Total returns

At 31 December 2017	1 mth %	3 mths %	6 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	7 yrs % p.a.	Inception % p.a. (Feb 2008)
Ralton Australian Shares	1.56	6.51	6.06	12.08	10.55	13.57	10.85	8.03
Income return	*0.12*	*0.65*	*2.11*	*3.92*	*3.68*	*3.81*	*4.11*	*4.28*
Growth return	*1.43*	*5.87*	*3.95*	*8.16*	*6.87*	*9.76*	*6.74*	*3.75*
S&P/ASX 300 Accum. Index	1.86	7.74	8.60	11.94	8.76	10.15	8.13	5.26
Difference	**-0.30**	**-1.23**	**-2.54**	**0.14**	**1.79**	**3.42**	**2.72**	**2.77**

Performance review

- The S&P/ASX 300 Accumulation Index had a strong finish to the year, adding 7.74% for the December quarter. Energy and Information Technology were the top performers for the quarter with all market sectors delivering a positive return for the period.
- The Ralton Australian Shares portfolio returned 6.51% for the quarter, underperforming the benchmark by 1.23%.
- For the December quarter, our overweight exposure to Health Care and stock selection with Industrials added value to the portfolio. Offsetting these gains was both our stock selection within Real Estate and our modest cash exposure in a rising market.

Performance attribution

The Ralton Australian Shares portfolio has underperformed the market over the past six months. Although this is very frustrating, from our perspective the key driver has been the portfolio's underweight exposure to the Materials Sector, principally resource stocks. Commodity pricing has been solid and global growth accelerating, both supportive of the sector.

The balance of the underperformance has been driven by stocks such as Lendlease (LLC) and iSelect (ISU), which we continue to hold. We expect the market to eventually realise the value in these stocks which we continue to view as undervalued. The exception was QBE Insurance Group (QBE), which we exited during the period.

We will continue to follow our process for generating above-market returns, which has worked over the past 10 years.

Key contributors

Key contributors	Positioning
BHP Billiton	Overweight
Santos Limited	Overweight
Aristocrat Leisure	Overweight

BHP Billiton Limited (BHP, +14.7%) – rising commodity prices for copper, iron ore and oil saw BHP add value to the portfolio for the quarter. We have been progressively adding to our BHP holding since mid year, highlighting since that time the noteworthy election of Ken MacKenzie as Chairman of the BHP board, succeeding Jac Nasser, effective September this year. As CEO of Amcor Limited (AMC), MacKenzie delivered strong shareholder returns, driving a cultural change and heightening focus on return and use of capital. Under his leadership, the company went through a turnaround and period of strong growth from 2006-2015.

MacKenzie joins BHP at an interesting time for Australia's largest miner and the broader resources industry. Activist shareholders are agitating for change, highlighting the poor returns and capital losses incurred from BHP's incursion into the US onshore shale oil and gas sector under prior CEO, Marius Kloppers. We look to Ken MacKenzie and the BHP management team, led by CEO Andrew MacKenzie (no relation) to continue to focus on optimised returns and use of capital. Under the CEO, the BHP of today is a smaller, more focused investment proposition than its predecessor of five years ago. The bulk of BHP's smaller, non-tier one assets have been either sold or divested into S32 (S32), which holds the aluminum, alumina, manganese and other smaller assets in coal, silver and zinc.

Broad cultural change at a giant company like BHP will certainly prove a challenge, however we look for the new Chairman to strike the appropriate balance in terms of the need to invest capital across new projects, maintain current tier one assets, return money to shareholders and deliver a strategy that ensures sufficient diversity and growth options.

Santos Limited (STO, +35.6%) – STO's shares rose across the quarter, boosted by a rising oil price, further progress on STO's operational turnaround and finally, speculation of M&A from a US private equity-backed group, Harbour.

STO's investor day in November provided further confirmation that CEO Gallagher's operational turnaround and strategic reset of the business continues to deliver.

Gallagher and his team have delivered impressive results in terms of cost reduction and more efficient drilling processes. Together with a reset of the balance sheet, lower interest costs and focus on core assets, these factors have combined to lower the cash flow breakeven of STO's various assets. At current oil prices, this drives solid free cash flow and further debt reduction and perhaps more importantly, provides a good buffer in terms of cash flows, should oil prices retest recent lows.

