Quarterly Report March 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	MORNINGSTAR ★★★★ ; LONSEC Investment Grade SMA

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	G8 Education Limited	GEM
2	Fletcher Building Limited	FBU
3	Sky Network Television Limited	SKT
4	Fisher & Paykel Healthcare Corporation	FPH
5	Beach Energy Limited	BPT
6	Tassal Group Limited	TGR
7	iSelect Limited	ISU
8	Magellan Financial Group	MFG
9	Blackmores Limited	BKL
10	Orora Limited	ORA

GICS Sector	Ralton	Index	+/-
Consumer Discretionary	31.6%	24.1%	7.5%
Consumer Staples	9.4%	2.9%	6.5%
Financials (ex-Property)	10.3%	7.8%	2.6%
Health Care	7.3%	4.8%	2.5%
Energy	7.3%	5.7%	1.6%
Industrials	16.8%	15.9%	0.9%
Information Technology	2.2%	2.6%	-0.4%
Utilities	0.0%	1.7%	-1.7%
Telecommunication Services	2.9%	6.0%	-3.0%
Materials	9.6%	17.6%	-8.0%
Property	2.4%	11.0%	-8.6%
Total	100.0%	100.0%	

Performance

Return %	1m	3m	1yr	3yrs	5yrs	Incept*
Ralton Smaller Companies	1.18	3.70	18.92	12.13	18.90	6.73
Income Return	0.87	1.14	4.17	3.93	3.98	4.00
Growth Return	0.31	2.56	14.76	8.19	14.92	2.72
S&P/ASX Small Ords Acc Index	-1.16	0.89	-1.46	-5.33	8.76	-3.24
Difference	**2.34**	**2.81**	**20.39**	**17.46**	**10.14**	**9.97**

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

Quarter in Review

Performance Summary

- The S&P/ASX Small Ordinaries Accumulation Index added 0.89% for the quarter, with the Industrials and Materials Sectors making strong gains.
- Over the same period the Ralton Smaller Companies Portfolio gained 3.70%, outperforming the benchmark by 2.81%.
- At a sector level, the portfolio's overweight to Consumer Staples & Industrials was a positive for performance while being underweight Materials stocks, particularly Gold companies, detracted from relative returns.

Portfolio Commentary

Quarterly Performance Attribution

Top Contributors	Positioning	Key Detractors	Positioning
G8 Education Limited	Overweight	iSelect Limited	Overweight
Beach Energy Limited	Overweight	Austbrokers	Overweight
Fisher & Paykel Health	Overweight	Treasury Wine Estates	Overweight

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 released 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.

Fletcher Building (FBU, +15.7%) and Fisher and Paykel Healthcare (FPH, +3.9%), two of our NZ domiciled investments, added to the portfolio's strong performance for the quarter. Fletcher's half-year profit results were well received by investors. The ongoing strength of the NZ economy, including residential housing, together with the continued rebuild of the Christchurch region and cost savings from the 'FBUnite' project were a highlight of Fletcher's results.

During the quarter, medical device manufacturer Fisher and Paykel Healthcare provided another increase to their FY14 profit guidance. FPH manufacture and sell respiratory and breathing products for two key markets, firstly obstructive sleep apnea (OSA) and secondly assisted breathing (RAC), typically humidifiers and associated consumables for either acute or chronic indications, for either the hospital or home setting. The recent profit upgrade was driven by strong sales and market share gains by FPH's OSA products, although sales in the RAC division have also been very strong of recent times and the company is positive that this will continue.

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.

Comparison website provider iSelect (ISU, -21.1%) detracted from portfolio returns for the quarter. 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. The results highlighted improvements in free cash flow, good sales growth in a number of smaller business lines (e.g. 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 that will reduce the upfront commissions payable to ISU. Despite this impacting near term profits and 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 is undervalued at these levels. During the quarter the company announced the appointment of Alex Stevens as new CEO. His CV appears impressive, with a history of being CEO or managing director for consumer product segments at Pepsi, Fonterra and Carlton and United Breweries, with roles in US, NZ, Asia and Australia. Interim CEO David Chalmers will return to the role of CFO, and we view the improved management stability as a positive.

Treasury Wine Estates (TWE) also detracted from portfolio performance, following a surprise earnings downgrade by the company in late January. Poor sales outcomes in the final quarter of 2013 drove TWE to downgrade its profit expectations for the full financial year. Specifically, the company cited profit shortfalls in each of Australia and China compared to prior expectations. The Chinese situation was reasonably well understood by the market as being due to the recent crackdown on gift giving and increased austerity measures amongst government entities in China. However, the results in Australia came as a significant surprise and were not sufficiently well explained by the company. In a limited press release, TWE highlighted that their decisions to raise prices and reduce participation in Christmas discounting in the usual manner had impacted Australian sales volumes. For us, this was the final straw as it eroded our confidence in management and the board's ability to achieve good returns for shareholders from what we believe are a reasonable group of assets. Therefore we elected to crystallise a loss on what was a relatively small holding for the portfolio.

Two of our smaller positions in the portfolio, Austbrokers (AUB, -9.5%) and Sims Metal Management (SGM, -7.8%) weighed on the portfolio, following the release of their half-year profit results. To add some further detail, although SGM's profit results for the December half year largely met market expectations, the key US division was weak and the company declined to pay a dividend. Financial concerns about emerging markets likely weighed on the SGM share price also. Specifically, Turkey is a key destination and price setter for global scrap and hence any market jitters in this area has the potential to flow through to scrap demand and price.

Portfolio Adjustments

During the Quarter we...

SOLD: Bega Cheese (BGA), Cromwell Group (CMW), Federation Centres (FDC), Investa Office Fund (IOF), M2 Group (MTU)

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

We added several new stocks to the portfolio this quarter, including Acrux Limited (ACR), Blackmores Limited (BKL), Orora Limted (ORA) 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 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.

Acrux (ACR) is a former investment for the portfolio, which has fallen considerably in price since we last held the stock. The company's key product is a testosterone replacement therapy delivered via an underam applicator, marketed globally by pharmaceutical major Eli Lilly. Recent share price weakness reflects 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. In our view the medical literature is not equivalent to gold standard 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 external 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, with a capacity to grow profits through it's own initiatives. The US side of the business makes up 30% of revenues, and provides for growth opportunities as that marketplace 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 quarter, 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 their reduction in discount to net tangible assets (NTA) since acquisition, which reduced the value on offer in our opinion.

We also 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.

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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