SIGMA FUNDS MANAGEMENT®

Sigma Select Equities Fund

Quarterly update as at 30 September 2017

	Quarter %	6 months %	FYTD %	1 year % p.a.	3 years % p.a.	5 years % p.a.	Since Inception^ % p.a.
Sigma Select Equities Fund*	4.0	5.0	4.0	17.8	6.9	12.1	8.6
S&P/ASX 300 Acc. Index	0.8	(0.8)	0.8	9.0	7.1	9.9	7.2
Value added	**3.2**	**5.8**	**3.2**	**8.8**	**(0.2)**	**2.2**	**1.4**

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

Key points

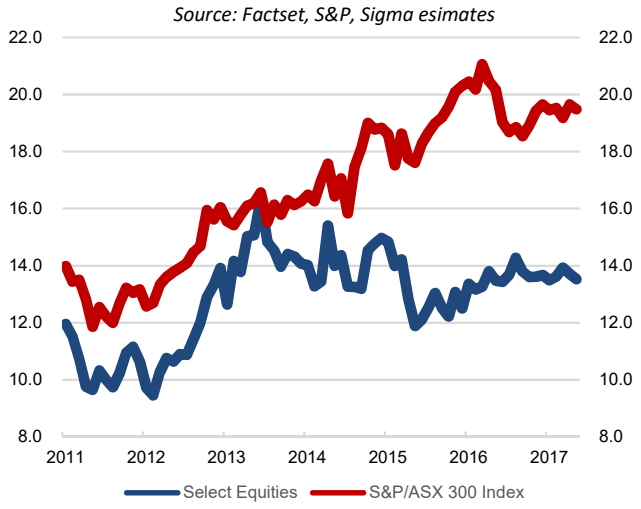
- Buyer beware as the market is **overvalued at 20x 1-year forward earnings** (ex BHP, RIO & Major Banks)
- Embracing mispriced uncertainty while avoiding expensive bond like proxies
- Portfolio metrics supportive of positive future returns albeit with more volatility in an ***overvalued market***

Portfolio commentary, positioning and outlook

Over the September quarter, the Sigma Select Equities Fund (Fund), outperformed a rising market. Overall, we remain cautious on Australian Equities given ***overvaluation*** and moderate rates of earnings growth. Figure 1 shows the PE of the market excluding the big six (BHP, RIO, ANZ, CBA, NAB and WBC). As these six large companies represent approximately 34% of the index, the remaining 66% of the market is currently trading near 20x 1-year forward earnings. Historically market PE's around 20x generate periods of negative returns. We therefore, expect the Australian Equity market to generate ***low returns*** going forward.

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

Source: Factset, S&P, Sigma esimates



The lower for longer interest rate thematic has resulted in widespread overvaluation of maturing growth stocks and low growth defensives, explaining the high market PE and why the index in aggregate is overvalued (5% downside) as shown in Table 1. Although we are cautious on index returns we are positive on the investment opportunities at hand (25% upside in the Select Portfolio)

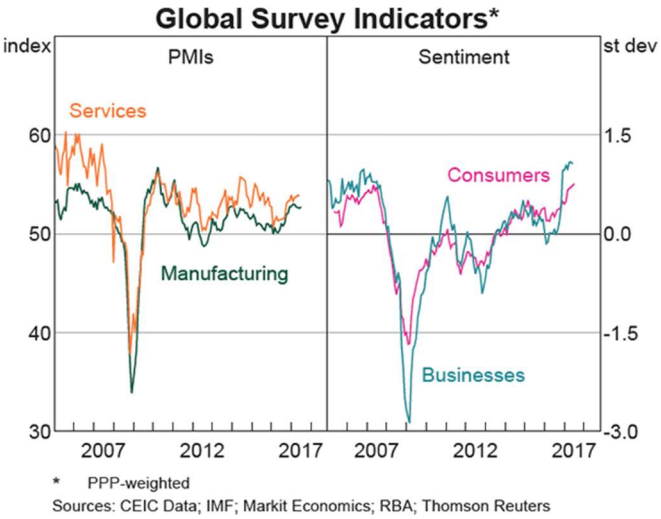
Table 1: Valuation Upside of Select and the S&P/ASX 300 Index

