SIGMA FUNDS MANAGEMENT®

Sigma Select Equities Fund

Quarterly update as at 31 December 2015

	Quarter %	6 months %	1 year %	2 years % p.a.	3 years % p.a.	4 years % p.a.	Since Inception^ % p.a.
Sigma Select Equities Fund*	1.4	(8.0)	(1.8)	(0.9)	9.0	11.5	6.6
S&P/ASX 300 Acc. Index	6.5	(0.4)	2.8	4.0	9.0	11.2	6.5
Value added	**(5.1)**	**(7.6)**	**(4.6)**	**(4.9)**	**0.0**	**0.3**	**0.1**

**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 *exceeding* local market dividend yields

Individual stock performance of note

The Fund *underperformed* a rising market in the December quarter as Chinese growth concerns weighed on commodities markets and the share prices of the large diversified miners: BHP (-29%) and Rio Tinto (-8%). The disproportionate fall in BHP's share price can mostly be attributed to the financial implications of the Samarco "mud slide" incident and the group's exposure to oil (about 20% of BHP's valuation). With the commodity complex on its knees, we continue to see a *substantial upside* in the industry leaders, with tier 1 assets and strong balance sheets. Whitehaven Coal (-22%) was similarly caught in the commodities downdraft notwithstanding a strong operational update indicating the Mauls creek mine was now essentially de-risked. Overall the three resources exposures accounted for approximately 50% of the underperformance during the period.

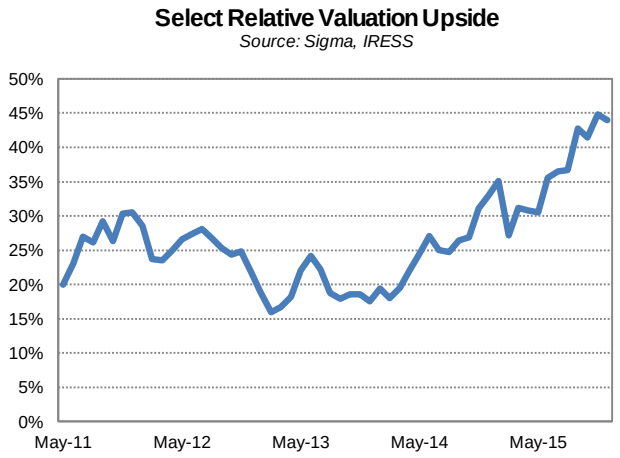
Stock contributors included regional banks, Bank of Queensland (+24%) and Bendigo and Adelaide (+21%). However, the gains were more than offset by a rally in the major Sydney retail banks not held (CBA +18% and WBC +17%). The bank sector as a whole moved on no real news. While there is not a lot of downside in the banks, the upside is fairly limited as regulators focus on de-risking the system through further reforms. Overall, the underweight bank position (approx. -7% relative to index) accounted for approximately 10% of the underperformance.

Other stock contributors included Broadspectrum (+33%) post an all cash takeover offer from Ferrovial and media stock, Nine Entertainment (+21%) on no real news other than ongoing buyback support, while Qantas (+15%) continued to rally as the oil price weakened. The absence of Telstra (-7%) contributed in a relative sense.

Other stock detractors included Slater & Gordon (-72%) and Sims Metal Management (-24%). The former was sold post management withdrawing guidance, suggesting UK business is more challenging than first expected. Combined with high debt levels, the uncertainty associated with the timing of cash flows creates an increased risk of needing to raise capital. While Sims Metal Management was weaker after management downgraded near term profits due to a collapse in global scrap prices. Significantly undervalued with net cash on the balance sheet, Sims remains well positioned to benefit from volume improvements in the key United States segment over the long term. The absence of Healthcare index heavyweight, CSL (+18%) impacted performance in a relative sense. The combination of these three stocks accounted for approximately 40% of the underperformance.

Portfolio positioning and outlook

The Fund's relative valuation upside currently (mid-January) stands at 51%, a since inception high, highlighting a portfolio ***embedded with future outperformance***. In an absolute sense the portfolio currently has 57% upside relative to the market which is fairly valued (+6% upside) in our view (see graph below). 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.

