# Monthly Report February 2015

**RALTON ASSET MANAGEMENT**

# 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 ★★★★ Approved Lonsec Research |

## Performance

| Return % | 1m | 3m | 1yr | 3yrs | 5yrs | Incept* |
|---|---|---|---|---|---|---|
| **Ralton Smaller Companies** | 3.92 | 8.33 | 11.40 | 16.50 | 13.09 | 7.28 |
| *Income Return* | 0.12 | 0.25 | 3.01 | 3.57 | 3.63 | 3.79 |
| *Growth Return* | 3.79 | 8.08 | 8.39 | 12.93 | 9.47 | 3.50 |
| S&P/ASX Small Ords Acc Index | 8.43 | 9.93 | 3.11 | -1.04 | 1.42 | -2.25 |
| **Difference** | **-4.51** | **-1.60** | **8.29** | **17.54** | **11.67** | **9.53** |

*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 | iSelect Limited | ISU |
| 3 | News Corporation | NWS |
| 4 | Aristocrat Leisure Limited | ALL |
| 5 | Energy Developments Limited | ENE |
| 6 | Super Retail Group Limited | SUL |
| 7 | Sky Network Television Limited | SKT |
| 8 | Skycity Entertainment Group Limited | SKC |
| 9 | SAI Global Limited | SAI |
| 10 | Virtus Health Limited | VRT |

| GICS Sector | Ralton | Index | +/- |
|---|---|---|---|
| Consumer Discretionary | 40.2% | 24.5% | 15.6% |
| Health Care | 13.9% | 7.0% | 6.8% |
| Utilities | 4.0% | 0.7% | 3.3% |
| Consumer Staples | 5.5% | 4.0% | 1.5% |
| Industrials | 12.8% | 14.1% | -1.3% |
| Materials | 3.0% | 5.3% | -2.4% |
| Information Technology | 2.5% | 4.9% | -2.4% |
| Energy | 2.1% | 4.7% | -2.6% |
| Financials (ex-Property) | 5.2% | 8.2% | -2.9% |
| Telecommunication Services | 10.9% | 15.2% | -4.3% |
| Property | 0.0% | 11.4% | -11.4% |
| Total | 100.0% | 100.0% | |

# Month in Review

## Performance Summary

- The S&P/ASX Small Ordinaries Accumulation continued its strong start to 2015, adding a further 8.43% in February, with Consumer Discretionary and Materials the top contributing sectors
- The Ralton Smaller Companies Portfolio made a solid gain of 3.92%, underperforming the benchmark by 4.51%
- The portfolio's underweight position in Metals and Mining, together with our cash holdings in a strong market, detracted from relative returns, as did our stock selection within the Consumer Discretionary sector

## Portfolio Commentary

# Monthly Performance Attribution

| Top Contributors | Positioning | Key Detractors | Positioning |
|---|---|---|---|
| iSelect Limited | Overweight | Cash Converters | Overweight |
| Energy Developments | Overweight | Transpacific Industries | Overweight |
| Nufarm Ltd | Overweight | Ardent Leisure | Overweight |

**Positive Contributors**

Comparison website iSelect Limited (ISU, +20.1%) was a strong contributor to returns for February, boosted by what we saw as four key highlights from the company's half-year results. Firstly, the profit results released in February (the second set of half-year results under the new CEO/ CFO team) were 'clean'. This highlighted the strong momentum in iSelect's key verticals, particularly the Energy segment. Secondly, the company noted likely progress regarding repayment of a loan they had extended to NIA (the parent of online health insurance company health.com.au) to fund the growth of their business and in turn promote competition on ISU's website. According to ISU, NIA are now well placed to either refinance this loan with various bank lenders or alternatively sell the business outright, in which case ISU will be repaid. The loan, currently around $50m, is due to be repaid in July and the market was reassured to hear that this issue was on track. Thirdly, ISU have said that once the loan is repaid, they will likely consider a share buyback with their excess cash, suggesting that major acquisitions are off the table. Finally, board restructure is ongoing, with a new Chairman to be appointed shortly.

Energy Developments (ENE, +16.7%) half-year profit results were strong as the company increased their profit guidance and confirmed dividend forecasts for the full (financial) year. ENE provides electricity generation in many remote sites across Australian and in the UK. With Australian miners seeking cost savings, ENE are seeing many opportunities to expand their service offering, which of course bodes well for future growth. These opportunities, together with the reasonably predictable cash flows that will be delivered from the current long-life, contracted utility assets, supports our investment in ENE.

Global crop protection specialist Nufarm Ltd (NUF, +27.6%) continued its recent business and share price momentum in February. The major newsflow during the month was the retirement of long-time managing director, Doug Rathbone. Simultaneously, the company announced a targeted $100m cost reduction program across their global operations, although concrete details are yet to be finalised by NUF or released to the market. As we discussed last month, Nufarm has made considerable progress in restructuring and refocusing the business following a period of time when profit forecasts were missed, debt rose, and oversupply of one of NUF's key products, glyphosate, rattled investors and the share price in turn. The Nufarm of today is a far more diversified business, by product, region and market segment. The business has a strong product offering across a range of crops and crop protection chemicals. Although Rathbone has long been a passionate, energetic leader and a key driver of NUF's global expansion, his tenure is certainly heavily tied to previous profit downgrades. On this basis, his exit, with the business now in far improved shape, would be seen by many investors as a reason to revisit NUF and hence the share price response.

