Ralton Australian Shares

Monthly Report
August 2015

Investment profile

A professionally managed portfolio of Australian shares

The Ralton 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 Australian Shares SMA is to to provide investors with long-term capital growth and some tax-effective income from a concentrated portfolio of Australian 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 300 Accumulation Index
Authorised investments	Companies in the S&P/ASX 300 Index or those among the top 300 by size
Number of stocks	20-35
Cash allocation	0% to 10%
Tracking Error	3% to 6%
Investment horizon	At least 5 years
Ratings	

Performance

Return %	1m	3m	1yr	3yrs	5yrs	Incept*
Ralton Aust Shares	-6.23	-5.73	8.22	16.61	11.67	6.85
Income return	*0.62*	*0.66*	*3.71*	*4.15*	*4.39*	*4.38*
Growth return	*-6.85*	*-6.39*	*4.51*	*12.46*	*7.28*	*2.47*
S&P/ASX 300 Accum. Index	-7.70	-8.83	-3.23	10.95	7.91	3.35
Difference	**1.47**	**3.10**	**11.45**	**5.66**	**3.76**	**3.51**

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

The portfolio is designed for investors who...

- Seek long-term capital growth and 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	National Australia Bank Limited	NAB
2	CSL Limited	CSL
3	Commonwealth Bank of Australia	CBA
4	Westpac Banking Corporation	WBC
5	Aristocrat Leisure Limited	ALL
6	Incitec Pivot Limited	IPL
7	ANZ Bank Group Limited	ANZ
8	QBE Insurance Group Limited	QBE
9	BHP Billiton Limited	BHP
10	Woolworths Limited	WOW

GICS sector	Ralton	Index	+/-
Consumer Discretionary	13.8%	4.6%	9.2%
Health Care	12.1%	6.5%	5.6%
Materials	17.5%	14.4%	3.1%
Energy	5.8%	4.5%	1.3%
Industrials	8.4%	7.6%	0.8%
Information Technology	1.7%	1.0%	0.8%
Consumer Staples	6.2%	6.9%	-0.7%
Utilities	1.6%	2.3%	-0.7%
Telecommunication Services	0.0%	5.7%	-5.7%
Property	1.8%	8.2%	-6.4%
Financials (ex-Property)	31.2%	38.5%	-7.2%
Total	100.0%	100.0%	

Month in review

Performance summary

- The S&P/ASX 300 Accumulation Index fell 7.70% for the month of August. All sectors recorded a negative return with Energy and Information Technology recording the largest percentage falls.
- The Ralton Australian Shares Model Portfolio lost 6.23% for the month, outperforming the benchmark by 1.47%.
- For the month, our overweight position in Consumer Discretionary, together with an elevated cash holding, added value to the portfolio, as did our underweight position in resource stocks for the period.

Portfolio commentary

Monthly performance attribution

Top Contributors	Positioning	Key detractors	Positioning
BlueScope Steel Limited	Overweight	iSelect Limited	Overweight
Asciano Limited	Overweight	Computershare Limited	Overweight
Macquarie Atlas Roads	Overweight	Woolworths Limited	Overweight

Positive contributors

August was one of the most tumultuous periods we have seen in the Australian market for many years. The market had fallen back to the level it last saw in December 2014. Ralton had been concerned about the level the market was trading at for some time and had cash / cash equivalents (i.e. takeovers pending) equivalent to levels comfortably greater than 10% in each of its portfolios.

Despite the large fall in the market, as always reporting season was a driver of short-term share price movements. The portfolio's top performer was Bluescope Steel (BSL, +18.7%). Shares in the diversified steelmaker responded well to a strong profit result, with the performance of the Australian steelmaking business exceeding the market's low expectations. Secondly, and following on from our comments in last month's report, BSL announced a clear strategy for improving the profit of both the Australian and NZ steelmaking operations. Specifically, in regard to the larger Australian steel operations at Port Kembla in NSW, the company announced its intention to either reduce costs of production by $200m per annum or, if this could not be achieved, take the more drastic step of mothballing or shutting the steelmaking foundry. This drastic move is in response to the falling price of imported steel, impacted by the stuttering Chinese economy and the need for China to export excess steel production into Asia. Of the $200m cost saving being targeted, about half of this figure will come from labour costs, including the loss of some 500 jobs. Although, philosophically, we would prefer to see the steelmaking capability remain in Australia, this bold strategy appears eminently rational from our vantage. Stakeholders – the company, employees, governments and unions – will now be working toward a deadline BSL has set, namely the company's November AGM.

Confirmation of a takeover bid from Brookfield Infrastructure Partners (BIP) saw Asciano Limited (AIO, +4.4%) gain ground in a weak market. The final bid of $9.15 has been recommended by the AIO board and comprises cash of $6.94, together with shares or scrip in the US listed BIP, equivalent to A$2.21 per share at the time of the offer. Ahead of deal closure, AIO is aiming to pay a special dividend of up to $0.90, fully franked. The cash offer will be reduced by the value of the special dividend, whose attraction, of course, is the additional franking credit that will be provided to investors.

Shares in Macquarie Atlas Roads (MQA, 0.0%) were flat in a negative market and hence outperformed. MQA's key asset, the French toll road continues to deliver modest profit growth driven by traffic growth, price increases and cost savings. At a group level, MQA continues to simplify its debt structure and amortise its debt, and therein interest paid, which overall should allow for growth in dividend payments going forward.

