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Sector Sigma Nordic Fund

Something has to give, but when?

Letter to Shareholders – May 2017

"We value investors have bored momentum investors for decades by trotting out the axiom that the four most dangerous words are, 'This time is different.' For 2017 I would like, however, to add to this warning. Conversely, it can be very dangerous indeed to assume that things are never different…What this argument probably does mean is that if you are expecting a quick or explosive market decline in the S&P 500…then you should at least be prepared to be frustrated for some considerable further time: until you can feel the process of the real interest rate structure moving back up toward its old level…there are two important things to carry in your mind: First the market now and in the past acts as if it believes the current higher levels of profitability are permanent; and second, a regular bear market of 15% to 20% can always occur for any one of many reasons. What I am interested in here is quite different: a more or less permanent move back to, or at least close to, the pre-1997 trends of profitability, interest rates, and pricing. And for that it seems likely we will have a longer wait than any value manager would like (including me)."
(Jeremy Grantham, Co-founder and Chief Investment Strategist, GMO, GMO Quarterly Letter, 1Q 2017)

In the excerpt above, we quote Jeremy Grantham at some length to highlight a number of factors that characterize current equity market conditions. Yes, things are different, with nominal interest rates having remained at historically low levels for an extended period of time despite a global economic recovery that currently trends roughly on par with post-WWII norms. Meanwhile, global debt levels – measured as the combined sum of public and private debt - are at all-time highs. In the developed world real rates are by and large negative. Savers are getting crushed, risk-takers are being rewarded, and prudence has become unfashionable. Higher levels of corporate profitability are reflected in much higher pricing of those profits. Embedded in the current pricing of equities is the assumption that interest rates will remain at or near historical lows for much, much longer. Or that central bankers have succeeded in killing the business cycle for good, at least the bad part of that cycle, i.e. the downturn. Risk premiums across financial asset classes have deflated further so far in 2017. Something has to give, but when? At present, a normalization of real interest rates (meaning positive returns after inflation) appears unlikely to happen in the foreseeable future. Yet as Alan Greenspan once said, "History has not dealt kindly with the aftermath of protracted periods of low risk premiums." As we see it, any upward move in interest rates or inflation, or a deceleration in global growth momentum, or an external shock, could trigger a serious equity market correction. A bear market of 15% to 20% can always occur for any one of many reasons. Or this time is different for a yet to be determined extended period of time.

The Sector Sigma Nordic Fund fell by 2.94% in May (Class A NOK figures). World equity markets measured by the MSCI World Index (USD) rose 2.19% in May. The Nordic equity market, as measured by the VINX Benchmark Index (NOK), rose by 2.90% for the month. The Fund's currency exposure is hedged, and a further weakening of the Norwegian kroner during May, detracted from the Fund's monthly return.

Global economic growth edged higher in May

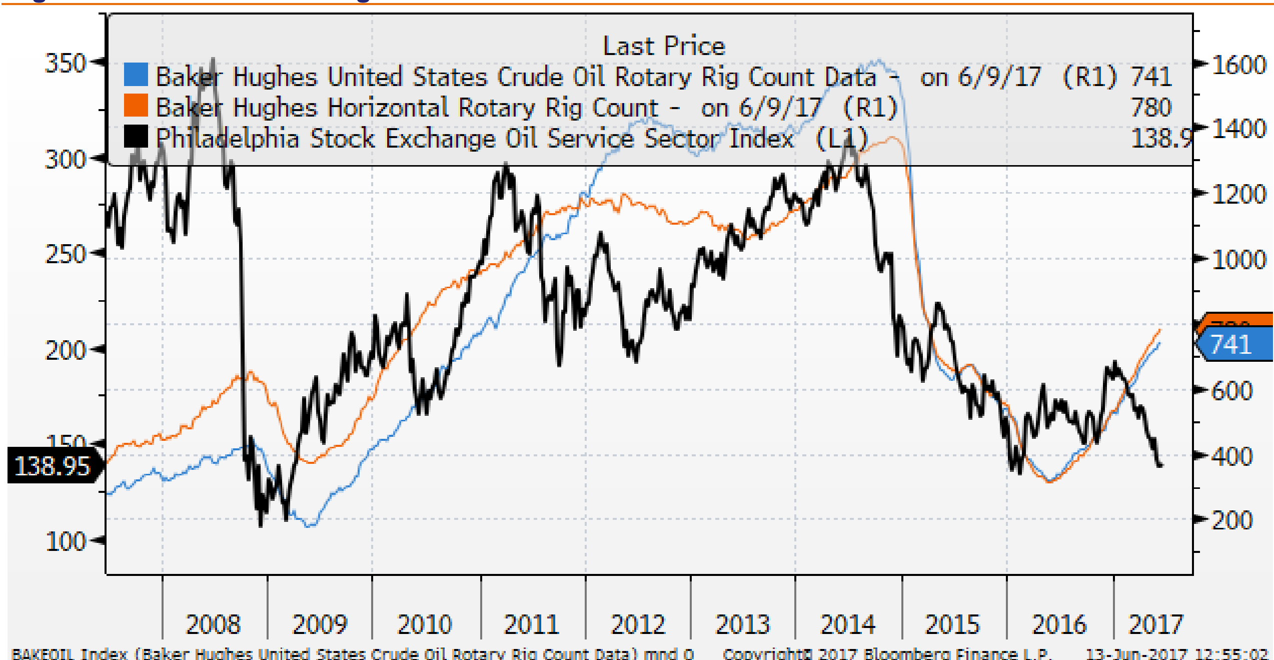
The global economic expansion remained solid and steady last month with the J.P.Morgan Global All-Industry Output Index posting a reading of 53.7 in May, up slightly from 53.6 in April. According to the survey, the expansion remained broad-based by sector. Furthermore, May signalled the steepest increase in new orders in four months, testing the

