Quarterly Report
March 2014

Ralton High Yield Australian Shares

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

Investment Profile

A Professionally Managed Portfolio of Australian Shares

The Ralton High Yield Australian Shares 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 High Yield Australian Shares SMA is to provide investors with consistent, tax-efficient and growing cash dividend yield, and long-term capital growth. The Portfolio aims to deliver a return superior to that of the market over periods of five years or longer and an above market yield.

Key Portfolio Features	
Inception	1 February 2008
Benchmark	S&P/ASX 300 Accumulation Index
Authorised Investments	Companies in the S&P/ASX 300 Index or those amongst the top 300 by size.
Number of Stocks	20-35
Cash Allocation	0% to 10%
Tracking Error	2% to 5%
Investment Horizon	At least 5 years
Ratings	

The Portfolio is designed for investors who...

- Seek an above market, tax-efficient cash dividend yield and long term capital growth
- 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	ANZ Banking Group	ANZ
2	Commonwealth Bank of Australia	CBA
3	Telstra Corporation Limited	TLS
4	Westpac Banking Corporation	WBC
5	BHP Billiton Limited	BHP
6	Woodside Petroleum Limited	WPL
7	Amcor Limited	AMC
8	Sydney Airport	SYD
9	Origin Energy Limited	ORG
10	Incitec Pivot Limited	IPL

GICS Sector	Ralton	Index	+/-
Industrials	11.4%	6.8%	4.6%
Consumer Discrectionary	8.5%	4.8%	3.7%
Telecommunication Services	7.3%	5.1%	2.2%
Energy	7.4%	5.8%	1.5%
Utilities	1.6%	1.6%	0.0%
Consumer Staples	7.7%	7.9%	-0.2%
Information Technology	0.0%	0.8%	-0.8%
Materials	15.4%	17.4%	-2.1%
Health Care	2.5%	4.7%	-2.2%
Financials (ex-Property)	35.4%	38.2%	-2.7%
Property	2.8%	6.7%	-3.9%
Total	100%	100%	

Performance

Return %	1m	3m	1yr	3yrs	5yrs	Incept*
Ralton High Yield	1.38	2.84	17.40	12.36	15.66	6.95
Income Return	0.46	1.46	5.31	5.29	5.03	5.15
Growth Return	0.91	1.37	12.09	7.07	10.62	1.80
S&P/ASX 300 Acc. Index	0.21	1.99	12.97	8.05	13.20	3.71
Difference	**1.17**	**0.85**	**4.43**	**4.31**	**2.46**	**3.24**

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

Quarter in Review

- The S&P/ASX 300 finished the quarter 1.99% higher, with the Utilities and Information Technology sectors offering the strongest percentage gains.

- The Ralton High Yield Model Portfolio also made solid gains, adding 2.84%, outperforming the benchmark index by 0.85%.

- The portfolio's stock selection within the Materials Sector was the strongest contributor to relative returns, offset to a degree by our underweight position in the Financials Sector.

Portfolio Commentary

Quarterly Performance Attribution

Top Contributors	Positioning	Key Detractors	Positioning
G8 Education	Overweight	Goodman Fielder	Overweight
Orora Limited	Overweight	Coca-cola Amatil	Overweight
Incitec Pivot	Overweight	Toll Holdings	Underweight

G8 Education (GEM, +60.4%) was the portfolio's top performer for the quarter, driven largely by successful acquisition activity. The childcare-centre operator added 63 centres to its Australian operations in early February, delivering a significant boost to future profitability. In March another sizeable acquisition opportunity arose in the form of Sterling Early Education. Sterling had sought to list as a separate company on the stock exchange but failed to receive adequate investor support at the nominated IPO price. This corporate failure created the opportunity for GEM to acquire a further 91 good quality childcare centres at a reasonable price, a move which boosted their profit outlook and also removed a potential competitor for future acquisitions from the landscape. In the midst of this acquisition activity, GEM delivered strong full year profit results in the February reporting period. The management of GEM seems to have a strong handle on all aspects of the business, providing a quality service while ensuring that utilisation, staffing levels and overheads (head office) are kept in check. They have an excellent track record in applying their management disciplines and systems to newly acquired businesses, and with access to further funding, we expect GEM to continue to deliver on both an acquisition and operational front.

Materials stocks featured prominently in portfolio returns for the March quarter, with Orora Limited (ORA, +18.5%) adding value to the portfolio. The company's maiden half-year profit result in February was reasonably solid with cost savings from recent plant closures in the Australian division a highlight of the results. Also, the smaller American packaging division demonstrated strong revenue and profit growth, boosted by the year-on-year decline in the Australian currency and a series of modest contract wins from large US companies. We expect much of Orora's future profit growth will be driven by efficiency gains from the B9 paper mill in Botany. This state-of-the-art plant, currently in ramp-up mode, replaces Amcor's three aging paper mills. Once B9 has been fine-tuned with regard to both the mix of feedstock (various grades of recyclable paper) and operating settings and is running near capacity, the plant is expected to deliver a strong step-up in company profits. ORA has a clean balance sheet containing relatively low debt levels and with cost savings from B9 driving profit growth, we continue to have a favourable view of the stock.

Recall Holdings (REC, +14.5%) was also recently added to the portfolio following a demerger, in this case demerging from Brambles (BXB). Like Orora, REC also posted a reasonably solid maiden half-year profit result. New CEO Doug Pertz and his team have been quick off the mark, already completing two small bolt-on acquisitions, one in the US and the other in the UK. As it is now under standalone management and board we expect REC will no longer be starved of capital and will be free to pursue selective acquisitions in the market. After the demerger, we added to our position in REC in December and again in January. With a strong balance sheet, good returns on capital and the completion of capital expenditure on software systems, we view REC as a stable business with strong market positions and an outlook for reasonably steady growth.

