Monthly Report
February 2014

RALTON ASSET MANAGEMENT

Ralton Smaller Companies

Winner of the 2010 Standard & Poors' Fund Awards
- Separately Managed Accounts Category

Investment Profile

A Professionally Managed Portfolio of Australian Shares

The Ralton Smaller Companies model portfolio is a separately managed account, or SMA, actively managed by Ralton Asset Management (Ralton). SMAs are professionally managed portfolios of direct shares whereby the investor receives beneficial ownership of the underlying securities.

Investment Objective

The objective of the Ralton Smaller Companies SMA is to provide investors with long-term capital growth and some tax effective income from a concentrated portfolio of smaller capitalisation ASX listed shares. The Portfolio aims to deliver a return superior to that of the market over periods of five years or longer while at the same time seeking to minimise the risk of investment capital loss.

Key Portfolio Features	
Inception	1 February 2008
Benchmark	S&P/ASX Small Ordinaries Accumulation Index
Authorised Investments	ASX listed companies that are not included in the S&P/ASX 50 Index
Number of Stocks	25-40
Cash Allocation	0% to 15%
Tracking Error	5% to 9% per annum
Investment Horizon	At least 5 years
Ratings	

The Portfolio is designed for investors who...

- Seek long term capital growth & some tax-effective income
- Expect consistent above market returns
- Have a long term investment horizon of at least five years and accept the risk of significant price fluctuations.

Portfolio Structure

No.	Company Name	ASX Code
1	Sky Network Television Ltd	SKT
2	Fletcher Building Ltd	FBU
3	G8 Education Limited	GEM
4	Transpacific Industries Group	TPI
5	Fisher & Paykel Healthcare Corporation	FPH
6	Beach Energy Limited	BPT
7	Tassal Group Limited	TGR
8	Auckland International Airport Limited	AIA
9	News Corporation	NWS
10	Village Roadshow Limited	VRL

GICS Sector	Ralton	Index	+/-
Consumer Staples	6.0%	2.4%	3.7%
Consumer Discretionary	30.1%	26.5%	3.6%
Financials (ex-Property)	10.0%	6.4%	3.6%
Health Care	7.3%	4.5%	2.8%
Energy	8.4%	6.5%	1.9%
Information Technology	2.7%	2.2%	0.5%
Telecommunication Services	5.8%	5.7%	0.2%
Industrials	15.7%	15.5%	0.2%
Utilities	0.0%	1.6%	-1.6%
Property	2.4%	9.6%	-7.2%
Materials	11.4%	19.2%	-7.8%
Total	100.0%	100.0%	

Performance

Return %	1m	3m	1yr	3yrs	5yrs	Incept*
Ralton Smaller Companies	4.46	5.61	19.11	11.98	20.42	6.62
Income Return	0.27	0.65	3.81	3.83	3.97	3.91
Growth Return	4.19	4.96	15.30	8.15	16.45	2.71
S&P/ASX Small Ords Acc Index	4.97	4.68	-3.62	-5.04	11.16	-3.10
Difference	**-0.51**	**0.93**	**22.73**	**17.02**	**9.26**	**9.72**

**Since Inception p.a., Feb 2008*

Month in Review

Performance Summary

- The S&P/ASX Small Ordinaries Accumulation Index added 4.97% for the month, with Consumer Discretionary and Materials making strong gains.
- Over the same period the Ralton Smaller Companies Portfolio gained 4.46%, underperforming the benchmark by 0.51%.
- At a sector level, the portfolio's overweight to Energy & Consumer Staples was a positive for performance, although being underweight materials stocks, particularly Gold companies, detracted from relative performance.

Portfolio Commentary

Monthly Performance Attribution

Top Contributors	Positioning	Key Detractors	Positioning
G8 Education Ltd	Overweight	iSelect Limited	Overweight
iiNet Limited	Overweight	Goodman Fielder Ltd	Overweight
Beach Energy Ltd	Overweight	Sims Metal Management	Overweight

G8 Education (GEM, +27.7%) was the portfolio's top performer, driven largely by acquisition activity. The Australian and Singaporean based childcare centre operator added a further 63 centres to its Australian operations in early February, delivering a significant benefit to future year profits. As well as acquisition activity, GEM also delivered strong full year profit results in the February reporting period. The management of G8 have a strong handle on all aspects of the business, providing a highly-regarded childcare service and also ensuring that utilisation, staffing levels, and overheads (head office) are kept in check. They have an excellent track record in applying these disciplines and systems to newly acquired businesses, together with access to further funding, and we expect GEM to continue to deliver on both an acquisition and operational front.

