Salt Long Short Fund Fact Sheet – October 2021

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 October 2021

Benchmark	RBNZ Official Cash Rate +5% p.a.
Fund Assets	$54.2 million
Inception Date	31 October 2014
Portfolio Manager	Matthew Goodson, CFA
Associate PM/Analyst	Michael Kenealy, CFA

Unit Price at 31 October 2021

Application	1.9901
Redemption	1.9821

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 October 2021

Long positions	54
Short positions	33

Exposures at 31 October 2021

Long exposure	101.03%
Short exposure	46.66%
Gross equity exposure	147.69%
Net equity exposure	54.36%

Largest Longs	Largest Shorts
Tower	Premier Investments
Emeco Holdings	Arena REIT
Australian Vintage	Wisetech Global
Lynch Group Holdings	Auckland International Airport
Shaver Shop Group	Commonwealth Bank of Australia

Performance[1] at 31 October 2021

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%			16.24%

Period	Fund	Benchmark	NZX 50 G/ASX 200 AI[2]
3 months	3.04%	1.30%	2.26%
6 months	5.53%	2.59%	4.67%
1 year p.a.	36.09%	5.24%	19.71%
2 years p.a.	13.08%	5.38%	11.47%
3 years p.a.	8.90%	5.76%	14.46%
5 years p.a.	6.95%	6.15%	12.47%
7 years p.a.	8.71%	6.63%	11.21%
Since inception p.a.	9.78%	6.71%	11.32%

[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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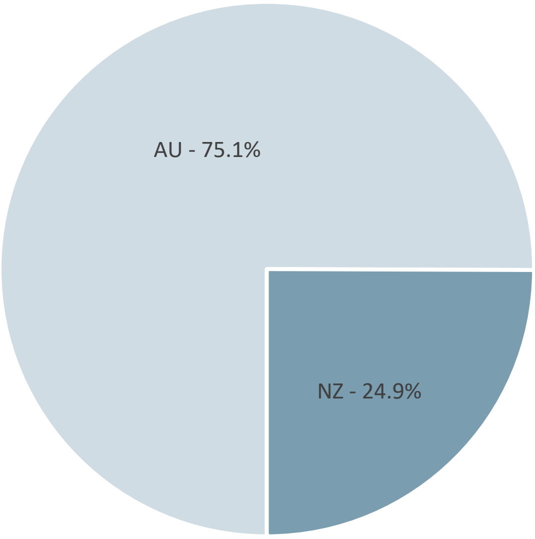
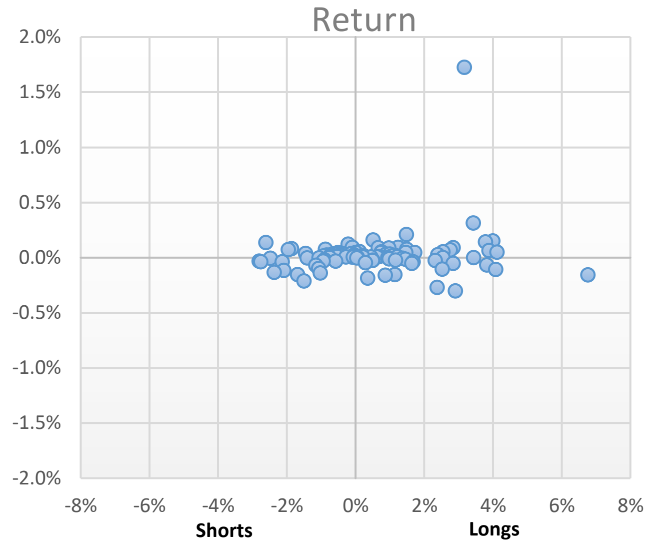
Country Allocation at 31 October 2021 (Gross Equity Exposure)



October 2021 Individual Stock Contribution



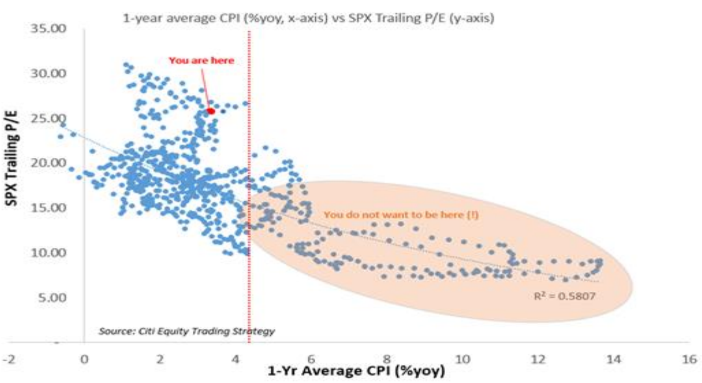
Fund Commentary

Dear Fellow Investor,

The Fund delivered a strong performance in the month of October, with a return after all fees and taxes of +1.52%. This contrasted with a decline in the NZ equity benchmark of -1.3%, while Australia fell by -0.1%.

