Monthly Report February 2015

Ralton Leaders

Winner of the 2010 Standard & Poors' Fund Awards
- Separately Managed Accounts Category

Investment Profile

A Professionally Managed Portfolio of Australian Shares

The Ralton Leaders 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 Leaders SMA is to provide investors with long-term capital growth and tax effective income from a portfolio of blue-chip Australian shares. The portfolio aims to deliver returns that are consistently above the S&P/ASX 100 Accumulation Index over a three to five year period.

Key Portfolio Features	
Inception	1 February 2008
Benchmark	S&P/ASX 100 Accumulation Index
Authorised Investments	Companies in the S&P/ASX 100 Index or those amongst the top 100 by size.
Number of Stocks	25-40
Cash Allocation	0% to 10%
Tracking Error	1.5% to 3.5%
Investment Horizon	At least 3 to 5 years
Ratings	MORNINGSTAR ★★★★

Performance

Return %	1m	3m	1yr	3yrs	5yrs	Incept*
Ralton Leaders	6.05	13.59	22.76	20.12	11.37	7.82
Income Return	0.68	0.78	3.76	4.33	4.50	4.49
Growth Return	5.37	12.80	19.00	15.79	6.87	3.34
S&P/ASX 100 Index	6.80	12.84	15.20	17.39	10.28	5.88
Difference	**-0.75**	**0.74**	**7.56**	**2.73**	**1.08**	**1.94**

*Since Inception p.a., Feb 2008

The Portfolio is designed for investors who...

- Seek long term capital growth & tax-effective income
- Expect consistent above market returns
- Have a long term investment horizon of at least 3-5 years and accept the risk of equity markets.

Portfolio Structure

No.	Company Name	ASX Code
1	Commonwealth Bank of Australia	CBA
2	ANZ Banking Group	ANZ
3	Telstra Corporation Limited	TLS
4	BHP Billiton Limited	BHP
5	CSL Limited	CSL
6	National Australia Bank Limited	NAB
7	QBE Insurance Group Limited	QBE
8	Amcor Limited	AMC
9	ResMed Inc.	RMD
10	Aristocrat Leisure Limited	ALL

GICS Sector	Ralton	Index	+/-
Health Care	13.3%	5.8%	7.5%
Industrials	13.9%	6.7%	7.3%
Consumer Discretionary	9.2%	2.6%	6.6%
Telecommunication Services	6.7%	5.8%	0.9%
Materials	16.3%	15.4%	0.9%
Energy	4.7%	4.6%	0.1%
Information Technology	0.0%	0.6%	-0.6%
Utilities	0.0%	2.1%	-2.1%
Property	2.5%	7.5%	-5.0%
Consumer Staples	1.2%	7.2%	-6.0%
Financials (ex-Property)	32.2%	41.8%	-9.5%
Total	100.0%	100.0%	

Month in Review

Performance Summary

- The S&P/ASX 100 Accumulation Index finished the month of February 6.80% higher, with strong performances from Energy and Materials sectors, particularly the Metals and Mining sub-sector

- The Ralton Leaders Model Portfolio returned 6.05% for February, underperforming the benchmark index by 0.75%

- Strong performance from our Financial and Consumer Staples stocks was offset by elevated cash holdings in a strong market and our stock selection within Industrials; both of these weighed on the portfolio's relative performance for February

Portfolio Commentary

Monthly Performance Attribution

Top Contributors	Positioning	Key Detractors	Positioning
Incitec Pivot	Overweight	BHP Billiton	Underweight
QBE Insurance Group	Overweight	Transpacific Industries	Overweight
Echo Entertainment	Overweight	Navitas Limited	Overweight

Positive Contributors

The market was very strong in February and we believe this was due to three factors: (a) foreign investors returning to the Australian market after the decline in the Australian dollar; (b) investors looking for yield being forced further into the market after the Reserve Bank's reduction in its base interest rate to 2.25% (a 25bp reduction) during the month; and (c) corporate Australia continuing to shovel cash back to investors through increased dividends during the recent reporting season.