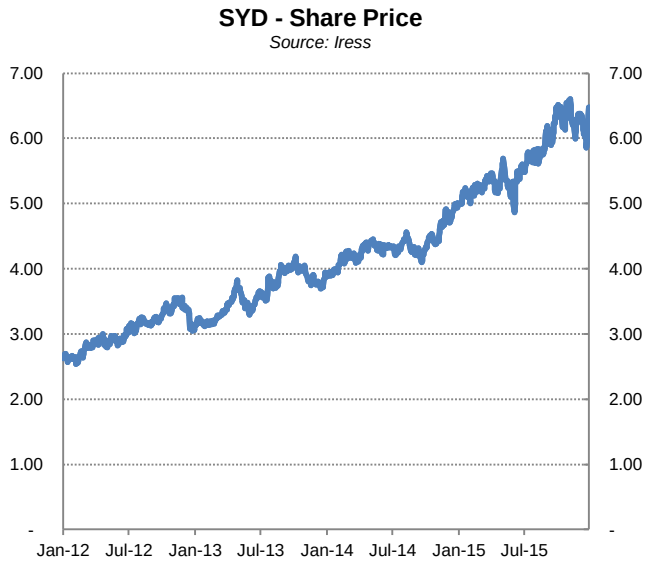
We believe Australian equities remain vulnerable to an unwinding of the ***"defensive-quality-yield"*** *(DQY) play* that has driven markets post the GFC due to unconventional monetary policy settings that held rates "near zero", distorting markets. While the unemployment rate is close to 5% in the United States (and has been there for some time) the Fed is has only just lifted rates after 8 years of being close to zero.

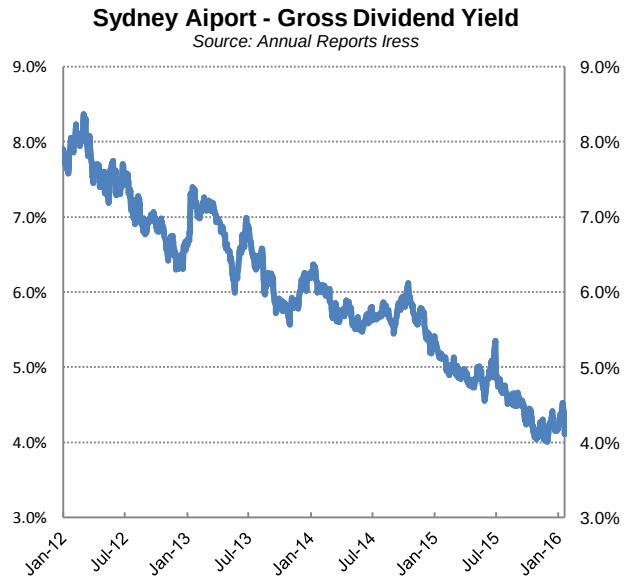
The focus on ***DQY*** has resulted in the market overlooking elevated stock prices as a function of earnings power, *justified* by "dividend yields" remaining attractive relative to "low interest rate settings". Defensive stocks (approximately 30% of market cap) have been the main recipients of this trend, followed closely by the major banks (another 30% of market cap) until recently.

We believe market participants have fallen into the trap of starting to assess approximately 60% of the equity market as a having "bond like coupons" (i.e. fixed "dividend payments") that can be discounted at interest rates currently being implied by the bond market. If the same logic was applied to Sigma's valuation framework i.e. let's use the current 10-year Australian bond rate of approximately 3.0% as our risk-free rate assumption (versus our assumption of 5.5%), our valuations would no doubt be substantially higher. Indeed, the market as a whole would look exceeding cheap on this basis. However, we believe equity markets stopped believing bond markets long ago.

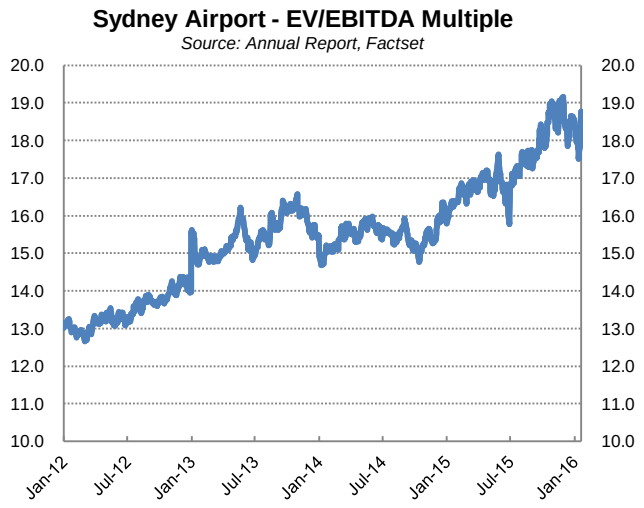
Our valuation framework favours a common sense approach, relying mainly on multiples of earnings power, whether that be PE, EV/EBITA etc. as the benchmark by which we assess value. Furthermore any disciple of valuation understands that dividends are an outcome of a capital allocation process. Earnings strength and the capital required to generate a particular level of earnings are the primary determinants of value in any business.

