

Sigma Select Equities Fund

Monthly update as at 29 February 2016

	Month %	Quarter %	1 year %	2 years % p.a.	3 years % p.a.	4 years % p.a.	Since Inception^ % p.a.
Sigma Select Equities Fund*	(2.8)	(7.8)	(21.3)	(6.8)	1.2	7.6	4.1
S&P/ASX 300 Acc. Index	(1.7)	(4.5)	(13.5)	(0.6)	2.9	8.2	4.7
Value added (deducted)	(1.1)	(3.3)	(7.8)	(6.2)	(1.7)	(0.6)	(0.6)

*Gross Performance. Past performance is not a reliable indicator of future performance. ^Since Inception: 2nd May 2011

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 February. Stock contributors included Bluescope Steel (+19%) post reporting better than expected results due to cost out initiatives while guiding to a more positive outlook. Harvey Norman (+8%) continued to rise (+6% last month) as better than expected results due to a buoyant housing sector and the 40% rise in the dividend confirmed management's confidence in the future. Seven West Media (+18%) also continued to run after reporting good cost control and in anticipation of media law changes. Banks globally were one of the worst performing sectors, weighed down by fears that low and falling interest rates may negatively impact their earnings. The Australian major banks were no exception, with the significant underweight to the majors (-17%) contributing in a relative sense. The absence of CBA (-8%), ANZ (-7%) and WBC (-6%) contributing while the Fund's holding in NAB (-8%) detracted. However, the overweight to regional banks Bendigo and Adelaide Bank (-20%) and Bank of Queensland (-19%) detracted from overall performance as a poorly received result from Bendigo on quality grounds, and the downgrading of expectations from Bank of Queensland exacerbated heightened negative sentiment. In comparison to last month, the overall bank underweight detracted from performance in a relative sense. Not surprisingly, Macquarie Group (-10%) was also weaker, caught in the financial sector sell-off globally. The Funds three resource holdings: Whitehaven Coal (+34%), Rio Tinto (+7%) and BHP Billiton (+1%) all contributed to performance as commodity markets railed in response to the Chinese

government's efforts to refocus on the "growth agenda" rather than the reform agenda of recent times. The absence of Newcrest (+36%) and Brambles (+12%), impacted performance in a relative sense.

Portfolio observations, changes and outlook

Over the last 18 months or so we have been communicating that Select's positioning is more than likely to generate above average returns for investors, however expect the volatility to increase as the "value" lies within the economically sensitive sectors of the economy. Accordingly, as world markets have become concerned with "global growth" in the face of rising US rates, the Fund has been caught up in the downdraft with financial year to date returns down more than the market as shown in the following table:

Select Gross Performance by Financial Year

Financial Year	2012* %	2013 %	2014 %	2015 %	16FYTD %
Select	(10.8)	27.2	22.0	5.9	(17.1)
Index	(10.7)	21.9	17.2	5.6	(7.4)
Relative	(0.1)	5.3	4.8	0.3	(9.7)

*Includes 2 months from financial year 2011

Back in 2011 & 2012 during the European Financial crisis, the market had a lot of upside, as highlighted in the following table, showing the valuation upside for Select and the market at the start of each financial year since 2012:

Valuation upside at the start of each Financial Year

Start – FY*	2012	2013	2014	2015	2016	Feb16
Select	46%	53%	36%	33%	35%	56%
Index	23%	26%	12%	6%	0%	5%
Relative	23%	27%	24%	27%	35%	51%

*Start of the Financial Year

At the start of FY2011 and FY2012 undervaluation was plentiful across a wide universe of stocks as indicated by the 23 & 26% upside respectively for the market. While the Fund had substantially more upside (46% and 53% for the same points in time), Sigma's proprietary *Business Risk Assessment* was showing the Fund's risk profile was in line with the market or slightly better.

Post the significant rally in markets over FY2013/2014 the market as a whole is no longer undervalued and the opportunity set has narrowed considerably. The “**defensive-quality-yield**” (DQY) thematic has resulted in *overpayment for certainty with low future returns* the most likely result. As approximately 60% of the Australian Equity market falls into this camp (Defensive stocks & Major Banks), we expect returns for the market as a whole to be low going forward.

However, embracing the perceived “uncertain and unloved names” neglected by the prevailing DQY dynamic is not an easy road for most investment managers. Most realise they will be compensated for *embracing the near term uncertainty* but cannot do so as they feel nervous about the near term volatility created within their portfolios, particularly in the post GFC world where investors are *paying up for certainty*.

While Sigma's Business Risk Assessment has clearly indicated the Fund has a higher fundamental risk profile than the market, the relative valuation upside more than compensates. As a team we continue to remind ourselves of the first golden rule of investing – **Don't Overpay!** Since inception in May 2011, the portfolio today has the greatest potential for outperformance as highlighted in the Select Relative Valuation Upside graph – i.e. *we are pregnant with performance*.

Select Relative Valuation Upside

Source: Sigma, IRESS



Economic developments and markets

Global equity markets exhibited larger dispersions (S&P 500 -0.4%: FTSE 100 0.2%: German DAX -3.1%: Shanghai Composite -1.8%: Nikkei -8.5%: Hong Kong -2.9%) as global growth concerns continued to persist in light of a rising US rate cycle. Markets generally fell through to mid-month with the US market falling to its lowest close since April 2014, before rallying into month end.