STO's share price was boosted further in mid-November by media coverage suggesting that a group called Harbour, backed by various private equity interests, was expected to make a takeover offer for STO. The press speculation remains just that, however Harbour has certainly approached the STO board in recent times with a non-binding proposal. The Harbour interest in STO somewhat confirms our own investment thesis, although we hold no particular insights as to whether further corporate activity is likely.

Aristocrat Leisure (ALL, +12.9%) – ALL shares added value to the portfolio following a solid half-year result and the acquisition of BigFish Social Gaming. Both announcements were made on the last day of November. The negative share price fall was a touch surprising as we highlighted during our November report, however by the end of quarter the shares had subsequently rebounded. Turning briefly to the half-year profit result, the numbers from our vantage were good quality and in line with expectations. Strong performance by ALL's Americas region, Gaming Ops, Digital and Class 3 outright sales segments contributed to some 36% growth in profit for the period. The market was maybe surprised by the softer tone around management's FY18 guidance – management has traditionally been conservative.

The main focus however was the acquisition of the BigFish Social Gaming Firm. This may also have had an impact on the share price. At an acquisition price of US$990m, this represents a material transaction for ALL. Once the deal completes ALL will become the number two player in social gaming globally, with 'digital' revenue at ALL accounting for nearly 40% of revenue. Our initial view is that the transaction makes strategic sense and builds upon ALL's exposure to the broader digital segment, which itself targets a younger demographic than ALL's traditional end customers. The initial share price move (which as we write has somewhat recovered) is likely 'sticker shock' as investors digest the size of the acquisition. Given ALL's track record in terms of integrating large acquisitions, adding growth to the businesses they acquire and rapidly reducing debt, we have confidence that in time the acquisition can add value for shareholders.

Key detractors

Key detractors	Positioning
Lendlease Group	Overweight
iSelect Limited	Overweight
IOOF Holdings	Overweight

Lend Lease (LLC, -8.8%) – LLC gave back prior share price gains following a market update in mid October. Although LLC's update broadly maintained profit expectations for the current year, the composition of earnings and issues within the Australian construction business were not well received by the market. Specifically, this division is now likely to deliver lower EBITDA than the prior year due to losses on some small, but problematic contracts. Our logic in revisiting LLC during May was focused on increasing the portfolio's exposure to the Australian east coast infrastructure theme. Lend Lease recently restructured its infrastructure team and aims to deliver $4-5bn in annual revenues from this division. This would nearly double current revenues, with LLC seeking a commensurate improvement in margins. Although these problematic contracts represent a step backwards for this division, these contracts were written and won several years ago, and hence we do not view them as representative of management and contract risk structures since put in place.

iSelect Limited (ISU, -10.3%) – ISU's shares underperformed in the quarter, continuing the negative pattern since an underwhelming FY17 profit result in August. News that well-regarded CFO, Daryl Inns, had resigned in November with immediate effect due to health reasons further rattled investors and the share price in turn. Despite this backdrop, our discussions with the company confirmed that the CFO had resigned for genuine health reasons. Further, ISU recently provided FY18 profit guidance at its AGM, confirming an outlook that was both in line with our expectations and further, provided good detail in terms of divisional expectations and the like. We look to the coming year to confirm the growth opportunities in non-health verticals as outlined in ISU's detailed guidance. As such we took the share price weakness as an opportunity to add to our ISU holding.

IOOF Holdings (IFL, -3.9%) – IFL shares traded lower in the December quarter against the backdrop of a rising market. The major news for IFL during the quarter was the proposed acquisition of part of ANZ's wealth division. In a near $1bn transaction, IFL has agreed to acquire ANZ's pensions and investment business, increasing debt and raising new equity to fund the transaction. Although initially well received by investors (including us) the transaction will take some time to be approved and

completed, which may weigh on investor sentiment. IFL has also been very successful as a major consolidator in the wealth management space, where its integration skills allow it to retain the core value of its acquired businesses while stamping out unnecessary costs. Having consolidated multiple platforms, IFL is now targeting an improved service offering to financial advisers and clients. IOOF is particularly focused on the flexibility, or 'open architecture', of its investment platforms which allows advisers to personalise investment services, rather than being restricted to in-house product offers. We like IOOF's focus on the customer which differentiates it from the big banks and other large financial institutions, particularly at a time when community trust in the banks is increasingly questioned.

