SIGMA FUNDS MANAGEMENT®

Sigma Select Equities Fund

Monthly update as at 30 June 2016

	Month %	Quarter %	FYTD %	1 year % p.a.	3 years % p.a.	5 years % p.a.	Since Inception^ % p.a.
Sigma Select Equities Fund*	(3.9)	(0.6)	(11.4)	(11.4)	4.6	6.0	5.2
S&P/ASX 300 Acc. Index	(2.5)	4.0	0.9	0.9	7.7	7.2	6.1
Value added (detracted)	**(1.4)**	**(4.6)**	**(12.3)**	**(12.3)**	**(3.1)**	**(1.2)**	**(0.9)**

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

Key points

- Objective investors can profit by embracing mispriced uncertainty
- Avoiding expensive safe havens that currently dominate that ASX300 Index
- Fund offers portfolio diversity, healthy cash generation, sustainable dividends & unpriced upside

Individual stock performance of note

The Sigma Select Equities Fund ("the Fund" or "Select") *underperformed* a falling market in June as the defensive-quality-yield thematic was reinforced by the surprise Brexit vote.

Fund performance was driven positively by:

- Resources, led by Whitehaven Coal (+27%) as higher thermal coal prices and a significantly lower risk profile post project completions drive a rerating. Perversely, diversified heavyweights, Rio Tinto (+2%) and BHP Billiton (+2%) were beneficiaries of Brexit as market participants looked for exposures beyond the United Kingdom;
- Mining services company, ALS (+22%) rallied after receiving a non-binding and highly conditional proposal from Advent International and Bain Capital of $5.30 per share. The board rejected the approach as it significantly undervalues the company and we concur;
- Small cap litigator, IMF Bentham (+11%) and lifestyle home provider, Ingenia Communities (+8%) continued to find support as key business indicators suggest continuing strengthening momentum in each business;

Fund performance was negatively impacted by:

- Financials sector exposures were generally weaker as global equity markets digested the uncertainty created by the Brexit vote;
- Consequently, the "lower for longer" interest rate thematic was perceived to have greater duration, thereby impacting QBE Insurance (-16%) and AMP (-9%) who have substantial investment portfolios tied to interest rate dynamics;
- The thematic also impacted Banks as the market speculated that lower net interest margins (approximately 65% of Net income for the Majors) would result as deposit competition requires a floor on pricing. The Fund's holdings in Bank of Queensland (-9%), National Australia Bank (-6%) and Bendigo and Adelaide Bank (-6%) were all impacted as a result. This was partially offset by the absence of the two largest stocks in the index, the two Sydney based retail banks, CBA (-4%) and Westpac (-4%);
- Unsurprisingly the largest Diversified Financial, Macquarie Group (-8%) also underperformed as lower market based activity is likely to be a headwind in some areas of the group offset somewhat by the volatility benefits in other areas;
- Small Cap, ERM Power (-42%) once again guided to lower profits. After a series of disappointing announcements by management credibility is being questioned and the Fund consequently exited the position;
- The absence of Newcrest Mining (+21%) impacted to performance in a relative sense as gold stocks look to become the insurance policy;

Portfolio observations, changes and outlook

The following table illustrates the Funds returns by financial year:

Select Gross Performance by Financial Year

Financial Year	2012* %	2013 %	2014 %	2015 %	2016 %
Select	(10.8)	27.2	22.0	5.9	(11.4)
Index	(10.7)	21.9	17.2	5.6	0.9
Relative	**(0.1)**	**5.3**	**4.8**	**0.3**	**(12.2)**

**Includes 2 months from financial year 2011. Past performance is not a reliable indicator of future performance*

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 table above illustrates.

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	May16
Select	46%	53%	36%	33%	35%	43%
Index	23%	26%	12%	6%	0%	-3%
Relative	**23%**	**27%**	**24%**	**27%**	**35%**	**45%**

**Start of the Financial Year*

At the start of FY2012 and FY2013 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.

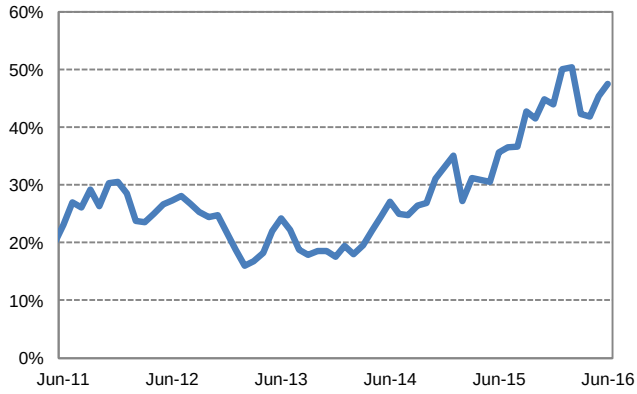
Post the significant rally in markets over FY2013/2014 the market as a whole is no longer undervalued and the opportunity set has narrowed considerably. The **"defensive-quality-yield"** (**DQY**) thematic has resulted in *overpayment for certainty with low future returns* the most likely result. As 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



Stocks Added

Clydesdale Banking Group (CYB) was acquired post a significant drop in the share price post the Brexit vote surprising markets. Regulatory undertakings provided by National Australian Bank places Clydesdale in a unique position with a strong and clean balance sheet. Although the road maybe bumpy, at 0.6 times price to book the business is undervalued.

Stocks Sold

Australian Agricultural Company (AAC) was sold on valuation grounds as the stock now trades above net tangible assets.

ERM Power (EPW) was sold outright as the company is no longer a high conviction stock in the Small Cap fund. Management downgraded FY17 earnings due to margin pressure from recently won contracts in the Australian

business. However, there was a positive surprise in the substantially improved profitability of the new US operations, highlighting the ability to export intellectual property. Overall, the position in the Small Cap fund was reduced to a 1% overweight given the margin pressure expected in the Australian business through to FY18, and the belief management should have been more forthcoming on the existing in-force energy book in previous announcements. Consequently the management score has been downgraded.

Pricing Metrics	1-Yr PE	Net Div. Yield	Price/ Book Value	Price to Cash Flow
Select Equities Fund	15.7	4.9%	1.4	4.9
S&P/ASX 300	18.7	4.6%	2.9	8.8
Date	**Jun-16**	**Jun-15**	**Jun-14**	**Jun-13**
Stock Numbers	33	34	38	33
Large Caps	19	20	23	22
Small Caps (ex-100)	14	14	15	11
Active Share	75.1%	72.9%	55.8%	55.8%
Small Cap Weighting	16.9%	13.7%	7.9%	7.9%

Source: Sigma estimates, FactSet

Top 5 active positions

Stock	Active weight %
By Large Cap stocks:	
Harvey Norman	5.4
Rio Tinto	5.1
BHP Billiton	5.0
Bendigo and Adelaide Bank	4.9
Bank of Queensland	4.5
By Small Cap stocks:	
Seven West Media	2.1
Sims Metal Management	2.1
APN News & Media	1.9
Nine Entertainment	1.6
Whitehaven Coal	1.6

Note: Active weights refer to positions above benchmark only.

Asset allocation

Sector	Active weight %
Consumer Discretionary	11.4
Materials	7.5
Financials ex-Real Estate	3.7
Energy	(0.6)
Information Technology	(1.2)
Industrials	(1.4)
Utilities	(1.8)
Consumer Staples	(2.9)
Telecommunications	(5.5)
Real Estate	(6.6)
Health Care	(7.4)
Cash & Other	4.8

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

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

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*
- Sigma is an investment partnership, 51% owned by Aziumt, Italy'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