The listed Sydney Airport (SYD) which owns 85% of Kingsford Smith is good example of DQY. The share price is up approximately 139% since 31 December 2011 (distributions are up 21% over the same time frame) with the gross distribution yield compressing from 8% to 4% (no franking here) as shown in the following two graphs.





At the current share price of $6.57 the implied EV/EBITDA multiple is 19x, or approximately 40% higher than just four years early. To put this in context, under Sigma's valuation framework the highest valuation multiple we are prepared to give to any business is a 30% premium to the market multiple, which implies an EV/EBITDA multiple of 9x. Therefore, Sydney Airport is currently trading out over 2x this metric.



So what changed in a fundamental sense that lead to the substantial re-rating? Very little. Traffic growth (international in particularly as the key driver of profits) has largely been in line with consensus numbers, regulatory reviews have been as expected, with minor changes at the board and management level but overall orderly. So what has really changed? The *perception around the distribution stream* – deemed to be more bond like due to the consistency and resilience through the current period. There are plenty of examples of this in the Australian market - healthcare, utility, infrastructure and property names and at times the Major Banks (until recently) have fallen into this camp.

Overpayment for *certainty* results in *low future returns*. As approximately 60% of the Australian Equity market falls into this camp currently we expect returns for the market as a whole to be low going forward as highlighted in the first table below.

Valuation Upside of Select and the S&P/ASX 300 Index

Financial Year	2012	2013	2014	2015	16FYTD
Select	53%	36%	32%	35%	43%
Index	26%	12%	12%	0%	-2%
Relative	**27%**	**24%**	**24%**	**35%**	**45%**

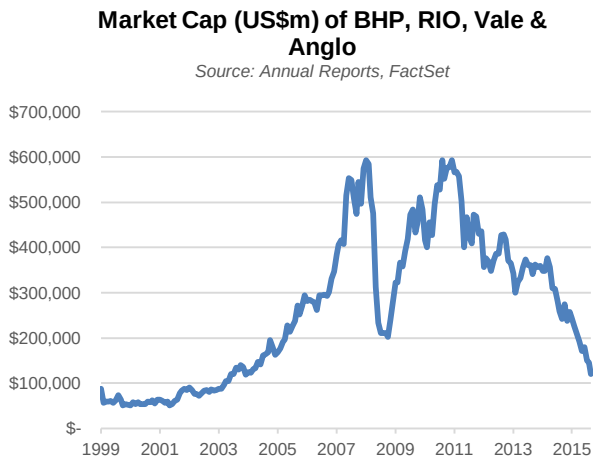
Performance of the Select Equity Fund by Financial Year

Financial Year	2012*	2013	2014	2015	16FYTD
Select	-10.8%	27.2%	22.0%	5.9%	-7.9%
Index	-10.7%	21.9%	17.2%	5.6%	-0.4%
Relative	**-0.1%**	**5.3%**	**4.8%**	**0.3%**	**-7.6%**

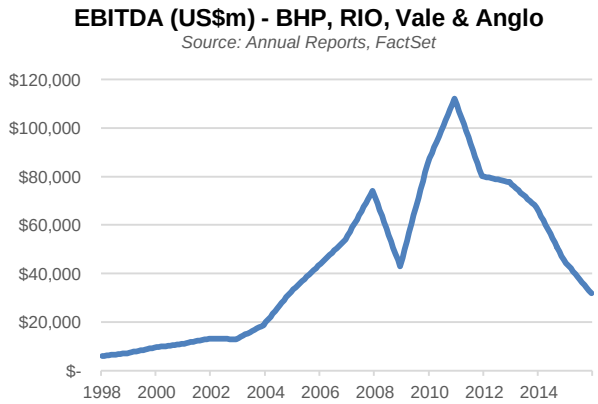
**Includes 2 months for the prior year to the inception date being 2 May 2011*

Going into financial year 2016, the market had no upside. This is in stark contrast to the start of financial year 2012 where we believed the market as a whole was cheap (26% valuation upside) and subsequently achieved double digit returns over the following two financial years with Select (53% upside) outperforming by approximately 5% per annum (our target) over the same period, a function of the greater level of upside. However, we also assessed the portfolio as having risk levels that were in line or better than the overall market as a whole due to the plentiful number of opportunities on offer in low risk franchises. However, with the market re-rating, the opportunity set has narrowed somewhat to the "uncertain and unloved names" neglected by the prevailing DQY dynamic. This presents a dilemma for most managers who 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*.