The month was notable for a surge in NZ 10-year bond yields from 1.97% to 2.61% as the market rapidly came to the view that the RBNZ has fallen far behind the curve in combating emerging inflation pressures – an argument we have been making for some months.

In this context, NZ equities held up rather well in a reminder that equities can be a useful hedge against inflation up to a point. Historical evidence would suggest that inflation is getting rather close to the 3%-4% tipping point where the negative impact from a higher discount rate starts to outweigh the positive impact of higher nominal earnings for some companies (especially cyclicals). This can be clearly seen in the chart below for the S&P500 that was sourced from Citigroup.



This chart shows that once inflation outcomes get up into the 3.5%-4.0% region, high PE ratios in the 25+ region start to disappear. This time around, deeply negative real bond yields are sheltering the market from the impact of inflation to some extent but the risk for investors is that these real yields may begin to normalise as central banks remove their leaden feet from the monetary accelerator.

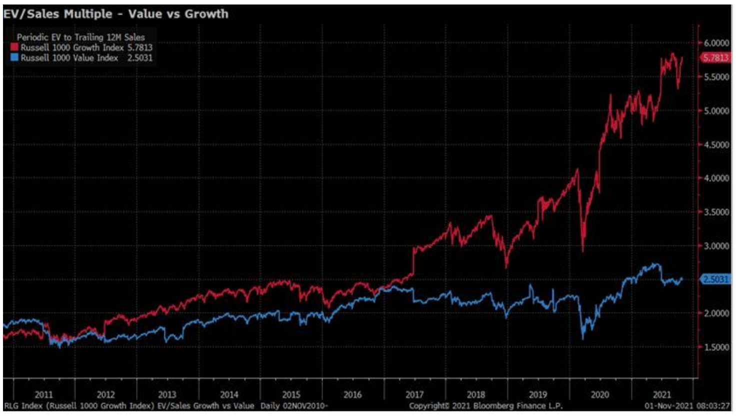
Our view of the investment backdrop is that there is widespread evidence of "flation", with the jury still being out as to which shade of "inflation" or "stagflation" that might be. The supply-side driven pressures causing the "flation" suggest that at least some elements of stagflation may be present.

Central banks have been caught napping, with some still being in denial, while some are surprising the market with the speed of their reaction function. For now, the RBNZ seems content to tell avian tales of herons versus doves versus hawks but much will depend on their OCR decision in November. Maybe an ostrich will be the best bird to describe their stance but we shall see. After a stunning record low 3.4% unemployment rate release as this is written, the chance of a 50bp rate hike surely has to come into focus although the impact of Covid lockdowns is a clear offset.

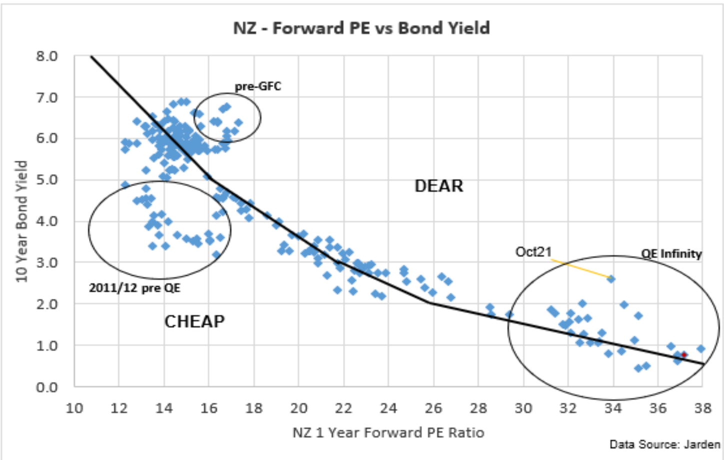
Linking this to equities, we have argued for some time that inflation is appearing, that central banks will have to tighten and that higher interest rates and the removal of excess liquidity may bring the bull market to its end. While equities are a reasonable inflation hedge, we would expect a choppier outlook ahead, with a dramatic change in what style works and what doesn't.