Portfolio changes

Key additions and material adjustments

Bought
Coca-Cola Amatil (CCL)
Healthscope Limited (HSO)
Macquarie Group (MQG)
Primary Healthcare (PRY)

Coca-Cola Amatil (CCL) – share price weakness and a less negative view in respect to the impact of the container deposit scheme (CDS) led us to revisit CCL. Although pressure remains on the group's core CSD or carbonated soft drinks division, we expect that new product launches across a range of beverage options, together with further cost efficiencies, can see CCL deliver modest growth in profits. CCL's CSD headwinds are well known and indeed a global phenomenon, which means that the parent company (KO) is working overtime on new products to sell through its pipes. CCL in Australia and Indonesia is the beneficiary of these efforts.

The pending CDS would see a levy charged on drinks containers at the point of purchase to cover part of the recovery and scheme costs. Early indications are that the retailers will be passing this cost on to the consumer in full. We will be monitoring both pricing to the consumer and potential volume impacts to determine to what extent CCL is impacted in the short term.

Early expectations suggest that costs are being passed on to the consumer rather than the producer being forced to bear the extra cost. Should this be maintained and given many market analysts appear to expect that CCL will bear the cost, such an outcome could certainly be well received by a skeptical investment community.

Healthscope Limited (HSO) – we added Australia's number two hospital operator to the portfolio in October. The stock was relisted via IPO in mid-2014. The share price rallied circa 50% at its peak before recently reverting toward the IPO price and we now view the valuation as more interesting. Recent concerns included the exit of long-standing CEO, Rob Cooke, and a slow-down in hospital admissions during FY17 which coincided with HSO bringing more bed capacity onto the market. Broader economic-driven affordability concerns for private health insurance (PHI) also weighed on the stock. We expect this to cap PHI participation in years to come, although expect that the core of HSO's patients, the 50-plus demographic, will attempt to maintain PHI to ensure access to preferred hospitals and surgeons. On this basis, and assuming that HSO can grow admissions around 2-3% per annum, we see HSO as reasonable value over the medium term.

We added a position in **Macquarie Group (MQG)** during the quarter. MQG under CEO Moore has materially reshaped the business over several years. The transformation of the MQG business to a higher 'annuity' share has changed the risk profile from its days as a more pure-play investment bank. The annuity-style businesses are heavily focused on funds management, with a range of asset classes managed by Shemara Wikramanayakeim, Head of Macquarie Asset Management. The cost-to-income ratio (CTI) is still transforming to reflect the change in profile of the business with a substantial reduction in CTI possible overtime. This provides a substantial amount of scope to drive/maintain earnings. MQG offers a good yield versus that of the broader market.

Primary Healthcare (PRY) – is one of Australia's largest healthcare service providers, supporting GP clinics, dentistry, radiology and pathology. In recent years with several changes in senior management, limited financial flexibility from a balance sheet perspective and a somewhat disjointed strategic effort and business mix, PRY has struggled to grow profits and returns for shareholders. With new CEO, Dr Malcolm Parmenter joining PRY, having successfully led Sonic Healthcare's GP division, we have a more positive view on PRY and see solid turnaround potential. In particular, we expect that a series of operational initiatives and modest capital investment can drive improved patient service, GP satisfaction and profitability of the medical clinics in turn. PRY's other divisions appear in better shape, although each will benefit from various operational tweaks and a new set of eyes at the CEO level. PRY has underinvested across each of its businesses for several years and hence some catch-up capital is required. This by itself will limit free cash flow for a couple of years, however we would highlight that changes to the upfront payment model for GPs – which created its own accounting issues in years prior – will be a driver of improved cash flows and an offsetting factor at a group level.

Key disposals and material adjustments

There were four outright sales from the portfolio in the December quarter.

Sold
Macquarie Atlas Roads (MQA)
Origin Energy (ORG)
Pact Group (PGH)
QBE Insurance Group (QBE)

Macquarie Atlas Roads (MQA) – we elected to sell our long-held position in MQA during the quarter. MQA shares had rallied to an all-time high, following the recent capital raise to support the purchase of an additional 4.9% in the APRR toll road network. News that long-time CEO, Peter Trent, was set to resign in February 2018, replaced by James Hooke, current CEO of Macquarie Infrastructure Corporation, was also well received by the market. Trent has been integral to the restructure, simplification and now expansion of MQA in the last eight years. With the commensurate reduction in yield for MQA securities and the stock trading at what we felt was fair value we took the opportunity to exit our holding in MQA.