Start of Financial Year	2014	2015	2016	2017	2018
Select	36%	33%	35%	49%	25%
Index	12%	6%	0%	1%	-5%
Relative	**24%**	**27%**	**35%**	**48%**	**30%**

Attractively valued Large Cap Resources, Diversified Financials, Domestic Cyclicals and overlooked Small Caps underpin Sigma's Select strategy. Ongoing economic scepticism provides an attractive platform of reasonable starting valuations in these sectors with confidence in superior earnings delivery. For some financial exposures higher interest rates also start to relieve a significant earnings burden that has been carried through low returns on regulatory capital. Although many cyclical and financial exposures have outperformed recently we see continued upside as investors reassess their growth and risk profiles. From a defensive point

of view, we prefer to hold cheaper short duration exposures through banks and cash in preference to overvalued long duration assets.

As we highlight in Sigma's December 2017 Quarterly Strategy Review the underlying drivers of Australian Equities continue to be supportive. Global economic growth is in a synchronised upswing, domestic non-mining activity is showing signs of improvement, the commodity cycle is supportive and monetary policy remains stimulatory. Supporting a transition in performance from *rewarding bond sensitivity* ***towards rewarding economic sensitivity***. This can be seen in the following RBA chart, highlighting the pick-up in the "softer" consumer and business sentiment indicators. Although, the growth acceleration underway is widely accepted the longevity of the current cycle has left investors cautious in expecting significant future duration.



We regard this caution as overly conservative when considering the broad lack of late cycle pressures and continued emphasis on stimulatory policy. The financial system has also deleveraged considerably reducing risk. Based on current trends, we suspect the ***current economic cycle may have longer duration than historical cycles by a significant margin.***

Individual stock performance of note

Fund performance was driven positively by:

- Bendigo and Adelaide Bank (+8%) rallied after reporting a slightly better than expected result while indicating net interest margins were likely to continue to rise into FY18. Bank of Queensland (+13%) was also stronger as the market extrapolated the trend for Regional Banking;
- Post clarification of APRA's new capital requirements, the major banks rallied, as the market expected more draconian measures. However, the Commonwealth Bank bucked the trend post alleged non-compliance with the Anti-Money Laundering and Counter Terrorism Finance Act 2006. As the regulator and courts go through due process the stock is likely to remain under a cloud;
- Diversified Miners, BHP Billiton (+15%) and RIO Tinto (+7%) were both stronger upon reporting solid results, that indicated cash generation and balance sheets where in good health;
- Contractor, RCR Tomlinson (+28%) rallied as investors sought exposure to infrastructure spend on the east coast and companies exposed to the nascent recovery in WA and the looming iron ore capex spend by the major mining companies. The mining services thematic is well and truly back after being pronounced dead two years ago;
- Travel retailer, Flight Centre (+19%) rallied post reporting a solid result and providing guidance on initiatives to further improve group profitability in the years ahead;
- Integrated Energy provider, Origin Energy (+9%) rallied primarily on a better than expected outlook for Energy Markets. The company also indicated APLNG has formally completed the lender's test, removing the requirement for debt guarantees. Combined with the imminent sale of Lattice Energy, Origin's balance sheet is set to significantly improve over the next 12 months;
- The absence of index heavyweights Commonwealth Bank (-7%), Telstra (-15%) and Suncorp Metway (-9%) helped performance in a relative sense.

