SIGMA FUNDS MANAGEMENT®

Sigma Australian Shares Strategy

Quarterly update as at 31 March 2016

	Quarter %	6 months %	1 year %	2 years % p.a.	3 years % p.a.	5 years % p.a.	Since Inception^ % p.a.
Sigma Australian Shares Strategy*	(4.3)	(1.6)	(14.4)	(2.7)	3.8	4.6	2.9
S&P/ASX 200 Accumulation Index	(2.7)	3.6	(9.6)	1.6	5.4	5.7	2.1
Value added	**(1.6)**	**(5.2)**	**(4.8)**	**(4.3)**	**(1.6)**	**(1.1)**	**0.8**

**Gross Performance. Past performance is not a reliable indicator of future performance. ^Since Inception: 1 July 2007*

Key points

- Significantly overweight Diversified Miners and underweight Major Banks
- Cyclical sectors expected to benefit as earnings bottom and risk appetite increases
- Fund positioned for US interest rate normalisation; while *exceeding* local market dividend yields

Individual stock performance of note

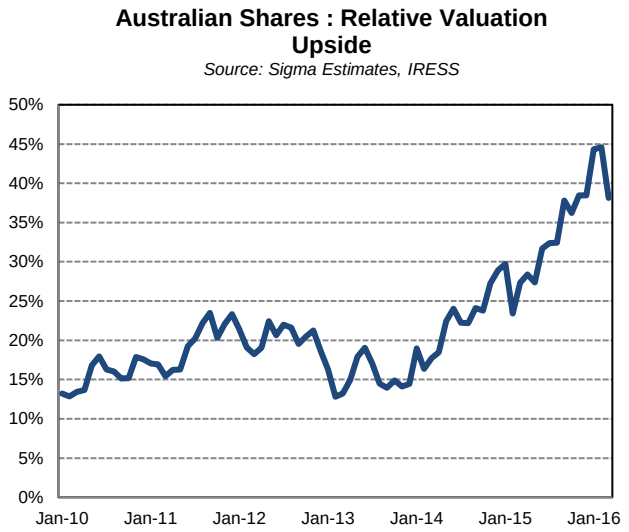
The Fund *underperformed* a falling market in the March quarter. Consumer discretionary stocks were among the best performers. Seven West Media (+38%) rallied significantly on media reform, somewhat offset by Nine Entertainments (-13%) earnings blip due to near term programming challenges. In response to Dick Smith's demise and a supportive retail spending climate, JB Hi-Fi (+24%) and Harvey Norman (+12%) rallied. The overall Materials exposure contributed positively to performance with Bluescope Steel (+40%) and Sims Metal Management (+21%) the standouts as the steel price rebounded from very low levels as the perception on China's growth prospects changed. Within this, the Funds resource exposures (RIO -1%; BHP -4%; WHC -6%) were broadly neutral with the absence NCM (+30%) and the highly leveraged FMG (+38%) & S32 (+38%) detracting in a relative sense. The banking sector (-11%) experienced a difficult quarter on global (the impact of negative interest rate) and local (rising bad debt) concerns. The relative benefit from the absence ANZ (-16%), CBA (-10%) and WBC (-10%) was slightly offset by the overweight to NAB (-10%) and the two regional banks, Bank of Queensland (-13%) & Bendigo and Adelaide (-22%). The asset quality concerns of the majors are unlikely to flow onto the regional banks, given the lack of institutional unsecured lending. Furthermore, highly competitive mortgage pricing campaigns of the majors are likely to fad as capital requirements continue to increase forcing further out of cycle mortgage repricing. Holdings in Diversified Financial and Insurance stocks detracted from performance. While AMP (+2%) was resilient in the face of a declining market, Macquarie Group (-20%) suffered in the global market banking rout notwithstanding reiterated profit guidance. QBE (-11%) was also impacted by the pervasive negative interest thematic. Finally, the absence of large defensive names within the top 50 stocks listed on the ASX (Transurban +8%; Scentre Group +8%, Westfield +7%; Sydney Airport +5%; Wesfarmers +2%) detracted from performance in a relative sense.

