RALTON
ASSET MANAGEMENT

Quarterly Report September 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

Performance

Return %	1m	3m	1yr	3yrs	5yrs	Incept*
Ralton Smaller Companies	-1.00	2.60	12.47	19.99	11.89	6.64
Income Return	1.09	1.35	3.39	3.95	3.83	3.97
Growth Return	-2.09	1.25	9.08	16.04	8.06	2.67
S&P/ASX Small Ords Acc Index	-5.47	1.49	-0.07	1.71	-0.28	-3.12
Difference	**4.47**	**1.11**	**12.54**	**18.28**	**12.17**	**9.76**

**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	Recall Holdings Limited	REC
3	Sky Network Television Limited	SKT
4	ISelect Limited	ISU
5	Fletcher Building Limited	FBU
6	Blackmores Limited	BKL
7	Virtus Health Limited	VRT
8	Orora Limited	ORA
9	Slater & Gordon Limited	SGH
10	Iress Limited	IRE

GICS Sector	Ralton	Index	+/-
Health Care	11.0%	5.1%	6.0%
Consumer Discretionary	28.0%	23.0%	5.0%
Consumer Staples	6.2%	3.2%	3.0%
Energy	9.0%	6.2%	2.7%
Industrials	18.5%	16.3%	2.2%
Utilities	2.8%	0.8%	2.1%
Information Technology	3.3%	3.7%	-0.4%
Financials (ex-Property)	7.4%	7.9%	-0.5%
Materials	11.5%	14.9%	-3.5%
Telecommunication Services	2.4%	9.7%	-7.3%
Property	0.0%	9.2%	-9.2%
Total	100.0%	100.0%	

Quarter in Review

Performance Summary

- The S&P/ASX Small Ordinaries Accumulation Index rose 1.49% for the September quarter, with both Information Technology and Telecommunications returning double-digit gains.

- The Ralton Smaller Companies Portfolio gained 2.60% for the quarter, outperforming the benchmark by 1.11%.

- At a sector level, the portfolio's underweight exposure to Materials added to relative returns, along with stock selection within Industrials and Healthcare sectors.

Portfolio Commentary

Quarterly Performance Attribution

Top Contributors	Positioning	Key Detractors	Positioning
Orora Limited	Overweight	Beach Petroleum	Overweight
Acrux Limited	Overweight	Transpacific Industries	Overweight
Blackmores Limited	Overweight	Horizon Oil	Overweight

Positive Contributors

Amcor spin-off Orora Limited (ORA, +15.1%) was the portfolio's 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.

Specialty pharmaceutical company, Acrux Limited (ACR, +52.3%) was a strong contributor to portfolio performance in the September quarter, recouping prior losses. The catalyst for the rebound in the share price was an improvement in reported sales by marketing partner Eli Lilly for the company's testosterone replacement therapy drug, Axiron. We took this opportunity to sell the stock. Although the rebound in reported sales was pleasing, we were concerned that the market for testosterone products in the US remained uncertain.

Blackmores Limited (BKL, +18.5%) also added to returns, following a solid profit result for the 2014 financial year. BKL are a manufacturer and distributor of vitamins and associated health products, largely sold under the well-respected 'Blackmores' brand. The results for the core Australian division confirmed that the local industry had returned to more rational behaviour after aggressive action by Swisse in past periods had hurt the whole industry. Results for the Asian division, where BKL has been steadily building a presence over many years, were also solid, despite the headwinds of political unrest in Thailand, a key market.

Negative Contributors

Cooper Basin oil and gas company Beach Petroleum (BPT, -16.1%) weighed on portfolio returns for the period. The combination of a falling oil price and concerns about Cheveron's commitment to its joint venture with BPT weighed on the stock.

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.

Horizon Oil (HZN, -14.3%), which had been pursuing a merger with ROC Oil (ROC), lost ground when ROC itself received a takeover offer from Fosun International Limited. When ROC directors accepted the offer from Fosun, the HZN merger was effectively terminated. Although this development is somewhat disappointing in the short term it does not detract from the quality of assets that HZN own. We expect that HZN will be pursuing all avenues to bring their key project, the Stanley gas project in the West of PNG, to development.

Portfolio Adjustments

During the Quarterly we...

SOLD: Acrux Limited (ACR), Charter Hall Group (CHC), Invocare Limited (IVC), Magellan Financial Group (MFG)

BOUGHT: Monash IVF Group Ltd (MVF), New Hope Corporation (NHC), Pact Group Holdings (PGH), Super Retail Group (SUL), Whitehaven Coal (WHC)

Portfolio Additions & Material Adjustments

There were several new stocks added to the portfolio during the quarter. We purchased two coal stocks, namely New Hope Coal (NHC) (which we have owned previously) and Whitehaven Coal (WHC). With prices for both heating (thermal) and steel-making (coking) coal well down from recent peaks and capacity being taken out of the market we felt that cautiously re-entering the sector was warranted. In the case of WHC, the company has successfully ramped up production at its Narrabri mine and is more than 60% complete in terms of construction of their premier asset, Maules Creek mine. Both mines are long life, tier 1 assets and once operational we expect that WHC will successfully reduce their current debt levels and in time be re-rated by the market accordingly. Both stocks will benefit from a fall in the Australian dollar, given that, in simplistic terms, they sell their commodity in US dollars and many of their costs are based in Australian dollars.

We added a position in Super Retail Group (SUL), which owns a number of household name brands, is well managed and has expected medium term profit growth driven largely by internal or 'self-help' initiatives. SUL's retail brands include Rebel Sport, Amart All Sports, BCF and Super Cheap Auto (the original franchise). The self-help is largely due to various supply chain, IT, and warehouse initiatives that SUL have been investing in over the last couple of years. These will make the business more efficient, release inventory (and cash in the process) and allow scope for growth.

Recently listed, Monash IVF (MVF) was also added to the portfolio, meaning we now own shares in both of the listed IVF (in vitro fertilization) companies, Virtus Health (VRT) being the other. MVF is a slightly smaller company than VRT, though between the two companies, they control more than 70% of the market – or 70% of all IVF babies that are born in Australia each year! We view this dominant industry structure as favourable and also, have a positive view of the offshore expansion opportunities that both companies are pursuing. The key risks, as with all healthcare sectors, are regulatory change and reductions in either government or private insurance funding.

Finally we bought an initial position in the recently listed Pact Group (PGH). Pact are a packaging and manufacturing company with multiple manufacturing plants across Australia, New Zealand and Asia, producing a broad range of simple and specialised packaging products for their clients, largely in the food industry. PGH has dominant market share in their industry segments, where typically there are few competitors of scale and concentrated market share. The company, when in private hands, had a strong track record of growth by acquisition and we would expect this to continue in the public markets.

Portfolio Disposals & Material Adjustments

As highlighted earlier we elected to sell our holding in drug delivery specialist Acrux Limited (ACR) after a strong rebound in the share price.

We also took profits in several long-standing holdings, namely property fund manager Charter Hall Group (CHC), funeral director Invocare (IVC) and fund manager Magellan Financial Group (MFG). In general these sales reflected our view that these stocks, while still quality businesses, were trading at or around fair value. We chose to rotate into stocks where we saw far better value.

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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