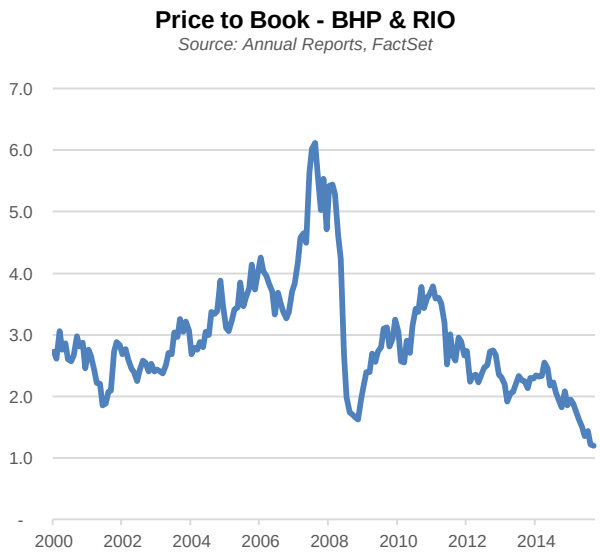
This issue is no clearer than in the large diversified miners. As the following graphs highlight, the sector is currently on its knees.



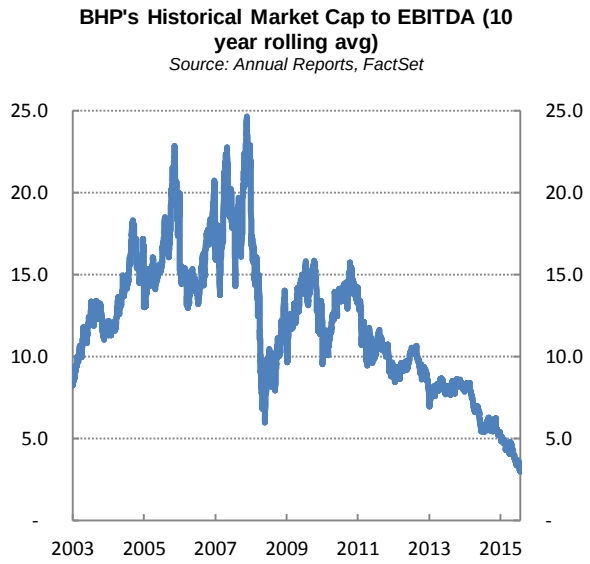
Share prices have followed earnings lower as commodity prices have fallen.



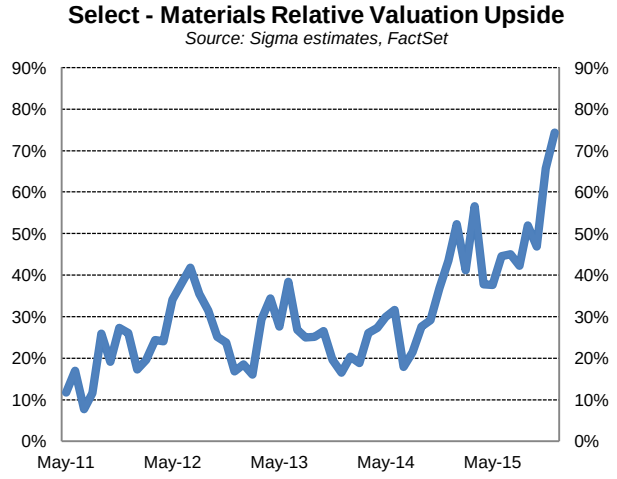
However, on simple price to book measures both BHP & RIO are trading at substantial discounts to long term averages (2.9x).



If we consider another very simple measure (Market Cap to EBITDA) of *through the cycle earnings power*, BHP is looking exceedingly cheap.



