Ralton Smaller Companies

Monthly Report
August 2015

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	-5.04	-6.47	4.73	15.34	12.92	6.60
Income return	*0.29*	*0.45*	*3.12*	*3.45*	*3.69*	*3.75*
Growth return	*-5.33*	*-6.92*	*1.61*	*11.89*	*9.22*	*2.85*
S&P/ASX Small Ords Acc Index	-4.87	-10.89	-9.62	0.38	-0.72	-3.32
Difference	**-0.17**	**4.42**	**14.35**	**14.96**	**13.64**	**9.92**

**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	Ardent Leisure Group	AAD
2	Super Retail Group Limited	SUL
3	Aristocrat Leisure Limited	ALL
4	Macquarie Atlas Roads Limited	MQA
5	Pact Group Holdings Limited	PGH
6	Fisher & Paykel Healthcare Corporation	FPH
7	Energy Developments Limited	ENE
8	Village Roadshow Limited	VRL
9	Tassal Group Limited	TGR
10	Fletcher Building Limited (Australia)	FBU

GICS sector	Ralton	Index	+/-
Consumer Discretionary	36.4%	22.7%	13.7%
Consumer Staples	7.8%	3.4%	4.3%
Utilities	3.9%	0.6%	3.2%
Materials	16.0%	13.3%	2.7%
Health Care	10.0%	9.3%	0.7%
Energy	5.4%	4.8%	0.6%
Financials (ex-Property)	6.2%	8.6%	-2.4%
Industrials	12.5%	15.8%	-3.3%
Telecommunication Services	0.0%	3.5%	-3.5%
Information Technology	2.0%	5.5%	-3.5%
Property	0.0%	12.5%	-12.5%
Total	100.0%	100.0%	

Month in review

Performance summary

- The S&P/ASX Small Ordinaries Accumulation Index fell 4.87% for August, with Energy and Utilities the worst performing sectors.
- The Ralton Smaller Companies Portfolio fell 5.04% in August, having risen 4.93% in July, underperforming the benchmark by 0.17% for the month of August.
- Our overweight position in Consumer Discretionary and Healthcare sectors was the key detraction from the portfolio, offset mainly by our overweight to Industrials.

Portfolio commentary

Monthly performance attribution

Top contributors	Positioning	Key detractors	Positioning
Blackmores Limited	Overweight	Sky Network Television	Overweight
Village Roadshow	Overweight	iSelect Limited	Overweight
SAI Global	Overweight	Cash Converters	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.

Blackmores Limited (BKL, +18.6%) rose again during August as the shares pushed through the $100 mark. Profit results for the full year were strong, growing 83%, with each of the key divisions, namely Australian retail, Australian bioceuticals and Asia each producing impressive trading results. Sales to Chinese customers have been very strong with Chinese consumers buying stock in Australia for consumption or larger scale distribution back into China. China is also opening up direct channels for sales of vitamins and similar products to China via various Free Trade Zones (FTZ). The Shanghai FTZ has only recently opened and it is this channel to market that offers the most upside to BKL and indeed why investors have excitedly pushed the share price so high. The Shangai FTZ offers a simple sales channel for both BKL and Chinese consumers, a lower tax rate or tariff on imported goods and allows the government to monitor and regulate products coming into China. Overall, the strength of BKL's brands and growth options in Asia continue to underpin the long- term outlook, although we have again reduced our position in the stock at these levels.

A strong list of movie titles (cinema sales) led to a strong FY15 profit result for Village Roadshow (VRL, +8.9%). Not only were the movie titles supportive, but VRL's premium price offering (Gold Class), together with new cinemas in growth corridors, meant VRL increased market share in Australia. Results for the theme parks, both on the Gold Coast and in Sydney, were less impressive but impacted by a series of poor weather days for the key holiday periods. VRL views that this poor run with weather could have cost the business near $20m for the full year. Theme parks should benefit from the falling Australian dollar as tourism is boosted by international arrivals. Also, the high cost of travelling overseas is expected to see more domestic travel and hence, travel to Queensland.