Performance of the Fund by Financial Year

Financial Year	2013	2014	2015	16FYTD
Fund	24.9%	19.4%	7.0%	(10.3%)
Index	20.5%	17.4%	5.7%	(3.3%)
Relative	**4.4%**	**2.0%**	**1.4%**	**(7.0%)**

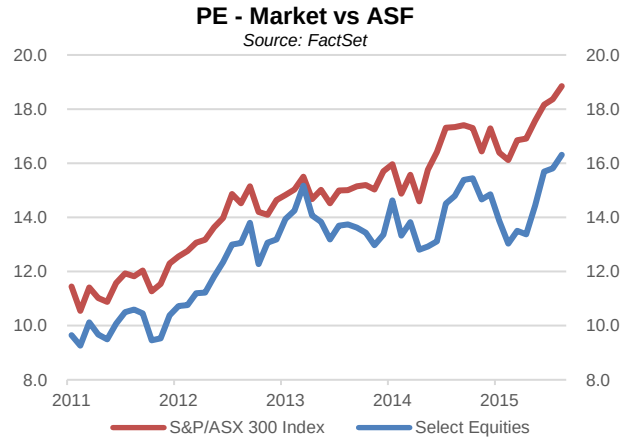
Portfolio positioning and outlook

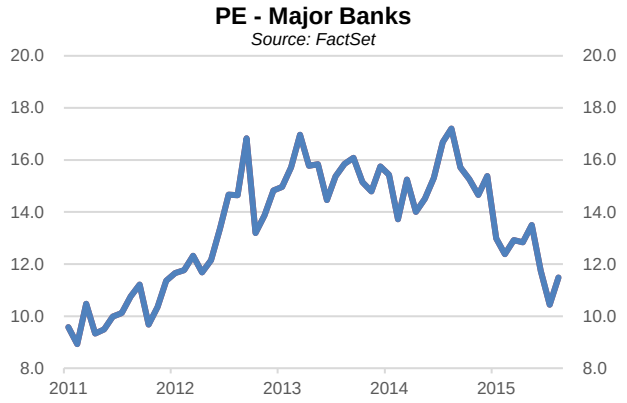
The Fund's relative valuation upside currently (mid-April) stands at 38%, highlighting a portfolio ***embedded with future outperformance***. In an absolute sense, the portfolio currently has 39% upside relative to a market we see as being fairly valued (+1% upside).



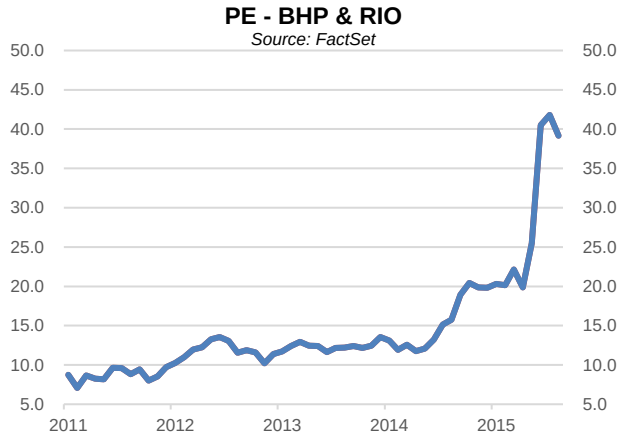
While the portfolio remains attractive on valuation grounds, our business risk metrics are the least attractive since inception. This has been the case for some 18 months, and as communicated in our quarterly strategy reviews we fully expect more volatile outcomes relative to market (as recent performance indicates), however we continue to believe the valuation upside will more than compensate for the volatility.

