Ralton Australian Shares

Quarterly Report September 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	-1.32	-2.54	9.65	15.45	10.35	6.59
Income return	*0.64*	*1.27*	*3.80*	*4.05*	*4.36*	*4.42*
Growth return	*-1.96*	*-3.80*	*5.85*	*11.40*	*5.99*	*2.17*
S&P/ASX 300 Accum. Index	-2.86	-6.47	-0.66	9.09	6.29	2.92
Difference	**1.54**	**3.93**	**10.31**	**6.35**	**4.06**	**3.67**

**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	Commonwealth Bank of Australia	CBA
3	CSL Limited	CSL
4	Westpac Banking Corporation	WBC
5	Aristocrat Leisure Limited	ALL
6	QBE Insurance Group Limited	QBE
7	Incitec Pivot Limited	IPL
8	ANZ Bank Group Limited	ANZ
9	Coca-Cola Amatil Limited	CCL
10	Woolworths Limited	WOW

GICS sector	Ralton	Index	+/-
Consumer Discretionary	14.3%	4.7%	9.7%
Health Care	11.9%	6.4%	5.5%
Industrials	10.4%	8.0%	2.5%
Materials	15.7%	13.9%	1.8%
Energy	5.5%	4.0%	1.5%
Information Technology	1.9%	1.1%	0.8%
Consumer Staples	7.5%	7.1%	0.4%
Utilities	0.0%	2.3%	-2.3%
Telecommunication Services	0.0%	5.7%	-5.7%
Property	1.6%	8.4%	-6.8%
Financials (ex-Property)	31.1%	38.4%	-7.3%
Total	100.0%	100.0%	

Quarter in review

Performance summary

- The S&P/ASX 300 Accumulation Index fell 6.47% for the quarter with Energy recording a near 25% fall and the Materials sector, predominantly resource stocks, also weighing heavily on the market.
- The Ralton Australian Shares Model Portfolio fell 2.54% for the quarter, outperforming the benchmark by 3.93%.
- For the quarter, stock selection within the Materials sector, together with our overweight position in both Consumer Discretionary and, to a lesser extent, Industrials, added value to the portfolio.

Portfolio commentary

Quarterly performance attribution

Top Contributors	Positioning	Key detractors	Positioning
Asciano Limited	Overweight	Transpacific Industries	Overweight
BlueScope Steel Limited	Overweight	Origin Energy Limited	Overweight
Incitec Pivot Limited	Overweight	National Australia Bank	Overweight

Positive contributors

Asciano Limited (AIO, +26.3%) - shares in AIO were boosted by a takeover bid from Brookfield Investment Management which was first disclosed to the market in July and then endorsed by the board in August. The final bid of $9.15, which was recommended by the AIO board, comprises cash of $6.94 together with shares or scrip in the US listed, BIP, equivalent to $AUD2.21 per share at the time of the offer. Of the $6.94 cash, the proposal includes payment of a special dividend of up to $0.90. The dividend will be subtracted from the total cash payment, but will attract franking credits for investors. We have a very positive view of AIO's assets and believe there is good reason for a bid by Brookfield. Like many takeovers, we have somewhat mixed feelings. The short-term capital benefit is very pleasing, however an Australian listed asset whose value collectively was not being appreciated by the market, has been sold to foreign investors whose time frames are longer dated.

Bluescope Steel (BSL, +20.0%) – following a period of underperformance, BSL added value to the portfolio. Shares in the diversified steelmaker responded well to a strong profit result in August, with the performance of the Australian steelmaking business exceeding the market's low expectations. Secondly, and following on from our comments in last quarter'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 need for China to export excess steel production into Asia. Of the $200m cost saving being targeted, about half 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 that BSL has set, namely the company's November AGM.

Incitec Pivot (IPL, +12.7%) - also added value to the portfolio in a negative quarter for the market. An investor tour to Louisiana showcasing the US Ammonia Nitrate plant was well received by investors. Our readers would be familiar with our view, namely that this plant will be a key driver of cash flow, returns and ultimately, capital management to shareholders. At current US gas (production) prices and allowing for current US selling prices of Ammonia Nitrate, this plant will offer exceptional returns for IPL. News the plant is essentially on budget and on time contributed to the near 13% gain for the quarter.

Underperformers

Transpacific Industries (TPI, -11.7%) - waste services company, TPI, underperformed in a weak market and weighed on portfolio returns. Recent years have been quite disruptive for TPI, with the business undergoing management change, asset sales and significant restructure and re-organisation of business functions. However, despite the share price fall during the period, we felt the August profit results contained some distinct positives. In particular, we would point to recent changes in the sales model and highlight that progress was evident on this front for the main Cleanaway business. Secondly, the benefit of waste internalisation – delivering waste to your own company's landfill – was also evident following the acquisition of a key landfill asset in Victoria. In July, TPI appointed Vik Bansal to the position of CEO. Mr Bansal has most recently led Valmont Industries in the US, however he has considerable experience in corporate Australia and hence his desire to return home to assume a CEO role. Our recent first meeting with Mr Bansal left a positive impression, however investors will be looking to what progress he is able to make in what has been a challenging company to manage in recent times.

