# Ralton High Yield Australian Shares

# Quarterly Report
# March 2015

## 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** | |

## Performance

| Return % | 1m | 3m | 1yr | 3yrs | 5yrs | Incept* |
|---|---|---|---|---|---|---|
| **Ralton High Yield** | 1.79 | 10.29 | 21.18 | 21.48 | 11.87 | 8.83 |
| *Income Return* | 0.46 | 1.37 | 4.61 | 4.95 | 4.99 | 5.08 |
| *Growth Return* | 1.33 | 8.92 | 16.57 | 16.53 | 6.88 | 3.76 |
| S&P/ASX 300 Acc. Index | -0.05 | 10.31 | 13.90 | 15.31 | 8.32 | 5.07 |
| **Difference** | **1.84** | **-0.02** | **7.29** | **6.17** | **3.55** | **3.76** |

**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 | National Australia Bank Limited | NAB |
| 5 | BHP Billiton Limited | BHP |
| 6 | Woodside Petroleum Limited | WPL |
| 7 | QBE Insurance Group Limited | QBE |
| 8 | Amcor Limited | AMC |
| 9 | Westpac Banking Corporation | WBC |
| 10 | Transurban Group | TCL |

| GICS Sector | Ralton | Index | +/- |
|---|---|---|---|
| Consumer Discretionary | 15.5% | 4.3% | 11.2% |
| Industrials | 16.2% | 7.3% | 8.9% |
| Energy | 7.1% | 4.4% | 2.7% |
| Telecommunication Services | 7.3% | 5.7% | 1.6% |
| Utilities | 1.8% | 2.0% | -0.2% |
| Materials | 13.9% | 14.4% | -0.5% |
| Information Technology | 0.0% | 1.0% | -1.0% |
| Health Care | 4.5% | 6.1% | -1.7% |
| Consumer Staples | 2.7% | 6.8% | -4.1% |
| Property | 1.9% | 7.7% | -5.7% |
| Financials (ex-Property) | 29.2% | 40.4% | -11.2% |
| Total | 100% | 100% | |

# Quarter in Review

## Performance Summary

- The S&P/ASX 300 Accumulation Index finished largely flat for the month of March, rounding out a 10.31% gain for the quarter. The Financials and Utility sectors were strong performers, and Energy the only sector to record a negative return
- The Ralton High Yield Model Portfolio returned 10.29% for the quarter, performing essentially in line with the benchmark
- Stock selection within each of the Materials and Consumer Staples segment added strongly to portfolio returns, but was offset by our underweight to Financials and elevated cash holdings

## Portfolio Commentary

# Quarterly Performance Attribution

| Top Contributors | Positioning | Key Detractors | Positioning |
|---|---|---|---|
| Incitec Pivot Ltd | Overweight | Transpacific Industries | Overweight |
| Coca-Cola Amatil | Overweight | Lend Lease Group | Overweight |
| ResMed Inc | Overweight | Pact Group Ltd | Overweight |

### Positive Contributors

A key contributor to returns was Incitec Pivot (IPL, +27.6%). Investor comfort that manufacturing issues had been rectified, together with favourable fertiliser and currency movements, saw IPL move strongly higher for the quarter. Now that IPL's key Queensland manufacturing plants for fertiliser (Phosphate Hill) and ammonium nitrate (Moranbah) are demonstrating consistent production in line with management targets, investors are turning their focus to the Louisiana ammonia project. This project, known as 'LOMO', is the construction of an 800kt ammonia plant, with first production set for 2017. We see several key positive attributes of this plant. Firstly, it is being built on a site with pre-existing infrastructure, saving costs on the total build. Secondly, as long as the US remains a net importer of ammonia, IPL will be able to leverage the cheap cost of US gas used to produce ammonia against the high cost of US ammonia imports, which of course set the price. Thirdly, IPL has committed buyers (off-take agreements) for all of the production, including using just over one-third of production for their own explosives plants in the US. Although any large-scale investment is not without risk, we like the dynamics for this project and expect that, all going well, the rise in cash flows will be significant for investors once production starts.