We believe Australian equities remain vulnerable to an unwinding of the ***"defensive-quality-yield"*** *(DQY) play* that has driven markets post the GFC due to unconventional monetary policy settings that held rates "near zero", distorting markets. While the unemployment rate is close to 5% in the United States (and has been there for some time) the Fed is has only just lifted rates after 8 years of being close to zero. The focus on ***DQY*** has resulted in the market overlooking elevated stock prices as a function of earnings power, *justified* by "dividend yields" remaining attractive relative to "low interest rate settings". Defensive stocks (approximately 30% of market cap) have been the main recipients of this trend. The following 1-year forward, price to earnings (PE) chart highlights this trend.

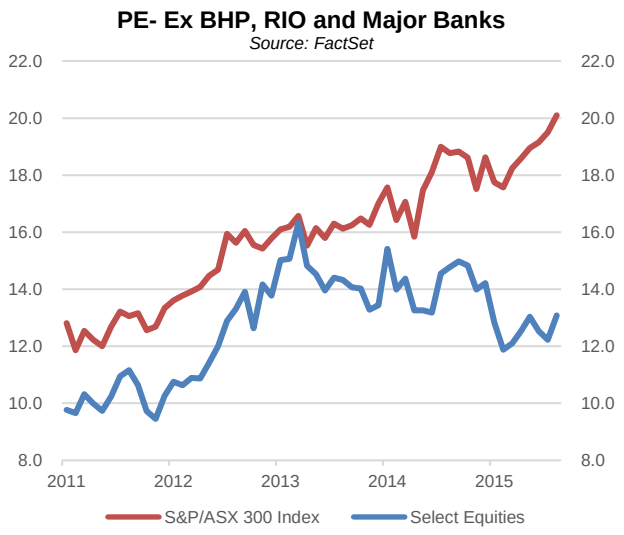




Over the last 12 months, the Major Banks have been de-rated. As they represented approximately 30% of the market at the peak (January 2015), this has placed significant downward pressure on the Market PE. While the PE of the two major miners, BHP & RIO have increased substantially over the same period notwithstanding significant share price falls due to the cyclical nature of their earnings. Although the major minors only represent 5% of the market today relative to 16% at the peak (May 2011), the very high PE (of 40) has a greater impact on the market PE.



Controlling for these two key factors highlights the influence of the DQY re-rating on the Australian Share market. Excluding the two big miners and four major banks (representing approximately 32% of the index today), the market PE is very high by historical standards.



The chart also highlights why the Fund has substantial valuation upside relative to the market, as PE of the Fund (putting the major banks and miners aside) is substantially less than the market overall.

We believe the market is overpaying for *certainty*, with *low future returns* the likely result. This is a direct result of non-conventional monetary policy, which has lowered borrowing costs and pushed savers further out on the yield and risk curves, in effect prompting a search for *yield.*

As the table below highlights, going into financial year 2016, we believed the market had no upside. This is in stark contrast to the start of financial year 2012 the market as a whole was cheap (26% valuation upside) and subsequently achieved double digit returns over the following two financial years with the Fund (47% upside) outperforming by approximately over the same period, a function of the greater level of upside.

Valuation Upside of ASF and the S&P/ASX 200 Index

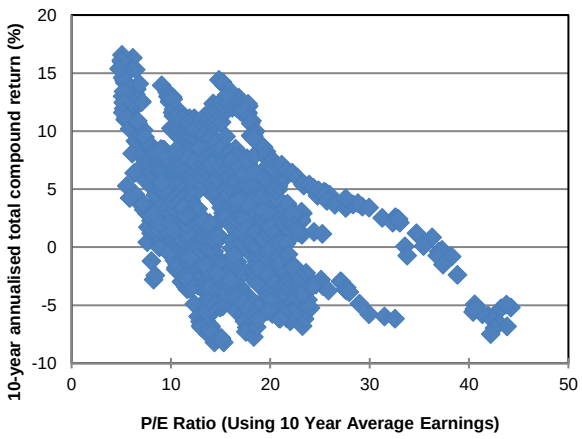
Financial Year	2012	2013	2014	2015	16FYTD
Fund	42%	47%	31%	30%	38%
Index	23%	26%	12%	6%	-1%
Relative	**19%**	**21%**	**19%**	**24%**	**39%**