capacity at both manufacturers and service providers, and led to the sharpest accumulation of backlogs of work since November 2013. On a global level, input cost inflation eased to a seven-month low last month, while output charges rose at a pace identical to April. However, both price measures indicated a sharper increase in developed nations compared to emerging markets. If economic activity levels hold firm in June, corporate results for the second quarter are likely to meet or exceed (sell-side) market expectations.

OPEC extends production cuts – rebalancing not yet visible in oil inventories

At the beginning of 2017 the Fund was positioned for an expected rebalancing of the supply-demand equation in the oil market. We expected OPEC's agreement, announced on November 30th 2016, to cut production by 1.2 barrels per day starting January 1st 2017 would begin to reduce the OECD oil inventory overhang in the first half of 2017. We were wrong, or at best too early, but certainly too optimistic. Although we could offer a number of explanations (or excuses) in defense of our original investment thesis, our level of conviction in this concentrated bet has eroded considerably, and as a consequence we cut our exposure in energy names in half in May. Although oil prices are down around 15% YTD as of June 12th, U.S. shale oil producers continue to invest in production growth, and capital still seems to be plentiful to fund it. As the graph below illustrates, the number of active oil rigs in the U.S. has continued to climb relentlessly, even though the equity prices of both U.S. onshore E&P names and oil service providers have declined sharply. The equity market apparently does not believe that this shale-oil investment boom will be profitable for producers, or sustainable at current or even higher activity levels judging by the share price performance of the oil service names. However, the surge in investment activity in the first half of 2017 may deliver strong U.S. production growth for the remainder of the year and into 2018. The risk is that growth in shale oil production will significantly delay a meaningful drawdown in U.S. oil inventories, thus offsetting the efforts of OPEC (and some non-OPEC members including Russia) to trim global oversupply. OPEC's decision on May 26th to extend production cuts for another nine months led to a sharp sell-off in oil prices, underlining how challenging it may be to rebalance the market. OECD oil inventories remain bloated, and as long as credit remains readily available to short-cycle producers in the U.S., we are concerned that oil prices risk being tested further to the downside in the coming months.

Figure 1: Active US oil rigs vs Oil Service Index



Source: Bloomberg

Portfolio Return and Attribution

Sector Sigma Nordic (Class A NOK) fell 2.94% in May. In local currency terms Sweden rose 1.23% (OMX30), Denmark rose by 2.21% (OMXC20), Finland rose by 3.24% (OMXH25) and Norway rose by 2.13% (OBX). The Fund's net long position has averaged 45.47%% in May. Our net long exposure was 48.6% at month's end.

The best profit contributors in May came from the long positions in two oil producers: Statoil and Royal Dutch Shell, which rose 4.97% and 2.85%, respectively. Oil prices rose from a low of 48 USD per barrel (Brent Crude) in the first week of May in anticipation of the announcement of an extended oil production cut at OPEC's scheduled meeting on May 26th. Oil prices peaked on May 23rd with Brent crude touching 54 USD per barrel before declining sharply after the OPEC announcement. Please read our comments regarding the Fund's oil exposure above and under the investment strategy section in this letter. Also contributing positively to performance in May was the long position in the Finnish pulp and packaging company Stora Enso, which rose 3.11% in May. We cut the position in Stora Enso in half before the company reported first quarter earnings as a risk management maneuver because the share price has been volatile in connection with earnings reporting in the past. The share price fell nearly 6% on the first quarter earnings report on the back of technical issues at its new Chinese production facility (one of three new generators broke down in connection with startup of the production line). As we believe that this situation will not materially impact our expectations for future free cash flow generation at Stora Enso (beyond a quarter or two), we used the share price correction to buy back and increase our position again. Stora Enso remains a core holding in the Fund.

