SIGMA FUNDS MANAGEMENT®

Sigma Australian Shares Strategy

Quarterly update as at 31 March 2017

	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*	2.9	14.1	26.7	4.2	6.3	11.4	5.1
S&P/ASX 200 Accumulation Index	4.8	10.2	20.5	4.4	7.5	11.1	3.9
Value added	**(1.9)**	**3.9**	**6.2**	**(0.2)**	**(1.2)**	**0.3**	**1.2**

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

Key points

- Buyer beware as the market is **overvalued at 19x 1-year forward earnings** (ex BHP, RIO & Major Banks)
- Embracing mispriced uncertainty while avoiding expensive bond like proxies
- Portfolio metrics supportive of positive future returns albeit with more volatility in an ***overvalued market***

Portfolio commentary, positioning and outlook

Over the March quarter, the Sigma Australian Shares Fund (ASF), underperformed (+3%) a rising market (+5%) as a "melt up" in markets extended the strong gains from the prior year. Overall, we remain cautious on Australian Equities given ***overvaluation*** and moderate rates of earnings growth. Figure 1 shows the PE of the market excluding the big six (BHP, RIO, ANZ, CBA, NAB and WBC). As these six large companies represent approximately 35% of the index, the remaining 65% of the market is currently trading slightly over 19x 1-year forward earnings. Historically market PE's around 20x generate periods of negative returns. We therefore expect the Australian Equity market to generate ***very low returns*** going forward. Consequently, our cash weighting has started to rise as portfolio positions are realised on valuations grounds. ASFs cash weighting currently stands at 9%. This is towards the upper end of the 10% maximum cash limit. However, we believe this remains a prudent position until an appropriate *discount to valuations return*. Sigma believes the market ***currently has 12% downside*** and therefore at a growing risk of a correction (see Table 1).

As we highlight in Sigma's June 2017 Quarterly Strategy Review, the current higher risk environment for equities requires a **strong focus on capital preservation**. Many financial assets currently offer low returns and are vulnerable to correction. Therefore, **maintaining valuation discipline is paramount** under present circumstances.

Figure 1 - PE ex BHP, RIO & Major Banks: S&P/ASX 300 vs Select

Source: Factset, S&P, Sigma esimates

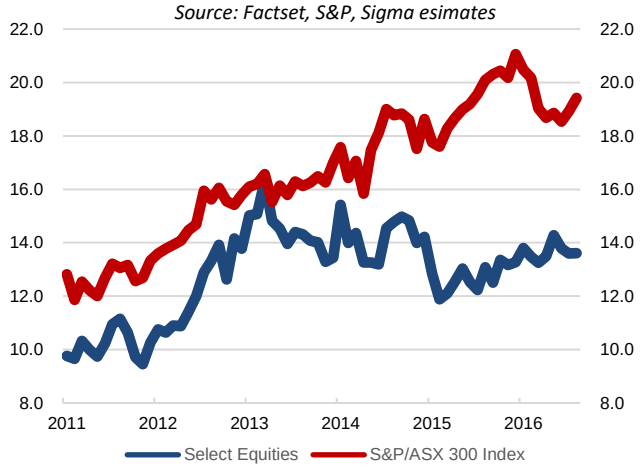

Table 1: Valuation Upside of ASF and the S&P/ASX 200 Index

Start of Financial Year	2013	2014	2015	2016	2017	Current 31 Mar 17
ASF	47%	31%	30%	31%	28%	15%
Index	26%	12%	6%	0%	-5%	-12%
Relative	**21%**	**19%**	**24%**	**32%**	**33%**	**27%**

Given a firming growth environment and bottoming of inflation it seems interest rates are unlikely to decline with support for elevated equity multiples peaking. The impact of gradual monetary tightening and rising real yields suggests a more corrosive environment for low growth, bond

beneficiaries than the market perceives. We therefore remain substantially underweight expensive defensives as we believe their valuations remain heavily reliant on ***low real interest rates***. This is also the sector where gearing has increased and payout ratios are highest. Table 2 illustrates this point, through an example of a stylized REIT geared at 30% of asset value, growing its rent at CPI and facing 200bps of higher interest costs over 5 years.

