SIGMA FUNDS MANAGEMENT®

# Sigma Australian Shares Strategy

Monthly update as at 31 January 2016

| | Month % | Quarter % | 1 year % | 2 years % p.a. | 3 years % p.a. | 4 years % p.a. | Since Inception^ % p.a. |
|---|---|---|---|---|---|---|---|
| Sigma Australian Shares | (7.5) | (9.1) | (9.0) | (1.8) | 4.5 | 8.0 | 2.5 |
| S&P/ASX 200 Acc. Index | (5.5) | (3.6) | (6.1) | 2.8 | 5.4 | 8.9 | 1.8 |
| **Value added (detracted)** | **(2.0)** | **(5.5)** | **(2.9)** | **(4.6)** | **(1.0)** | **(0.9)** | **0.7** |

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

## Key points

- Significantly overweight Diversified Miners and underweight Major Banks
- Cyclical sectors expected to benefit as earnings bottom; avoiding expensive defensives
- Fund positioned for US interest rate normalisation; while matching local market dividend yields

## Individual stock performance of note

The Fund *underperformed* a falling market in January. Stock contributors included JB Hi-Fi (+20%) and Harvey Norman (+6%), beneficiaries of Dick Smith's downfall. Seven West Media (+7%) also continued to run in anticipation of media law changes. The absence of ANZ (-13%), CBA (-8%) and WBC (-8%) contributed in a relative sense, while somewhat offset by falls in Bendigo and Adelaide Bank (-10%) and National Australia Bank (-8%). Overall the bank underweight contributed to performance in a relative sense. The Funds three resource holdings: Whitehaven Coal (-41%), BHP Billiton (-14%) & Rio Tinto (-12%) all detracted from performance as commodity markets continued to pressure. The absence of big defensive names: Westfield (+4%), Scentre Group (+4%), Sydney Airport (+4%) Transurban (+3%), Wesfarmers (1%), Telstra (0%) and CSL (-1%) impacted performance in a relative sense and were the largest detractors as a group.

## Economic developments and markets

Global equity markets declined during the month (S&P 500 -5.1%: FTSE -2.5%: Nikkei -8.0%, Hong Kong -10.2%) as global growth concerns continue to persist in light of a rising US rate cycle. China was one of the worst performing markets, with the Shanghai Composite down 23% over the month, however the market is still some 35% higher than 2 years ago.

The S&P/ASX 300 Accumulation Index fell 5.4% in January, somewhat recovering from a near 10% intra-month fall courtesy of the Bank of Japan's surprise negative interest rate move. The local index was dragged down by a slump in both the Resources (-9.0%) & Bank (-9.1%) sectors with a rush to defensive names (REIT +0.2%, Utilities +0.7% and Telco's +0.7%), all slightly in positive territory, holding up the market.

The Small Ordinaries Accumulation Index outperformed the S&P/ASX100 equivalent by 0.4%. The Small Industrials Accumulation Index underperformed the S&P/ASX 100 by 0.2%, while the Small Resources Accumulation index outperformed the S&P/ASX100 Resources index by 4.8%. The Small Ordinaries Accumulation Index has now outperformed the S&P/ASX100 Accumulation Index by 2.4% over the last quarter and 10.2% over the year.

Commodity markets were again weaker due to concerns over Chinese growth & US monetary policy tightening. 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 during the month. Iron Ore prices fell by 1.3% to US$43 per tonne. Base metals were mixed with lead (-4%), copper (-3%), nickel (-2%) and platinum (-2%) declining, whilst Gold (+5%), Silver (+3%), tin (+2%), zinc (+1%) and aluminium (+1%) all closed higher. The A$ depreciated (-2.8%) against the US$ in light of ongoing commodity weakness.

