SIGMA FUNDS MANAGEMENT®

August 2015

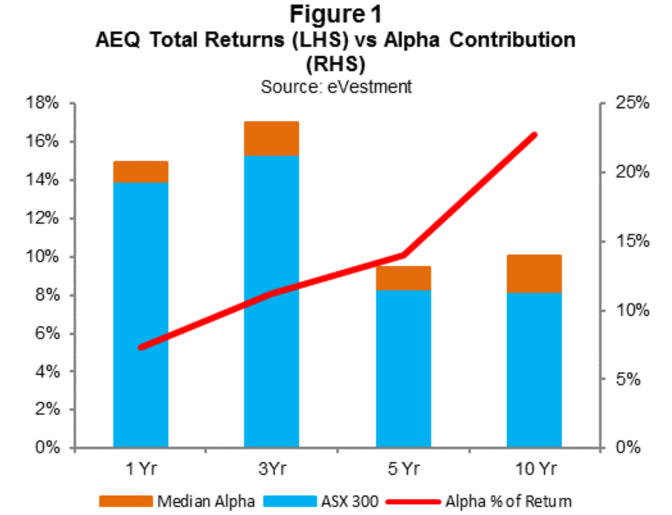
Sigma Insights –Alpha & Active Risk in a low return environment

Australian equities in a low return environment; the importance of alpha and active management

The persistence of low discount rates in financial markets has increased Australian equity valuations to historically high levels. In the absence of a strong earnings cycle Australian equity returns will therefore be modest in future. This research piece focuses on the increased importance of alpha in a lower return Australian equity environment to improve future returns and deliver superior results from a large component of investor portfolios. We also highlight the importance of superior risk management from active management in an environment dominated by increasingly overvalued, higher risk assets as an increased value add. As a high conviction, active manager we track the evolution of Sigma's Select strategy to provide evidence of our skill in capturing major outperformance opportunities and the benefits of superior risk management. We believe accessing high alpha, flexible, actively managed strategies is compelling in the current Australian equity investment environment.

Beta was the past; alpha is the future

Australian equities over the last three years, have delivered returns well above long-term averages as markets recovered from depressed valuations and participated in yield compression due to reductions in the global interest rate structure. Although active Australian All Cap managers have outperformed the ASX300 over this period, returns have been dominated by the high market return or beta available. Investors have recently experienced a rewarding period even where their Australian equity portfolio has underperformed the market benchmark.

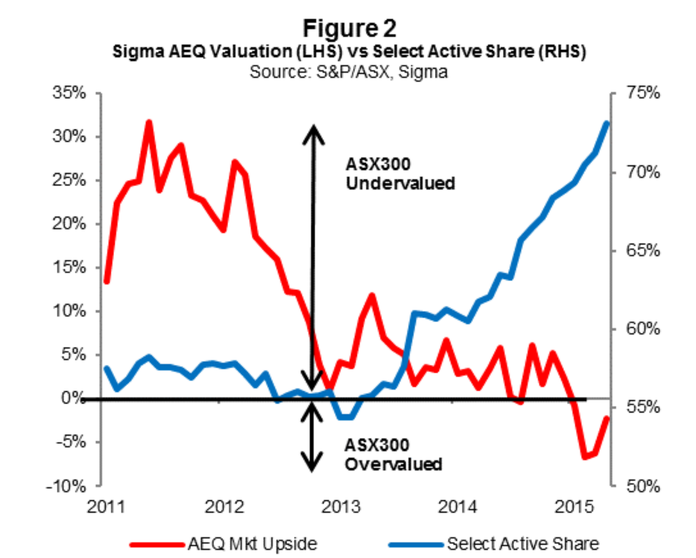


Over the last three years the median alpha return has contributed around 10% of the total return achieved by active managers. Over a longer duration, where total returns are more normalised, the alpha contribution is higher at 15%-25%. As none of the periods measured in recent history can be regarded as a low return environment, we assess that manager alpha contribution will increase to a much higher composition level when market returns are lower.

Active risk should be higher in fully valued markets

Has active risk increased in your Australian equities portfolio? We believe it should.