Coca-Cola Amatil (CCL, +15.7%) added to portfolio returns as CEO Alison Watkin's turnaround strategy began to gain traction. Although full year results for FY14 showed a 22% decline in group profit, investors were pleased with signs that CCL is beginning to turn around. In particular, many of the initiatives that Watkins outlined at last year's strategy day in October are now moving into execution phase. CCL has delivered on the sale of a strategic stake in their Indonesian operations to parent company, The Coca-Cola Company (KO), sales in the Australian region have shown signs of stabilisation, and the benefits of various initiatives in key distribution channels have begun to flow. In the short-term the launch of 'Coca-cola Life' looks set to reinvigorate the segment and brand, as well as appealing to the more health conscious segment of consumers.

Medical technology company Resmed (RMD, +34.0%) was another key contributor to portfolio returns for the quarter, buoyed by a strong quarterly profit result released in January. The key driver was the launch of ResMed's latest product platform, namely the S10 flow generator used for patients with sleep apnea. RMD's sales results for the second quarter of the financial year, the first full period after the much-anticipated launch of the S10, did not disappoint, with very strong sales growth in both the US and ROW regions. The S10 is very much "infomatics" (or data sharing) focused with the device monitoring patient results and compliance, automatically sending the data via an inbuilt modem to doctors, distributors and insurance companies. At this stage, RMD appear to have the jump on their competitors, leading distributors and doctors to preference the use of the RMD device. The key here is user simplicity. If the device is easy to use for patients, and the distributors spend less time in set-up and service calls, profitability is boosted. Given the rapid appreciation in share price and commensurate reduction in dividend yield for the stock, we elected to sell our holding in RMD for the High Yield portfolio.

### Underperformers

Transpacific Industries (TPI, -7.6%) underperformed the market for the quarter following a disappointing half-year profit announcement in which the company flagged a short-term need to increase spending in order to speed up and support the ongoing operational turnaround. Profit results were particularly weak in the Industrials segment of TPI, due to both 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 management's initiatives. As such, we modestly increased our position following the results and share price fall.

One of the portfolio's larger positions, Lend Lease Group (LLC, +1.5%), weighed on relative returns for the quarter as it failed to match the strong performance of the market. However, LLC delivered a solid profit result and outlook statement at their February half-year profit results, and has returned 40.4% over the last 12 months. Perhaps the one area of concern to investors involves the Queensland and Victorian state governments. In Victoria, the recently elected Andrews Government appears intent on cancelling the $6bn East West Link project, of which LLC was a key participant. In Queensland, the election of the Palaszczuk Government appears highly likely to reduce the planned asset sales and subsequent infrastructure investment that had been flagged by the prior government. The loss of these potential projects is no doubt a negative for LLC, however with construction operations in several regions across the globe the company can, to some degree, absorb the loss of a single project. Further, the LLC business is quite diverse, with operations across residential property, funds management, and asset recycling. Overall, we remain supporters of the company.

Packaging and manufacturing company Pact Group Limited (PGH, -3.0%) released first-half profit results that disappointed the market and led the share price lower. The profit shortfall was largely driven by an inability to pass through rising input costs to customers in a timely manner. With product inputs such as resin priced in US dollars, the company faced a short-term hit from the fall in the Australian dollar, which it could not immediately recoup. The bulk of PGH's clients have mandatory pass-through of such costs with a time lag - typically three months - and hence PGH is expected to recoup these input costs and, all else being equal, restore profit margins. The significant volatility in both exchange rates and resin prices - which in turn are based on the oil price - in the fourth quarter of calendar 2014 was atypical and hence the surprise impact to profits and market reaction. Significantly, PGH should now be able to profit from a lower resin price given the oil price falls of recent times. Although the first half result was disappointing, we are maintaining our PGH investment, noting the targeted cost savings from an announced efficiency program (largely manufacturing plant consolidation) and the future growth opportunities available to PGH in Asia and markets further abroad.

