SIGMA FUNDS MANAGEMENT®

Sigma Australian Shares Strategy

Monthly update as at 31 October 2016

	Month %	Quarter %	1 year %	2 years % p.a.	3 years % p.a.	5 years % p.a.	Since Inception^ % p.a.
Sigma Australian Shares	0.3	5.0	4.8	1.5	3.0	9.1	3.9
S&P/ASX 200 Acc. Index	(2.2)	(3.2)	6.1	2.6	3.9	9.2	2.7
Value added (detracted)	**2.5**	**8.2**	**(1.3)**	**(1.1)**	**(0.9)**	**(0.1)**	**1.2**

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

Key points

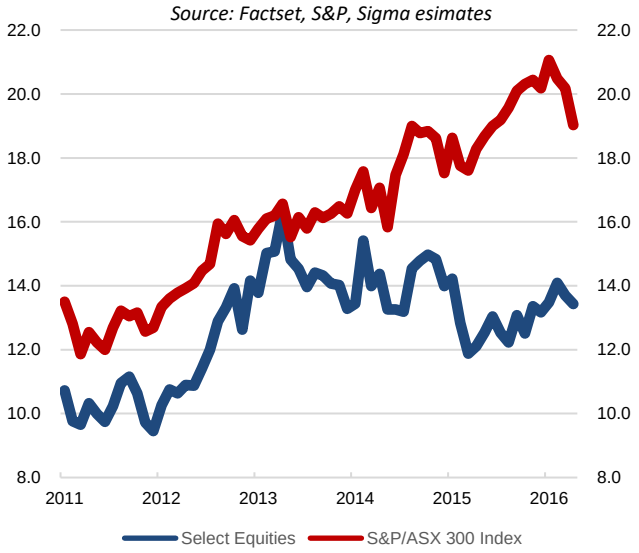
- Objective investors can profit by embracing mispriced uncertainty
- Avoiding expensive safe havens that currently dominate that ASX200 Index
- Fund offers portfolio diversity, healthy cash generation, sustainable dividends & unpriced upside

Portfolio observations, changes and outlook

The Australian Share Fund (ASF) *outperformed* a falling market in October as the defensive–quality-yield (DQY) thematic that has driven the Australian Equity Market (AEQ) to lofty multiples (as shown Figure 1) *started to show signs of reversing*. Approximately 70% of the AEQ by market cap (excludes the four major banks and two major miners) is currently trading on a lofty PE multiple of 20x. Historically, when equity markets have attained these levels, low to negative returns are ***near* certain.**

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

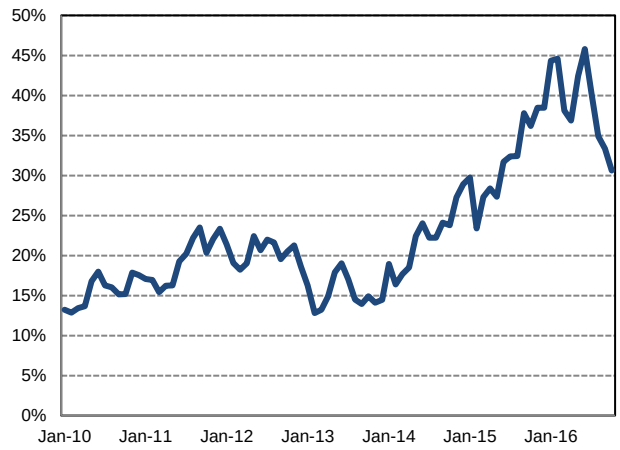
Source: Factset, S&P, Sigma esimates



Perversely, protecting hard earned capital in the current environment requires investors to embrace a more ***volatile portfolio* of businesses where *valuation support* is clearly evident**. Regardless of your views on risk, growth, quality, momentum etc., portfolios trading on high PE multiples have historically delivered low returns. Thus being true to our value label requires commitment to our *valuation disciplines*.

Figure 2: ASF Relative Valuation Upside

Source: Sigma Estimates, IRESS



Accordingly, ASF's s valuation metrics (Figure 2) remain supportive of delivering *positive returns* (+26% upside) in an overvalued market *(market has 4% downside overall)*, albeit we expect to have volatile outcomes over the short-to-medium term in line with recent experience.

Individual stock performance of note

Fund performance was driven positively by:

- Whitehaven Coal (+23%) was again stronger as coal markets surprised to the upside on supply concerns. At 31 October 2015 the stock was $1.03, and subsequently declined to low of 37.5 cents in Feb 2016 on very little news. The Fund exited the position at close to $3 per share on valuation grounds;
- The large diversified miners continued to buck the downwards trend, with BHP (0%) and RIO Tinto (+5%) flat to positive. If the duration of the current *spot pricing trends extends* this dynamic is likely to persist. *The diversified miners have substantial upside* (+50%) and remain key portfolio holdings (19% of the portfolio vs 6% for the index);
- Scrap metal giant, Sims Metal Management (+9%) and explosives services provider, Orica (+7%) were both stronger as the positive shift in the commodity environment suggests better volume and pricing outcomes for profits;
- Regional bank, Bendigo and Adelaide Bank (+3%) was also stronger buoyed by the ongoing strength of Sydney and Melbourne housing markets underpinning the Homesafe business. However, unlike the majors who face increasing capital requirements, the regionals trade on low multiples with supportive yields;
- Global commercial insurance giant, QBE (+7%) was also stronger reversing the weakness experienced in recent months as the market extrapolated a below expectation result, highlighting ongoing pricing pressure and the impact of lower interest rates. With the balance sheet and a sustainable dividend profile restored, the future will look brighter when macro headwinds abate;
- The absence of telecommunications, regulated utilities, property infrastructure exposures helped performance in a relative sense;

Fund performance was negatively impacted by:

- Wealth Manager, AMP (-13%) was the largest detractor during the month 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 major Sydney Retail banks, Westpac (+3%) and Commonwealth Bank (+1%) impacted performance in a relative sense.

Stocks Added

Incitec Pivot Limit (ALQ) is leading manufacturer and distributor of fertilisers and explosives. Sigma's valuation upside is approximately 14% higher than the current stock prices. Given depressed fertiliser prices and an improving coal volume outlook the fundamentals are starting to look more attractive.

Stocks Sold

ALS Limited (ALQ), BlueScope Steel (BSL) and Whitehaven Coal (WHC) were all sold on valuation grounds.

Top 5 active positions

Stock	Active weight %
By Large Cap stocks:	
Rio Tinto	5.8
BHP Billiton	5.5
Bendigo and Adelaide Bank	5.1
Bank of Queensland	4.4
ANZ Banking Group	3.9
By Small Cap stocks:	
Clydesdale Bank	1.3
Seven West Media	1.1
Nine Entertainment	0.9
Cleanaway Waste Management	0.6
McMillian Shakespeare	0.4

Note: Active weights refer to positions above benchmark only.

Asset allocation

Sector	Active weight %
Materials	10.2
Consumer Discretionary	5.5
Financials ex-Real Estate	4.8
Consumer Staples	(0.5)
Information Technology	(1.0)
Utilities	(2.0)
Energy	(2.9)
Industrials	(3.1)
Telecommunications	(5.9)
Health Care	(6.0)
Real Estate	(7.9)
Cash & Other	8.8

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

Contact

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

See also www.sigmafunds.com.au