Quarterly Report June 2014

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	

Performance

Return %	1m	3m	1yr	3yrs	5yrs	Incept*
Ralton Smaller Companies	-0.55	0.13	21.72	13.28	16.16	6.48
Income Return	0.21	0.40	3.42	3.82	3.81	3.91
Growth Return	-0.75	-0.28	18.31	9.47	12.35	2.57
S&P/ASX Small Ords Acc Index	-1.11	-2.26	13.11	-2.94	3.43	-3.46
Difference	**0.57**	**2.39**	**8.61**	**16.22**	**12.73**	**9.94**

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

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 equity markets.

Portfolio Structure

No.	Company Name	ASX Code
1	Fisher & Paykel Healthcare Corporation	FPH
2	Sky Network Television Limited	SKT
3	Fletcher Building Limited	FBU
4	Beach Energy Limited	BPT
5	Tassal Group Limited	TGR
6	Recall Holdings Limited	REC
7	SAI Global Limited	SAI
8	Horizon Oil Limited	HZN
9	ISelect Limited	ISU
10	Village Roadshow Limited	VRL

GICS Sector	Ralton	Index	+/-
Consumer Discretionary	30.2%	25.0%	5.2%
Health Care	9.8%	4.7%	5.1%
Financials (ex-Property)	9.3%	5.6%	3.8%
Consumer Staples	6.8%	3.2%	3.6%
Industrials	17.7%	14.8%	2.9%
Energy	7.0%	6.1%	1.0%
Information Technology	2.7%	2.7%	0.0%
Utilities	1.4%	2.0%	-0.6%
Telecommunication Services	2.9%	6.0%	-3.1%
Property	2.5%	10.2%	-7.6%
Materials	9.6%	19.9%	-10.3%
Total	100.0%	100.0%	

Quarter in Review

Performance Summary

- The S&P/ASX Small Ordinaries Accumulation Index finished down 2.26% for the quarter, with strength in Financials and Industrials offset by weakness in other sectors.
- Over the same period the Ralton Smaller Companies Portfolio gained 0.13%, outperforming the benchmark by 2.39%.
- At a sector level, the portfolio's overweight to both the Industrial and Consumer Discretionary sectors helped to drive outperformance.

Portfolio Commentary

Quarterly Performance Attribution

Top Contributors	Positioning	Key Detractors	Positioning
Fisher & Paykel Healthcare	Overweight	Goodman Fielder Ltd	Overweight
SAI Global Ltd	Overweight	Chandler Macleod Group	Overweight
Cash Converters	Overweight	Fletcher Building	Overweight

Positive Contribution

SAI Global (SAI, +24.6%) rose strongly on the back of a proposed takeover by Pacific Equity Partners (PEP) for between $5.10 and $5.25 per share. The bid is non-binding and conditional, although the board indicated their willingness to engage with the private equity firm. At the same time as disclosing the bid, the SAI board served notice of termination on their recently appointed CEO, Stephen Porges. It would appear that the new CEO had a difference of opinion with the board on how quickly his strategy would deliver on profit growth and perhaps on how to engage with the PEP bid. Regardless, we have been long-term investors in SAI Global, based on a positive view of their exposure to annuity-type revenue streams from ongoing demand for their assurance, standards and compliance services and products. At this juncture, the business remains undervalued in our view, given the valuation multiple at which similar businesses have been acquired in recent years.

Fisher & Paykel Healthcare (FPH, +11.0%) was a strong contributor to the portfolio's return following the release of the New Zealand-based medical device company's FY14 annual results. Excluding the impact of foreign exchange movements and hedging, the company grew profits by 46% for the period. The company's two key divisions, sleep therapy or obstructive sleep apnea (OSA) and respiratory (RAC), both grew sales by double digits for the full year, with profit further supported by expanding gross margin from both scale benefits and the ongoing shift of manufacturing to Mexico. FPH have guided the market toward similar growth in underlying profit for the coming year, from similar sales trends and further gross margin expansion. We continue to hold a positive view on the company's growth prospects, in particular the evolution in medical practice for both in-hospital and home care for FPH's medical technology.

Cash Converters International (CCV, +12.5%) was also a strong contributor to performance during the quarter. The CCV share price has been steadily recovering off it's lows late last year, when the company announced that trading results in the September quarter were well below expectations. At the time the company highlighted the impact on customer behaviour from new regulatory requirements for CCV's loan products. Despite this, we were prepared to back company management, who at the time flagged that conditions were expected to improve beyond this period. Pleasingly, the company's half-year results in December and a further market update in April confirmed that recent periods have seen a continued improvement and rebound toward normal trading. CCV management continue to improve their systems and service offering, with improvements in the online customer offering continuing to grow the customer base. Future growth will also come from expansion in Cash Converter stores, both in Australia and New Zealand.

Negative Contribution

Goodman Fielder (GFF) was sold from the portfolio in early April, following a further profit downgrade. Under relatively 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 explained 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. Our confidence in GFF was however further dented 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.

Recruitment services company Chandler Macleod (CMG, -20.5%) also detracted from performance across the quarter. The company issued a profit downgrade citing a softening of business confidence in recent months, which related to the persistently high Australian dollar and the potential negative impact of the May budget. Demand for CMG's blue collar workers has been improving, while results in CMG's physiotherapy placement service Vivir and hotel outsourcing business have been in line with company forecasts. However, demand for white collar workers has been below expectations. Overall the mix of outcomes will see CMG fall short of the expected level of profit growth for the financial year. Although disappointed, we expect that CMG will continue to grow profits, particularly through internal initiatives, provided that the overall economic environment does not deteriorate markedly. Well regarded CFO Owen Wilson also resigned late in the quarter having accepted the same role at the much larger REA Group (REA). We will continue to monitor the economic environment closely as risks are currently skewed to the downside.