However, we also assessed the portfolio in 2012 as having risk levels that were in line or better than the overall market as a whole due to the plentiful number of opportunities on offer in low risk franchises. However, with the market re-rating, the opportunity set has narrowed to the more "uncertain and unloved names" neglected by the prevailing DQY dynamic. This presents a dilemma for most managers who realise they will be compensated for *embracing the near term uncertainty* but cannot do so as they feel nervous about the near term volatility created within their portfolios, particularly in the post GFC world where investors are *paying up for certainty*.

Sigma's fundamental business risk metrics indicate the portfolio as a whole is likely to be more volatile than the market. This is unsurprising given exposure to likes of the Diversified Miners, which tend to respond to commodity prices. While portfolio volatility is expected to be higher than in the past, our explicit focus on ***protecting the downside*** remains unchanged. Fund is favourably disposed relative to the market on many of the traditional implied metrics (PE's, Dividend Yields, Price to Book Value, Price to NTA, Gearing etc.) indicating strong downside protection.

It is important to differentiate between *volatility* and the *risk of losing hard-earned capital.* The defensive-quality-yield thematic is leading to *overvaluation* of earnings quality and certainty. ***Overvaluation* is the key determinant of future losses.** As the following chart shows, the historical relationship between PE and future expected returns since 1871 is clear – high PE result in low future expected returns.

Historical Relationship between PE and Total Return



Source: Robert Shiller, *Irrational Exuberence*

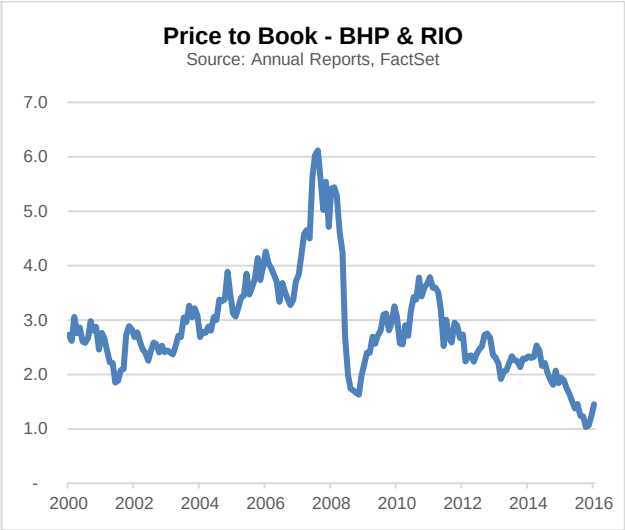
Thus for DQY, low future returns are far more likely, with the possibility of capital loses as the market re-evaluates the high price paid for certainty.

For the Fund, *short-term volatility* is being embraced as our long term, valuation framework consistently applied over many years clearly indicates valuation support is evident. The Funds 39% valuation upside relative to a market that is fairly valued, implies the *likelihood of outperforming* over the period ahead is very high, albeit with volatility (as has been experienced in the last 12 months). Over time, we believe fundamentals will weigh on share prices as they have throughout time, and portfolio returns will exceed the market.

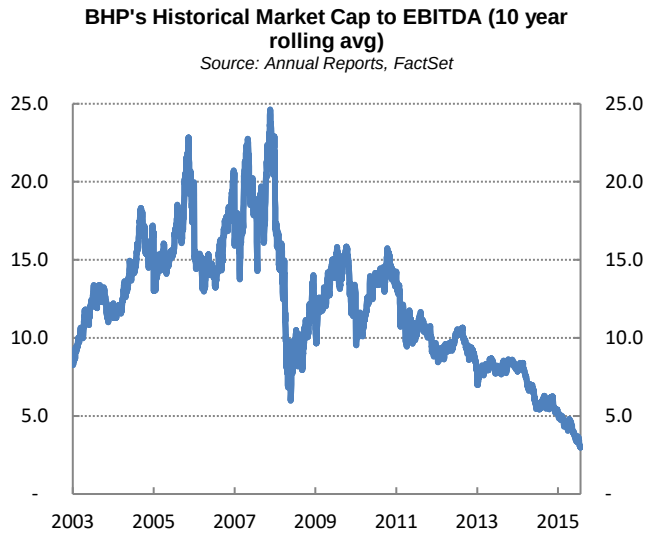
Update on the Big Miners

Since quarter end, BHP and RIO are up 20% (to mid-April 2016).