Table 2: Impact of +2% change in interest rates on a geared REIT

Year	2018	2019	2020	2021	2022	Change
Rent	100.0	102.5	105.1	107.7	110.4	+10%
Interest	21.0	24.0	27.0	30.0	33.0	+57%
Net Income	**79.0**	**78.5**	**78.1**	**77.7**	**77.4**	**-2%**
Cap Rate	5.0%	5.3%	5.5%	5.8%	6.0%	
Rental Growth		2.5%	2.5%	2.5%	2.5%	
Gross Value	**2000**	**1952**	**1910**	**1873**	**1840**	**-8%**
Debt	600	600	600	600	600	
Net Value	**1400**	**1352**	**1310**	**1273**	**1240**	**-$160**
Interest Rate	3.5%	4.0%	4.5%	5.0%	5.5%	+2%
Real Interest Rate	1.0%	1.5%	2.0%	2.5%	3.0%	+2%
Distribution Yield	5.6%	5.6%	5.6%	5.5%	5.5%	-0%
Debt: Capital	30%	31%	31%	32%	33%	-3%
Interest Cover	**4.8**	**4.3**	**3.9**	**3.6**	**3.6**	**-30%**

This REIT would deliver an investor a 16.5% total return (net income of $390 over 5 years offset by $160 in capital losses) or 3% per annum with a ***declining distribution profile***. The return estimate is also generous as it assumes no dilution to address the deterioration in the balance sheet and interest cover, with the latter declining significantly.

Within an improving economic environment, we continue to see pockets of opportunity and cyclical tailwinds in some economically sensitive exposures where macroeconomic risk and structural decline themes have been overplayed. Accordingly, **ASF's strategy remains positioned in cheaply valued cyclical exposures** in Large Cap Resources, Diversified Financials, Domestic Cyclicals, Regional Banks and overlooked Small Caps. Stronger economic tailwinds for good franchises with strong balance sheets and reasonable starting valuations remain as core attractions.

However, consistent with our concerns on elevated risk and overvaluation across many Large Cap exposures, the strategy retains an overweight to Small Caps and an above average cash allocation as a preferred defensive position.

Individual stock performance of note

Fund performance was driven positively by:

- The large diversified miners, with BHP (+13%) and RIO Tinto (+16%) buoyed by earnings upgrades and the unwinding of negative sentiment. If the duration of the current *spot pricing trends extends* this dynamic is likely to persist. *The diversified miners continue show upside* (+20%) and remain key portfolio holdings (16% of the portfolio vs 7% for the index).
- Global commercial insurance giant, QBE (+34%) was stronger during the quarter as the market started to consider the impact of rising interest rates on QBE's investment portfolios which are currently earning very little.
- Regional bank, Bendigo and Adelaide Bank (+18%) was stronger along with the entire banking sector. APRA's deferment of defining "unquestionably strong" capital plans by 12 months, combined with the reassessment of interest rates, was received positively by the market.
- Scrap maker, Sims Metal Management (+40%), was also stronger as management's outlook comments suggest far more leverage to improving conditions than previously thought. The proposed infrastructure spending plan of US President Elect Trump gave further impetus as over 50% of earnings are derived from the US.
- The absence of index heavyweights CSL Limited (-6%), Wesfarmers (-4%) and Telstra (-2%) helped performance in a relative sense.

Fund performance was negatively impacted by:

- Travel company, Flight Centre (-14%) was weaker during the quarter as the company guided to a slowing in year on year total transaction value.
- Wealth Manager, AMP Limited (-5%) fell as Life Insurance woes re-merged. Strengthening claims assumptions led to a $1bn write-down and group earnings declines of circa 5-6%. Reinsurance initiatives and capital reallocation away from the capital hungry life division will help underpin future dividend flow and reduce earnings volatility.
- The absence of the two largest stocks in the 300 index, Commonwealth Bank (+14%) and Westpac Bank (+14%) were the largest detractors in a relative sense. The rally in forward power prices also supported utility provider, AGL (+16%) which the fund also does not hold.

Stocks Added

None

Stocks Sold

None

Top 5 active positions

Stock	Active weight%
By Large Cap stocks:	
Bank of Queensland	4.5
ANZ Banking Group	4.3
Rio Tinto	4.3
National Australia Bank	4.1
BHP Billiton	4.1
By Small Cap stocks:	
Sims Metal Management	2.2
Nine Entertainment	1.5
Clydesdale Bank	1.2
Seven West Media	1.1
McMillan Shakespeare	0.8

Note: Active weights refer to positions above benchmark only.

Asset allocation

Sector	Active weight %
Materials	8.6
Consumer Discretionary	5.4
Financials ex-Real Estate	3.3
Consumer Staples	(0.2)
Information Technology	(1.1)
Energy	(1.9)
Utilities	(2.3)
Telecommunications	(2.7)
Industrials	(4.0)
Health Care	(7.0)
Real Estate	(7.5)
Cash & Other	9.4

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*
- Sigma is an investment partnership, 51% owned by Aziumt, Italy's leading independent asset manager with the Executive founders owning the remaining 49%

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