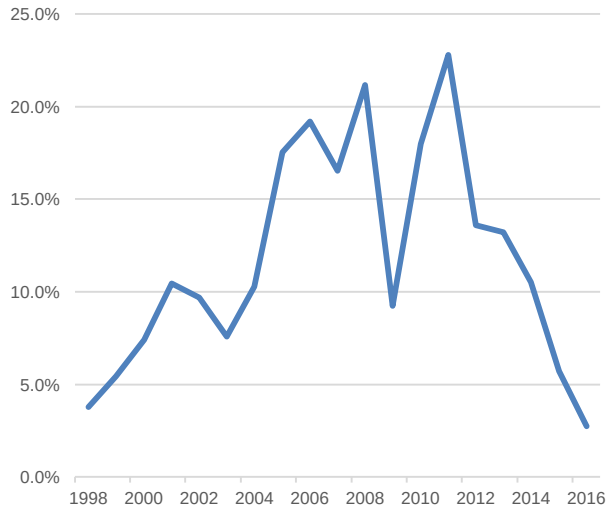
Sigma's valuation framework which is based on discounted cash-flows for the large miners, confirms a substantial amount of upside on offer.



The big miners are currently facing a similar situation as to the major banks during the GFC: *Share price pressure resulting from a near term focus on current earnings without looking at the forward indicators of change*. The potential for stronger earnings and improved returns from the Major Miners required an *austerity commitment first and foremost*, which is now well underway. While the entire commodity complex is under pressure, as evidenced by the steep share price falls of Swiss commodities trading house, Glencore, in this environment the strong thrive just as the Major Banks did during the financial crisis. RIO and BHP's have *Tier 1 assets with unassailable scale advantages* placing them in a *very strong position* which is likely to be reinforced in the current environment.

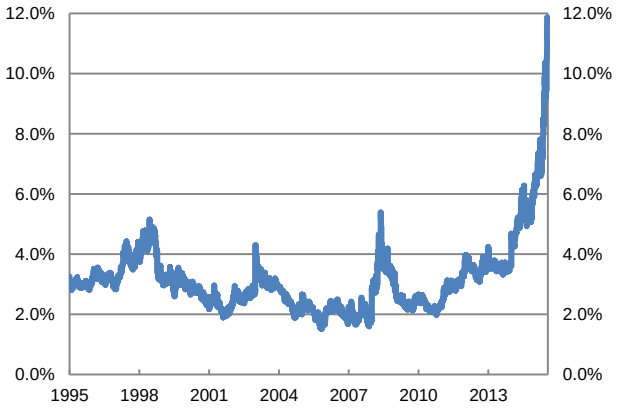
However, the advocates of dividend cuts are extrapolating the recent excesses convinced the Major Miners will need to continue spending rather than prioritise returns. We believe the evidence to the contrary in this regard, and the very austerity measures employed by the ***largest industry players*** will eventually create a *positive commodity price response* in itself to turn around exceptionally low returns.

EBIT to Assets - BHP, RIO, Vale & Anglo
Source: Annual Reports, FactSet

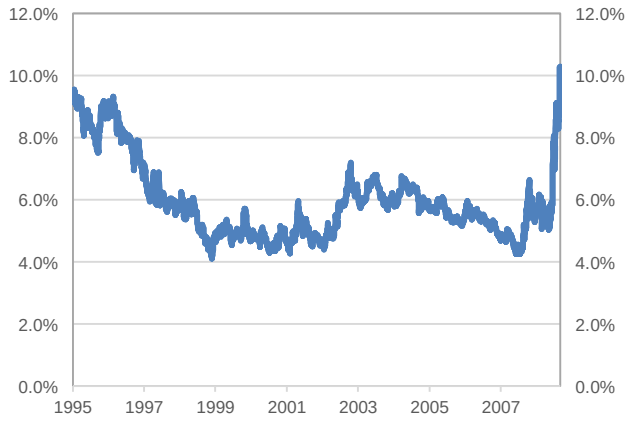


BHP's current dividend yield trajectory bares a similar resemblance to CBA's during the bank GFC woes of 2008. While CBA went onto cut the dividend (by 14%) the stock price rallied strongly.