Mid-cap Telco company, iiNet Limited (IIN, +15.9%) reported a strong profit result. The company has grown by acquisition in recent times and has a strong track record of successful integration and synergy realisation. This recent result however demonstrated strong growth in organic sales, with the company adding new customers at its strongest rate in many years. IIN's view is that their larger scale now allows them to spend money on a marketing strategy that gains traction in the mass market, for example, capital city TV advertising and sponsorship of major sporting teams (e.g. Hawthorn Football Club). The market was pleased with what IIN delivered and responded accordingly.

Beach Energy (BPT) also delivered what the market was hoping for, namely strong operating leverage and profit growth. In particular, Beach delivered strong operating output and profit growth from their key 'conventional' oil assets in the Cooper Basin, South Australia. Combined with a prospective series of exploration assets currently held by Beach, the market is warming to this name.

Other companies to report solid profit results and receive a share price boost included Henderson Group (HGG, +10.8%) and Tassal Group (TGR, +10.6%). The former benefitted from improved FUM flows in Europe, the latter from the strength of their industry position in salmon supply; salmon demand continues to grow.

Comparison website provider iSelect (ISU, -21.7%) was the portfolio's worst performer for February. The company reported profit results for the half year to December which were in line with their forecasts, and on this basis, we were somewhat surprised by the share price weakness. Also, the results highlighted improvements in free cash flow, good sales growth in a number of smaller business lines (eg. energy) and a stabilisation in revenue per sale (RPS) for their key healthcare segment. The principal cause of weakness appeared to be lowered expectations for profits in the second half of FY14. The company explained that this was due to both increased investment in data mining capabilities and changes in partner programs which will reduce the upfront commissions payable to ISU. Despite this reinvestment impacting near term profits and further denting shareholder sentiment, we have maintained our investment in ISU as we understand the investment rationale. With the company holding significant cash assets post the IPO and demonstrating good revenue growth, we continue to believe it remains undervalued at these levels. At the time of writing, ISU have just confirmed the appointment of Alex Stevens as CEO. His CV appears impressive and we will likely discuss this development in more detail in our March monthly report.

Goodman Fielder (GFF, -8.1%) had a poor month following a disappointing profit result. Under new management, the company has made strong progress in selling off non-core assets and improving pricing structures with its customers in their key baking division. These savings were however offset in the first half by increased costs to maintain service standards to customers. GFF admitted that network rationalisation across their asset base had lead to supply production issues, which in turn had forced them to increase costs to meet demand and service standards. Goodman Fielder management are now nearly 2 years into a business turnaround that is quite significant. Although we are wary of the danger of turnarounds in this industry sector, we have accepted this backward step as we continue to expect this management team to deliver on their objectives. We continue to have a positive view of the broader agriculture and food thematic, particularly where supported by what we perceive to be competent management.

Sims Metal Management (SGM, -6.0%) reported quite reasonable profit results for the December half year, largely meeting market expectations, and rallied on the day of the result before closing the month lower. Of its various geographies, the Australian division reported strong results, the larger US division was weak, and Europe was a touch better than expected. In our view, it is only a matter of time until US scrap metal demand improves, in line with the general US economy. Economic growth, in particular a strong manufacturing sector and improving housing demand, drive demand for scrap. As consumers buy new houses and new cars, this leads to increases in scrap supply from old cars and older household goods (fridges, washing machines) as these are typically recycled. SGM's recently appointed CEO, Mr Galdino Clara, outlined plans for a review of all divisions and a focus on best practice across the group. Although these statements may sound generic, we look forward to hearing the detail in coming months.

Portfolio Adjustments

During the Month we...

SOLD: Bega Cheese (BGA), Cromwell Group (CMW), Federation Centres (FDC), Investa Office Fund (IOF)

BOUGHT: Acrux (ACR), Macquarie Atlas Roads (MQA) Orora Limited (ORA), SkyCity Entertainment Group (SKC)

We added four new stocks to the portfolio this month, including Acrux Limited (ACR), Macquarie Atlas Roads (MQA), Orora Limited and Sky City Entertainment (SKC).

SKC is an entertainment business, focused on hotels, casinos and broader entertainment precincts. The company has interests in key facilities in each of Auckland, Adelaide and Darwin. Broadly speaking SKC is mid-way through a series of upgrades across its portfolio of assets. Once these are complete we believe that revenues and profits should rise due to improved patronage and, critically, that cash flows should also increase as development expense is completed. The stock already pays a very solid yield and we will look for this to increase further once capital expenditure decreases.