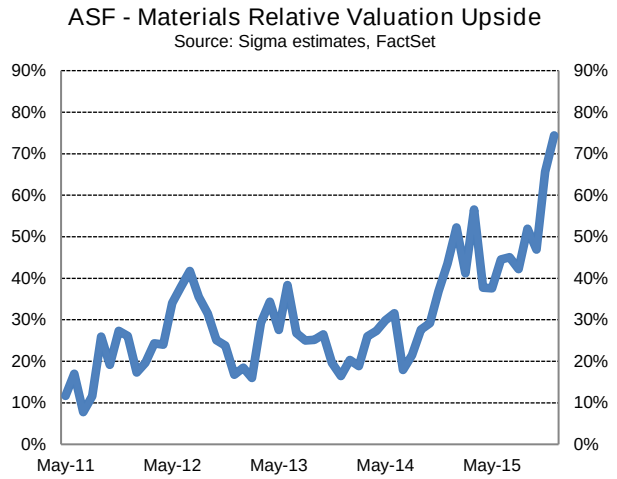
This issue is no clearer than in the large diversified miners. Share prices have followed earnings lower as commodity prices have fallen. However, on simple price to book measures both BHP & RIO are trading at substantial discounts to long term averages (2.9 times).



If we consider another very simple measure (Market Cap to EBITDA) of *through the cycle earnings power*, BHP is looking exceedingly cheap.

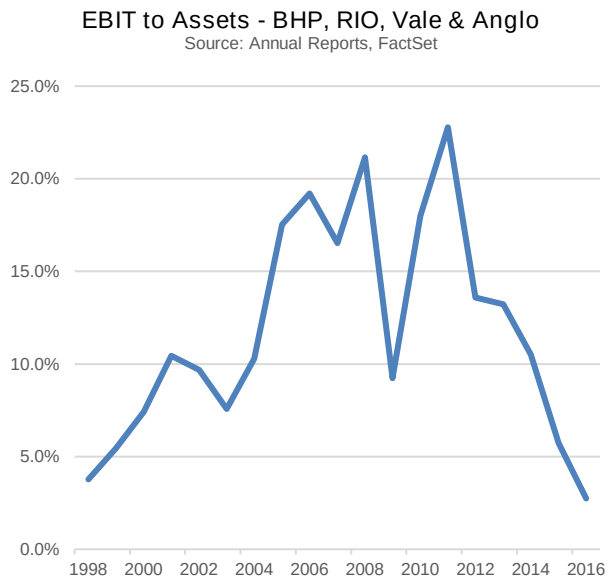


Sigma's valuation framework which is based on discounted cash-flows for the large miners, confirms a substantial amount of upside on offer.