BHP's Historical Dividend Yield
Source: Annual Reports, IRESS

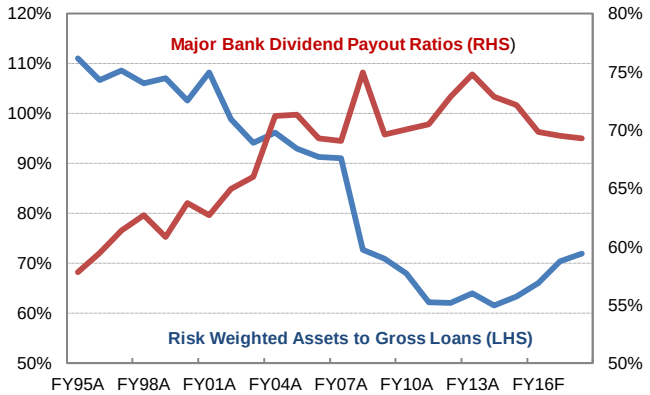


CBA Historical Dividend Yield near the GFC
Source: Annual Reports, IRESS



Ironically, the sustainability of bank dividends in light of the new capital requirements is only just starting to permeate market psychology. The following figure highlights the issues facing the major banks as we move forward. The regulator wants to address the trend of declining risk weighted assets to gross loans (RWA to GL) over time as shown in figure below. As RWA to GL increases, this requires more capital to support any given level of loan growth, therefore more earnings are required to be retained, and less dividends paid out. After 15 years of rising dividend payout ratios, the possibility of *going back to the future* of 60-65% of bank earnings like we had in the past is something the market is yet to fully appreciate. ***Capital intensity is clearly on the rise.***

Dividend Payout Ratio vs RWA to Gross Loans
Source: Annual Reports & Sigma Estimates



However, it is not all bad news for Banking. Regional Banks (Bendigo and Adelaide; Bank of Queensland) remain well positioned in the transition to a more *resilient and competitive banking system*, as they already hold more capital than the Major Banks. As the Major Banks re-price loans (WBC just announced such a measure in October with their $3.5bn capital raising) to offset the profitability pressures, the Regionals should benefit through higher margins and market share gains that should eventually see the ROE of the Majors and Regionals converge. In other words, earnings should expand on the existing capital base leading to improvements in future profitability.

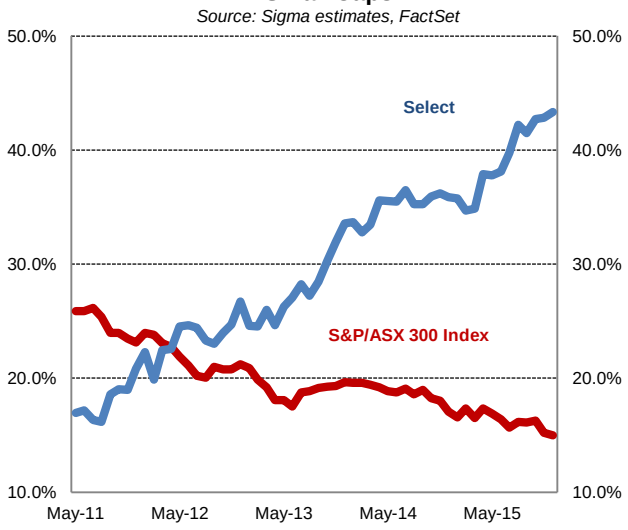
As valuation support is clearly evident (+50% valuation upside) and likely to improve for the reasons outlined above, the Major Miners and the Regional Banks are in our Top 5 Active positions representing approximately 30% of the portfolio. These stocks an average net dividend yield of approximately 6.5%, well above the Australian Equity's market net yield of 5%. *Thus importantly we are more than likely to be paid along the way, while participating the upside as the perception differential changes.*

Furthermore, as the valuation support lies within areas of the market (Regional Banks, Diversified Miners and Small Caps)

that are a smaller proportion of the index it is not surprising that Active Share is currently at all-time highs.

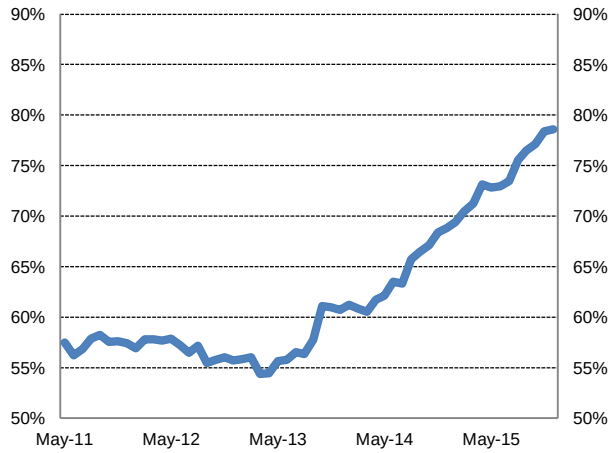
Select Portfolio Weight vs Index Weight: Regionals Banks, Diversified Miners & Small Caps

