Total returns

At 31 August 2017	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 Australian Shares	-0.25	-0.94	3.96	12.77	9.85	14.20	11.39	7.64
Income return	*0.82*	*0.92*	*1.95*	*3.78*	*3.68*	*3.82*	*4.14*	*4.30*
Growth return	*-1.07*	*-1.86*	*2.02*	*8.99*	*6.17*	*10.38*	*7.24*	*3.34*
S&P/ASX 300 Accum. Index	0.75	0.99	2.43	9.54	5.16	10.41	8.40	4.62
Difference	**-1.00**	**-1.93**	**1.53**	**3.23**	**4.69**	**3.79**	**2.99**	**3.01**

Performance review

- The S&P/ASX 300 Accumulation Index made a small gain in August, finishing 0.75% higher for the month. Strength in Energy and Consumer Staples added value to the benchmark, with Telecommunications the key negative sector.
- The Ralton Australian Shares portfolio returned -0.25% for August, underperforming the benchmark by 1.00%.
- For the month of August, being overweight Energy added value to the portfolio, offset by stock selection within Health Care and Financials, both of which detracted materially from returns.

Performance attribution

Reporting season was the key driver for many of our portfolio holdings in August. Listed companies report their financial progress for the completed period (half- or full-year results) and provide outlook commentary on the period ahead. As well as highlighting the portfolio's top and bottom performers in terms of return against the benchmark, we also highlight two stocks, Telstra Limited (TLS) and Commonwealth Bank of Australia (CBA), both of which are high profile Australian companies which were down materially for August, impacting investors' absolute dollar returns from the portfolio.

Commonwealth Bank (CBA) - CBA has fallen almost 7.5% over the past month (ex-dividend payment) while most other major banks remained flat. This decline is mostly due, in our view, to the revelations about the Austrac anti-money laundering court case. The case involves automated cash sorting machines which were allegedly used by money launderers. CBA has admitted there was a software error which caused the problem to persist, but once the code was changed the problem was eliminated. The positions of the parties appear to be:

- Austrac – CBA allowed 53,700 contraventions involving 'serious and systematic non-compliance' with the Anti-Money Laundering and Counter-Terrorism Financing Act which requires banks to report cash transactions. Late lodgement carries a penalty of up to $18m per offence.
- CBA – has expressed the view the contraventions could be considered to arise from a single course of conduct to the extent that they emanated from the same system error.

We would also make the following observations: -

- ASIC has launched an investigation into the AML matter as well, focusing on the culture of the whole CBA organisation. This matter has further raised the risk of a full Royal Commission into the major banks and the distractions that this would bring.
- Since the announcement was made about the Austrac lawsuit, Ian Narev has announced his intention to retire by mid next year. This is never a good look as it does imply there was responsibility for the actions and it was not just a simple system error. There are also suggestions the bank is looking outside the organisation for a new CEO and other internal management will depart. This will be a major distraction for the organisation in a competitive market.

We initially felt the stock's fall reflected an adjustment for the uncertainty and it would likely trade in line with its peers for a period. However, recent news reports suggest other potential transaction monitoring issues in the institutional business, which has grown very rapidly in recent years in foreign jurisdictions. CBA has argued this was part of a move from manual systems, but the report suggests there were holes in the system. As an external party, it is difficult to get a true read on what the facts actually are. However, this will likely lead to further investigations and management distraction.

Given this latest revelation we are becoming more concerned the issues within CBA may be systemic and have elected to reduce the position size. From late August we have reduced the portfolio's holding in CBA by circa 5%. We will continue to monitor developments, including public announcements by the bank, and highlight the core tenant of our investment process of the need for companies to maintain a social license to operate.

Telstra Limited (TLS, -6.6%, ex-dividend) - As readers will be aware, TLS has been undergoing a substantial change to its business model with the fixed line voice and broadband infrastructure businesses being re-nationalised by the government through the NBN. As a result, TLS was expected to lose $2.0bn to $3bn of annual EBITDA and would be paid in the order of $9bn in return. To offset these earnings headwinds, TLS needs to grow its mobile business, cut costs and grow into new service areas such as Cloud computing and security services. Prior to this result, we had been of the view the earnings hole was likely around $2.5bn (based on NBN's FY20 revenue expectations). However, the company has now said the hole will be closer to $3bn. In addition, TLS has re-set the dividend to a more sustainable level, and will distribute the balance of NBN payments separately to the dividends.

We expect TLS can replace about $2-$2.2bn of this earnings hole and believe management has been conservative about the margins it can achieve in the NBN reseller business.

In conclusion, we view that TLS management has rebased earnings with more conservative assumptions, although the company does need to deliver on productivity improvements and the delivery of some growth from new businesses to achieve the earnings we expect. At the current share price, we view the stock as cheap, although it may trade at these levels for a period whilst the market gains confidence in the company's capacity to deliver.