Incitec Pivot (IPL, +12.7%) was the portfolio's top contributing stock as it again consolidated gains made in the last quarter of 2014, adding a further 13% in February. The stock has now returned more than 40% since reporting their annual results in mid November. A solid set of profit results in line with market expectations, confirmation of improvement in manufacturing performance at two key Queensland plants and the falling Australian dollar have all boosted IPL's share price. Reported Australian dollar (AUD) profits for IPL benefit from the translation of US dollar profits earned offshore, principally from the sale of fertiliser and explosives in North American markets. Also, as fertilisers in Australia are sold on a US dollar import basis, the leverage in AUD profits is significant, given that IPL have a largely Australian dollar cost base. Although only a small portion of group sales, the leverage here is quite strong.

QBE Insurance Group (QBE, +22.4%) performed strongly after the company finally delivered a clean set of results and completed a major de-risking strategy. This has been a frustrating turnaround to be invested in, as there have been a number of false starts. However, QBE has now made major strides in improving the quality of its capital position and reducing the risk associated with its insurance book. The steps taken on the insurance book should serve to substantially reduce future earnings volatility. The company has also completed a major business transformation, moving many back-office functions from high cost operations in Sydney, London and New York to a company-owned operation in Manila. We are of the view QBE is again positioned to grow its core revenue and future dividends.

Continued strong profit results from Echo Entertainment (EGP, +8.2%) added to returns for the month. EGP's profit results rose 78% on the prior half-year's result, driven by increases in patronage at both the Sydney and Brisbane casinos. Both VIP and the domestic gaming operations were strong, the latter continuing to benefit from improvements in marketing, the loyalty program, and service offerings. Echo and their consortium partners in the proposed redevelopment of the Brisbane casino and entertainment precinct are still waiting to hear as to which bid will be successful. The winner is due to be announced shortly, and despite the election of a new government in Queensland it appears from press reports that this timeline is largely unchanged.

Underperformers

BHP Billiton (BHP, +15.0%) was a positive contributor to portfolio returns, however detracted from relative performance as the portfolio held an underweight position in the stock. BHP's $4.2bn profit for the half-year period was supported by a heavy dose of cost cutting which offset the fall in prices for key commodities, namely iron ore and oil. Management again reduced their anticipated spending on new projects (good for shareholders perhaps, but less positive for GDP) and maintained their view that the progressive dividend is sustainable; both of these factors were well received by the market. BHP is set to spin off a series of mining assets via demerger into a company to be known as South32.

BHP considers these assets to be non-core or subscale; they are largely focused on base metals, thermal coal and aluminum.

Transpacific Industries (TPI, -13.3%) underperformed the market in February, following a disappointing profit result and the company flagging the need to increase spending in the short term to speed up the operational turnaround that CEO Boucher is implementing. Profit results were particularly weak in the Industrials segment of TPI, due to the falling oil price (TPI collect, process, recycle, and sell various oil-based waste products) and falling demand for manufacturing and mining clean-up work. More positively, progress is being made in TPI's much larger Cleanaway division, where profit results, although not stellar, were reasonable. The CEO is pleased with the pilot sales programs in this division. These programs should drive an improvement in volumes and route density for the Cleanaway network and will now be rolled out across the whole network, in part contributing to rising costs in the short term.

In the medium term, we remain positive that these initiatives, together with increased internalisation of waste volumes following TPI's recent landfill acquisition, will lead to strong profit growth as TPI will be able to direct waste toward their own facilities, rather than pay away tolling fees to third parties. Whilst the turnaround at TPI is taking longer than first envisaged, we continue to be attracted to this sector and remain supportive of TPI management's initiatives. We modestly increased our position following the results and share price fall.

