Ralton High Yield Australian Shares

PERFORMANCE REPORT
31 March 2016

Total returns

At 31 March 2016	1 mo. %	3 mo. %	1 yr. %	2 yr. p.a. %	3 yr. p.a. %	5 yr. p.a. %	7 yr. p.a. %	Inception p.a. (Feb 2008) %
Ralton Australian Shares	5.96	-3.54	-6.34	6.54	10.04	10.00	12.97	6.85
Income return	*0.73*	*1.43*	*4.35*	*4.48*	*4.76*	*4.97*	*4.87*	*4.98*
Growth return	*5.23*	*-4.97*	*-10.69*	*2.06*	*5.29*	*5.03*	*8.10*	*1.86*
S&P/ASX 300 Accum. Index	4.78	-2.64	-9.27	1.66	5.29	5.45	9.77	3.20
Difference	**1.18**	**-0.90**	**2.93**	**4.88**	**4.75**	**4.55**	**3.20**	**3.65**

Performance review

- The S&P/ASX 300 Accumulation Index fell 2.64% in the first quarter of the year, with falls in Information Technology and Consumer Staples and A-REITs (property) the strongest sector.
- The Ralton High Yield portfolio finished the quarter down 3.54%, underperforming the benchmark by 0.90%.
- For the quarter, being underweight Materials, together with poor returns from our Materials exposures detracted from portfolio returns.

Performance attribution

Key contributors

Key contributors	Positioning
Macquarie Atlas Roads (MQA)	Overweight
Amcor Limited (AMC)	Overweight
Sky Network (SKT)	Overweight

Macquarie Atlas Roads (MQA, +17.8%) - shares in the toll road owner added value in the March quarter, following both solid performance from MQA's core assets, together with the potential for corporate activity at an asset level. MQA's key toll road, APRR in France, was a beneficiary of solid growth in traffic, particularly the higher-fee-paying heavy vehicles or trucks. Growth in truck movements suggests some strength in the French economy, particularly the industrial base. On the corporate front, MQA indicated that it has right of first refusal when its partners, including Macquarie 'sister funds', complete the tender process for their stake in Dulles Greenway. MQA could potentially acquire 100% of this asset, however in the current environment it seems more likely it will sell its stake to the highest bidder. In all likelihood, this capital will be returned to shareholders in some form.

Amcor Limited (AMC, +6.8%) - shares finished the quarter higher after a strong profit result for the half year, a result that highlighted the strength of AMC's global packaging offer and the customer and regional diversity it brings. In particular, AMC reported solid volume demand in Europe and strong demand for drinks volume in the US and parts of Latin America. In recent years, emerging markets have been the key driver of volumes at AMC, so it is pleasing to see the larger, developed markets deliver some improved volumes. AMC continues to acquire bolt-on packaging businesses, particularly in emerging markets, noting small acquisitions in both India and China in recent periods.

Sky Network (SKT, +6.1%) - shares in the New Zealand pay TV operator rallied despite a mixed profit result and muted outlook. Like many media companies, SKT is under pressure as eyeballs continue to switch mediums and consume media and entertainment content via different channels. In our view, SKT still owns the key content that Kiwis want to watch and is also moving to offer its content over a diverse array of channels and distribution options. Our recent meeting with management highlighted that SKT is abreast of these issues and seeking to compete effectively. The roll-out of SKT's digital offering is proceeding well and the recent deal with telco distributors (Vodafone) is having good success. Assuming SKT can continue to defend its business against competitors, we believe it offers good value at the current share price.