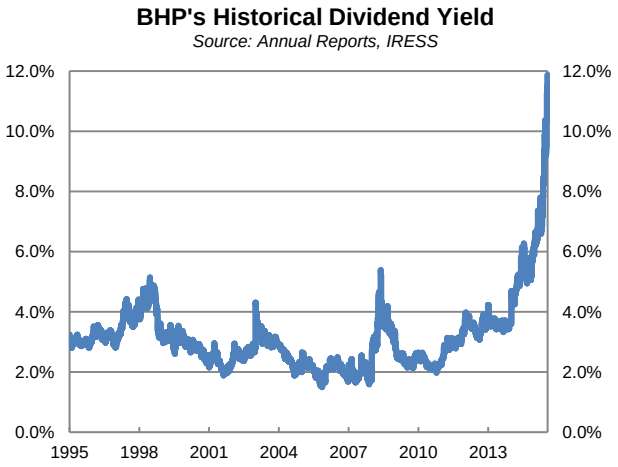


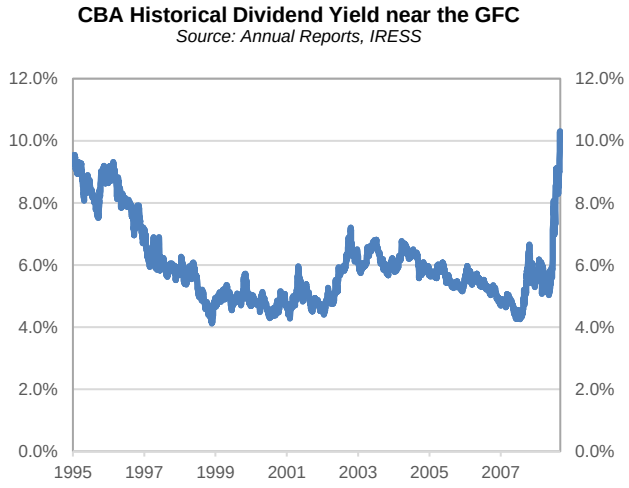
The big miners are currently facing a similar situation as to the major banks during the GFC: *Share price pressure resulting from a near term focus on current earnings without looking at the forward indicators of change*. The potential for stronger earnings and improved returns from the Major Miners required an *austerity commitment first and foremost*, which is now well underway. While the entire commodity complex is under pressure, as evidenced by the steep share price falls of Swiss commodities trading house, Glencore, in this environment the strong thrive just as the Major Banks did during the financial crisis. RIO and BHP's have *Tier 1 assets with unassailable scale advantages* placing them in a *very strong position* which is likely to be reinforced in the current environment.

However, the advocates of dividend cuts are extrapolating the recent excesses convinced the Major Miners will need to continue spending rather than prioritise returns. We believe the evidence to the contrary in this regard, and the very austerity measures employed by the ***largest industry players*** will eventually create a *positive commodity price response* in itself to turn around exceptionally low returns.

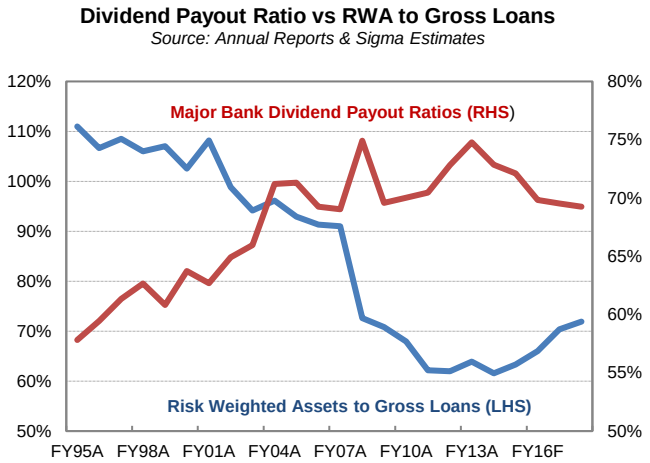


BHP's current dividend yield trajectory bares a similar resemblance to CBA's during the bank GFC woes of 2008. While CBA went onto cut the dividend (by 14%) the stock price rallied strongly.





