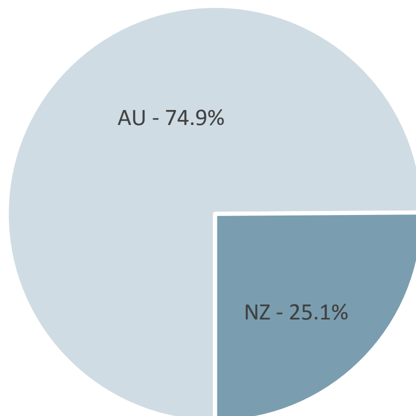
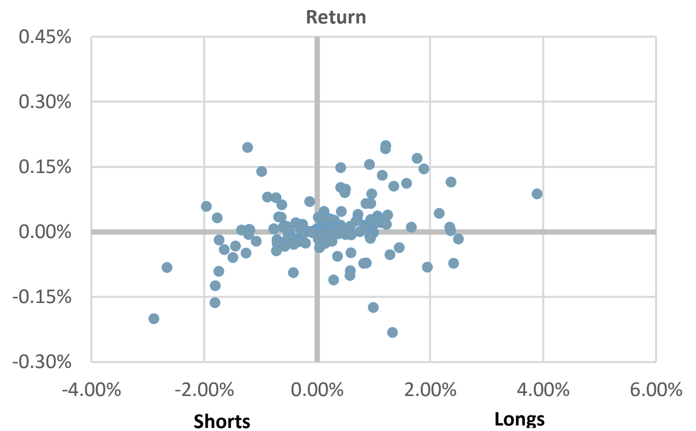
Country Allocation at 31 May 2018 (Gross Equity Exposure)



May 2018 Individual Stock Contribution



Fund Commentary

The Fund began May very strongly, being well ahead at the mid-point but progressively gave this up over the balance of the month, culminating in several nasty random movements on the last day tipping us into slight negative territory. The Fund returned -0.21% after all fees and expenses. This compares to the S&P/NZX 50 Gross Index advancing +2.55% despite earnings downgrades across key names such as a2 Milk (ATM) and Fisher & Paykel Healthcare (FPH). The Australian S&P/ASX 200 Accumulation Index rose by 1.03%.

Since inception on 30 June 2014, the Fund has now returned +54.3% after all fees and expenses. Thirty-four of those forty-seven months have had positive returns and we are yet to have a negative quarter although a very strong June month will clearly be required to maintain this record. Our correlation to extremely expensive equity markets remains statistically zero. This will really matter when these markets turn.

The one year forward PE for the NZ market (using FNZC data) reached a new record high of 23.9x at end-May. This rose from a “mere” 22.9x at end-April as the index advanced in defiance of falling earnings forecasts from the likes of FPH and ATM. When the great NZ bull market started back in January 2012, the forward PE was only 13.3x and we have fond albeit increasingly distant memories of being bullish. Since then, the NZ index has delivered a 165% return (from 3274 to 8678) while earnings have only risen by 51%. Dividends and most importantly major multiple expansion have accounted for the balance. Lower bond yields explain some of the PE multiple expansion but right now the NZ market is more expensive than it has ever been relative to bond yields. Whichever way you cut it, this market is extremely expensive.

According to UBS research, a full two-thirds of their NZ coverage universe has experienced consensus earnings downgrades for FY18 over the last year, yet FY19 forecasts have barely been downgraded despite gathering economic clouds. We track the monthly ANZ Business Outlook survey as a timely update on the NZ economy and the May release was not good. Firms’ own activity outlook fell from +17.8 to +13.6 which is far below the +30 to +60 range of the last few years and points to sub-2% GDP growth.

Firms’ profit expectations slumped to -8.5 from -0.9. We need to go back to mid- 2009 to find previous negative readings. This measure has a reasonable linkage with NZX listed company earnings and it had been running at +20% to +30% through most of the last two years. Bottom-line, there is clear downgrade risk to the earnings forecasts upon which the market is placing a nose-bleed 23.9x PE multiple.

In our rather lonely view, the bulls have run far too hard and they have done so on an increasingly narrow group of “darling” companies. Valuation appears to be of little consequence relative to the “story” and the perceived long-term opportunity. According to Citigroup research, the MSCI Australia Growth Index is on a 20.5x PE versus the Value Index on 11.9x, with the size of this divergence last being seen in early 2000 and late 2007. We are a touch wary of this measure given the high proportion of financials in the Value Index, but the general point still holds. Citi also shows that the proportion of stocks with a PE over 25x now exceeds 2007 and is approaching the Nasdaq bubble era. These stocks are concentrated in the healthcare, IT and food (i.e. China demand) segments and medium-term EPS forecasts

for these companies have risen despite their current earnings outcomes being rather mixed.