US Economic data generally softened with the ISM manufacturing index for December falling to a worse than expected 48.2, the second straight month of sub-50 readings indicating contraction. The non-manufacturing ISM for December fell to 53.3, below expectations. Retail sales and

Industrial production for December were also weak. Payrolls once again, were the only bright spot, with December payrolls rising to a higher than expected 292k.

Chinese economic data continued to weaken. The 'official' manufacturing PM for December rose marginally to 49.7 – the fifth straight month of sub-50 readings indicating contraction. Industrial production for December grew at a weaker than expected 5.9%y/y, while GDP for Q4 growth also disappointed at 6.8%y/y - the weakest calendar year growth rate in 25 years.

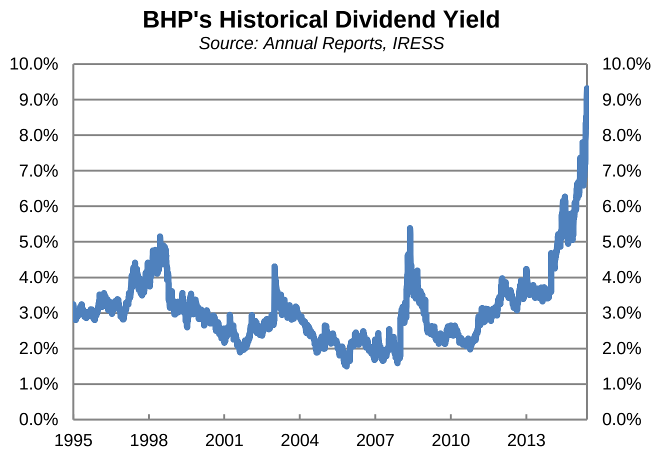
On the last trading day of the month the Bank of Japan surprised markets by announcing it was adopting negative interest rates. Specifically, a negative interest rate of -0.1% would be imposed on a portion of reserves that financial institutions deposit at the central bank.

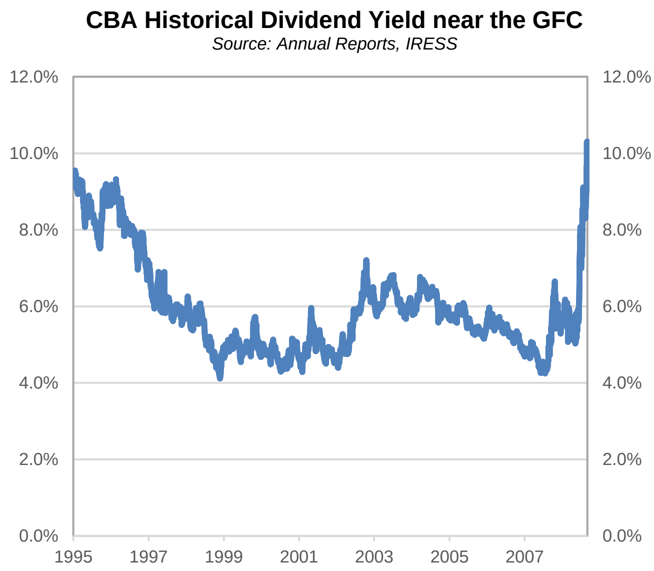
On the domestic economic front, building approvals for November fell a much worse than expected 12.7%m/m to an annualised rate of 205k. Employment for December beat expectations once again, falling by only 1k with the unemployment rate remaining constant at 5.8%. Over calendar year 2015 employment growth was 2.7% (312k more people employed) and well above the average y/y growth rate of 1.8% over the last 20 years.

## Portfolio changes and outlook

The Fund's relative valuation upside currently stands at 44%, a since inception high. In absolute terms, the portfolio has 48% upside relative to the market which is fairly valued (4%) in our view (see graph). 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.