SAI Global (SAI, -2.0%) outperformed in a down market following a reasonably steady and unremarkable set of profit results. SAI has had a busy couple of years, with proposed takeover activity failing to complete, a short-lived CEO in Stephen Porges, an interim CEO in the form of Chairman, Andrew Dutton, and more recently the internal appointment of Peter Mullins as CEO, having most recently headed up the SAI property division.

In a recent meeting we had with the CEO, we gained confidence about the strategic changes he is making to the business and the options for the standards Australia contract (a key component of earnings). Mullins is undertaking considerable organisational change centered upon familiar themes of improved efficiencies and business realignment. On this last front, SAI is merging three key divisions under one banner and will look to capture synergies and in particular, drive the cross selling of services across assurance, compliance and standards. He is really moving the business down the path where many of Australia's major professional service firms headed many years ago. This gives us a degree of comfort that his actions should drive future revenue and profit growth.

Underperformers

Firstly, New Zealand pay TV operator Sky Network Television (SKT, -18.6%) was sold down on concerns of a flat profit outlook in coming years. 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 as competition continues to nip at SKT's heels.

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 averseto 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.

Cash Converters (CCV) has been a recent underperformer for the portfolio and was reluctantly sold in August. The stock has been plagued by negative publicity around its payday loans business in the media in recent months, coupled with ongoing litigation concerns. Although we have stuck with the investment until now, the move by major lender, Westpac, to withdraw its funding to CCV in August was a significant event. Although the company can likely find alternative sources of funds, we recognise this introduces an unknown element to the business as uncertainty exists as to the cost and tenor of replacing this source of lending. Reluctantly, we elected to sell and crystallise a loss for investors, believing the outlook for CCV had become more uncertain.

Portfolio adjustments

During the month we...

SOLD: Cash Converters International (CCV), Monash IVF Group (MVF)

BOUGHT: Austbrokers Holdings Limited (AUB)

Portfolio additions

We bought back into Austbrokers Holdings (AUB) during the month, having satisfied ourselves that headwinds from the premium cycle had abated. AUB is focused on insurance broking. AUB has ownership stakes in a network of insurance brokers across Australia that offer a range of insurance services to its network of clients, largely SME-type businesses. Insurance premiums in Australia are in an up cycle, so AUB can produce organic top-line revenue growth and additional growth from the addition of new broking firms to its network.

Portfolio disposals

We further reduced our holding in BKL as the stock moved above $110 as discussed.

We also sold our holding in medical services provider, Monash IVF (MVF). MVF provides in vitro fertilisation (IVF) and ultrasound services across a range of clinics in Australia. MVF was in the press for what we consider the wrong reasons in August with news of doctor dissent and concerns from various doctors (IVF specialists and laboratory staff) being raised with the board about patient care and the overlap with corporate strategy. Such matters are a concern for a people- or service-focused business, particularly once they escalate into the public forum. As we were unable to confirm with the company the nature and degree of such claims, we took the decision to sell our position in MVF, with a view to revisit the stock if we are able to satisfy ourselves that such concerns are not material.

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)

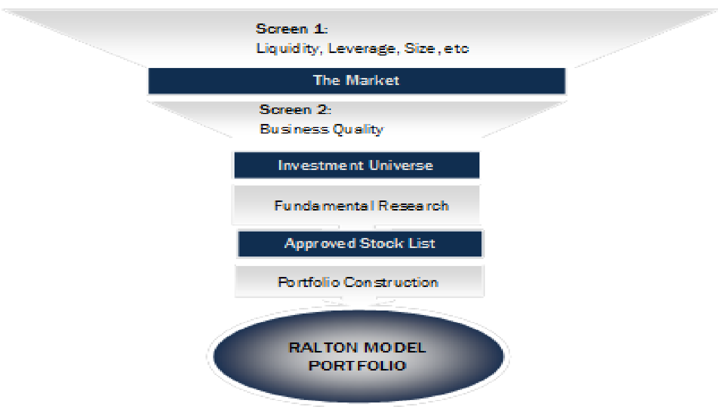
The first stage of the process is to narrow the number of stocks in the investment universe by applying a number of screens. This approach systematically eliminates companies that do not meet certain minimum standards, allowing the Investment team to focus more intensely on companies of potential interest.

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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