The S&P/ASX 300 Accumulation Index fell 1.7% in February. Resources (+7.5%) outperformed reflecting the reversal in the commodity space, while Banks (-8.2%) underperformed as fears of tightening credit markets drove share prices lower. The Small Ordinaries Accumulation Index outperformed the S&P/ASX100 equivalent by 2.9%. The Small Industrials Accumulation Index outperformed the S&P/ASX 100 by 1.4%, while the Small Resources Accumulation index outperformed the S&P/ASX100 Resources index by 13.1%. The Small Ordinaries Accumulation Index has now outperformed the S&P/ASX100 Accumulation Index by 4.5% over the last quarter and 10.8% over the year.

Commodity markets experienced a sharp reversal. Oil rallied with WTI (US\$33.75) and Brent (US\$36.64) close to YTD highs on talk of OPEC supply cuts (later dismissed) and a combination of supply disruption fears (Nigeria/Iraq). Iron Ore prices rose 18.9% to US\$49.62 per tonne on supply disruptions and restocking in China. Base metals turned up, with the LME Metals Index rising 3.5%. Notably zinc (+8%), tin (+7%), aluminium (5%), copper (3%) and lead (+2%) rose, while nickel (-1.1%) declined. Spot Gold rose 10.8% as rising US economic risks added upside bias to the precious metal. The A\$ appreciated 0.8% against the US\$ in light of the commodity reversal.

US Economic data continued to be mixed. The ISM manufacturing index for January rose marginally to 48.2, the fourth straight month of sub-50 readings indicating contraction, while the non-manufacturing ISM for January fell to weaker than expected 53.5, the weakest level since

February 2014. However, Retail sales for January rose 0.2% with prior months revised up, with payrolls rising a weaker than expected 151k. However the unemployment rate fell to 4.9%, notwithstanding higher labour force participation (edged up to 62.7%).

Chinese economic data continued to come in on the soft side. The NBS manufacturing PMI fell 0.4 to 49.0, with the underlying details showing broad based easing across the major components, including output and new orders, while new export orders rose. Meanwhile PPI deflation has now been in deflationary territory for 47 months, reflecting overcapacity both on the domestic front as well as imported deflation pressure related to global commodity prices. In response, the PBOC announced a further 50bp cut to the reserve requirement ratio (RRR) for all financial institutions effective March 1st.

On the domestic economic front, building approvals for December rebounded by a higher than expected 9.2% m/m to an annualised rate of 226k. Employment growth for January was worse than expected falling -8k though employment growth was still reasonable at +2.6% y/y, while the unemployment rate rose to 6.0% on a steady participation rate (65.2%). 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. However, the wage price index fell to a record low of 2.2% y/y in the series (dates back to 1998). The RBA held the cash rate at 2.0%.

Stocks Added

Australian Agricultural Company (AAC) is a provider of beef and agricultural products. A position was initiated during the month as operational cash flow improvements are likely to see the 24% discount to net tangible assets narrow over time.

Stocks Sold

MACA Limited (MLD) a mining and civil construction company was sold on valuation grounds post a strong share price rally, mirroring the sell down in the Small Cap fund.

Pricing Metrics	1-Yr PE	Net Div. Yield	Price/Book Value	Price to Cash Flow
Select Equities Fund	15.8	5.3%	1.5	4.8
S&P/ASX 300	18.4	4.8%	2.7	8.4
Date	Feb-16	Feb-15	Feb-14	Feb-13
Stock Numbers	34	34	34	32
Large Caps	19	20	23	22
Small Caps (ex-100)	15	14	11	10
Active Share	79.8%	70.5%	60.9%	56.0%
Small Cap Weighting	17.5%	10.5%	8.2%	7.7%

Source: Sigma estimates, FactSet

Top 5 active positions

Stock	Active weight %
By Large Cap stocks:	
Harvey Norman	5.8
Bendigo & Adelaide Bank	5.3
Rio Tinto	5.2
Bank of Queensland	5.2
National Australia Bank	5.1
By Small Cap stocks:	
Nine Entertainment	2.2
Seven West Media	2.1
Ingenia Communities Group	1.4
Broadspectrum	1.3
APN News & Media	1.3

Note: Active weights refer to positions above benchmark only.

Strategy summary

Sigma Select is a concentrated 'broad-cap' strategy blending the highest conviction stock ideas from Sigma's Large Cap and Small Cap investment teams, leading to:

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

What makes Sigma Select unique?

- Concentrated, value-biased portfolio of 20 to 40 stocks
- Broad investment universe (ASX 300) increases alpha opportunities and diversification benefits
- Timely execution of Small Cap exposure (up to 25%) to capture beta opportunity
- Efficient alpha extraction from holding meaningful Small Cap positions
- Focus on downside protection: cash allocation (up to 25%) varies according to market outlook

Asset allocation

Sector	Active weight %
Consumer Discretionary	10.0
Materials	9.9
Financials ex-Real Estate	2.2
Industrials	0.6
Information Technology	(1.3)
Energy	(1.8)
Utilities	(1.9)
Consumer Staples	(2.1)
Telecommunications	(5.8)
Real Estate	(6.0)
Health Care	(7.3)
Cash & Other	3.5

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

Why aren't other investment management firms doing this?

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 the Select strategy.

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

DISCLAIMER: This document was prepared by Sigma Funds Management Pty Limited (ACN 137 097 075, AFSL 339901) ('Sigma'). Sigma does not give any warranty as to the accuracy, reliability or completeness of the information contained in this document, and any persons relying on this information do so at their own risk. This document is provided for general information purposes to wholesale clients only. Accordingly, reliance should not be placed on this commentary as the basis for making an investment, financial or other decision. This document has been prepared without taking account of any person's objectives, financial situation or needs, and because of that, any person should before acting on the information, consider the appropriateness of the information having regard to their objectives, financial situation and needs. Past performance is not a reliable indicator of future performance. The Information Memorandum (IM) should be read in full before investing in the Fund and is available upon request. © Sigma 2015.