The largest loss contributors in May came from the Fund's long positions in energy and related oil services, in addition to a long position in the Swedish engineering company SKF. SKF, a Swedish late cyclical industrial company (producer of bearings for industrial sectors among other things) gained nearly 10% in April, but gave it all back with a decline of 8.63% in May. We have held long positions in four US listed oil service companies in anticipation of a pick-up in US onshore shale oil production activity. With the recent rout in oil prices, these companies' share prices were hard hit; Helmerich & Payne fell 12.09%, Baker Hughes fell 6.83%, Schlumberger fell 3.44% and Halliburton fell 1.50% in May. We have sold all positions in these oil service names – we refer readers to our comments regarding short-term oil price expectations and the outlook for oil related equities in the above and in the investment strategy section of this letter.

Portfolio Risk

The Fund's expected annual volatility was 7.1% at the end of May, compared to historical volatility of 22.5 % for the VINX Benchmark, and 11.6% volatility for the VINX Benchmark over the past 12 months. At month's end, the Fund had 30 positions (of which 10 longs and 10 shorts), a gross exposure of 89.2% and a net long exposure of 48.6%. Value-at-risk (VAR) was 0.7% at month's end, down from 0.9% in April.

Investment Strategy

We sold our long positions in four US listed oil service names in May, confounded that the sharp pick-up in onshore-related drilling, completion and production activity – as well as evidence of a pick-up in pricing for services – had no positive effect on share prices. In fact, quite the opposite, as positive fundamental newsflow only seemed to elicit more selling. We have also reduced our long exposure to oil producers, and are weighing a complete exit out of these names, as we fail to see near-term triggers for relative outperformance.

At the outset of 2017, we assumed that interest rates would continue to rise gradually throughout the year. We expected a normalization of central bank policy, and a move in the direction of positive real rates was underway. We shorted a basket of listed Swedish real-estate companies in the second half of last year, a trade that contributed positively to the Fund's performance towards the end of 2016. So far this year, rates have retreated and the share prices of these names have reversed in tandem. We have halved our short exposure to this sector, but retain a short basket of around 5% in total in four different names. Fundamentally, we believe these names are overvalued, even with current record-low interest rates. Furthermore, in a white paper made public in March, the Swedish government has proposed new tax

legislation directed at the domestic real estate sector that will effectively re-introduce a capital gains tax and a stamp duty on all transactions. If passed into law, deferred taxes would become payable upon sale of assets. The negative effect on NAVs in the sector would be in the 10-12% range. Most names in the sector are trading at or significantly above NAVs. The public consultation period on the proposed capital gains tax and stamp duty ends on August 14. There is broad political support for the proposal.

The Fund remains long select cyclical names within the industrial sector, as well as financials and materials (within forest product and packaging, but no metals). In addition, we have re-established long positions in a few defensive names within the consumer staples and consumer discretionary spaces, largely offsetting long-held shorts in the same sectors. Although it may be dangerous to assume that things are never different, we do not think the risk-on trade is safe indefinitely. Not even over the summer.

Sector Sigma Nordic investment team			
Jannik Arvesen	Investment Manager/ CIO	**Jan Gabrielsen**	Investment Manager
Bjørn Tore Urdal	Investment Manager		

Sector Sigma Nordic Fund – May 2017

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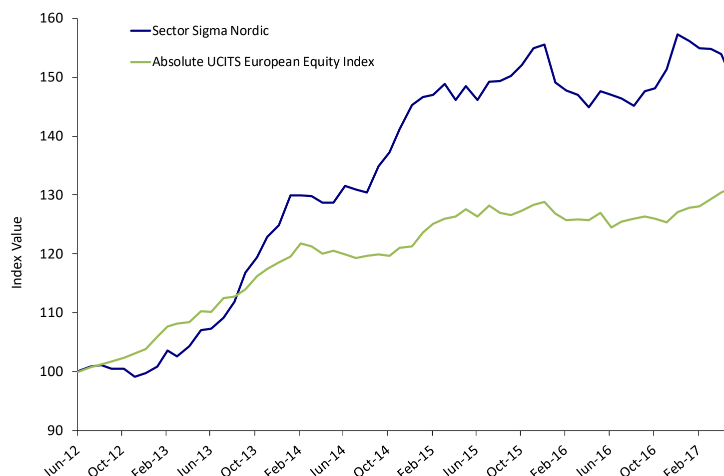
Analysis of Return