Ironically, the sustainability of bank dividends in light of the new capital requirements is only just starting to permeate market psychology. The following figure highlights the issues facing the major banks as we move forward. The regulator wants to address the trend of declining risk weighted assets to gross loans (RWA to GL) over time as shown in figure below. As RWA to GL increases, this requires more capital to support any given level of loan growth, therefore more earnings are required to be retained, and less dividends paid out. After 15 years of rising dividend payout ratios, the possibility of *going back to the future* of 60-65% of bank earnings like we had in the past is something the market is yet to fully appreciate. ***Capital intensity is clearly on the rise.***



However, it is not all bad news for Banking. Regional Banks (Bendigo and Adelaide; Bank of Queensland) remain well positioned in the transition to a more *resilient and competitive banking system*, as they already hold more capital than the Major Banks. As the Major Banks re-price loans (WBC just announced such a measure in October with their $3.5bn capital raising) to offset the profitability pressures, the Regionals should benefit through higher margins and market share gains that should eventually see the ROE of the Majors and Regionals converge. In other words, earnings should expand on the existing capital base leading to improvements in future profitability.

As valuation support is clearly evident (+50% valuation upside) and likely to improve for the reasons outlined above, the Major Miners and the Regional Banks are in our Top 5 Active positions. These stocks an average net dividend yield of approximately 6.5%, well above the Australian Equity's market net yield of 5%. *Thus importantly we are more than likely to be paid along the way, while participating the upside as the perception differential changes.*

Furthermore, as the valuation support lies within areas of the market (Regional Banks, Diversified Miners and Small Caps) that are a smaller proportion of the index it is not surprising that Active Share is currently at all-time highs.

Economic developments and markets

The S&P/ASX 300 Accumulation Index fell -2.6% in the March quarter to be down -3.0% FY16YTD. Large Caps (S&P/ASX100) have underperformed Small Caps by 4.0% and 12.1% respectively over the same periods. Small Cap Industrials (-1.1% Mar16Qtr; +11% FY16YTD) continued to outperform their Large Cap counterparts (-3.9% Mar16Qtr; -0.7% FY16YTD) while, Small Cap Resources (17.3% Mar16Qtr; -5.6% FY16YTD) outperformed their Large Cap equivalents (3.2% Mar16Qtr; -21.6% FY16YTD). Banks significantly underperformed in the quarter (-11.2%) to be down 11.2% FY16YTD.

Commodity markets experienced a weak start to the quarter on concerns over Chinese growth & US monetary policy tightening. Fears subsided throughout February and March as the Chinese government indicated policy settings would be supportive of growth while the trajectory and timing of the US Fed Funds rate was pushed down and out.

Brent crude briefly fell below US$30 a barrel for the first time since 2004 as the International Energy Agency warned the market could "drown in oversupply", as sanctions on Iran were lifted. Oil then rose with diminished macro risks, underlying momentum in supply cuts and the prospect of a potential supply agreement delivering the majority of the gains to end up +8% to US$38.72/bbl.

Iron Ore prices rose by 23% in the quarter to US$53.75/mt, dominated by strong price rises in February (+19%) and March (+9%) as a result of supply disruptions and restocking in China. The iron ore price experienced its biggest ever single day gain of 19% on 7th March rising to US$63.74/mt. The steel price also rose strongly in March (+20%) off depressed levels.

Base metals turned up, with the LME Metals Index rising 3.1%. Notably zinc (+13.5%), copper (+3,7%) and aluminium (+0.7%) rose, while nickel (-.38%) and lead (-5.6%) declined. Spot Gold rose 16.1% over the quarter as negative interest rate policy added upside bias to the metal.

The A$ appreciated 5.1% against the US$. The currency appreciated against most of its trading partners (CNY +4.4%, KRW +2.3%, EUR +0.3% and JPY -1.6%).

In the US, the outcome of the FOMC meetings during quarter was unexpectedly and unambiguously dovish. The future Fed Funds rate, or the 'dots', were revised down 50bp, implying only two hikes this year. Core inflation was firm once again. Headline CPI rose to 1.0%, but core CPI ex-food and energy rose up to 2.3%: an expansion high. The increase in core goods prices mirrors the rise in import prices for consumer goods, which suggests global disinflationary headwinds are abating. Jobs growth was solid, with non-farm payrolls increasing 628k over the quarter. The unemployment rate fell to 4.9% in January, but subsequently returned to 5.0% in March. The participation rate increased by 0.4% to 63.0%.