This story played out briefly earlier this year, which saw this Fund do extremely well from its array of cyclicals and cheap longs. However since then, Australian and NZ equities have doggedly ignored higher bond yields, with darling GAAP (growth at any price) stocks being bid to the stratosphere. That said, it is noticeable in recent weeks that TINA (there is no alternative) yield stocks have started to make rather heavy weather of it. We have gradually and painfully lifted our shorts in the darling GAAP names – they cannot defy gravity forever.

The chart below sourced from Evans & Partners shows how the EV/sales ratio for the Russell 1000 Growth Index has exploded relative to the Russell 1000 Value Index. It went particularly vertical following the move to zero-rate policies post-Covid. To date, it has not reverted even as bond yields have risen in recent months. This is concerning.

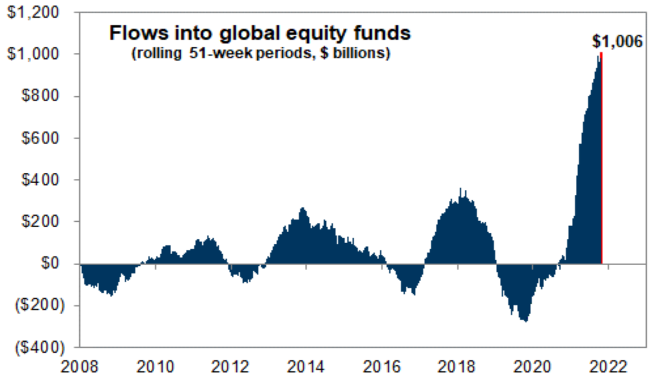


The overall NZ equity market does appear fully valued. The chart below suggests that a forward PE of 24x would be more appropriate at current 2.5% bond yields rather than the actual 33.9x. The median PE is however more in the region of 23x and Covid impacts may be seeing investors look beyond one-year forward earnings. This suggests that the market is not quite as expensive as it looks but there are certainly some pockets of extremity.



Signs of liquidity-driven excesses are everywhere. For example, in the month of October, Tesla rose by a staggering 44% and it did another +8% on the first day of November. This is not trivial, it is a US$1.2trn company. What drove it was a retail-initiated surge in close-to-the-money call option activity, to the point that in the last week of October, Tesla accounted for 75% of the entire options turnover for the Nasdaq 100 Index.

Retail inflows to equity markets have been unprecedented. Below, we update last month's chart sourced from Goldman Sachs looking at flows into global equity funds. They have continued to surge. According to Fed data, equity allocations amongst all investors now sit at 52% compared to the previous high of 51% in 1999. What possible source of concern could there be as central banks start to tighten?



Source: Goldman Sachs Investment Research Division, Cormac Conners, returns.

Inflation continues to break out around the globe. In NZ, the ANZ Business Outlook at end-October found a net 57.1% of firms plan to lift prices over the next 12 months – ANZ described this as "unheard of". Inflation expectations soared from 3.02% to 3.45% in just one month.

The CPI inflation reading for the September quarter came in far higher than expected at +2.2% q/q and 4.9% y/y. The old "problem" of persistently low tradeables inflation is ancient history – it came in at +2.8% q/q and 5.7% y/y. Non-tradeables were 1.8% q/q and 4.5% y/y. All core inflation measures were over 4.0% y/y. Everything is going up and the RBNZ simply has to get a move on and tighten.

We are not alone. Australia abandoned its yield curve control policy following a far higher than expected underlying inflation reading. However, for now they are continuing QE and pushing back on market pricing for rate hikes. Ostriches. Near month's end, the Bank Of Canada unexpectedly ended its aggressive QE policy early although the BoE pushed out a potential rate hike to December.

Amid surging inflation expectations, the US Fed has clearly signalled that they will begin to pull back on QE this month. Credit Suisse pointed out that the use of the word "transitory" to describe inflation in the Fed minutes has declined to zero from a peak of nine times back in April. The US has 1.25 job openings for every unemployed person – "spiral" would be a far more appropriate word than "transitory". Finally here, the Chinese manufacturing PMI for September came in at a contractionary 49.2 but producer prices jumped by 4.7 to 61.1 to set a new record.