With shares in **Origin Energy (ORG)** at $8, which we view as fair value, we elected to sell our holding. Since its lows and the capital raising of late 2015, the stock has been a strong contributor to the portfolio. New CEO Calabria has continued to reduce debt, simplify the business and successfully bring the two Gladstone LNG trains online without a hiccup. Unless oil and LNG prices push higher from current levels, we see limited upside for ORG, although we will continue to monitor this stock.

Pact Group (PGH) – we sold our position in PGH late in the quarter. PGH management has been successful in reducing costs and simplifying the manufacturing footprint and processes, following a 'lean manufacturing' approach. Acquisitions and contract wins have also contributed to group profit. However end-market conditions for PGH's customers and consumers alike have remained tepid in line with broader economic conditions in Australia. It also appears that PGH has been forced to cut prices in order to retain contracts for the medium term. This last factor has in particular offset other positive initiatives and capped organic growth. With this headwind, we elected to sell our position and reinvest the proceeds where we see the prospect for better returns for our investors. We will look to revisit PGH should valuation become more attractive in the future.

QBE Insurance Group (QBE) – we funded our holding in MQG through the outright exit of QBE. A number of QBE's core businesses have underperformed in recent times, testing our faith in what we saw as a long-held, turnaround candidate under CEO Neal. Although we believe the stock continues to look cheap, the continuous series of set-backs for the company and now a new CEO, we have elected to remove the position. IOOF and MQG remain our preferred investments in the financial services sector.

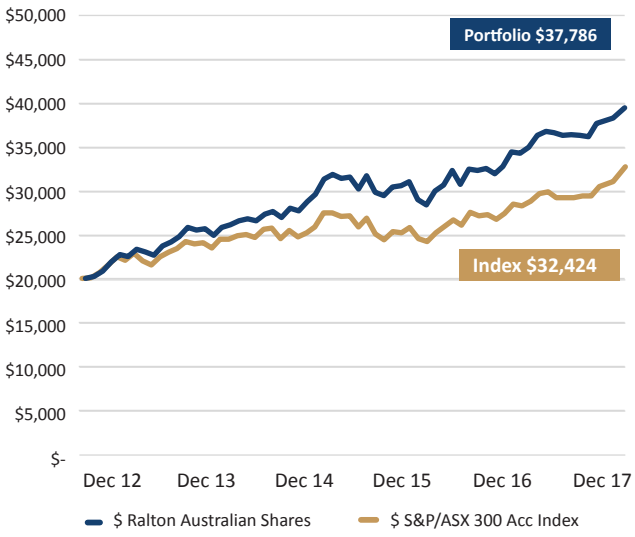
Sector allocation

GICS sector	Ralton	Index	+/-
Health Care	11.4%	7.1%	4.3%
Consumer Discretionary	8.4%	4.9%	3.5%
Consumer Staples	10.6%	7.5%	3.1%
Materials	19.1%	17.7%	1.3%
Utilities	2.9%	2.0%	0.9%
Information Technology	2.8%	2.1%	0.7%
Energy	5.5%	5.2%	0.3%
Telecommunication Services	3.3%	3.0%	0.3%
Real Estate	7.9%	8.2%	-0.3%
Industrials	1.4%	7.4%	-6.0%
Financials	26.8%	35.0%	-8.1%
Total	**100.0%**	**100.0%**	**0.0%**

Top 10 holdings#

Company name	ASX code
BHP Billiton Limited	BHP
Westpac Banking Corp	WBC
ANZ Banking Group Limited	ANZ
Woolworths Limited	WOW
National Australia Bank Limited	NAB
Aristocrat Leisure Limited	ALL
Boral Limited	BLD
Telstra Corporation	TLS
Healthscope Limited	HSO
Vicinity Centres	VCX

Performance comparison of $20,000*



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Performance of the Ralton Wholesale Australian Shares Model Portfolio is based on a model portfolio and is gross of investment management and administration fees, but net of transaction costs. The total return performance figures quoted are historical and do not allow the effects of income tax or inflation. Total returns assume the reinvestment of all portfolio income. Past performance is not a reliable indicator of future performance.

*The performance comparison of $20,000 over 5 years is for illustrative purposes only. Performance is calculated on a gross basis. Actual performance will vary depending on the amount of fees charged by the relevant platform that a client uses to implement the portfolio. The comparison with the S&P/ASX 300 Accumulation Index is for comparative purposes only. Index returns do not allow for transaction, management, operational or tax costs. An index is not managed and investors cannot invest directly an in index. There is no guarantee these objectives will be met.

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