

# Sigma Emerging Companies Strategy

Monthly update as at 31 May 2017

	Month %	Quarter %	FYTD %	1 year %	3 years % p.a.	5 years % p.a.	Since Inception <sup>^</sup> % p.a.
Sigma Emerging Companies Strategy*	0.4	1.4	20.8	19.8	5.9	7.7	6.6
S&P/ASX Small Ordinaries Accumulation Index <sup>#</sup>	(2.1)	0.3	4.9	3.6	6.0	4.2	1.5
<b>Value added (deducted)</b>	<b>2.5</b>	<b>1.1</b>	<b>15.9</b>	<b>16.2</b>	<b>(0.1)</b>	<b>3.5</b>	<b>5.1</b>

\*Gross returns. <sup>#</sup>The benchmark. <sup>^</sup>Inception date: 1 January 2010. Past performance is not a reliable indicator of future performance.

## Key points

- Small Cap “value opportunity” clearly evident as traditional metrics remain compelling
- Cyclical sectors expected to benefit as earnings bottom and risk appetite increases
- Strategy positioned for cyclical re-rating and away from lower return defensives

## Individual stock performance of note

The Sigma Emerging Companies Strategy (“Strategy”) *outperformed* a falling small cap market in May with the Strategy posting a positive return. Performance was characterised by stock selection, with a number of companies providing trading updates.

Strategy performance was impacted positively by:

- Regional Airline, Alliance Aviation Services (+32%) announced that the ACCC had cleared the joint operation with Virgin Airlines in servicing the remote areas fly-in fly out market;
- Contractor, RCR Tomlinson (+21%) rallied after announcing further contract wins in the solar space;
- Electronics provider, Codan (+10%) upgraded its guidance on the back of continued strength in its metal detection business;
- Waste management company, Tox Free Solutions (+7%) was stronger after an investor site tour showcasing its Worth and Daniels acquisitions which was well received by the market;
- Pacific Energy (+7%) also rallied post a contract win for 11MW of new power generation; and
- Not holding Sigma Pharmaceuticals (-38%), Mayne Pharmaceuticals (-19%) and Quintis (-75%) contributed to performance in a relative sense.

Fund performance was impacted negatively by:

- Kitchen Appliances and Consumer Products company, Shriro Holdings (-18%) was lower on the back of weak sentiment towards consumer discretionary;
- Media company, HT&E (-6%) was weaker after highlighting a slow start to radio earnings at the AGM;
- Osprey (-20%), RXP Services (9%) and Infigen (-8%) were all lower on little or no news; and
- Not holding Worley Parson (+9%) and Fisher and Paykel Healthcare (+10%) impacted performance in a relative sense.

## The Consumer and the entry of Amazon

From a sector point of view the market started to focus in on the deteriorating consumer environment as well as the long-awaited arrival of Amazon to Australia with several brokers downgrading the retail sector as a result. Our view is more nuanced and we spent the month visiting and talking to retailers to understand the cyclical versus structural issues. In a nutshell, Amazon is coming and will take a share of consumer spending over time. As a retailer, you need to own your brand, control distribution and provide the customer with an omni channel offer that is seamless across both bricks and mortar as well as online. Department stores in both diversified or specialty form are vulnerable, being largely resellers of branded products. Apparel is challenged as offshore retailers such as Zara and H&M increase their penetration in Australia making Australian apparel retailers business models, of being fast followers, redundant. They need unique design capability or a specific market niche to survive. Overlaying this is a

potential slowdown in retail spend into the second half of the year as consumers deal with increasing utility and financing costs against a background of limited wages growth. Even though the retailers are showing up as value on our screen it is a case of buyer beware, given the above-mentioned factors.

## Portfolio Changes

### Stocks Added

**Baby Bunning (BBN)** is a fast expanding, large format retailer focussing on baby related products. It has an immature store rollout underway and currently is estimated to have 10% share of the Australian market. Sigma believes that the company has many years of growth ahead of it by simply winning market share in a fragmented market as it builds economies of scale in procurement and ranging. Several competitors have closed with the latest being My Baby Warehouse, highlighting the opportunity going forward. Most competition appears to come from discount department stores but they have a limited range of products. The company has mapped out the next 40 stores to be rolled out towards maturity. The entry of Amazon could impact the business but it is more likely to occur when the store rollout approaches maturity. Simply put, there is sufficient room for both companies to grow in a fragmented market segment. BBN is trading on 14x FY18 earnings.

**SRG Ltd (SRG)** is a civil contracting and mining services business. The civil engineering part of the business is focused on infrastructure and non-residential construction with specialised skills that make it difficult for competitors to imitate. The company has a new, highly experienced management team in place which has been instrumental in turning around and repositioning the business. The pick-up in infrastructure spend is providing a tailwind with a growing pipeline of tenders driving future growth. The mining services business services two major clients being Evolution Mining and Fortescue with drill and blast services under long term contracts which generates free cash for further potential investment in the civil engineering business via acquisitions of specialist service providers both in Australia and North America. The stock is trading on 12x FY18 earnings with net cash on the balance sheet.

### Stocks Sold

**GUD Holdings Limited (GUD)** was sold on valuation grounds given the strong price performance.

## Top 5 active positions

Stock	Active weight %
<b>Overweights:</b>	
IMF Australia	4.2
Tox Free Solutions	3.6
Ingenia Communities Group	3.3
HT&E	2.9
McMillian Shakespeare	2.9
<b>Underweight:</b>	
Charter Hall Group	1.8
NIB Holdings	1.7
A2 Milk Company	1.6
Washington H Soul Pattinson	1.4
Steadfast Group	1.4

Note: Active weights refer to positions above benchmark only.

## Strategy summary

The Strategy is a 'value based' investment approach that specifically focuses on avoiding "value traps", leading to:

- superior performance potential,
- lower risk, and
- increased consistency.

## What makes the Strategy unique?

- Value-biased portfolio of 40 to 60 stocks
- High conviction small cap positions: we back our ideas
- Focused on downside protection through *Sigma's Value: Risk: Adjust* investment approach

## Asset allocation

Sector	Active weight %
Industrials	6.9
Utilities	4.8
Consumer Discretionary	1.0
Information Technology	1.0
Telecommunication Services	(0.1)
Healthcare	(2.6)
Financials-x-Real Estate	(2.8)
Materials	(4.1)
Financials-A-REIT	(4.2)
Consumer Staples	(4.6)
Energy	(4.6)
Cash & Other	9.3

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

## What makes the Strategy different?

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 and completely aligned to the success of its two *interlinked* strategies: Select Equities and Emerging Companies. As the best Small Cap ideas are also high conviction holdings in the Select Equities strategy, the whole investment team is focused on delivering outperformance relative to the relevant benchmark.

## About Sigma

- 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, i.e. 51% owned by Azimut, Italy's leading independent asset manager, with the remaining 49% owned by Sigma's executive founders.

## Contact

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

See also [www.sigmafunds.com.au](http://www.sigmafunds.com.au)

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