## Portfolio Adjustments

### During the Quarter we...

**SOLD:** Orora Ltd (ORA), Recall Holdings Ltd (REC), ResMed Inc. (RMD)

**BOUGHT:** Ardent Leisure Group (AAD), Asciano Ltd (AIO), CSL Limited (CSL), Energy Developments Ltd (ENE), Echo Entertainment Group Ltd (EGP), Macquarie Atlas Roads Ltd (MQA), Super Retail Group Ltd (SUL)

**Portfolio Additions & Material Adjustments**

We added several new stocks to the portfolio during the quarter, with turnover reflecting the sale of some of our strong performers and in turn, the introduction of several new investment ideas. Below, we have discussed three of the new stocks to the portfolio.

We invested in transport company Asciano (AIO), whose three core assets are Container Terminals, which operates at four major Australian ports (the former Patrick's Stevedores), Pacific National, which operates 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, 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 sold in US dollars.

On the terminals side, Container Terminals has nearly completed 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 has 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.

CSL's first-half results disappointed some in the market and lead to some short-lived weakness in the share price. We took this opportunity to acquire a position in the stock, confident in our view that the ongoing demand for the company's core plasma-derived products, including IVIG, Albumin and a broad range of 'specialty' products, will remain strong. CSL are a top 1 or 2 provider of plasma products across most geographies and continue to demonstrate manufacturing excellence in what is a high barrier-to-entry, highly regulated segment of the healthcare industry. Dealing with blood products is not taken lightly by the general public! Going forward, the company has a solid pipeline of both novel and follow-on compounds in R&D. In particular, we highlight the potential for market share gains when CSL launch their recombinant products for the treatment of haemophilia and similar blood clotting disorders. This space will become increasingly competitive, however we believe that CSL are well placed.

Finally, we added a small position in Utility company Energy Developments (ENE). The company had a history of disappointing the market with problems with a key project. However, under private equity control, but whilst remaining listed, the company was transformed through a major capital investment program. Today, ENE delivers a reasonably predictable and growing cash flows from a series of long-life, contracted utility assets. The increased cash flow is already giving rise to increased dividends for investors. The company will likely have opportunities to add to its asset base and in time, we expect the private equity investors, who remain significant shareholders, to sell down and improve stock liquidity.

**Portfolio Disposals & Material Adjustments**

There were three outright stock sales from the portfolio across the quarter, namely Resmed (RMD) as discussed earlier, Recall Holdings (REC) and Orora Limited (ORA).

Since demerging from Brambles in late 2013, REC had been a very strong performer. Confirming our investment thesis, management had 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 and sold our holding. IRM may well increase their bid, however we view the upside as modest versus the potential downside in the near term if IRM abandon the takeover.

We also sold the balance of our holding in Orora (ORA) in March. Like Recall, ORA was formed via demerger from it's parent (Amcor) in late 2013, was up-weighted in the portfolio and was one of the strong contributors to our performance across 2014. Management has done an excellent job since the demerger, delivering on what we largely saw as self-help initiatives. ORA continues to meet cost saving targets, the bulk of which are flowing from the ongoing ramp-up to full production of the Botany paper mill (B9) in Sydney. The US side of the business makes up 30% of revenues and has received considerably more focus under ORA management than during AMC's ownership. The benefits of this have been improved sales growth and also margin improvement from manufacturing initiatives. We do however believe that these benefits are largely priced in now and hence we are comfortable taking profits.

# 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 partnered with Copia Investment Partners, an administration and distribution specialist providing a range of tailored services to each of our leading boutique investment partners.

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 24 years, including the past 9 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 8 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 Adviser Services at:


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