Monthly Report
July 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 equity markets

Portfolio Structure

No.	Company Name	ASX Code
1	Commonwealth Bank of Australia	CBA
2	Telstra Corporation Limited	TLS
3	ANZ Banking Group	ANZ
4	BHP Billiton Limited	BHP
5	National Australia Bank Limited	NAB
6	Westpac Banking Corporation	WBC
7	Transurban Group	TCL
8	Woodside Petroleum Limited	WPL
9	Recall Holdings Limited	REC
10	Origin Energy Limited	ORG

GICS Sector	Ralton	Index	+/-
Industrials	16.2%	7.4%	8.9%
Telecommunication Services	8.2%	5.4%	2.8%
Consumer Discretionary	7.7%	5.5%	2.2%
Energy	7.3%	6.6%	0.7%
Utilities	1.8%	2.1%	-0.3%
Information Technology	0.0%	0.9%	-0.9%
Health Care	3.4%	4.8%	-1.4%
Consumer Staples	5.1%	7.6%	-2.5%
Financials (ex-Property)	32.6%	35.4%	-2.8%
Property	3.9%	7.1%	-3.2%
Materials	13.8%	17.3%	-3.5%
Total	100%	100%	

Performance

Return %	1m	3m	1yr	3yrs	5yrs	Incept*
Ralton High Yield	3.07	3.24	16.58	17.39	12.84	7.27
Income Return	0.00	0.81	4.83	5.04	4.87	5.01
Growth Return	3.07	2.44	11.74	12.36	7.97	2.26
S&P/ASX 300 Acc. Index	4.41	3.57	16.27	13.00	10.34	4.34
Difference	**-1.34**	**-0.32**	**0.31**	**4.39**	**2.50**	**2.93**

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

Month in Review

- The S&P/ASX 300 accumulation index made strong gains, adding 4.41% for the month. Materials and Information Technology were the top performing sectors, although all market sectors were in positive territory.

- The Ralton High Yield Model Portfolio made solid gains, adding 3.07% for the month, underperforming the benchmark index by 1.34%.

- Although the portfolio made a positive return, our underweight exposure to both Materials and Financials detracted from relative returns and lead to the portfolio underperforming against the benchmark.

Portfolio Commentary

Monthly Performance Attribution

Top Contributors	Positioning	Key Detractors	Positioning
Recall Holdings	Overweight	Rio Tinto	Underweight
Automotive Holdings	Overweight	Amcor Limited	Overweight
Sonic Healthcare	Overweight	Sky Network Television	Overweight

The market rose a strong 4.41% in July, while the portfolio gained 3.07%, underperforming the benchmark by 1.34%. The key reason for this underperformance was the portfolio's underweight exposure to both metals and mining (resource) stocks and, to a lesser degree, several 'China facing' industrial stocks. Iron ore focused miner, Rio Tinto (+11.9%), Alumina Limited (AWC, +18.9%), BlueScope Steel (BSL, +15.9%) and Orica Limited (ORI, +12.9%) were all not held by the portfolio and therefore detracted from relative returns.

Regular readers will understand our cautious views on the Chinese economy as it seeks to rebalance from a fixed asset investment and export driven growth model to a domestic consumption driven growth model. This means slowing demand growth for commodities in future years just as the major miners are delivering massive supply increases to the market. Whilst this analysis has proven largely correct in recent years, short-term improvements in several Chinese economic indicators fuelled the performance of this segment of the market in July. We are sticking to our view that China will need to address the imbalance in their economy in the next couple of years, and as such, we believe there are better opportunities for us to invest in companies with less direct exposure to the Chinese economy.

Positive Contributors

Document and information management company Recall Holdings (REC, +8.0%) was the portfolio's top contributor for July. Late in June, REC announced a Facility Optimisation Program (i.e. productivity improvements), designed to decrease costs and increase utilization across their global storage facilities. Essentially, REC will be fine-tuning their real estate footprint and boosting storage density at their remaining facilities. The company's plan is to achieve $11m in cost savings over the next 18 months. Our investment in Recall is based on its existing annuity-type revenue streams and the opportunity focused management (post demerger from BXB) to continue to grow the business through productivity improvements and selective acquisitions. We view there is a huge opportunity for REC to make bolt-on acquisitions given its global footprint and the changing global regulatory environment making it harder for small players. We continue to view REC as a stable business with strong market positions and an outlook for reasonably steady organic and acquisition growth.

Automotive Holdings (AHE, +7.1%) boosted portfolio performance for the month. AHE own a series of automotive-based businesses, including new and used car dealerships and automotive part supply businesses. AHE also has a refrigerated transport business, which is one of the largest players in the Australian market following its acquisition of the Toll refrigerated logistics business. We like the management and continue to believe that the outlook for growth is quite solid. Growth in new car sales has paused in recent months, dipping below the long term trend, however we believe that through acquisition of existing dealerships and expansion via new brownfield sites, AHE is well positioned to deliver growth for investors across the cycle. Although recent acquisitions in the refrigerated transport division have been slow to boost growth, AHE now appear to have the right national footprint, and hence, we are more confident management can deliver an appropriate level of return from these assets.