Sigma, as an experienced active manager, has historically observed that the opportunity for investors to take higher levels of active risk improves as the ASX300 benchmark becomes increasingly dominated by overvaluation. Strong periods of outperformance and an increased ability to raise capital, mean certain sectors inevitably become large, fully valued components of capital weighted indices. Investors who employ active management should therefore expect to see a correlation between active risk in their portfolio—as measured by active share or tracking error—and overall valuation levels in the market.



Sigma Select's active share measure in Figure 2 illustrates the correlation between active risk taken and market valuation. At a time when the ASX300 was significantly undervalued in 2011 and 2012, Sigma observed attractive valuation support and low risk in many Large Cap Industrials with high index weights, particularly the bank sector. The size of these index weights inevitably limited the degree of active risk that could be taken. This type of positioning is not indicative of limited alpha potential, as the strategy focused on a **more certain outcome in low risk, undervalued Large Cap Industrials** and avoided the higher risk and overvalued Resource and Small Cap sectors. Sigma Select delivered a total return of 31.8% and 12.2% outperformance in 2013 as this opportunity set was realized.

In fully valued markets opportunity for active risk increases as highly weighted stocks become unattractive. This is currently evident in Sigma's Select strategy where overvaluation in defensives and banks limits portfolio opportunities. Unfortunately, investors may not take advantage of higher active risk opportunities as many active strategies **over rely on relative to benchmark portfolio construction.** Factors that influence this outcome include:

- Large FUM restricting capital deployment opportunities
- Business risk considerations
- Tight portfolio limits aiming to manage volatility of benchmark deviations

As investors have experienced, combinations of "index hugging" strategies has limited value add. This has been a key consideration in the expansion of passive and smart beta strategies by many institutions. At the same time the opportunity for active managers to outperform and manage risk in fully valued markets is considerably higher. As a result investors would benefit in considering well-credentialed, high conviction portfolios to sit alongside increased passive and smart beta exposure.

Sigma's high conviction approach to active risk

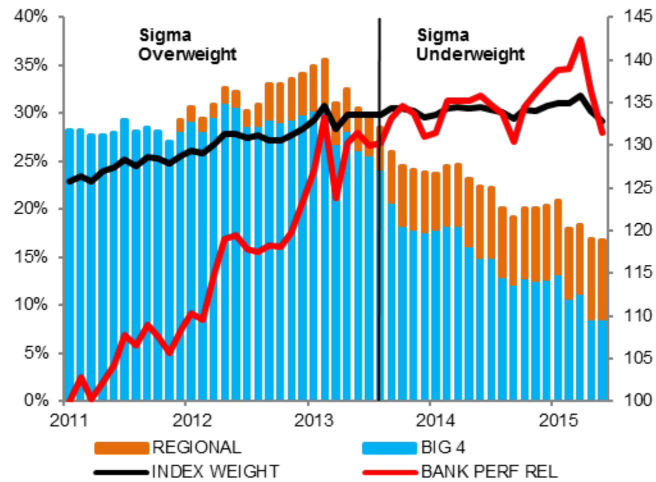
We argue high conviction investing is best served by implementing both an absolute and relative approach to stock selection and portfolio construction. With a firm focus on attractive valuation this approach allows Sigma to be fully aware of overvaluation risk and restrict portfolio exposure accordingly rather than diluting returns with expensive assets justified on relativities. Additionally Sigma, through sensible capacity limits and mandate flexibility is able to efficiently deploy meaningful capital into smaller opportunities without suffering the capital deployment constraints of high FUM levels. Sigma's systematic method to assessing fundamental stock and portfolio risk delivers an approach that takes active risk with the aim of delivering the most certain outcome from potential outperformance opportunities. This means risk is not defined relative to benchmark, as portfolio deviation from the benchmark is an outcome of the opportunity set available.

Sigma's approach in fully valued markets leads to portfolios with significantly more active risk. This is not fundamental risk, as the benchmark is where the greater risk lies. To provide evidence of Sigma's approach we have tracked our Select strategy's positioning in the key Banks, Basic Materials and Small Caps sectors over time to highlight how we position the portfolio to profit from major sector mispricing and avoid periods of overvaluation and high risk.