Put all this together and our view is clear. Goldilocks has been replaced by some form of inflation, with the jury still being out on whether this is stagflation or something less dire. Markets are being driven by the last vestiges of QE that is now hopelessly inappropriate in the face of overwhelming evidence of inflation. Some central banks are pulling their heads out of the sand. This may see the greatest bull market of our lifetimes morph into something rather choppier, with very different styles of stocks leading the way. This is how we have positioned the Fund

Returning to our performance in the month of October, the Fund's net length rose a little from 51.6% to a high 54%, while the gross declined from 158% to 148%. We are having little difficulty finding cheap companies with reasonable earnings outlooks. It is the 80x earnings and 20x revenue darling stocks that we detest.

Despite our high net length, the Fund still did very well on average on negative days, which speaks to the firepower contained in our shorts. There were an unusually high ten negative days for the 50/50 index of Australia and NZ, with the average loss for the market being -0.36% on those days. The Fund was up on six of the ten days and delivered an average return of +0.11%.

The Fund's performance in October of circa +1.7% (pre fees and tax) came entirely from our long book, with our short book being flat. We might have hoped for more gains from our shorts but ultra-expensive names tended to outperform in the month. Our overall "winners to losers" ratio was a very strong 66%. However, there was a major skew, with there being one stand-out winner and many of our losers being larger than our other winners.

By far the largest tailwind came from the frequently mentioned Intega Group (ITG, +57.0%), which received a takeover bid from a Canadian engineering firm. This looks like a done deal and we have leaked some out to arbitrageurs given a tight spread and it being very unlikely that there will be a higher bid. The rump still comprises around 2% of the portfolio.

ITG was a classic example of our investment style. We were very lonely buyers back at 25cps when the PE was circa 5x and the outlook appeared solid. The position became a little larger than we were truly comfortable with but their results were good and ultimately the takeover bid came in at 90cps. We feel as though we have a number of other diamonds in the rough amongst our array of longs but happy endings such as this are far from guaranteed. That said, our style has seen this Fund benefit from an unusual number of takeover bids over the years. Long may they continue.

The second largest contributor was of far lesser magnitude and came from Emeco (EHL, +4.3%). We did lighten what was a very large position near the month's highs but remain bemused at its lowly valuation and range-bound share price. The balance sheet has been fixed, demand generally remains solid across their range of commodity exposures, labour shortages are not a major constraint and it is on forward PE multiples of 7.2x Jun22 and 6.4x Jun23.

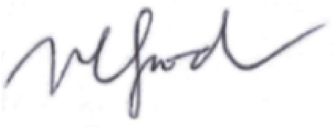
Other tailwinds were numerous but largely small. Our moderate long in 3P Learning (3PL, +16.2%) did well as investors begin to focus on the upside potential of this new merged entity. A small long in Superloop (SLC, +32.3%) surged on the sale of their Hong Kong subsidiary which leaves the Australian business as a prime consolidation target. Our large long in Australian Vintage (AVG, +3.7%) ground higher on no new information.

Headwinds were led by our relatively large long-term holding in Kina Securities (KSL, -9.3%) which appeared to be sat on by a large seller. There was no new news. The Covid outbreak in PNG is concerning but the economy is actually doing rather well from booming commodity prices, with the foreign exchange situation being the best in some time. KSL's giant competitor, Bank South Pacific reported a solid result, raising no red flags for the sector. KSL is flush with capital post the regulator not allowing them to purchase Westpac PNG and is on a forecast PE of 5.5x Dec22 and dividend yield of over 12%. We are a moth to the flame.

The second key laggard was our disappointing long in Omni Bridgeway (OBL, -10.9%). There was no new news but the market is perhaps spooked by plans to more tightly regulate the litigation funding sector in Australia. Our view is this would have little impact on OBL's current practices and that Australia is now a relatively small part of their business in any case. OBL has shifted the bulk of its business to being a fund manager, where investors take the litigation risk and OBL charges a mix of fees.

A final notable holding which hurt us was our short in Lovisa (LOV, +14.3%) which soared on no news other than general re-opening optimism. This retailer of low-end "junk" jewellery is being priced for global domination. This is possible but it seems an optimistic base-case given the absence of branding and lack of entry barriers combined with ultra-high margins. It is on a 2-year forward PE of 40x.

Thank you for your continued support of the Fund. We were pleased to deliver a strong result in the month albeit most of it was attributed to one holding. We are in a fascinating period for markets. Money continues to flood into a range of expensive darling growth stocks which we are carefully shorting into undue strength. At the same time, inflationary pressures are breaking out everywhere and the monetary punchbowl is on the cusp of being taken away.



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