Source: Sigma estimates, FactSet



Select - Active Share

Source: Sigma estimates, FactSet



Sigma's fundamental business risk metrics indicate the portfolio as a whole is likely to be more volatile than the market. This is unsurprising given exposure to likes of the Diversified Miners, which tend to respond to commodity prices. While portfolio volatility is expected to be higher than in the past, our explicit focus on ***protecting the downside*** remains unchanged. Select is favourably disposed relative to the market on many of the traditional implied metrics (PE's, Dividend Yields, Price to Book Value, Price to NTA, Gearing etc.) indicating strong downside protection.

Finally, it is important to differentiate between *volatility* and the *risk of losing hard earned capital.* The defensive-quality-yield thematic is leading to *overvaluation* of earnings quality and certainty. ***Overvaluation* is the key determinant of future losses.** For DQY, low future returns are far more likely, with the possibility of capital loses as the market re-evaluates the high price paid for certainty.

For Select, *short term volatility* is being embraced as our long term valuation framework, consistently applied over many years clearly indicates valuation support is evident. Select's 50% valuation upside relative to a market that is fairly valued, implies the *likelihood of outperforming* over the period ahead is very high, albeit with volatility (as has been experienced in the last 6 months). Over time, we believe fundamentals will weigh on share prices as they have throughout time, and portfolio returns will exceed the market.

Economic developments and markets

The S&P/ASX 300 Accumulation Index was up (+6.5%) in the December quarter, somewhat reversing the fall in the September quarter (-6.5%). For CY15 the Australian Equity market returned 2.8%, with Large Caps (S&P/ASX100) underperforming Small Caps by 8.0% over the same period. CY15 Small Cap Industrials experienced a strong year (+15.0%) outperforming Large Cap industrials (+7.7%), while Large Cap resources (-25.8%) significantly lagged Small Cap Resources (-14.7%). Banks slightly underperformed the broader index to be up 1.7% for CY15 with most of the underperformance coming in the 2nd and 3rd quarters (down 11% each). For the first time since the GFC the Top 20 stocks (S&P/ASX 20) ended CY15 down 1.4%, underperforming the broader index by some 4.2%.

Commodity markets were weaker during the quarter due to concerns over Chinese growth, US monetary policy tightening and the disappointment over the extent of European stimulus.

Spot Brent Crude fell -21% to US$37 a barrel during the quarter. A combination of warm weather and a muted response thus far from non-OPEC production to the collapse in prices, as well as the threat of further supply gains from Iran early next year continued to pressure prices. During December crude briefly fell below US$35 a barrel for the first time since 2009 after Iran pledged to boost crude exports, bolstering speculation OPEC members will exacerbate the global oversupply. In response oil majors have started to announce further significant capex reductions. Locally, the S&P/ASX 300 Energy Accumulation Index was down only 1.3% during the quarter as most of the adjustment was anticipated in the September quarter (-24%) with CY15 down 28%, to be one of the worst performing sectors.

The other major commodity of note to fall during the quarter was Iron Ore, down -23% to US$44 per tonne. As a result high cost producers are starting to exit the industry. Other commodities experienced minor changes: aluminium (-3.5%), Nickel (+0.6%), Copper (+0.8%) and Gold (-4.8%). During the quarter, the A$ appreciated (+3.9%) against the US$ in light of stronger domestic data.

In the US, the Fed ended seven years of near zero interest rates, guiding to gradual rate adjustments going forward with expectations of a 3% or higher rate in three years. While the October and November FOMC statements were unexpectedly hawkish, a strong labour market supported the call lift off in December. The unemployment rate fell from 5.1% to 5.0% during the quarter to near its lowest since the first half of 2008. The Fed beige book indicated that the US economy expanded at a modest pace in November amid rising consumer spending and a tightening labour market. There was moderate to steady growth in 10 out of 12 of the districts with New York levelling out and Boston somewhat slower.

The Australian Commonwealth 10-year bond yield rose 21bps, reaching 2.81%, a slightly smaller move that its US equivalent, which rose +23bps to 2.27% during the quarter. However, more importantly credit market anxiety caught the notice of equity investors after Third Avenue Management froze redemptions at a high-yield mutual fund in mid-December. The SPDR Barclays High Yield Bond ETF, a proxy for the high-yield market fell 2% shortly thereafter, its biggest drop in four years.