Banks are weighing on portfolios

At portfolio inception in 2011, Sigma's Select strategy held large positions in three of the Big Four banks. Sigma recognised the significant sector valuation support and diminished levels of risk as Australian banks positioned themselves to structurally raise returns inclusive of higher capital requirements due to a benign competitive and asset price environment post GFC. The Select strategy held slightly less than 30% of the portfolio in the bank sector.

Figure 3
Sigma Bank Weight (LHS) vs Bank Relative Performance (RHS)
Source: S&P/ASX, IRESS, Sigma



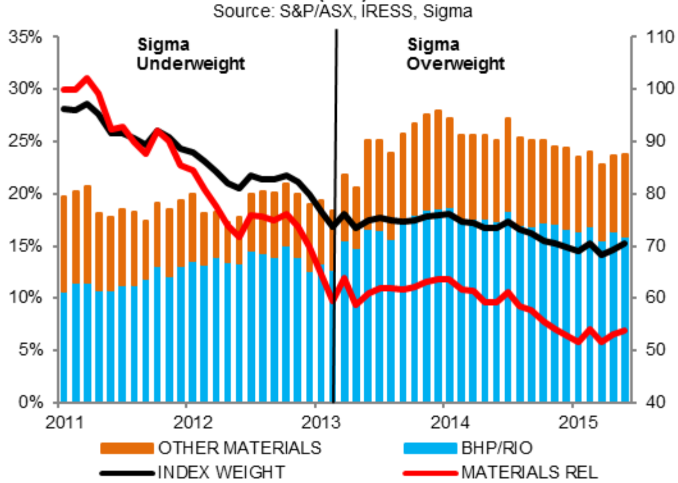
Following a strong period of outperformance and a bank weight peaking at 35% of the portfolio, Sigma's thesis was playing out and sector attractiveness was declining. This led to a sustained reduction in bank weight and rotation out of fully valued majors, such as CBA, into more attractively valued regionals. As the sector continued to rise and modestly outperform in a relative sense the weighting has declined to around half peak levels. Currently within the sector regionals account for half the Select bank weight and only NAB is held amongst the Big Four.

In an environment of full valuation multiples, higher capital requirements, declining ROE and greater restrictions on dividend payout retaining a major bank weight portfolio of 25%-35% due to index size makes little sense. This weighting opportunity was available four years ago when banks were cheap. We also assess that there is **little gain from tying up 30% of portfolios to marginally over and underweight individual banks,** as the alpha opportunity is typically small and can take long periods of time to realise. We believe there is more value add in an actively managed bank sector weighting that is cognizant of fundamental risk, absolute and relative valuation.

Basic materials weight should be material

At Select portfolio inception in 2011, the second phase of the Resources boom drove the Basic Materials sector to excessive levels of valuation and a high index weight. This sector group at the time accounted for nearly 30% of the index capitalization. The boom limited cheap opportunities within a sector grouping covering many more stocks with greater diversity compared to the more homogenous banks sector.

Figure 4
Sigma Materials Weight (LHS) vs Materials Relative Performance (RHS)
Source: S&P/ASX, IRESS, Sigma



The declining Resource boom drove significant underperformance by many highly weighted stocks in the sector. Sigma's Select strategy benefited, in a relative sense, due to a much lighter sector exposure.

Select's sector weight was maintained during the initial underperformance period as opportunities to add positions and reweight underperformers presented themselves. The Basic Material weight was subsequently raised to a higher exposure level during 2013 after a 40% underperformance period opened attractive valuation and lower risk, particularly in BHP and RIO. This example highlights that Sigma's approach objectively considers the full suite of investment opportunities rather than relying on structural biases, such as limiting investment in Resources, where fortunate timing in the sector's collapse has driven an unintended benefit for this bias type in a relative sense.