Incitec Pivot (IPL, +10.5%) rallied strongly across the March quarter, buoyed by rising prices for fertilizers (both DAP and UREA) in recent months. As highlighted in our January report, fertilizer prices have been boosted recently by seasonal demand, together with a decline in US inventories and a positive outlook for crop demand across key regions. Ralton's investment in IPL is however based more around the company's explosives (ammonium nitrate) division. Increased production and an increased percentage of profits will come from this division, firstly as the Moranbah (Queensland) manufacturing plant ramps up production this year, and secondly when the company's Louisiana ammonia plant, currently under construction, is completed in 2017. In future years, when the fertilizer division contributes only a small portion of group profits and capital expansion has been completed, we expect free cash flow for IPL to rise strongly.

Consumer Staples were negative contributors to performance across the quarter. Goodman Fielder (GFF, -10.2%) had a poor quarter following the release of 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 manufacturing plants had lead to production supply issues, which in turn had forced them to increase costs to meet demand and service standards. Despite this setback, we had been prepared to back management to deliver a turnaround in profits in what has historically been a tough segment of the market. Our optimism has however been further dimmed by another profit downgrade early in April. Although several factors contributed to this latest profit revision, GFF noted that ongoing manufacturing shortfalls had again necessitated additional costs to meet service standards. At this point we sold the stock, having lost faith that management were suitably in control of the necessary business levers.

Another Consumer Staples stock to underperform was Coca-Cola Amatil (CCL, -8.3%). CCL released a mixed FY13 profit result, the last from long-time and successful CEO, Terry Davis. Specifically, ongoing discounting in the Australian supermarket sector together with mixed results from the company's Indonesian and PNG operations weighed on profits for the period. Despite this we continue to see the strength of CCL's brand offering, the exposure to the Indonesian growth region, strong free cash flow and the potential for new initiatives from the incoming CEO Alison Watkins as providing a platform for CCL to reverse the profit decline. On a topical note, given the pressure Australia's manufacturing sector has recently faced, we noted that the small but problematic SPC Ardmona (a division of CCL) fruit business received some good news in the quarter, with Woolworths committing to a 5 year contract to purchase fruit from the Victorian based operations.

Toll Holdings (TOL, -8.5%) and Chandler Macleod (CMG, -7.8%) each underperformed after releasing somewhat underwhelming half-year profit results. Both stocks are domestic cyclicals and continue to face the headwind of a lacklustre Australian economy, particularly on the East Coast. Toll provides transport services and CMG provides labour hire, so they are both at the forefront of the economy. However with both businesses we have confidence that management have various cost and efficiency levers to pull, and in time, the changes that are being undertaken at each organisation will drive an improvement in operating performance and profits.

Portfolio Adjustments

During the Quarter we...

SOLD:	Federation Centres (FDC), Investa Office Fund (IOF), M2 Group (MTU), Sims Metal Management (SGM)
BOUGHT:	Blackmores (BKL), National Australia Bank (NAB), SkyCity Entertainment Group (SKC)

We added three new stocks to the portfolio, namely SkyCity Entertainment Group (SKC), National Australia Bank (NAB) and Blackmores Limited (BKL).

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 offers a very solid yield and we will look for this to increase further once capital expenditure decreases.

We added a small position in Blackmores (BKL) following the release of the company's first half profit results. BKL are a manufacturer and distributor of vitamins and associated health products, largely sold under the well-respected 'Blackmores' brand. The company was established more than 70 years ago in Queensland, and for some time has been expanding into Asian markets such as Korea, Thailand, Singapore and Malaysia. In recent times, industry newcomer Swisse has unsettled the market with blanket advertising, and this together with aggressive discounting to suppliers across the industry by various manufacturers, not only Swisse, has impacted the sales and profit profile for BKL in Australia. Having established both brand and market share, Swisse and its new investors now appear to have changed tack and become more focused on profits, not just sales. Assuming this more stable industry dynamic continues, we consider that Blackmore's solid brand and reputation in the Australian market, together with growth opportunities throughout Asia, should allow the company to return to reasonable profit growth.

Price weakness in National Australia Bank (NAB) and the banking sector as a whole was the trigger for adding a position, at what appeared a reasonable valuation.

We also sold four stocks outright from the portfolio. The outright sale of Federation Centres (FDC) and Investa Office Fund (IOF) were part of a broader reduction in our exposure to property stocks. Both stocks had narrowed their discount to net tangible assets (NTA) since acquisition, reducing the value on offer in our opinion.

With Sims Metal Management (SGM) we were disappointed by the lack of dividend payment from the company, and given some share price strength following the first half results, took the opportunity to sell the stock. To add some further detail, the company reported quite reasonable profit results for the December half year, largely meeting market expectations. Of its various geographies, the Australian division reported strong results, the larger US division was weak, and Europe 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, and in particular a strong manufacturing sector and improving housing demand, drive demand for scrap. In particular, 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, and although these statements sound somewhat generic, we look forward to hearing the detail in coming quarters. We will reconsider the stock for this portfolio when conditions in the US improve as expected and we therefore see a return to a more favourable dividend policy, consistent with our portfolio's objectives.

Finally, we took profits in telecommunications supplier M2 Group (MTU). The stock has been a beneficiary of aggregation in the sector with company management demonstrating a good track record in mergers and also a strong sales culture. Although further transformational acquisitions cannot be ruled out, our sense was that opportunities were now more limited and that organic growth, typically low for the industry, would restrict the outlook for profit growth. The dividend yield had also reduced given the movement in the share price, which is a key consideration for investors in this portfolio.

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.

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