Monthly Report
May 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	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 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	Tassal Group Limited	TGR
5	Beach Energy Limited	BPT
6	Horizon Oil Limited	HZN
7	Village Roadshow Limited	VRL
8	Recall Holdings Limited	REC
9	SAI Global Limited	SAI
10	ISelect Limited	ISU

GICS Sector	Ralton	Index	+/-
Financials (ex-Property)	11.9%	6.0%	5.9%
Consumer Staples	6.9%	3.1%	3.8%
Health Care	8.3%	4.6%	3.7%
Consumer Discretionary	28.2%	24.8%	3.4%
Energy	9.1%	6.0%	3.1%
Industrials	18.5%	16.4%	2.0%
Information Technology	2.2%	2.6%	-0.4%
Utilities	0.0%	1.9%	-1.9%
Telecommunication Services	2.9%	6.1%	-3.2%
Property	2.6%	10.1%	-7.5%
Materials	9.4%	18.4%	-9.0%
Total	100.0%	100.0%	

Performance

Return %	1m	3m	1yr	3yrs	5yrs	Incept*
Ralton Smaller Companies	0.76	1.86	20.24	12.16	16.67	6.66
Income Return	0.06	1.06	3.49	3.76	3.80	3.93
Growth Return	0.70	0.80	16.75	8.40	12.87	2.73
S&P/ASX Small Ords Acc Index	0.08	-2.31	6.20	-4.25	4.28	-3.34
Difference	**0.68**	**4.17**	**14.04**	**16.42**	**12.39**	**10.00**

*Since Inception p.a., Feb 2008

Month in Review

Performance Summary

- The S&P/ASX Small Ordinaries Accumulation Index was basically flat for the month, adding 0.08% with strength in Utilities and Healthcare offset by falls in the Information Technology and Consumer Staples sectors.

- Over the same period the Ralton Smaller Companies Portfolio gained 0.76%, outperforming the benchmark by 0.68%.

- At a sector level, the portfolio's overweight to the Industrial and Consumer Discretionary sectors helped to drive outperformance.

Portfolio Commentary

Monthly Performance Attribution

Top Contributors	Positioning	Key Detractors	Positioning
Village Roadshow	Overweight	Chandler Macleod Group	Overweight
SAI Global Ltd	Overweight	Fletcher Building	Overweight
Fisher & Paykel Healthcare	Overweight	Ozforex Group Ltd	Overweight

Positive Contribution

Village Roadshow (VRL, +17.1%) was the portfolio's top performer for the month. Rolling-year to the end of May the share price is now up 61%. The strength in the share price is, in our view, representative of the quality of the assets that VRL own, namely cinemas, film distribution rights, and entertainment parks, mostly in Australia but with several modest sized operations elsewhere. Historical issues around debt levels and corporate governance had kept VRL out of our investment universe, however, substantial improvements on this front brought the company onto our investment radar. VRL successfully built and opened a large scale water park in western Sydney last summer, tapping into a market ripe for an entertainment product of this type and applying one of its successful concepts in a new market. Investment team members have been waiting to try it out, but the crowds have kept them away from the slide so far!

SAI Global (SAI, +19.9%) 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-time 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, +12.3%) 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.

Negative Contribution

Recruitment services company Chandler Macleod (CMG, -18.1%) was the largest detractor from portfolio performance. 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. We will continue to monitor the economic environment closely as risks are currently skewed to the downside.

Ozforex (OFX, -12.8%) is a recent market IPO and leader in online international payments. Following a strong share price movement since last year's IPO, OFX's maiden full year profit result lead to a retracement in share price across May. Although OFX met its prospectus forecasts at a headline profit level, investors focused on the shortfall in new dealing clients (NDCs) against prospectus forecasts, noting that NDCs were up 38% year over year, but some 10% below prospectus – this will impact new transaction levels in the next half. Despite this shortfall, we remain attracted to the growth prospects of the business and believe that OFX can continue to be a disruptive force in the market for international payments. OFX is capital light, well managed, and delivers strong cash flows, and hence the rationale for our initial investment still holds.

Falling Australian consumer confidence together with a plateau in Australian housing approvals in recent months likely weighed on the Fletcher Building (FBU, -9.6%) 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 Month we...

SOLD: Equity Trustees Limited (EQT)

BOUGHT:

Purchases

There were no outright buys for the portfolio in May, however we increased our exposure to Recall Holdings (REC) in the portfolio. We have been pleased to see the strong start REC has made in terms of acquisitions since the demerger from Brambles at the end of 2013. The company recently acquired US-based CitiStorage for $47.2m. Given their clean balance sheet and a quite fragmented industry, REC are well placed to grow by acquisition, building on the current storage footprint and the high degree of recurring revenue and free cash flow that the business delivers. We also recently attended a meeting with management where they provided far more insight about the moat which exists around the storage business (it is a very sticky business). As counterintuitive as it might seem in this digital age, the demand for long-term hard storage is growing due to regulatory requirements and litigation risks.

Disposals

The only outright sale was Equity Trustees (EQT). The stock was only added to the portfolio recently, however the share price has 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.

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

Stephen Sedgman Chairman OC Funds Risk Mgt Committee

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