Unsurprisingly, the Fund has found a number of short opportunities in these segments with there being many names with PE multiples of 30x to 40x or higher despite having earnings outlooks that are not unambiguously strong. Examples such as IDP Education (IEL, +26%), Wisetech Global (WTC, +46%), REA Group (REA, +6%) and Costa Group (CGC, +6%) are names which have been rather painful for us over the last several weeks despite cautious sizing and implementation on our part. In our view, these sorts of companies require flawless execution or they will see sharp sell-offs such as the 31% plunge that the Fund enjoyed from the short side in WTC back in February. Flows are trumping fundamentals for now but the extreme volatility back in February is a warning of how quickly things can change and that's how we're positioning the Fund.

Another key thematic in the Fund's positioning has been playing China-leveraged iron ore and coal from the short side, while being cautiously long a basket of oil names. We have been relatively light-footed to use volatility to our advantage and this has generally worked well. We see sizeable potential upside from names such as FAR (+3%), Sundance (SEA, +11%), Senex (SXY, -2.4%) and Central Petroleum (CTP, +21%). We have been generally short Fortescue (FMG, +2.9%) given its high position on the grade-adjusted iron ore cost curve and South 32 (S32, +0%) which has seen alumina and manganese prices retreat.

While US investor positioning appears to have pulled back from its extreme levels in January, we would argue that this has not been the case in NZ and Australia, with market valuations at extremes and investors aggressively crowding into a small number of perceived growth names which are doing all the heavy lifting in the index performance.

Signs of easy money excess continue to abound. We are currently seeing record levels of US share buybacks with the closest parallel being early-mid 2008; Carlyle Group co-founder David Rubenstein commented that with money flowing into private equity firms, "it's easier to raise money than any time I've been in the business in the past 30 years or so"; and according to the Financial Times, global M&A year-to-date hit a new record of $2.0tn late in May, with the previous peaks being in 2007 and 2000. History never exactly repeats but it sure is rhyming.

The sudden strength in the US$ created significant issues for emerging markets in the month. Currencies were pummelled and just eleven months after issuing a $2.75bn 8% US$100-year bond, Argentina turned to the IMF for a US$30bn loan. This bond is now down 20% from its issue price - it seemed like such a good idea at the time. Clearly the lessons of the 1997 Asian crisis have been forgotten and foreign currency debt has been rising again in these countries.

Rising US rates and a stronger US$ are also a key reason for caution in China. By definition, a fixed currency regime requires China to import US monetary policy and either tighten or accept currency outflows. This was particularly illustrated in Hong Kong with the HKMA having to spend billions during the month defending their $7.85 peg with the USD – at some point they will have to lift rates, which could have very interesting implications for their overheated property market.

Signs of impending US inflation pressures (and thence higher future rates) continued to build during May, with even the most dovish of the Fed Governors, Lael Brainard suggesting that policy may need to tighten beyond neutral levels. Unemployment hit 3.9% at month-end, wage inflation rose to 2.7% and the New York Fed underlying inflation gauge rose to +3.20%. This uses a wide range of financial data and had been running at +1.5% to +2.5% in recent times after having bottomed at -1.0% post GFC. Cost-push inflation from recent moves in oil and tariff impositions may add to this picture. Even in Europe, German inflation has picked up to +2.2% and France to +2.0%.

These inflation levels are hardly panic stations but from an investment point of view, they do suggest that current unusually low levels of bond yields will continue their recent stuttering trend to the upside. Who wants a German bund paying 0.45% when inflation is running at 2.2% - the answer would seem to be only the ECB. Rising yields should remove support for yield sensitive equity segments such as utilities, property companies and long-dated growth stocks. This did not work out in May but given the gradual accumulation of fundamental evidence, the Fund is net short equities which will suffer from this trend.

Aside from US inflation leading to higher bond yields, another factor to consider is any return of the European issues that weighed on markets prior to 2012 and Draghi's "whatever it takes" monetary policy. Italy provided a brief case of déjà vu with markets being hammered for all of one night when the Italian President would not approve the appointment of a Euro-sceptic Finance Minister from the two populist parties that wished to form a coalition to govern. For now, the political posts have been shuffled and

fears of an early election have dissipated. However, the problems remain.

The Italian economy is the third largest in Europe and has never really recovered from the GFC and the populist proposals encompass a dramatic unfunded loosening of fiscal policy and at their extreme have seen some calls for exiting the Euro. Italy's problem is that the Euro is largely driven by the leviathan that is Germany and is therefore far too strong for them. Prior to the adoption of the Euro, the Lira depreciated every year without fail against the Deutsche Mark, but this is now not an option. Italy is left with deflation and unemployment as their adjustment mechanisms. However, an exit could see even worse outcomes because it would lead to capital flight as depositors and investors fear being redenominated into Lira. This is why Italian bonds sold off sharply and they will sell off again if investors credibly fear either an exit from the Euro or some sort of dual currency system to fund easy fiscal policy.

Returning to the performance of the Fund during May, our return of -0.21% actually encompassed a "winners to losers" ratio of 57%, which would normally be sufficient for a very good month. However, there was an unfortunate skew where each of our five largest losers was bigger than our largest winner.