The following two charts highlights the changing fortunes over time of two of Australia's largest listed companies. At the height of the GFC in late 2008 and early 2009 nobody wanted to buy Australia's largest and least riskiest bank, the Commonwealth Bank of Australia, even as the dividend yield approached 10% (fully franked!). You couldn't give the stock away at below $30 per share. A few years on, the market is now willing to pay nearly $80 per share for the same business. Post the GFC, the industry position of CBA and all the majors have been strengthened considerably. Higher profits with lower risk has been the result. The large diversified miners are in a similar position. The current shake out will benefit shareholders in the coming years. While BHP may end up cutting the dividend (like CBA did during the GFC) we believe profitability and net cashflow is more than likely to improve substantially going forward.




## Stocks Added

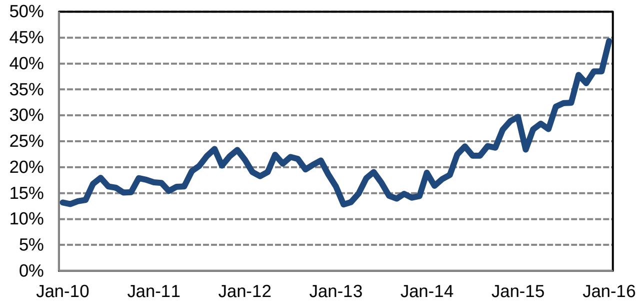
None

## Stocks Sold

None

**Australian Shares : Relative Valuation Upside**

*Source: Sigma Estimates, IRESS*




| Pricing Metrics | 1-Yr PE | Net Div. Yield | Price/ Book Value | Price to NTA |
|---|---|---|---|---|
| Sigma ASF | 12.2 | 5.9% | 1.2 | 1.6 |
| S&P/ASX 200 | 14.6 | 5.1% | 1.7 | 2.5 |
| **Date** | **Jan-16** | **Jan-15** | **Jan-14** | **Jan-13** |
| Stock Numbers | 25 | 25 | 26 | 34 |
| Active Share | 71.4% | 65.0% | 59.3% | 49.1% |

*Source: Sigma estimates, GS Portfoliowise*

## Top 5 active positions

| Stock | Active weight % |
|---|---|
| **By Large Cap stocks:** | |
| Bank of Queensland | 5.1 |
| Bendigo and Adelaide Bank | 4.8 |
| AMP | 4.7 |
| Harvey Norman Holdings | 4.7 |
| Rio Tinto | 4.5 |
| **By Small Cap stocks:** | |
| Nine Entertainment | 2.3 |
| Seven West Media | 1.5 |
| G8 Education | 1.1 |
| Whitehaven Coal | 0.9 |
| McMillian Shakespeare | 0.9 |

Note: Active weights refer to positions above benchmark only.

## Asset allocation

| Sector | Active weight % |
|---|---|
| Financials ex-Real Estate | 11.7 |
| Consumer Discretionary | 7.6 |
| Materials | 4.4 |
| Information Technology | (0.9) |
| Industrials | (1.4) |
| Utilities | (1.7) |
| Energy | (3.2) |
| Consumer Staples | (3.4) |
| Health Care | (4.6) |
| Telecommunications | (5.3) |
| Real Estate | (7.1) |
| Cash & Other | 3.9 |

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

## Strategy summary

Sigma Australian Shares is a concentrated 'Large-cap' strategy blending the highest conviction stock ideas from Sigma's Large Cap investment team, leading to:

- Superior outperformance,
- Lower risk, and
- Increased consistency.

## Features of Sigma Australian Shares:

- High conviction value-biased portfolio of 15 to 30 stocks
- Focused primarily on the Top 100 stocks listed on the Australian Stock Exchange
- Return Objective of 4% over the benchmark over rolling 3-5 year periods

## Benefits of Sigma Australian Shares investment approach:

- *Capital protection* is our first priority, and achieved through an absolute as well as relative valuation focus while maintaining a diversified portfolio of large Australian businesses;
- *Outperforming* by allocating capital to a focused portfolio of undervalued business that increase the probability of achieving the Return Objective.

## 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

## Contact

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

See also www.sigmafunds.com.au