On the domestic economic front the strong October labour force survey was reinforced in November with the economy adding 71,400 jobs (October 58,000) the largest two month gain since 1988. Not surprisingly, the unemployment rate fell significantly during the quarter to 5.8% from 6.2% at the end of September quarter, notwithstanding a higher participation rate (increased by 0.4% to 65.3%). Retail sales were also strong, up +0.5% m/m in October following rises of 0.4% m/m in September and August. The weak 3Q CPI print of 0.3% q/q was heavily influenced by lower energy prices. The NAB business confidence survey and Westpac-MI consumer confidence index were also generally supportive of expanding conditions. Accordingly the RBA decided to leave cash rates unchanged at 2.0%.

Stocks Added

Perpetual (PPT) is an independent and diversified financial services group providing specialised investment management, wealth advice and corporate fiduciary services. New management has reshaped PPT into a leaner, sharper funds management outfit with improved alignment between fund managers and shareholders. After 6 years of net funds outflow, high margin retails flows have turned positive. The markets overreaction to a large low-margin institutional outflow provided an opportunity to invest at attractive rates of return (+20% upside). The PE was sub 15x at purchase, with a fully franked dividend yield of 6%.

ALS Limited (ALQ) a global provider of testing and analytical laboratory services was added to the portfolio. The business is currently trading at a deep discount to Sigma's long term valuation driven by an overreaction to the recent oil price declines. Oil related services only make up approximately 15% of the companies portfolio. Furthermore, we believe the non-commodity related Life Sciences division is substantially undervalued.

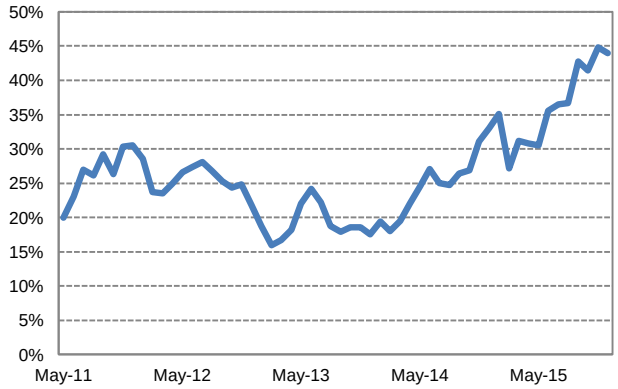
Stocks Sold

Slater & Gordon (SGH) Management have withdrawn guidance after confirming things were on track a few months before. It is our view that the UK business has proved more challenging than first expected. The uncertainty with timing of cash flows creates an increased risk of needing to raise capital due to debt levels.

South32 (S32) sold on valuation grounds.

Select Relative Valuation Upside

Source: Sigma, IRESS



Pricing Metrics	1-Yr PE	Net Div. Yield	Price/ Book Value	Price to NTA
Select Equities Fund	13.2	5.2%	1.3	1.6
S&P/ASX 300	15.5	4.8%	1.8	2.6
Date	**Dec-15**	**Dec-14**	**Dec-13**	**Dec-12**
Stock Numbers	34	37	37	31
Large Caps	18	20	24	22
Small Caps (ex-100)	16	17	13	9
Active Share	78.6%	68.8%	60.7%	55.7%
Small Cap Weighting	16.9%	11.7%	8.9%	7.7%

Source: Sigma estimates, GS Portfoliowise

Top 5 active positions

Stock	Active weight %
By Large Cap stocks:	
Bendigo & Adelaide Bank	5.9
Bank of Queensland	5.6
National Australia Bank	5.3
Harvey Norman Holdings	4.8
Rio Tinto	4.6
By Small Cap stocks:	
Nine Entertainment	2.6
Seven West Media	1.5
Ingenia Communities Group	1.3
Broadsprecturm	1.3
APN News & Media	1.2

Note: Active weights refer to positions above benchmark only.

Asset allocation

Sector	Active weight %
Materials	9.8
Consumer Discretionary	8.7
Financials ex-Real Estate	2.7
Industrials	0.4
Information Technology	(1.3)
Energy	(1.5)
Utilities	(1.8)
Consumer Staples	(1.9)
Telecommunications	(5.4)
Real Estate	(5.6)
Health Care	(7.1)
Cash & Other	3.0

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,
- 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*
- 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