Quarterly Report September 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	MORNINGSTAR ★★★★ ; LONSEC Investment Grade SMA ; van Eyk

Performance

Return %	1m	3m	1yr	3yrs	5yrs	Incept*
Ralton High Yield	-2.76	1.48	9.42	19.30	9.72	6.83
Income Return	0.63	1.57	4.77	5.15	5.04	5.13
Growth Return	-3.39	-0.08	4.66	14.16	4.69	1.71
S&P/ASX 300 Acc. Index	-5.37	-0.56	5.73	14.37	6.57	3.47
Difference	**2.60**	**2.04**	**3.69**	**4.93**	**3.15**	**3.36**

*Since Inception p.a., Feb 2008

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	Recall Holdings Limited	REC
7	Westpac Banking Corporation	WBC
8	Amcor Limited	AMC
9	Origin Energy Limited	ORG
10	Woodside Petroleum Limited	WPL

GICS Sector	Ralton	Index	+/-
Industrials	16.5%	7.6%	8.9%
Telecommunication Services	8.6%	5.6%	3.0%
Consumer Discretionary	8.4%	5.6%	2.8%
Energy	7.9%	6.9%	1.0%
Utilities	1.9%	1.9%	0.1%
Materials	16.2%	16.2%	0.0%
Information Technology	0.0%	1.0%	-1.0%
Health Care	3.6%	5.4%	-1.8%
Consumer Staples	5.5%	7.6%	-2.1%
Property	2.7%	7.3%	-4.6%
Financials (ex-Property)	28.8%	35.0%	-6.2%
Total	100%	100%	

Quarter in Review

- Despite a strong start, the S&P/ASX 300 Accumulation Index recorded a loss of 0.56% for the September quarter. The top performing sectors were Healthcare and Telecommunications.
- The Ralton High Yield Model Portfolio recorded a solid gain of 1.48%, outperforming the benchmark index by 2.04%.
- The portfolio's outperformance was driven by our overweight exposure to the Industrials sector together with our underweight to resource stocks within the Materials sector.

Portfolio Commentary

Quarterly Performance Attribution

Top Contributors	Positioning	Key Detractors	Positioning
QBE Insurance Group	Overweight	Transpacific Industries	Overweight
Recall Holdings	Overweight	Sky Network Television	Overweight
Orora Limited	Overweight	Sonic Healthcare	Overweight

Positive Contributors

QBE Insurance (QBE, +7.3%) added value to the portfolio as the market responded positively to management's release of their half-year financial update along with a comprehensive capital plan. Firstly, QBE announced a US$750m equity raising, largely to finance the repurchase of a maturing convertible note. Secondly, it announced plans for the outright sale of its American agencies, together with a partial sale of its Australian agencies. Thirdly, QBE are planning for the partial IPO of QBE's LMI or Lenders Mortgage Insurance business in Australia. Overall, these measures were well received as they continue the portfolio clean-up and simplification under CEO Neale's tenure.

Recall Holdings (REC, +17.2%) was the portfolio's top contributor for the quarter, buoyed by speculation that they may be a takeover target for US peer Iron Mountain (IRM). IRM is the number one player in the global document storage market and their acquisition of REC, the number two player, would make sense from a synergistic perspective. REC however denied that they had fielded any approach from IRM. Earlier in the quarter, REC shares were boosted by the announcement of productivity improvements across their global storage facilities. The productivity program is consistent with our view that since the demerger from Brambles, REC management has considerable scope for 'self-help' initiatives that will deliver value to shareholders.

Amcor spin-off Orora Limited (ORA, +15.1%) was the portfolio's next-best contributor. The company's maiden profit result, released in August, was well received as key financial targets were achieved. ORA is benefitting from various cost savings derived from a capital investment program and operational improvement initiatives started by its former parent. The new B9 pulp mill in Botany continues to 'ramp-up' production and management confirmed that B9's multi-year commissioning is proceeding broadly in line with expectations.

Negative Contributors

Transpacific Industries (TPI, -19.7%) weighed on portfolio performance after the company announced that they had increased their landfill remediation provision by $189m (after tax), noting the need to spend more cash than previously planned over the next 5 years ($25-35mpa). TPI also grounded their entire waste management fleet nationally during August, following a fatal accident involving one of their vehicles in South Australia. All vehicles were required to pass a roadworthy certificate and all vehicles have subsequently returned to the road. We continue to have confidence the relatively new CEO, Bob Boucher, will be able to deliver improved results over the next few years.

Sky Network Television (SKT, -12.2%), one of the portfolio's smaller positions, underperformed this quarter despite posting quite solid profit results for the financial year 2014. 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. SKT were recently unsuccessful in retaining the broadcast rights to several US, European and Asian Golf Tour events, although we would flag these as minor in the scheme of SKT's program rights. Positively for SKT, several higher profile events have recently been retained. Currency movements likely had a small impact on the performance of the Australian listed shares, as the weakening of the NZ dollar against the Australian dollar impacts the value from an Australian perspective.

Sonic Healthcare (SHL, +1.2%) underperformed the portfolio after it provided a cautious outlook commentary for FY15, and investors continued to have a degree of concern about the impact of the proposed co-payment legislation in the Federal Budget. However, we continue to be attracted to SHL's strong business model, doctor-centric culture and management's ongoing focus on improving the investment returns of the business. Sonic have a global pathology business with significant operations in Australia, the US, and several countries in Europe.

Portfolio Adjustments

During the Quarter we...

SOLD: Macquarie Group Limited (MQG), Mirvac Group (MGR), Suncorp Group Limited (SUN), Village Roadshow Limited (VRL)

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

Portfolio Additions & Material Adjustments

We added three new stock positions, Aristocrat Leisure (ALL), Transpacific Industries (TPI) and Navitas Limited (NVT) during the quarter.

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.

NVT is an education service provider whose core business is providing 'pathway' courses for students ahead of university entrance. NVT have a global network of 'colleges' across four continents. These 'colleges' provide NVT courses, typically on campus at the host university. NVT source the bulk of their students from international markets, via their own recruitment networks. The share price has weakened recently following the loss of a contract with one major partner university. We are confident that, as this contract was terminated as part of the host university's branding strategy, this does not threaten the long term business model of NVT. With a growing presence in the US, established patiently over recent years, and improving performance from NVT's CAE division, we believe the outlook for NVT is favourable.

Portfolio Disposals & Material Adjustments

We sold three stocks from the portfolio during August after deciding to reduce our exposure to the financial sector. Firstly we disposed of our final stake in Suncorp Group (SUN), a stock we had acquired in the early stages of its turnaround. The company delivered solid FY14 results across all divisions. However, the insurance pricing cycle has started to peak and it is not clear how much of the planned costs savings will need to be reinvested to protect market share in this environment. Also the market had, in our opinion, started to price in the special dividends as permanent.stock, we are concerned about how it will perform as the US Federal Reserve ends qualitative easing, given its current valuation. This was the last of our diversified financial holdings in the portfolio.

We also disposed of our holding in Macquarie Group (MQG). Whilst we like the medium term outlook for MQG, given it's current valuation we are concerned about how it will perform as the US Federal Reserve ends quantitative easing. This was the last of the diversified financial holdings in the portfolio.

We took some profits in Mirvac Group (MGR). The stock has re-rated well since acquisition and no longer trades at the discount to net tangible assets (NTA) it had at the time of purchase. Property sales in the company's residential division have been strong, reflective of the rise in demand for residential property. Although the housing cycle may remain at current highs we believe that the scope for further upside here is modest and hence are comfortable taking profits in this stock.

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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For Further Information

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