Key detractors

Key detractors	Positioning
Incitec Pivot (IPL)	Overweight
Super Retail Group (SUL)	Overweight
QBE Insurance (QBE)	Overweight

Incitec Pivot (IPL, -19.4%) - shares fell heavily in January as investors and market analysts alike took a negative view of the mounting price headwinds in several of IPL's key business exposures. With the sustained fall in the oil price sending a deflationary push through the commodity sector, prices for global gas used in production of both urea and ammonia – key IPL products – were falling. In the US, where coal mines are key customers of IPL's explosives businesses, an unseasonably warm winter has reduced the demand for electricity and with it, coal demand. Several of the US coal producers are under financial duress, although we note the bulk of IPL's customers operate low-cost, top quality mines. Pricing for the DAP fertilizer segment has weakened, though this is seasonal as global pricing is typically set in March/April. Although we recognise the effect of these impacts, we subscribe to the view that the oil price will rebound and with it, pricing for each of the outputs tied to energy prices. As such, IPL should produce solid cash flows across the cycle, which is not reflected in the current share price.

Super Retail Group Ltd (SUL, -25%) - profit results for the first half of FY16 disappointed overall expectations with the group's leisure businesses, BCF and Ray's, disappointing investors. BCF was the key negative as its offering was not competitively priced versus its main competitor and this led to weak sales in the key pre-Christmas months of November and December. Both the auto and sports divisions produced very solid results, exceeding most market forecasts, but this was not enough to offset the weakness in leisure. SUL's management has identified strategic shortfalls in the sales program for BCF and has taken steps to improve delivery and ensure sales momentum is not lost in the key sales window again. Early results are positive with strong sales growth highlighted in January and February, yet despite this, we remain cautious on this division and frustrated that management continues to fail to get to grips with the diverse array of businesses.

QBE Insurance Group (QBE, -13.3%) - was weaker during the quarter as investors remained concerned about margin pressure across the global insurance sector and declining bond yields. QBE relies on bond yields for its investment returns. With global volatility rising and bond yields falling, the market was factoring less uplift in bond returns than what they were anticipating at the end of 2015. Despite this, we have been impressed by cost efficiencies delivered by QBE in recent years and believe the business is in solid shape. QBE has also made major strides in improving the quality of its capital position and reducing the risk associated with its insurance book. Finally, after many years of shrinking the business and focusing internally, QBE management is able to target growth across its businesses by acquiring specialist underwriting teams – something that would be well received by investors.

Portfolio additions and disposals

Key additions and material adjustments

Bought
Orora Limited (ORA)
Telstra Corporation (TLS)
DUET Group (DUE)

There were three new stock additions to the portfolio during the month, plus the addition of UK-based bank, CYBG Plc (CYB), following the demerger from NAB.

Orora Limited (ORA) - we added ORA back to the portfolio following a pull-back in the share price. Since the demerger from Amcor (AMC) in December 2013, ORA's profit growth has been delivered from self-help initiatives largely focused on its Australian operations devoted to Australian-oriented packaging, bottles, cans and paper/fibre packaging. The US side of the business provides ORA with growth opportunities given the marketplace is more fragmented than in Australia. In the near term, we expect US sales to approach 50% of ORA's total sales.

With internal self-help initiatives almost completed, ORA is shifting towards a more active investment phase with two recent announcements involving approximately $150m of committed spending. Firstly, the company decided to expand glass manufacturing capacity at Gawler in South Australia to meet growing demand for bottled wine – linked to the weakening Australian dollar – and secondly, ORA acquired IntegraColor, a specialist US-based packaging business. Given its track record to date, we have a supportive view of ORA's management and its decision to invest these funds to grow the business and meet its own investment hurdles.

Telstra Corporation (TLS) - we added TLS back to the portfolio in February, having seen the share price pull back somewhat since we last held the stock in mid-2015. The February profit results were largely as expected and despite improvement from competitors, TLS retains the dominant mobile network in Australia. As the NBN roll-out gains traction, and with it a series of billion dollar cash payments flow to TLS, investors continue to focus on where TLS will invest its capital. The recent decision not to pursue an investment in the Philippines mobile market suggests management will be disciplined.

