Monthly Report October 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	

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	ISelect Limited	ISU
4	Orora Limited	ORA
5	Fletcher Building Limited	FBU
6	News Corporation	NWS
7	Virtus Health Limited	VRT
8	Transpacific Industries Group Limited	TPI
9	Skycity Entertainment Group Limited	SKC
10	Blackmores Limited	BKL

GICS Sector	Ralton	Index	+/-
Consumer Discretionary	31.8%	23.2%	8.6%
Health Care	10.8%	5.0%	5.8%
Consumer Staples	5.6%	3.3%	2.3%
Energy	7.8%	5.7%	2.1%
Utilities	2.8%	0.8%	2.0%
Industrials	18.2%	16.3%	2.0%
Information Technology	3.2%	3.9%	-0.7%
Materials	12.5%	13.9%	-1.4%
Financials (ex-Property)	4.9%	8.4%	-3.4%
Telecommunication Services	2.3%	10.0%	-7.7%
Property	0.0%	9.6%	-9.6%
Total	100.0%	100.0%	

Performance

Return %	1m	3m	1yr	3yrs	5yrs	Incept*
Ralton Smaller Companies	-0.10	0.12	8.58	17.11	11.74	6.54
Income Return	0.08	1.43	3.40	3.67	3.73	3.93
Growth Return	-0.18	-1.31	5.19	13.44	8.01	2.60
S&P/ASX Small Ords Acc Index	-0.54	-3.79	-1.81	-1.01	-0.15	-3.16
Difference	**0.44**	**3.91**	**10.39**	**18.11**	**11.89**	**9.70**

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

Month in Review

Performance Summary

- The S&P/ASX Small Ordinaries Accumulation Index finished in negative territory for October, falling 0.54%, lead down by the Energy and Materials sectors.
- The Ralton Smaller Companies Portfolio was down 0.10% for the month, outperforming the benchmark by 0.44%.
- At a sector level, the portfolio's underweight exposure to Materials added to relative returns, along with stock selection within the Industrials and Consumer Discretionary sectors.

Portfolio Commentary

Monthly Performance Attribution

Top Contributors	Positioning	Key Detractors	Positioning
Fisher & Paykel H/care	Overweight	Beach Petroleum	Overweight
Transpacific Industries	Overweight	Whitehaven Coal	Overweight
Sky City Entertainment	Overweight	News Corporation	Overweight

Positive Contributors

Fisher and Paykel Healthcare (FPH, +7.8%) was the portfolio's top contributor. The stock has recorded a rolling year return of 58.1%. FPH continue to deliver good sales growth in both their respiratory (RSA) and sleep therapy (OSA) divisions. In particular, we believe that FPH has a particularly strong industry position in the respiratory segment, where their products are gaining traction for use in the home care setting. Keeping patients out of high cost hospitals and reducing readmissions is a key theme in the global search for healthcare savings. FPH's devices are proving very effective in this regard and we look for them to continue to penetrate this very large market for indications such as Chronic Obstructive Pulmonary Disorder, or COPD.

Transpacific Industries (TPI, +10.4%) performed strongly, rebounding from recent share price weakness. At the company's AGM, CEO Robert Boucher confirmed that trading conditions in their key markets remain challenging which was not unexpected. On a positive note, TPI noted that their entire waste management fleet has returned to the road following the voluntary grounding for safety checks in August. Equally positive was the progress being made with the new sales program introduced by the CEO which is key to why we believe TPI can continue to grow earnings despite challenging economic conditions. This program is in pilot stages in various markets but shortly will be rolled out across the Cleanaway network. We consider this a key cultural change initiative, which will, in turn, drive future company profitability.

A positive trading update at the Sky City Entertainment (SKC, +8.4%) AGM was well received by the market. In broad terms, SKC are mid-way through a series of refurbishments at each of their key properties in Adelaide and Auckland. The refurbishments include upgrades to the gaming facilities, car parks and broader entertainment precincts. Revenue trends reported at the AGM were positive, particularly for the Auckland precinct.