Education service provider Navitas Limited (NVT, -14.2%) fell after undershooting profit expectations for the first half of 2015. The key area of profit shortfall against market expectations was NVT's SAE division, and within that, the US region was the major reason for the shortfall. SAE offers accredited certificates, diplomas, and bachelor degrees across 6 disciplines - Animation, Audio, Design, Film, Games, and Web & Mobile - and is the world's largest provider of such education, operating in 27 countries. They are a dominant player in Australia - next time you are at a conference, ask one of the sound or visual technicians (dressed in black usually) where they trained and chances are they will say SAE. In this period however, the US division had a cost blow out, reducing group profit by a couple of million dollars. NVT's management have responded to the problem, replaced the senior management in the US and tightened processes around management reporting. Results for NVT's core university 'pathway' colleges were quite reasonable. The pathway courses are the core driver for NVT. In the medium term, we expect solid growth in global student numbers and new agreements with partner universities.

Portfolio Adjustments

During the Month we...

SOLD: Caltex Australia Limited (CTX)

BOUGHT: Asciano Ltd (AIO)

Portfolio Additions & Material Adjustments

We added one stock, Asciano Limited (AIO) to the portfolio in February. AIO's three core assets are Container Terminals, which operates at four major Australian ports (the former Patrick's Stevedores), Pacific National, who operate train haulage for coal and other bulk goods transport, and BAP, a smaller logistics division largely focused on car imports and storage. Our investment focus is on familiar themes - a well-managed company with good assets, self-help initiatives driving profit growth, and rising free cash flow. CEO Mullins is some four years into both his role and the turnaround of AIO. Strong progress has been made on several fronts, including the automation of the Port Botany containers facility, significant cost savings from a BIP (Business Improvement Program), merging the intermodal and coal rail divisions under the Pacific National banner, and focusing the group on free cash flow and improving return hurdles.

Pacific National, and specifically, coal haulage, is the core profit driver for AIO, underpinned by long-dated 'take or pay agreements' with largely top tier miners to ship coal from mine to port. Although coal markets and pricing have been under pressure, our view is that the bulk of Australia's coal exports will continue. Why? Some cutbacks, removing the weaker players, have already occurred. Globally, the seaborne trade in thermal coal has been reduced by production curtailments in Indonesia, Russia and the US, bringing the thermal coal market back closer to balance. Pricing has stabilised, Australian companies have been improving productivity and reducing their own cost bases, and finally, the currency weakness is driving an improvement in profit margin per tonne for Australian miners, whose export is of course sold in US dollars.

On the terminals side, Container Terminals is near completion of a significant automation works program at Port Botany, which will drive cost savings and contribute meaningfully to the company's $300m BIP target.

Overall, we see AIO trading at quite a reasonable valuation in today's market and on the cusp of a rise in free cash flow and dividend growth for investors. The key overhang is the leverage that AIO holds to the broader economy - a fall in either coal exports or imports of consumer goods would impact AIO in the short term. We believe that such outcomes are containable and that AIO under CEO Mullen is now in a far stronger position to weather these forces.

We also added to several existing holdings, including NVT, QBE and TPI, each of which we have already discussed in some detail.

Portfolio Disposals & Material Adjustments

We sold one stock from the model, namely Caltex Limited (CTX). Since the stock was purchased last year, the share price has rallied strongly. As per our original thesis, the market has re-rated their view of Caltex's profit stream as it reduces its capital intensive fuel refinery operations and focuses its attention on marketing (petrol station sales) and fuels distribution, largely via an import model. As a result the CTX profit stream is likely more reliable and less capital intensive. However, at current levels, we were unable to justify the valuation and elected to sell.

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*
Head of Australian Equities, 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 6 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

Roger Walling is responsible for stock coverage of several industry sectors and assists with the portfolio management process. He has over 12 years of direct funds management experience, including the past 6 years managing the Ralton portfolios. Previous to Ralton, Roger was a shareholder and employee of Cinnabar Equities, a Global Healthcare Fund. In his role as a Senior Analyst, he had sub-sector and stock investment decision responsibility. Prior to his career in financial markets, Roger practiced as an Optometrist.

For Further Information

Financial advisers seeking additional information can contact Ralton Advisers Services at:

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