Acrux (ACR) is a former investment for the portfolio, which has fallen considerably since we last held the stock. The company's key product is a testosterone replacement therapy, delivered via an underam applicator and marketed globally by pharmaceutical major, Eli Lilly. Recent share price weakness has been driven by a weakening in US sales trends for all testosterone products and more recently, published medical reports suggestive of negative safety impacts from usage of testosterone in older patients. From our vantage the medical literature is not equivalent to gold standard clinical trials and is counter to a strong body of medical evidence supporting the use of testosterone in older males. The US FDA has not taken any material action in regards to testosterone usage and we are further reassured by the fact that use of supplimental testosterone has been a constant in medicine for over 50 years. We saw the stock price reaction as overdone and took a small position in the portfolio.

We also bought a position in recent Amcor spin-off Orora Limited (ORA). Orora is a largely Australian-oriented packaging business, focused on bottles, cans and paper/fibre packaging. The US side of the business makes up 30% of revenues, but does provide for growth opportunities as that market place is more fragmented than Australia. Under Amcor, the company spent millions of dollars on plant closures and new capital expenditure, including the Botany paper mill (B9) in Sydney. These initiatives are set to drive tens of millions of dollars in cost savings, with B9 alone bringing some $50m in efficiencies as the plant is progressively ramped up to full production over several years. With a clean balance sheet containing relatively low debt levels and costs savings from these initiatives, we expect ORA to deliver solid profit growth despite low, defensive-type revenue growth for the underlying operations, and to have the capacity for special dividends or acquisitions.

We made several sales during the month, including the outright sale of property stocks, Cromwell Property (CMW), Federation Centres (FDC) and Investa Office Fund (IOF). These sales were part of a broader reduction in our exposure to property stocks, spurred on by a reduction in the discount to net tangible assets (NTA) since acquisition, reducing the value on offer in our opinion.

Finally, we sold our remaining position in Bega Cheese (BGA) as the battle for ownership of Warrnambool Cheese and Butter (WCB) completed. Once the Canadian bidder Saputo had gained a near majority of shares with their cash offer for WCB, BGA themselves elected to tender their shares into the Saputo offering. BGA's 18.8% shareholding will deliver between approximately $61m and $68m to BGA, post tax. With this transaction complete we elected to take profits in our Bega shareholding, but will of course keep a watchful eye on the company in the future.

Investment Approach

A Three Stage Investment Process

Intensive bottom-up research is the cornerstone of the entire process, supplemented by top-down economic and thematic views. The process is disciplined and consistently applied, using a number of proprietary qualitative and quantitative techniques to ensure that targeted companies have been thoroughly scrutinised. The aim is to uncover undervalued businesses. The companies that Ralton typically invests in are those with strong and reliable management, good profit and dividend growth expectations, reasonably predictable future profits and cash flows, and a very clear business model.

Stage 1: Defining the Investment Universe (Screening)

The first stage of the process is to narrow the number of stocks in the investment universe by applying a number of screens. This approach systematically eliminates companies that do not meet certain minimum standards, allowing the Investment team to focus more intensely on companies of potential interest.

Stage 2: Bottom-up Fundamental Company Research

Ralton's research programme is focused on understanding the key drivers of business performance and returns, namely people, operations, products and services, and market dynamics. For companies remaining in the Investment Universe, a detailed assessment is made of executive management, interviews competitors and suppliers, reviews financials, and forms a clear view on the outlook for the company's industry.

Stage 3: Portfolio Construction

Risk management and capital preservation are key themes underlying the portfolio construction framework. With a focus on actively managing down-side portfolio risk for investors, Ralton constructs an efficiently diversified portfolio of high quality, undervalued companies, and invests for the long term (typically 3 to 5 years) in an effort to maximise after tax-returns.

About the Manager

Ralton Asset Management is part of the OC Group, a boutique investment specialist majority owned by members of its investment team and key executives.

Ralton is a Value manager with a fundamental investment approach designed to identify quality businesses trading at a considerable discount to valuation. The process is guided by three fundamental beliefs:

- Markets are not perfectly efficient and the true value of a business is not always reflected in its share price;
- Undervalued companies can be identified through detailed and intensive research; and
- Capital preservation is critical to wealth creation.

The Investment Team

Andrew Stanley *BEc, LLB, ACA, FFin, MA AppFin*
Portfolio Manager, Ralton Model Portfolios

Andrew Stanley is the lead portfolio manager for the Ralton portfolios. He is supported by a dedicated and highly experienced team of investment professionals each with an average 18 years investment experience. Andrew has been working in financial markets for more than 19 years, including the past 5 years managing the Ralton portfolios. Prior to Ralton, he was an Executive Director at UBS in Hong Kong, and over the course of his career has held senior positions with major investment institutions in Melbourne, Hong Kong, Tokyo and New York. Andrew started his career at Arthur Andersen in Melbourne.

Roger Walling *BOptom, MBB* Portfolio Manager, Ralton Model Portfolios

Stephen Evans *B Com, ACA*, Portfolio Manager

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For Further Information

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