Fund performance was negatively impacted by:

- Healthcare operator, Japara Healthcare (-12%) was weaker on a disappointing result due to the inclusion of property sale profits in the earnings, however, this will be an ongoing feature of their profitability;
- Agriculture infrastructure provider, Graincorp (-8%) was weaker as the market anticipates dry weather conditions will impact on receival volumes;
- Insurance giant, QBE Insurance (-14%) was weaker, as the market extrapolated a disappointing result and a subdued outlook which was further accentuated by the impending costs associated with Hurricanes Harvey, Irma, Maria and the Mexican Earthquakes. Post quarter end management indicated increases to large individual risk claims as a result;
- Superannuation wealth manager, AMP Limited, (-5%) was weaker. While reporting an operationally sound result in August, the market was disappointed by the requirement to reinvest capital released from the current re-insurance deal;
- Global scrap provider, Sims Metal Management (-11%) rallied in August after reporting a better than expected result, however weaker US scrap prices in September weighed negatively on sentiment;

- The absence of Westpac (+5%), Wesfarmers (+6%) and South32 (+25%) impacted performance in a relative sense.

Stocks Added

None

Stocks Sold

Aveo Group (AOG) has been caught up in a media investigation claiming that its retirement village contracts are onerous towards retirees. The company to its credit has publicly responded to each issue in detail. We believe that the company is not earning excessive returns given the capital intensity required in the business. We also believe many of the issues highlighted are isolated. However, we became concerned when the ACCC and the Minister for Aged Care said they would be investigating issues raised. This has also led for broader calls of regulation of the sector including a review of current pricing structures. We believe that the increased scrutiny has heightened the risk that the government may cap or limit returns in the sector, with a flow on impact into future profitability and asset values. This has resulted in increased business risk and lower valuation.

Seven West Media (SWM) reported a low quality FY17 result with a disappointing outlook. We were expecting earnings to improve in FY18 following substantial losses on the Olympics during the year. A key risk to our investment thesis of profit recovery was overpayment for sports rights over the medium term resulting in material reduction in earnings potential from Seven Network. A weak outlook and substantial provisions for future rights costs confirmed this risk was playing out. Diminished profitability also adds financial risk at current levels of balance sheet debt. Following the result, we reduced our valuation materially and given an unfavourable risk reward trade off we exited the position.

Infigen Energy (IFN) was sold after evaluating the impact of solar renewable power projects on the electricity market. Speaking with industry participants, has highlighted that solar has now become cheaper to install from a capital cost point of view versus wind and has lower operating costs. We expect the wave of solar power projects to impact both Large scale Generation Certificate (LGCs) pricing as these solar projects come on line as well as helping to alleviate rising energy prices in the medium term. Our other concern has been management's shift in business strategy from focusing on guaranteed output contracts with generators and moving into the Commercial market to transact directly with clients which increases the potential volatility around the earnings. The combination of lower forward energy prices and LGC prices has seen our valuation fall as well.

Pricing Metrics	1-Yr PE	Net Div. Yield	Price/ Book Value	Price to Cash Flow
Select Equities	13.7	4.7%	1.7	4.7
S&P/ASX 300	17.4	4.5%	3.1	8.7
Date	**Sep-17**	**Sep-16**	**Sep-15**	**Sep-14**
Stock Numbers	31	34	34	37
Large Caps	17	20	18	22
Small Caps (ex-100)	14	14	16	15
Active Share	71.9%	73.1%	76.5%	66.6%
Small Cap Weighting	14.0%	13.3%	15.8%	11.3%

Source: Sigma estimates, FactSet

Top 5 active positions

Stock	Active weight %
By Large Cap stocks:	
Rio Tinto	4.5
Bank of Queensland	4.1
Bendigo and Adelaide Bank	3.9
BHP Billiton	3.8
National Australia Bank	3.2
By Small Cap stocks:	
Sims Metal Management	1.8
Nine Entertainment	1.6
CYBG Group	1.2
HT&E	1.1
McMillan Shakespeare	0.9

Note: Active weights refer to positions above benchmark only.

Asset allocation

Sector	Active weight %
Consumer Discretionary	5.4
Materials	3.0
Financials	2.6
Consumer Staples	(0.9)
Energy	(1.3)
Information Technology	(1.5)
Industrials	(2.1)
Utilities	(2.2)
Telecommunications	(3.3)
Health Care	(6.4)
Real Estate	(6.6)
Cash & Other	13.3

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, 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 AZ Sestante the Fund's distributor, on +61 2 9093 1331.

See also www.sigmafunds.com.au