	Class A NOK	Class A USD **	Class A EUR	Absolute UCITS European Equity
NAV at month end	**1,493.70**	**113.11**	**109.83**	**131.25**
Last month	(2.9%)	(2.9%)	(3.0%)	0.7%
Year to Date	(5.0%)	(4.9%)	(5.5%)	3.3%
Last 12 months	1.2%	1.4%	0.1%	3.4%
Last 3 years annualised	5.1%	4.1%		2.9%
Since Inception*	49.4%	38.6%	9.8%	31.2%
Compounded growth, p.a	8.5%	6.9%	3.0%	5.7%
Standard deviation	7.1%	7.1%	7.3%	3.0%
Sharpe ratio	1.2	1.0	0.3	1.9
Best Month	4.4%	4.0%	4.0%	2.1%
Worst Month	(4.1%)	(4.1%)	(4.2%)	(1.9%)
Positive Return	61.7%	57.6%	48.7%	74.6%
Maximum drawdown	(7.9%)	(8.0%)	(8.8%)	0.0%



*Class A NOK since inception June 25th 2012, Class A EUR was launched March 27th 2014.
**The performance reported is for Class B USD from June 29th 2012 until May 7th 2014, and for Class A USD from May 7th 2014 onwards

Class A NOK	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2017	(0.71%)	(0.77%)	(0.11%)	(0.58%)	(2.92%)								(5.01%)
2016	(4.10%)	(0.95%)	(0.44%)	(1.47%)	1.86%	(0.36%)	(0.44%)	(0.89%)	1.77%	0.30%	2.16%	3.95%	1.14%
2015	0.97%	0.20%	1.26%	(1.78%)	1.61%	(1.59%)	2.08%	0.08%	0.61%	1.21%	1.91%	0.35%	7.04%
2014	4.04%	0.05%	(0.12%)	(0.85%)	(0.03%)	2.21%	(0.42%)	(0.45%)	3.45%	1.76%	2.89%	2.85%	16.30%
2013	1.17%	2.67%	(0.92%)	1.69%	2.50%	0.25%	1.82%	2.48%	4.37%	2.24%	2.92%	1.59%	25.22%
2012						0.16%	0.77%	0.16%	(0.61%)	(0.02%)	(1.32%)	0.62%	(0.26%)

Attribution last month	Total
Long book	0.2%
Short book	(3.1%)
Sum	(2.9%)

Attribution YTD	Total
Long book	1.1%
Short book	(6.1%)
Sum	(5.0%)

Analysis of Risk

Portfolio Exposure	% of NAV	Number of Positions
Long	68.9%	20
Short	(20.3%)	10
Net	48.6%	
Gross	89.2%	

Ex-ante Risk	
1D VaR (95%)	0.7%
Annualized St Dev.	7.1%

Sector Exposure	Net Exposure	% Gross
Consumer Discretionary	2.7%	3.0%
Consumer Staples	(3.1%)	9.8%
Energy	17.3%	19.4%
Financials	10.6%	11.9%
Index	(4.1%)	4.6%
Industrials	20.5%	23.0%
Materials	8.8%	17.7%
Real Estate	(6.8%)	7.6%
Telecommunication Services	2.7%	3.0%
	48.6%	100.0%

Top 10 Holdings Long	Exposure
Statoil	4.8%
Aker BP	4.8%
Skandinaviska Enskilda Banken	4.3%
ABB	4.2%
SKF AB	4.2%
Total SA	3.9%
Royal Dutch Shell	3.7%
Investor AB	3.7%
Stora Enso	3.7%
Chr Hansen Holding	3.5%
	40.9%

Geographical Exposure	Net Exposure	% Gross
Denmark	2.8%	11.0%
Finland	11.5%	12.9%
France	3.9%	4.4%
Netherlands	3.7%	4.2%
Norway	12.3%	13.8%
Sweden	10.1%	49.0%
Switzerland	4.2%	4.7%
	48.6%	100.0%

Top 10 Holdings Short	Exposure
Materials	(3.5%)
Consumer Staples	(3.1%)
Consumer Staples	(2.8%)
Real Estate	(1.9%)
Real Estate	(1.8%)
Index	(1.6%)
Real Estate	(1.6%)
Real Estate	(1.5%)
Index	(1.4%)
Index	(1.1%)
	(20.3%)

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