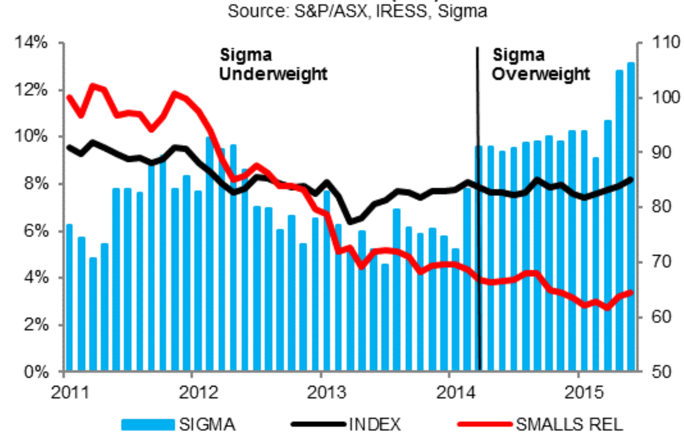
Since inception, Select's Basic Materials weight has increased from around 20% to 25% along with a higher mix towards the two large miners. Interestingly the current weight is well above index weight which, due to severe underperformance, has halved from 28% to 14% of market capitalization. Although Select is significantly above index weight, the portfolio weight is moderately higher than inception and concentrated in large, low cost exposures generating strong cash flow at the bottom of the cycle. In our view, this example demonstrates that using both an absolute and relative approach provides a superior basis for fundamental risk management and portfolio construction.

Small cap exposure should be larger

Sigma having two specialist investment teams fully aligned and integrated sharing a common investment philosophy and approach provides a unique opportunity to systematically compare the attractiveness of Large and Small Caps. This is expressed in Sigma's Select strategy where the portfolio tilts between Large and Small Caps depending on valuation attractiveness and risk of the key portfolio positions held by each of the two teams.

At Select's inception in 2011 the portfolio tilt was in favour of Large Cap Industrials due to significantly more attractive valuation and low levels of risk when compared to the key exposures in the Small cap strategy.

Figure 5
Sigma Small Cap Weight (LHS) vs Small Cap Relative Performance (RHS)
Source: S&P/ASX, IRESS, Sigma



A significant period of Small Cap underperformance benefitted the Select strategy in a relative sense. The strategy was also able to add value from a few small cap stock positions that outperformed given superior attractiveness to the ASX300 benchmark.

Since early 2014 and following a three year period of underperformance, we have seen a highly attractive opportunity set opening up in Small Caps. The average weight in Select has been increased from around 7% pre 2014 to currently be more than 14%. Sigma's approach has multiple advantages. Firstly, in accessing individual high conviction positions in Small Caps to build the Select portfolio exposure. Secondly, selecting individual stocks is capital efficient and improves diversification in an intended manner. And finally by comparing Select's Small Cap positions to the ASX300 benchmark it aligns performance with the broad market rather than a smaller subsector.

Summary

Has active risk increased in your Australian equities portfolio? We argue it should. Fully valued equity markets moderate future returns and raise risk. This increases the opportunity for active management to add value through superior performance and risk management. Investors benefit by raising exposure to well-credentialed, high conviction managers in the current environment. This paper provides clear evidence of the success of Sigma's approach in consistently adding value through active portfolio positioning and strong focus on risk management to protect potential downside in returns.

The author, Michael Jenneke, is a Director, co-founder and Portfolio Manager for Sigma Funds Management. Mike is primarily responsible for the direct coverage of Consumer, Transport, Property sectors and for the Sigma Select Equities Fund.

Sigma Funds Management Performance							
Performance to 30 June 2015	Quarter %	6 months %	1-Year %	2-Years % pa	3-Years % pa	4-Years % pa	Inception* % pa
Sigma Select Equities Fund	(3.9)	6.7	5.9	13.7	18.0	10.5	9.6
ASX 300 Accumulation Index	(6.5)	3.2	5.6	11.3	14.7	8.3	7.4
Value Added	**2.6**	**3.5**	**0.3**	**2.4**	**3.3**	**2.2**	**2.2**

** From inception date: 2nd May 2011. Past performance is not a reliable indicator of future performance.*