Sonic Healthcare (SHL, +4.9%) added to portfolio returns as measures announced in the federal budget, specifically the implementation of a 'co-payment' by medical services for GPs, pathology and radiology, appeared unlikely to pass the Federal Senate and become law. Leaving the nuances of Australia's legislative assembly to one side, we believe that any co-payment that does pass Australia's new Senate may well be watered down, hence we do not expect a material, long term impact on SHL. In fact, establishing market-based payments via co-payments is likely a positive development in the medium term for healthcare providers. Late in the month, SHL announced further expansion in it's UK operations, whereby SHL's UK subsidiary will form a partnership with both the University College London Hospital NHS Foundation Trust (UCLH) and the Royal Free London NHS Foundation Trust (Royal Free). The partnership will tender for various public pathology contracts, and with Lord Carter as its Chairman - something of a coup given Lord Carter chaired the influential 2008 review of UK pathology services - we expect that SHL will do well from this joint venture over time. SHL expects to book £50m of additional revenue per annum, although the initial earnings impact will be modest as the joint venture will provide services to SHL and its NHS partners at near cost. A new lab is planned in 2015. We estimate Sonic's share of the capex requirements will be A$30-40m. Securing additional contracts should become more material and is therefore the opportunity in our view.

Negative Contributors

Rio Tinto (RIO, +11.9%) was the key detractor from portfolio performance for the month as we did not have a position in the stock. The relatively new management team of Sam Walsh (CEO) and Chris Lynch (CFO) have performed well since taking the reigns in early 2013. Operational cost targets have been met, capital expenditure has been reduced and debt metrics improved in turn. The legacy of prior management still exists however, as evidenced by the recent sale of RIO's Riversdale Mining (Mozambique) coal operations for some $53m, a far lower figure than the $3.9bn paid for the assets at the height of the boom. Ralton has not owned shares in RIO for some time due its substantial exposure to iron ore demand and price risk. As a best case scenario, iron ore prices will continue to drift lower given rising global supply (particularly from Australian majors BHP, RIO, FMG). As a worst case, the iron ore price could fall relatively quickly if China has a more serious property slow down. The global market is likely to continue to absorb all the iron ore RIO produces, it is just the pace and extent of the price decline which is in question. We continue to monitor RIO and will re-enter the stock if we see these risks reflected in the share price.

Amcor Limited (AMC, 0.0%) finished flat for the month of July and, given the strong market, contributed to our relative underperformance. We have held the stock for many years, prior to the large, transformational acquisitions of both Alcan and Ball Packaging, and have witnessed management deliver on a series of cost and operational targets as well as pursue their drive to consolidate and rationalise their industry and markets. Late in the month Amcor announced the introduction of a revolutionary 'liquiform technology' designed to reduce both cost and manufacturing steps in production of Amcor's RPCs (rigid plastic containers). Together with joint venture partner Sidel we expect AMC to license, commercialise and manufacture this technology. Amcor's intellectual property in the packaging space is considerable and a key differentiator with global customers when it comes to choice of packaging partner in emerging markets.

Finally, Sky Network Television (SKT, -3.8%), one of the portfolio's smaller positions, underperformed in a strong market on a lack of news flow. The NZ-based pay TV operator has an industry-leading position in the New Zealand market, where the economy as a whole is strong and demand for its services remain high.

Portfolio Adjustments

During the Month we...

SOLD:

BOUGHT: Aristocrat Leisure (ALL), Transpacific Industries Group Limited (TPI)

Portfolio Additions & Material Adjustments

We added two new positions, Aristocrat Leisure (ALL) and Transpacific Industries (TPI) to the portfolio in July and increased the holding in National Australia Bank (NAB).

In ALL we are attracted to the progress being made by the company under CEO Jamie Odell's 5-year turnaround. ALL have invested heavily in resources to improve the quality of their gaming offering, both in the traditional slot machine setting, and also online software. Despite the backdrop of a modest demand growth for slot machines, the company has been gaining share in key markets. The recent acquisition of US based Video Gaming Technologies (VGT), funded by a capital raising from shareholders and debt, also appears strategically sound.

We added a position in Transpacific Industries (TPI) during the month after its admission into the Top 100 index created some short-term market noise which led to a sharp pull-back in the share price (i.e. small cap managers were forced sellers and large cap managers had not had a chance to get their minds around the new profile of the company). This is a company we have owned in other portfolios, but not this one due to the absence of a dividend. The changed financial position of the company means it should be able to start paying dividends again. After a near death experience during the GFC when the company was over-indebted, there has been a major transformation to the point where the company is debt free after the recent disposal of its NZ operations.

In addition, Robert Boucher (CEO) can focus on the core Australian business and domestic growth options. The company has already outlined a number of productivity initiatives to improve its existing business. Further, the group is looking to use its balance sheet capacity to acquire additional landfills which offer attractive margins (you would appreciate this if you have attempted to take any garden waste to a recycling area recently). We believe short-term market noise has created an attractive entry point into a company with a solid medium term growth and dividend outlook.

We made a significant increase in our National Australia Bank (NAB) holding in July. Although NAB has been our least preferred bank, two recent developments renewed our interest in the stock. Firstly, new CEO Andrew Thorburn (replacing Cameron Clyne) is an experienced banker who achieved encouraging cultural change in the NZ operations - something we believe is essential to improve the Australian operations. Secondly, the improvement in the outlook for the UK should mean the bank can divest its legacy UK commercial property loan portfolio and potentially divest its interest in Clydesdale Bank. During the month the bank sold a £625mn parcel of UK commercial real estate loans at above book value to an affiliate of Cerberus Global Investors. This was a good start, although there is still some way to go on this legacy book. This potential for change and the discount at which NAB trades relative to its peers gave us more confidence to increase our position.

Portfolio Disposals & Material Adjustments

There were no outright stock sales for the month for the High Yield model portfolio. We did however take profits in several stocks within the portfolio, including Duet Group (DUE), Incitec Pivot (IPL) and Mirvac Group (MGR).

An increase in our NAB holding was funded by a reduction in our positions for each of ANZ Banking Group (ANZ) and Westpac Banking Corporation (WBC), leaving our exposure to the sector as a whole unchanged.

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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Robert Frost *B Com, LLB*, Portfolio Manager

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