Falling Australian consumer confidence together with a plateau in Australian housing approvals in recent months likely weighed on the Fletcher Building (FBU, -8.5%) share price. The housing cycle in Australia is important to FBU and accounts for some 20% of group profits. Our view is that low interest rates will continue to support the domestic housing industry; however housing approvals are likely to fall from current elevated levels. Our favourable view of FBU is premised on the strength of the NZ economy (where FBU earn 55% of their profits), the improving housing cycle in NZ, and the benefits of CEO Mark Adamson's cost and efficiency program 'FBUnite'.

Portfolio Adjustments

During the Quarter we...

SOLD: Equity Trustees Ltd (EQT), G8 Education (GEM), Goodman Fielder (GFF), IOOF Holdings (IFL), New Hope Corporation (NHC), Qube Holdings Ltd

BOUGHT: Aristocrat Leisure Ltd (ALL), Energy Developments Ltd (EBE), Mermaid Marine Australia Ltd (MRM), Ozforex Group Ltd (OFX)

Purchases

Mermaid Marine (MRM) is a WA-based service provider to the oil and gas industry, with two core business divisions. Firstly they own and lease a range of specialized marine vessels to the oil and gas industry, typically on a 1 to 3 year rental basis. Secondly they own supply bases in Dampier and Broome, giving the company a strategic advantage and allowing MRM to provide a range of port and storage services to the major oil and contract companies operating in the NW shelf. In February this year, the company embarked on a significant transaction with the purchase of Singapore listed Jaya Holdings for $A550m. Like MRM, Jaya own a series of marine vessels and associated assets, rented out to the oil and gas industry, though with Jaya, the geographic exposure is far more diverse, rather than WA specific. The transaction was funded via a combination of debt and the issuance of new shares. Post the transaction the share price has weakened materially. Our view is that the acquisition of Jaya makes strategic sense as it allows MRM to diversify its geographical exposure to the offshore oil and gas industry. In coming years the demand for services in the NW region of Australia will fall as key projects are completed and not replaced with new ones. With the share price and value of the company having fallen to the level of net tangible assets (NTA) – the value of the boats and supply bases, less debt - we have begun to build a position in the stock.

In Aristocrat Leisure (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. To this end, despite modest backdrop in demand growth for slot machines, the company has been gaining share in key markets. The rollout of the 'E*series games' in particular, has been well received.

Ozforex (OFX) is a recent market IPO and leader in online international payments. In a short period, it has built a strong brand and a reputation as a price leader in a market where fees are high, and has faced limited competitive pressure. We believe the technology platform OFX own is difficult to replicate and offers potential for geographic expansion and new partnership opportunities. Although the stock is not cheap, following a strong post IPO rally, the recent market weakness in global technology and online stocks created an opportunity to acquire a position in OFX. Assuming the company can execute on its strategy we believe the scope for growth in operating profit is attractive.

We also bought a small position in Utility company Energy Developments (ENE). Under previous management and shareholders the company had a history of disappointing the market with noteworthy budget blowouts on key energy projects. Although the company has remained listed, it was largely recapitalized by private equity investors whose attempt to gain 100% ownership was unsuccessful. The attraction today is the reasonably predictable cash flows that will be delivered from a series of long-life, contracted utility assets. The company will likely have opportunities to add to its asset base and in time, we expect the private equity investors, who remain significant shareholders, to sell down.

RALTON ASSET MANAGEMENT

Disposals

To fund the above purchases we sold several stocks from the portfolio across the quarter, including Qube holdings (QUB), Equity Trustees (EQT), G8 Education (GEM) and GFF, the last of which we have highlighted above.

Transport service provider, Qube holdings (QUB) has been in the portfolio for several years and benefitted from a strong period of both organic and acquisitive growth. Recently, the company moved into direct negotiations with the Federal government to develop the Moorebank Intermodal site with partner, Aurizon. Despite these positives, we do have some concerns around the company's exposure to the resources industry, particularly as some lower quality mining operations come under pressure as prices fall. Our decision to sell was based on the current valuation appearing fair, and not appearing to factor any such risks. All the same we would highlight the high quality management team at QUB and our willingness to reconsider the stock at a future date, should valuation become more appealing.

With G8 Education (GEM) we have made very strong gains from this stock both in the last quarter and the last year. Recent sizeable acquisition by the group, as discussed in our March quarterly report, boosted the number of childcare centres under management and as a result the forecast group profit. The recent share price rally took it beyond our assessed valuation for the company so we decided to exit the position.

Equity Trustees (EQT) was only added to the portfolio recently, however the share price re-rated quickly and we took the decision to reduce our overall exposure to the Diversified Financials sector. To recap, EQT offers a broad range of financial services, focused on estate planning, private wealth services, and philanthropy along with corporate fiduciary services, such as RE or responsible entity. For example the company manages and oversees various estates and trusts on behalf of individuals or organizations such as charities. By their nature, these client accounts tend to be long lasting. Given the share price rally after the ANZ trustees acquisition and subsequent equity raise, we took the opportunity to take profits, although will continue to monitor the company and its progress. As part of the same portfolio strategy of reducing our exposure to the diversified financials, we also elected to sell our holding in IOOF Holdings (IFL).

We also sold our position in New Hope Coal. The QLD based thermal coal miner is well managed, has long relationships with Asian customers, and holds a significant amount of cash on its balance sheet. However, our views on the demand for thermal coal have evolved in recent times and suggest that the outlook for thermal coal and the traded seaborne price are likely to remain uncertain and under pressure for some time. At current thermal coal prices, NHC's mines are barely profitable. We will look to revisit NHC subject to our views on the outlook for thermal demand. History suggests that it may take some time for marginal mines to close and for thermal coal prices to rise.

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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