Ralton Smaller Companies
PERFORMANCE REPORT
31 May 2016

Total returns

At 31 May 2016	1 mth %	3 mths %	6 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	7 yrs % p.a.	Inception % p.a. (Feb 2008)
Ralton Smaller Companies	4.84	12.08	7.61	7.32	14.20	11.81	15.11	7.75
Income return	*0.00*	*1.10*	*1.44*	*3.05*	*3.23*	*3.50*	*3.60*	*3.73*
Growth return	*4.84*	*10.98*	*6.18*	*4.26*	*10.97*	*8.32*	*11.51*	*4.02*
S&P/ASX Small Ord Accum. Index	4.09	13.12	12.60	6.91	6.93	0.21	5.14	-0.88
Difference	**0.75**	**-1.04**	**-4.98**	**0.40**	**7.26**	**11.60**	**9.97**	**8.63**

Performance review

- The S&P/ASX Small Ordinaries Accumulation Index gained 3.69% in May, with Financials and Health Care the top performing sectors.
- The Ralton Smaller Companies portfolio added 4.84% for the month, outperforming the benchmark by 1.15% for the period.
- Our overweight position in Health Care, together with our underweight in Materials, specifically metals and mining names, contributed to the outperformance.

Performance attribution

Key contributors

Key contributors	Positioning
Aristocrat Leisure Limited (ALL)	Overweight
Fisher and Paykel Healthcare (FPH)	Overweight
Cybg PLC (CYB)	Overweight

Aristocrat Leisure Limited (ALL, +28.6%) – added significant value to the portfolio following a 20% upgrade to profit guidance for the 2016 financial year. The profit uplift was driven by a number of factors including market share gains in Australia and North America, continued growth in participation gaming machine installations (annuity-style income) and continued stellar growth for the Digital division (from a low base). This growth reflects the continued investment in product by ALL through its studio strategy. Looking forward, we believe ALL's operating momentum should continue while its main peers remain distracted by their own large-scale acquisitions. With a strong balance sheet and free cash flow, ALL has the option of increasing distributions or making another acquisition. We are comfortable with ALL pursuing acquisitions given its success integrating VGT and Product Madness.

Fisher and Paykel Healthcare (FPH, +18.2%) – a strong profit result for the FY16 financial year, including an approximate 50% increase in operating profit, excluding any currency-driven hedging impacts, saw FPH shares gain ground. Both key operating divisions reported solid revenue growth, suggesting ongoing market share gains for the OSA (obstructive sleep apnoea) division and further penetration of various hospital-based treatments for the RAC (respiratory) division. In the medium term, ongoing growth and penetration of hospital-based oxygen treatments, the recent in-sourcing of FPH's US sales force and expanded manufacturing capacity in lower-cost jurisdictions, should all contribute to future profit growth. Further over the horizon, we have a positive view on FPH's use of various 'oxygen'-based treatments in COPD (Chronic Obstructive Pulmonary Disorder) in the home setting and perhaps in the surgical setting, reducing complications and costs. Evidence for the use of FPH's technology in these areas is building, but we do not expect material contribution to sales for several years.

Cybg PLC (CYB, +35.1%) – shares in mid-tier UK bank, Clydesdale and Yorkshire Banking Group, rose across the month as 'Brexit' fears eased and following the well-received half-year profit result – the first major update since CYB demerged from NAB earlier this year. The key driver of the strong result was the achievements on costs to date and the full-year guidance around costs. Specifically for the current year, CYB lowered its cost-to-income ratio guidance by a little over 2%, but also clearly stated its intent to continue to lower costs in the years to come. Given that the potential to lower the bank's cost-to-income ratio (from a very high 72% into the high 50s) was part of our thesis for adding to the holding post-demerger, this was a pleasing result. Other aspects of the result were broadly as expected and CYB has now made all key appointments of senior executives post the demerger.

One risk to any UK business at present is the pending Brexit vote or referendum in the UK which is focused on remaining in the European Union, scheduled for 23 June. We continue to monitor this event closely as we note that in the short term, there is potential for disruption to the UK financial system should a 'yes' vote occur.

Key detractors

Key detractors	Positioning
Sky Network Television Ltd (SKT)	Overweight
Speedcast International Ltd (SDA)	Overweight
MG Unit Trust (MGC)	Overweight

Sky Network Television Ltd (SKT, -13.6%) – a fall in pay TV subscriber numbers and subsequent profit downgrade for FY17 led to a material fall in SKT shares. The fall in subscribers was somewhat greater than what the company had flagged last October, when it forecast an expected fall after the Rugby World Cup. Despite, this clear negative, our recent meeting with the company in Auckland provided us with some confidence that SKT's recent headwinds, including cyclical factors, new competitors and rising content costs are abating.

In the pay TV space, our view is that content ownership is key and on this score SKT has 'locked up' all the key content Kiwis want to watch through multi-year agreements. The market remains concerned about the impact of competitors like Netflix, but SKT has had the benefit of watching what happened in other markets and learning from those experiences. SKT has locked up key content for sports (with the benefit of no anti-syphoning laws as we have in Australia), cable channels and movies, albeit at increased cost. This makes it very tough for competitors to obtain scale and get onto a path to profitability. Whilst it will take time to play out, we felt the stock had been oversold and hence increased our position following the profit downgrade.