Underperformers

iSelect (ISU, -17.6%) largely gave up the gains from July, which in turn followed the repayment of a loan from NIA (owner of health.com.au). The company's full-year profit results were reasonable from our vantage, although the Health division was perhaps weaker than some were forecasting (the company had certainly highlighted the flow-through of 'trading down' in health insurance policies) offset by the very strong profit results from the 'HUF' or Household Utilities and Finance division. Investor concerns appear to be focused on the lack of immediate capital management, with ISU flagging that a share buyback is likely in coming months, but yet to be finalised. With a new Chairman only just installed, the negative reaction to what we understand to be only a 'delay' in likely capital management was surprising. Similarly, investors were perhaps concerned that ISU flagged the need to invest in more staff to meet growing demand, particularly for the HUF division. Overall, the market as a whole seems averse to both investment by companies in their own business and secondly, hypersensitive to dividends and buybacks when they don't materialise. Our preference at this point of the cycle is to look for companies prepared to invest and those we believe will achieve an adequate return on their investments and hence, we continue to support ISU.

Lower-than-expected profit guidance for the 2016 financial year saw Computershare (CPU, -19.9%) lose ground. CPU's core business is focused on data and cash management for individuals and corporates. They are facing margin headwinds as competitors continue to nip at their heels and corporates continue to seek to extract cost savings from their service providers such as CPU. These margin pressures are somewhat reflected in the profit outlook along with the uncertainty around interest rates (CPU earns fees of the account balance of their clients and the interest rates earnt). At current levels, CPU appears good value.

Finally, Woolworths (WOW, -7.7%) also weighed on portfolio returns for the month. Like most turnarounds, mixed progress is not altogether unexpected in the early days. The company's turnaround plans, announced in May at their investor day, were the trigger for Ralton to invest in WOW. We view the recent appointment of Gordon Cairns as Chairman as positive and now look to both the appointment of a well-credentialed CEO by year's end and some definitive progress in terms of strategic changes being made at each of the key business divisions. From the FY15 results, our view was that the company is sounding more confident that hardware chain Masters was deriving improved sales results from new initiatives and store format under divisional CEO, Matt Tyson. Offsetting this, sales growth at core supermarket divisions continues to stutter (recent initiatives and investments will likely require some 12 months plus before any customer momentum will be visible).

Portfolio adjustments

During the month we...

SOLD: Sky Network Television Limited (SKT)

BOUGHT: Brambles Limited (BXB), Sonic Healthcare Limited (SHL)

Portfolio additions

With the shares having pulled back from where we recently sold our position, we added Sonic Healthcare (SHL) back to the portfolio in August. FY15 profit results were reasonable, although Australian pathology operations had a weak result, following government cuts to the funding of Vitamin D tests. The company, however, appears upbeat on the outlook for FY16, where acquisitions, the ramp-up in tender wins from the UK and improving US market for pathology testing, has seen the company provide earnings guidance for 20% growth in EBITDA in FY16. We like the overall stability of SHL's global business and were happy to add it back to the portfolio.

Similar to SHL, we also added back Brambles Limited (BXB) to the portfolio in August, again using some cash holdings to take advantage of the share price weakness. Brambles' global transport business is typically a stable exposure to global product demand – many of the everyday items Brambles moves via its traditional CHEP pallet business, newer age Rigid Plastic Containers (those shiny display pallets used for supermarket fruit) or more specialised products, are less economically sensitive than many internationally traded goods. The share price has weakened of late, perhaps owing to concerns around trade flows and the overall state of emerging markets. BXB has exposure to emerging markets, with some 15% sales coming from non-Western countries. Most of the BXB's business in these markets is driven by domestic consumption, not trade-based exports in the short term. Clearly the two are not completely unrelated, but certainly we believe BXB's overall exposure to emerging markets is manageable. In the medium term, consumer demand for Western goods and supply-chain sophistication is the driver of BXB's services and, on this basis, we remain positive.

At the full-year results, BXB highlighted the need to boost growth capital expenditure in coming years. Our recent meeting with management highlighted the bulk of the additional $500m being flagged over four years is due to growth in customer demand hence, such investment is a positive. BXB achieved outstanding returns on incremental capital and we are attracted to companies that can invest capital and achieve strong returns in the current low-growth climate.

Portfolio disposals

We sold the last of our position in NZ pay TV operator, Sky Network Television (SKT), largely to fund the investments in BXB and SHL. SKT is the dominant pay TV provider in NZ and is a strong and stable business. Despite this, we recognise the competition for consumers' entertainment dollar is intensifying. Although noting the recent negative trends in eyeballs and marketing dollars in the largest pay TV market, the US, we tend to believe the industry will endure, although in NZ we note the outlook for profit growth in the short term is muted.

RALTON ASSET MANAGEMENT

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)

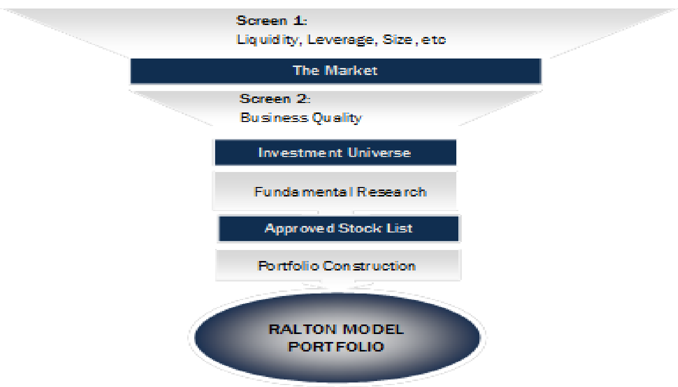
The first stage of the process is to narrow the number of stocks in the investment universe by applying a number of screens. This approach systematically eliminates companies that do not meet certain minimum standards, allowing the Investment team to focus more intensely on companies of potential interest.

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 seven 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 seven 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.

More information

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