In China, the PBOC announced a 50bps cut to the reserve ratio requirement (RRR) for all financial institutions, effective March 1st. While the China Banking Regulatory Commission and the PBOC announced further easing of mortgage policy. Chinese Premier Li delivered the government work report at the National People's Congress. The 2016 growth target was lowered to a range of 6.5-7% (compared to the 7.0% in 2015 and the 7.5% in 2012-2015), and while reiterating "prudent" monetary policy in 2016 to support growth.

Chinese economic data remains generally weak with manufacturing PMI's, Exports, Industrial production and retail sales weaker than expected. However, fixed asset investment growth for January-February improved to a better than expected 10.2% y/y and CPI growth for February accelerated to 2.3% y/y.

On the domestic economic front, Employment decreased by 6.6k over the quarter (-6.2k full- time and -0.4k part-time). The unemployment rate increased to 6.0% in January, but returned to 5.8% in February. Australia's business confidence and conditions recovered some ground in the NAB business survey. The confidence measure holding steady at 3, however business conditions climbed from +5 to +8 indicating firming domestic demand ahead, while consumer views were more downbeat during the month with the Westpac consumer confidence index slipping 2.2%. Retail sales slowed notably. This comes as sales were unchanged in December and rose by only 0.3% in January.

CPI came in stronger than expected for the 4Q15. Headline inflation for the quarter printed at 0.4%, overshooting consensus expectations by 0.1%. The core inflation measures were also up +0.55% for the quarter. The RBA held the cash rate at 2.0% with few changes in the wording of the statement.

Stocks Added

None

Stocks Sold

None

Top 5 active positions

Stock	Active weight%
By Large Cap stocks:	
Harvey Norman Holdings	5.5
Rio Tinto	4.8
AMP	4.7
Bank of Queensland	4.7
BHP Billiton	4.3
By Small Cap stocks:	
Nine Entertainment	2.1
Seven West Media	2.0
G8 Education	1.2
Whitehaven Coal	0.9
McMillian Shakespeare	0.5

Note: Active weights refer to positions above benchmark only.

Asset allocation

Sector	Active weight %
Consumer Discretionary	8.8
Financials ex-Real Estate	7.4
Materials	5.5
Industrials	(0.9)
Information Technology	(0.9)
Utilities	(1.8)
Energy	(2.5)
Consumer Staples	(3.1)
Health Care	(5.7)
Telecommunications	(5.8)
Real Estate	(7.7)
Cash & Other	6.7

Note: Active weights refer to positions above or below benchmark.

Strategy summary

Australian Shares combines the highest conviction stock ideas from Sigma's Large Cap investment team driving superior performance, lower risk and increased consistency of returns.

Australian Shares - Competitive Advantage

- Deep and rigorous fundamental analysis of companies and sectors
- Thorough ongoing peer review by a very experienced team of investors
- Investing with conviction in a focused portfolio of undervalued businesses
- Putting aside benchmarks to allocate capital with the aim of achieving the stated return objective

Contact

For more information contact Pinnacle Investment Management, the Fund's distributor, on 1300 010 311.

See also www.sigmafunds.com.au

Sigma's Differentiated Business Model: 'Integrated & Aligned Investment teams'

- Most investment management firms comprise distinct Large Cap and Small Cap teams with separate incentive structures and competing interests
- In contrast, Sigma's Large Cap and Small Cap teams are equal partners, completely aligned to success of the Sigma's investment strategy's
- Sigma Australian Shares strategy is enhanced by an integrated investment approach of an experienced investment team

About Sigma Funds Management

- Value-style Australian equities manager which aims to outperform without the downside of "value traps" through an investment approach called *Value: Risk Adjust*
- Independent and majority employee-owned firm founded in 2009 by six experienced investment professionals who previously worked together at a leading global investment manager

† Since Inception performance includes 22 months at a former investment manager plus median value manager performance for transition period prior to setting up Sigma.