Underperformers

Our overweight position in Energy stocks detracted from portfolio returns in October. The oil price has fallen some 25% since mid-year, triggered by increased supplies (mainly from the US) and negligible demand growth from the global economy. Oil demand growth rates are falling in key emerging market oil consumers such as China, as economic growth slows. Typically when the oil price stages a significant decline in a short space of time, OPEC responds by cutting production (often mainly by key producer Saudi Arabia). However this has not yet happened, suggesting that the Saudis are comfortable with the lower oil price. The weakening oil price was a key contributor to the Beach Petroleum (BPT, -16.1%) share price fall, along with concerns about Chevron's commitment to its joint venture with BPT in the Cooper Basin.

Whitehaven Coal (WHC, -11.4%), recently added to the portfolio, weighed on performance for October. 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. WHC has successfully ramped up production at its Narrabri mine and has more than 60% completed construction of its 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. In the short-term the recent move by China to impose a tariff on imported coal weighed on the WHC share price. Such moves, if they persist beyond a potential FTA (Free Trade Agreement) with China, will serve to continue to weed out high cost coal producers. In time this will benefit WHC given the quality of its assets. We also note that only 5% or so of WHC's coal sales are made to China.

Shares in News Corporation (NWS, -9.3%) fell heavily in October, as investors reacted negatively to the company's acquisition of the US online real estate provider 'Move Inc'. The acquisition cost was US$950m, of which NWS contributed 80%, with the balance of 20% acquired by NWS' 62% subsidiary realestate.com.au (REA). Despite the size of the US real estate market, the online players do not appear to have penetrated and developed the market to the degree that has occurred in many countries. Investors are either skeptical about NWS' ability to compete in this market or concerned about the size of the cash outlay. Our sense is that NWS and REA have the potential to add considerable value to Move, which will provide a meaningful growth avenue for the NWS group. We look forward to a better understanding of the potential and NWS/REA's strategy over time.

Portfolio Adjustments

During the Month we...

SOLD: Ozforex (OFX)

BOUGHT: Ardent Leisure (AAD)

Portfolio Additions & Material Adjustments

We added one new position during October, Ardent Leisure (AAD). AAD own a reasonably diverse series of entertainment assets in Australia and the United States. The key attraction is the 'roll out' of the Main Event business in the United States. Main Event is a big box entertainment complex that offers bowling, laser tag, and video games along with food and function facilities. The business has been highly successful in its home state of Texas and is now rolling out its offering both within and beyond Texas. AAD also own theme parks on the Gold Coast and so will benefit from any strengthening in domestic and inbound tourism, both of which are likely should the Australian dollar continue to weaken.

We had built up reasonable cash holding in the portfolio from dividend payments and recent stock sales, so we saw the market weakness across September and October as an opportunity to add to several of our existing holdings. Notably on this front, we increased our holdings in recent stock additions Mermaid Marine (MRM), Pact Group (PGH) and Super Retail Group (SUL).

Portfolio Disposals & Material Adjustments

Ozforex (OFX) was the only stock sale from the portfolio in October. The company has, in a relatively short space of time, built a strong brand and reputation as a price leader in online international payments. This market has historically been dominated by large banks that charge high fees and have faced limited competition. Although OFX's progress and market share gains have been impressive, our further due diligence suggests its market position is more tenuous than we had thought. OFX does not have a "brand name" like a bank, so bids for "Keywords" in Google. As a result, it is exposed to margin compression as the cost of the "Keywords" go up as others enter the market. Given this concern about the strength of OFX's position, we elected to capitalise on the recent share price strength and sell the stock.

We also took profits in several of our better performing holdings, namely vitamin manufacturer and distributor Blackmores (BKL), document and information storage specialist Recall Holdings (REC) and law firm Slater and Gordon (SGH). 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 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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