Origin Energy (ORG, -49.0%) - shares in ORG fell heavily across the quarter, underperforming the overall Energy sector which fell near 25%. Our investment thesis has centred on the strength of Origin's core assets: their Energy Markets division which is a vertically integrated energy retailer and secondly, their operating stake in the APLNG gas plant in Queensland. In addition, a key part of our reason to invest was our belief that rising gas prices on the east coast would drive higher prices and profits to ORG's domestic sales. That said, the sustained fall in the oil price has significantly pressured ORG's share price and indeed balance sheet. The company's full-year profit results were, in this context, a trigger for investor concerns. ORG highlighted the need to expend further capital on the APLNG plant ahead of its completion. Recent gas sales to third parties have also been at far lower rates than will occur going forward. Why? The broad ramp-up in gas to supply all of Queensland's gas trains has driven a short-term supply glut and dampened prices.

Finally, with oil prices yet to rebound from their rapid fall of almost a year ago, investors started to worry that the new gas plant would only be marginally profitable if oil prices continue to remain at these levels and as such, that ORG would need to raise equity. Finally, as the share price weakened such views became self-perpetuating and the ORG board elected to raise $2.5bn of new equity at $4 per share. This, together with a package of targeted cost savings, reductions in capital expenditure and potential asset sales, should see ORG's balance sheet move into far more conservative territory. This was a disappointing outcome, given ORG had flexibility to act earlier on several fronts. We had held only a small position, mindful of all these pressures, but still with a firm view that value existed in ORG. Pleasingly, the share price has rebounded (as we write) following the capital raise at $4 per share and it appears investors will make a profit on the rights issue.

National Australia Bank (NAB, -10.0%) - also weighed on portfolio performance for the period, largely on the basis of external or global factors. Firstly, confusion over the direction of US interest rate policy under the Federal Reserve, together with broader fears over the Chinese economy (see our article, Renminbi devaluation underway), led to broad market weakness, particularly among large-cap stocks. Secondly, capital raisings by ANZ and CBA, saw general weakness among the banking sector. Even though several of the other major banks fared somewhat worse across the quarter, our holding in NAB was however, a negative contributor to performance.

Portfolio adjustments

During the quarter we...

SOLD: Sky Network Television Limited (SKT), Energy Developments Limited (ENE)

BOUGHT: Brambles Limited (BXB)

Portfolio additions

Brambles Limited (BXB) - with the shares having pulled back from where we recently sold our position, we added back BXB to the portfolio in August using some of our 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 that Brambles moves via their 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% of sales coming from non-Western countries. Most of 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 demands 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 (CAPEX) 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

Sky Network Television (SKT) - we sold the last of our position in New Zealand pay TV operator, SKT, largely to fund the investments in BXB and to increase several other holdings. 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.

Energy Developments (ENE) - we also sold our position in ENE during the quarter. ENE's board and major investors have agreed to a takeover of DUET Group (DUE) at $8 per share. By selling the stock on market, we have effectively accepted the offer price, adjusted for the time value of money.

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)

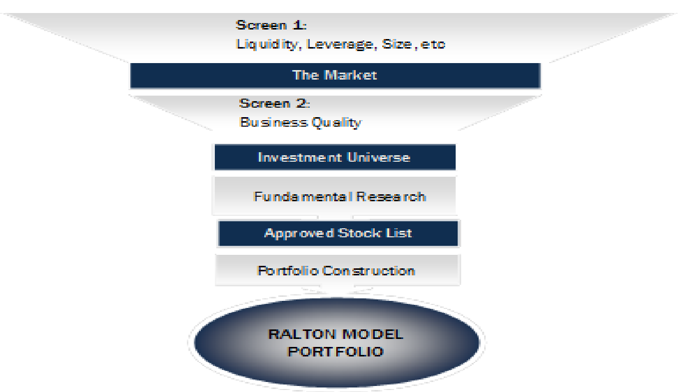
The first stage of the process is to narrow the number of stocks in the investment universe by applying a number of screens. This approach systematically eliminates companies that do not meet certain minimum standards, allowing the Investment team to focus more intensely on companies of potential interest.

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

Financial advisers seeking additional information can contact:

John Clothier
General Manager, Distribution
T: 02 8216 0782
M: 0408 488 549
E: jclothier@copiapartners.com.au