**Underperformers**

Cash Converters (CCV, -15.8%) reported solid profit results from their Australian operations, however losses on the UK loan portfolio appear to have weighed on the CCV share price. In the UK, the pawnbroking industry has been undergoing regulatory change similar to that which Australia experienced several years back. This has seen the industry shrink and bad debts rise, triggering CCV to report a writedown on most of the outstanding loan book. For CCV the UK is only a small contributor, however the CEO is committed to turning around the UK business this year or exiting short term lending entirely. With the UK market shrinking, CCV's position has likely improved and hence we suspect a turnaround has merit. However for the time being the market viewed the reduced group profit as very much a 'barnacle on the boat.'

Transpacific Industries (TPI, -13.3%) underperformed the market in February, following a disappointing profit result

RALTON ASSET MANAGEMENT

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.

Ardent Leisure (AAD, -13.7%) surprised the market with a profit shortfall at their Healthclubs (or gymnasiums). AAD own a series of 75 clubs across Australia, mostly under the Goodlife banner, and these account for some 25% of company profits. AAD had experimented with a shorter gym membership offering, attempting to compete with low-cost 24-hour offerings in various regions. The experiment appears to have backfired with AAD reporting a rise in member churn from the shorter tenure offering. This in turn lowered profits from AAD's existing gym network and lead to a change in strategy. AAD will now move a series of their gyms toward a 24 hour offering, increasing access times for members, but with a lower staff and service offering outside regular hours.

On a positive note, the group's US-based Main Event offering - the key attraction for our investment - continues to grow and expand at a very strong rate. The company's theme parks will also benefit from the fall in the Australian dollar, boosting tourism to their parks and also potentially steering Australians from their annual offshore holiday to holiday at home instead. So whilst the Healthclubs result was disappointing and now requires a re-jigged strategy, on balance we took the share price weakness as an opportunity to modestly increase our position.

# Portfolio Adjustments

## During the Month we...

**SOLD:** Recall Holdings Limited (REC)

**BOUGHT:** Navitas Limited (NVT)

### Portfolio Additions & Material Adjustments

Navitas Limited (NVT) was the only new stock added to the portfolio during February. The company's first-half profit results underwhelmed the market due to one-off costs in the smaller SAE division in the United States and we saw the resulting share price weakness as an opportunity to buy the stock. 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 a 'host' university. NVT source the bulk of their students from international markets, via their own recruitment networks. The share price pulled back mid-2014 following the loss of a contract with one major 'partner' or host university. We believe, 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 technology-focused SAE division, we believe the outlook for NVT is favourable.

### Portfolio Disposals & Material Adjustments

The only outright sale from the portfolio during the month was Recall Holdings (REC). Since demerging from Brambles in late 2013, the stock has been a very strong performer. Confirming our investment thesis, management has completed a series of strategic steps, selectively acquiring bolt-on businesses, undertaking a thorough optimisation and operational overhaul and taking steps to move with customers into the digital age. When the stock was buoyed by a takeover bid from US company Iron Mountain, we saw the share price reach what we considered fair value. IRM may well increase their bid, however we view the upside as modest versus the downside in the near term if IRM walk away entirely from the bid.

## 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)

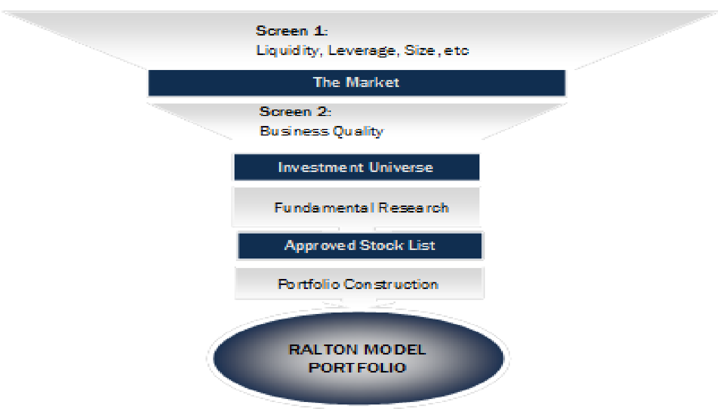
The first stage of the process is to narrow the number of stocks in the investment universe by applying a number of screens. This approach systematically eliminates companies that do not meet certain minimum standards, allowing the Investment team to focus more intensely on companies of potential interest.

### 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:

Name: John Clothier
Phone: 02 8216 0782
Mobile: 0408 488 549
Email: jclothier@ocfunds.com.au

S&P FUND AWARDS 2010 AUSTRALIA FINALIST STANDARD & POOR'S professional planner