Speedcast International Ltd (SDA, -13.3%) – shares in SDA were lower across May, tempered by cautious comments from management at the AGM who specifically flagged delays in terms of contract awards in the energy segment and their service start-up being pushed out. This in turn has been driven by the pressures on the oil industry at present. All the same, energy is a smaller part of SDA's business which primarily services the growing demand for telecommunications services to shipping lines and other remote business locations. As such, the current moderation of growth should only be temporary and we expect SDA to grow substantially through acquisition and organically in coming years.

IOOF Holdings Limited (IFL, -7.7%) – underperformed following a somewhat modest profit downgrade. Specifically, IFL flagged that underlying net profit for the current financial year will be broadly in line with last year's profit figure. This was several per cent below market expectations, with revenues for IFL "adversely affected by equity market devaluations." So, yes, market volatility has affected fund balances and likely tempered in-flows. It also appears likely IFL were 'cleansing' the market with its current profit expectations ahead of a possible acquisition, in turn requiring a potential capital raising. IFL were in the running to purchase NSW-focused State Super Financial Services (SSFS). As it turned out, IFL were not the successful bidder.

Portfolio changes

Key additions and material adjustments

Bought
Cybg PLC (CYB)
Evolution Mining Limited (EVN)
Northern Star Resources Ltd (NST)
Nufarm Limited (NUF)
Steadfast Group Ltd (SDF)
Worley Parsons Ltd (WOR)

There were several new stocks added to the portfolio during the month, noting that **Cybg PLC (CYB)** has already been discussed.

We added two gold exposures to the portfolio, namely **Evolution Mining Limited (EVN)** and **Northern Star Resources Ltd (NST)**. Both of these names have a strong capital position and across their portfolios mining costs are heavily biased to the first and second quartile of global production (i.e. low-cost mines). Australian gold miners have benefited in recent times from the falling Australian dollar which increases the value of gold sales, while the bulk of their costs are Australian dollar based. With costs across the whole mining sector falling as miners seek large productivity improvements, this has been highly favourable to the gold names as the gold price has trended higher. Going forward, we expect both EVN and NST to participate in further industry consolidation as it arises.

Nufarm Limited (NUF) – we added global crop protection specialist, Nufarm Ltd, back into the portfolio having exited the position late in 2015 when the share price was higher. With the valuation coming back to a more realistic level, we were comfortable to begin buying the stock again. Our investment thesis is unchanged however, highlighting the benefits of costs savings, productivity measures and a simplified, strategic focus. At a recent investor day, we gained further insights and confidence into the strategic focus and management team changes that NUF has undertaken and hence our confidence to re-enter the stock. Critically, we look to NUF to not only achieve the costs savings, but to retain them on an ongoing basis.

Steadfast Group Ltd (SDF) – we acquired a small position in SDF, Australia's largest general insurance broker - a service provider and equity investor for insurance brokers in Australia, New Zealand and Singapore. SDF's broker network distributes general insurance products and related services to the SME segment of the market. SDF also operates a number of specialist insurance agencies focusing on businesses such as caravan parks and boutique transport operators. One of the key drivers of SDF's profitability is the position in the insurance premium cycle. SDF has been early in calling that we will see hardening insurance premiums in the Australian market given the lack of profitability in a number of key lines for insurers. Our discussions with other parties also suggest the premium cycle is hardening and this is an attractive point of the cycle to invest in an insurance broker as they take commissions on the rising premiums upfront (as opposed to insurance companies which earn the premium over time). At our recent meeting with management, we walked away impressed by the investment SDF is making in its service offering, and in particular, in its IT systems. All of this is very user friendly and designed to assist the brokers in accessing a full range of service options and ultimately, becoming more efficient. The group should also be able to continue down the path of acquiring more insurance broking businesses to further enhance growth.

Worley Parsons Ltd (WOR) – we added a position in WOR following its investor day in late May. WOR is a contract engineering service provider, focused predominantly on the energy sector. WOR is a former market darling, however with the downturn in the oil price, as a service provider to the hydrocarbon industry, WOR has been hit hard by the collapse in capital investment across the sector. The investor day provided Ralton with comfort on two key fronts. Firstly, WOR's actions to downsize its operations are progressing and the likelihood is that capital expenditure across the sector is nearing a bottom, suggests further steep declines in WOR's profits are unlikely. Secondly, under new CFO, Tom Honan, we believe WOR has a clear strategy to improve its cash flow and continue the repair of its balance sheet. Honan was CFO of Transurban post GFC, where he had to repair the capital structure which was too aggressive in the post-GFC environment. We are more confident after the investor day that Honan will be able to contribute to the improvement of the WOR capital structure to adapt to the post-oil boom environment. On the basis of these two factors, the stock looked attractive from a valuation perspective.