The biggest hit came from a moderate long in Ainsworth (AGI, -39%) which delivered a nasty earnings warning just several months after reiterating guidance at their half-year release. We had been attracted to this gaming machine manufacturer from several angles. Firstly, there is a potential M&A angle via the part ownership of AGI by the large Austrian company, Novomatic post their purchase of the stake of the AGI founder, Len Ainsworth. Secondly, there are strong synergies with Novomatic. Thirdly, there are very long product cycles in the space and significant multiples can be made on one's investment if one can successfully invest somewhere near the bottom prior to a pick-up. Unfortunately, some tentative evidence that AGI was making up a little ground on the gorilla that is Aristocrat proved to be fleeting. It seems that we bought this straw-hat at the beginning of winter rather than the end, but we did cut our holding both pre-warning and immediately post, so it is now only of minor consequence.

The second largest headwind was a medium-sized short in IDP Education (IEL, +26%), which we progressively put in place as it seemed that the share price could not possibly go any higher, but it did. IEL is on a forward PE of 45.8x Jun18 and 40.0x Jun19 earnings. Rather than discovering alchemy, is merely a global provider of international student placements and is the licenced provider of the International English Language Testing System. Since the start of February, IEL has risen from $6.00 to $9.90 with the only new news being a reasonable result and an index inclusion. In the past, student placement volumes have proven to have nothing like the straight-line growth implied by the share price, while the relationship with the language test licensor, the British Council, will require monitoring. The mix of passive and momentum investors proved lethal to this short during the month, but the valuation now defies logic.

The third notable detractor was a moderate short in the transport SaaS software company, Wisetech Global (WTC, +46%), which is now up 80% from its lows in February when it reported a weak result, showing little in the way of organic revenue growth. Thankfully we had covered much of the short near the lows but dipped our toe back in the water too early. WTC is something of an acquisition machine, buying numerous small transport/customs software businesses in different countries at very low multiples. However, the core business appears to have only tepid growth, considerable costs are capitalised and it is on a Jun18 PE of 103x. When we map WTC against global SaaS comps, it stands out as having an extraordinarily high EV/revenue multiple relative to its revenue growth.

Another negative of note came from a moderate long in MYOB (MYO, -14%) who abandoned their bid for Reckon late in the month and committed to sharply higher capex over the next several years, with the revenue benefits being somewhat long dated. The final laggard of note was our large short in Ryman (RYM, +7.6%) which we saw as delivering a mediocre result with disappointing sales numbers, but the market simply did not care …. yet. The NZ housing market is showing numerous signs of topping out (the Auckland median price in March was -0.1% on last March) and RYM's foray into Melbourne may be running into a combination of development delays and a weakening housing market there.

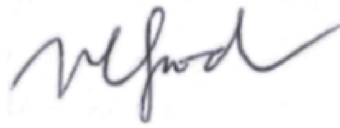
Our long in Webjet (WEB, +13.8%) was our largest positive contributor. WEB has appeared several times in these pages on both sides of the ledger. There was no new news driving the price action during the month and we actually exited into strength (close to all-time highs) near month-end. While WEB still looks moderately cheap on a 2-3 year view, we have noticed that it has been a particularly high beta stock during negative periods and we may use any repeat to re-enter.

The second largest positive was our mid-sized short in Technology One (TNE, -13.3%), a position we have held off and on over the last several years. TNE is a high multiple IT services consultant and we have never been able to reconcile the 30x PE with the 10% earnings growth in a business that has considerable competitive tension and implementation risk. Their first half result was poor and leaves them with an awful lot of second half catch-up.

Other positives came from our generally painful long in Evolve Education (EVO, +18.8%) who received a moderate funding boost in the Budget and whose result came in at the top-end of downgraded guidance. EVO is now on a PE of 8.5x in a sector that has seen significant trans-Tasman corporate activity. Other longs to work well included the high-end auto cooling system manufacturer PWR Holdings (PWH, +10%), the lowly geared 7x PE Australian retailer Shaver Shop (SSG, +16%); the mining equipment rental company Emeco (EHL, +27%); and the outdoor media company QMS Media (QMS, +7%).

As can be seen from this array of longs, we are playing the long-side in an expensive market by looking for eclectic bottom-up ideas, by diversifying, by looking for valuation support and by investing across the market cap spectrum (while sizing small caps appropriately). We have started to find that the occasional large cap long in Australia is coming onto our radar screen as leadership there gets more and more confined to a select group of ultra-momentum darlings and any momentary or perceived slip-ups get heavily punished.

Thank you for your ongoing interest and investment in the Fund. We were pleased with our performance in the volatile and negative March quarter but have found April and May to be rather difficult. Right now, we are finding that valuation matters very little and that quant, passive and momentum investors are ruling the roost. This is frequently hurting our shorts while leaving many of our longs looking on wistfully from the side-lines. These market conditions will assuredly change and we see rising inflation and bond yields as being one logical trigger – the gyrations of February may turn out to be a tasty wee entrée to the main course that is yet to come. We will stick to our knitting and attempt to take opportunities where we find them in the aim of repeating the solid uncorrelated returns of the last several years. Right now, those opportunities are across an eclectic set of momentum-less and orphaned longs, balanced with a set of highly over-extended “darling stock” shorts.



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