DUET Group (DUE) - was the final addition to the portfolio. DUE owns a series of long-life infrastructure assets including the Dampier to Bunbury Pipeline (DBP) and gas and electricity networks in south east Australia and last year, purchased Energy Developments (ENE) – at the time, a portfolio holding for the Ralton High Yield portfolio. ENE in turn owns and operates a series of long-life, contracted utility assets. Included in ENE's portfolio are a series of low greenhouse gas emission, energy and remote energy generation plants for multiple clients. The company is likely to have opportunities to add to its asset base in time, and we expect further opportunities will be examined under DUE's ownership. As an example, we note DUE recently raised equity to increase its ownership of DBP to 100%. DUE offers a solid, cash covered yield of circa 8%.

Key disposals and material adjustments

Sold
Sky City Entertainment (SKC)
Navitas Limited (NVT)
G8 Education (GEM)
Transpacific Industries (TPI)

There were four outright stock sales from the portfolio during the quarter.

Sky City Entertainment (SKC) - a profit upgrade from the company in January was well received by the market and allowed us the opportunity to take profits and sell our position. SKC continues to operate well with favourable tailwinds in the form of the Auckland economy and rising tourism into NZ, supported by a strong management team leading the key casino asset in Auckland to report strong profit growth. However, with SKC about to embark on significant capital expenditure and projects in both Auckland and the smaller Adelaide asset, which continues to struggle from an operational perspective, our view was to take profits and watch for a potential cheaper entry point in the future.

Transpacific Industries (TPI) - TPI's solid share price recovery in recent periods led to our decision to exit the stock. The turnaround under CEO Vik Bansal appears to be gaining some traction and to some degree reflects the strategic changes implemented by Bansal's predecessor. Although we expect steadily improving conditions for the core waste business, we are cognisant of the pressure that further oil price weakness will place on the smaller hydrocarbons segment. Despite the improved operating results, we believe further upside in the short term may be capped by ongoing cash flow drain caused by the landfill provisions and need for ongoing remediation work at some of the older assets. We will look to revisit TPI should valuation become more compelling.

Navitas Limited (NVT) - we elected to sell our holding in education provider, NVT. The shares have performed strongly in recent times in a weak market. Although the company is making headway in terms of improved profitability of the smaller SAE division and continues to grow its college offering offshore, the headwinds from the loss of a key Sydney contract appear to be proving harder to offset at the profit line. By itself, our sense was that this longer time frame was acceptable as an investment proposition, however the prospects for emerging markets and key education source countries have worsened. Although families frequently sacrifice most items for their children, we are concerned that the coming periods may see education demand from the emerging markets temper with a flow-through impact on NVT's outlook. Given the valuation and recent performance, we elected to sell, but like TPI, we will keep NVT on our investment radar.

G8 Education (GEM) - despite some solid progress around governance, including a new Chair, auditor appointment and reasonable operating conditions, we remain concerned about financing risk for GEM. We have provided management ample time to resolve this and in the current climate, we believe the refinance risks are rising. Further, the exit of CFO, Chris Sacre, to take on a consulting role for the development and sale of childcare assets back to GEM raises some questions as to corporate governance.

Sector allocation

GICS sector	Ralton	Index	+/-
Consumer Discretionary	13.8%	5.3%	8.6%
Consumer Staples	9.3%	7.2%	2.1%
Health Care	8.8%	6.8%	2.0%
Financials (ex-Property)	38.0%	36.9%	1.1%
Energy	4.3%	4.1%	0.2%
Materials	13.1%	13.0%	0.1%
Utilities	2.1%	2.5%	-0.4%
Information Technology	0.0%	1.2%	-1.2%
Telecommunication Services	3.8%	5.5%	-1.7%
Industrials	5.2%	8.4%	-3.2%
Property	1.7%	9.1%	-7.3%
Total	100.00%	100.00%	

Top 10 holdings#

Company name	ASX code
Westpac Banking Corporation	WBC
National Australia Bank	NAB
Commonwealth Bank of Australia	CBA
Amcor Limited	AMC
Aristocrat Leisure	ALL
QBE Insurance Group	QBE
AMP Limited	AMP
Macquarie Atlas Roads Group	MQA
CSL Limited	CSL
Star Entertainment Group Ltd	SGR

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