Key disposals and material adjustments

Bought
Blackmores Limited (BKL)
Vitaco Holdings Ltd (VIT)
Super Retail Group Ltd (SUL)

There were three outright sales from the portfolio during the month of May.

Blackmores Limited (BKL) – we exited BKL, one of our more successful, long-held investments during the month. This sale was driven by both valuation considerations and also regulatory concerns that relate to BKL's key growth market, China. Despite some confusion, the recent regulatory changes by the Chinese authorities in relation to the importation and sale of vitamins and other food products into China appear to be driven by a desire to increase taxes for the central government and provide greater regulatory oversight for Chinese consumers. We note however, that these regulatory changes will likely have some negative impact on BKL, certainly in the short term and in the long term it is simply too hard to say with any conviction. These measures will impact BKL's direct retail sales in China, its online or e-commerce sales and also the 'grey market' of friends and relatives who purchase goods in Australia and transport or perhaps post them into China. BKL's long-term presence in China will no doubt assist the company in navigating a pathway through these changes in time, though to be clear, we felt the current climate was simply too uncertain upon which to maintain our investment.

Vitaco Holdings Ltd (VIT) – we also exited our position in the NZ-based consumer goods company, Vitaco. Since we last increased our position, the stock has performed quite well, and to be fair, we continue to like the brand proposition and global focus VIT is taking to expansion. As examples, we note VIT is a leading provider of health food products into the Middle East, it has recently signed an agreement with Boots in the UK to distribute its 'body building' brands and also continues its aggressive expansion into the Chinese vitamin and milk channels – unlike BKL, VIT sales into China are quite a modest percentage of overall sales. In the short term however, our sense is VIT has material investment ahead to recognise its potential. Sales, marketing and distribution costs are all set to be increased, having perhaps been 'fine-tuned' ahead of the prospectus in order to maximise near-term profits.

Super Retail Group Ltd (SUL) – after reducing the position following a poor profit result for SUL in February, we fully exited the stock in early April. We still harbour concerns as to management's ability to improve returns from the Leisure division and also note the potential for larger scale foreign players in the mass sports category to impact on returns and market share gains for both Rebel Sport and Super Amart.

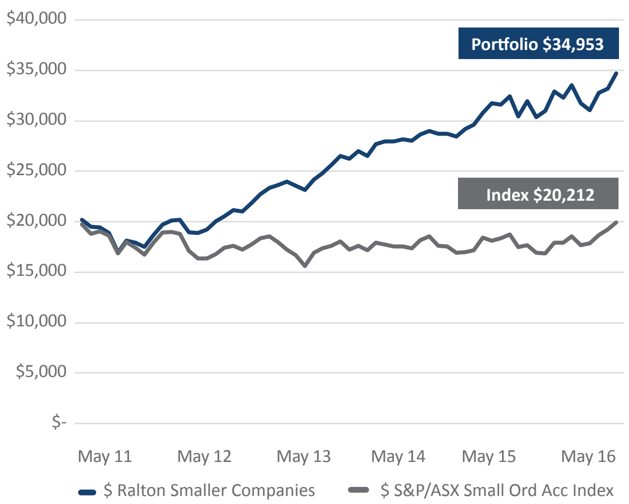
Sector allocation

GICS sector	Ralton	Index	+/-
Financials (ex-Property)	14.5%	7.9%	6.5%
Consumer Staples	13.7%	8.0%	5.6%
Industrials	12.1%	10.2%	1.9%
Telecommunication Services	2.5%	1.4%	1.2%
Health Care	7.4%	6.7%	0.7%
Energy	4.0%	3.7%	0.2%
Materials	18.0%	18.3%	-0.2%
Consumer Discretionary	22.6%	23.1%	-0.5%
Utilities	0.0%	0.9%	-0.9%
Information Technology	2.4%	7.7%	-5.4%
Property	2.9%	12.1%	-9.2%
Total	**100.0%**	**100.0%**	

Top 10 holdings#

Company name	ASX code
Macquarie Atlas Roads Group	MQA
Fisher & Paykel Healthcare Corporation	FPH
Sky Network Television Ltd	SKT
Fletcher Building Limited (Australia)	FBU
Tassal Group Limited	TGR
Aristocrat Leisure Limited	ALL
News Corporation	NWS
Ardent Leisure Group	AAD
Costa Group Holdings	CGC
SAI Global Limited	SAI

Performance comparison of $20,000*



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* The performance comparison of $20,000 over 5 years is for illustrative purposes only. All returns shown are based on Australian dollar figures. Past performance is not a reliable indicator of future performance. The total returns shown are prepared on an exit-to-exit basis (i.e. they include all ongoing fees and expenses and assume reinvestment of all distributions). They do not take personal taxation into account. The comparison with the S&P/ASX Small Ordinaries Accumulation Index is for comparative purposes only. Index returns do not allow for transactional, management, operational or tax costs. An index is not managed and investors cannot invest directly in an index. There is no guarantee these objectives will be met.

Portfolio holdings may not be representative of current or future recommendations for the portfolio. The securities listed may not represent all of the recommended portfolio’s holdings. Future recommended portfolio holdings may not be profitable.

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