Key contributors

Key contributors	Positioning
WorleyParsons Ltd	Overweight
IOOF Holdings Ltd	Overweight
Evolution Mining	Overweight

Worley Parsons Ltd (WOR, +13.8%) – in line with our investment thesis, Worley's FY17 profit result confirmed a stabilisation in revenues, improved cash flows – including the collection of outstanding payments from various sovereign clients – and solid EBIT margins. This confirmed that WOR has been successful in adjusting its cost base in the face of a downturn in its core hydrocarbons market. The outlook for WOR remains positive, with a bottoming in its global clients' capital expenditure budgets, an improving win rate on large tenders and management expecting to retain savings, which will boost margins as demand returns. Visibility on the strength and timing of any uptick in demand remains limited and dependent on the vagaries of oil price movements. This continues to check our position size on the WOR investment and we elected to take some profits in August. We continue to monitor OPEC supply cuts closely.

Fellow Energy sector holdings **Origin Energy (ORG, +10.6%)** and **Santos Limited (STO, +10.9 %)** were also boosted by cost efficiencies, simplification and ongoing balance sheet deleveraging, outperforming the market despite the oil price being slightly down for the month.

IOOF Holdings (IFL, +10%) – a solid profit result for IOOF, boosted by strong industry FUM flows and the benefit of an increase in the number of financial planners operating under the IFL banner, was well received by investors. This profit number was supported by cost savings called out by the CFO at the half year result and delivered in spades for the second half of the year. It was pleasing to see the growth in planner numbers as we believe this reflects the attractiveness of the IOOF platform. As we have written previously, IOOF have worked extensively on the flexibility, or 'open architecture', of its investment platforms which allows advisers to personalise investment services rather than being restricted to in-house product offers. We like IOOF's focus on the customer which differentiates it from the big banks and other large financial institutions.

Evolution Mining Limited (EVN, +9.0%) – North Korean geopolitical tensions saw the gold price push 3% higher in August, passing through the US$1300/oz mark and boosting the gold sector in turn. Our preferred gold stock, EVN reported a very clean set of financial results and mine operating performance in FY17, which combined with moves by the board to boost to the dividend was well received by investors.

Key detractors

Key detractors	Positioning
Japara Healthcare	Overweight
QBE Insurance Group	Overweight
iSelect Ltd	Overweight

Japara Healthcare (JHC,-17.2%) – a low quality FY17 profit result and guidance for the coming year disappointed investors in nursing home operator Japara. The key pressure point for JHC was the fall in government reimbursement and rise in labour costs across its portfolio. These government fee freezes were already known to the market, having driven a material fall in JHC shares from their 2015 peak, ahead of our initial purchase. However, the degree and duration of these factors, together with recent labour cost pressures – JHC has a strong bias to Victoria where public nurse EBA-driven pay rises have been above the nation's average – are set to crimp margins in the coming year. In response, JHC is seeking to improve efficiencies and boost margins. However, ahead of the ACFI freeze lifting in FY19, the coming year looks challenging for JHC and the industry. In the medium term, return of CPI type government fee increases, a shift toward discretionary payments and scale benefits as JHC bed numbers increase paint a more positive outlook for our investment. Our view that JHC's land assets and operating businesses are being undervalued by investors remains unchanged.

QBE Insurance Group (QBE, -11.9%) – having downgraded full year profit expectations in June, QBE's half year profit and guidance were a further disappointment to investors. The issues cited were largely a continuation of various losses in emerging markets. Unfortunately, this latest unexpected issue comes on the back of a raft of profitability concerns in various segments over recent years. Each time, QBE has promised to address or divest the offending business and appointed new management, but new problem areas have consistently sprung up from unexpected corners. Although some blame can certainly be laid at the feet of management and the type of insurance business being written, the global industry has been under pressure for some time, impacted by excess liquidity globally and the lack of fixed income returns. We see it as inevitable that these pressures ease – typically a major insurance event, such as a US cyclone, creates extensive industry losses and sees a return to more rational pricing and often an increase for insurance policy coverage.

In this context, the misses we keep seeing by QBE are a function of the fact it has no hidden buffers left after such a long period of revenue decline. Investor confidence in QBE is low despite a five year program of cost-out success, a turn up in premium rates, reinsurance efficiencies and faster than expected portfolio remediation in Australia. We will continue to monitor improvements in the global premium cycle and interest rates to determine the positioning going forward.

iSelect Limited (ISU, -17%) – ISU's FY17 profit met the company's forecast earnings range for the financial year, though fell some $1.5m short of the top of its guidance. The 'shortfall' was driven by some consumer softness in the fourth quarter in the Energy and Telco sector, a smaller tax-driven private health insurance push in late June and increased investment in its South African consultant centres, which was a decision made in March against a slightly more positive trading backdrop. The market's disappointment was severe as investors quickly revisited the credibility issues of the 'old ISU' and wiped a good portion of the last year's share price gains from ISU's value. In the medium term, we believe that ISU's offering to consumers, its linkage with key product providers, increasing diversification of earnings streams and the positive steps taken by the management team have not disappeared. The net cash backing of the balance sheet, ongoing share buyback and valuation support add strength to our conviction. We will be looking for positive signals that ISU remains on track to hit FY18 targets before increasing our position.

Portfolio changes

Key additions and material adjustments

Bought
Wesfarmers (WES)

We added a position in Australian conglomerate **Wesfarmers (WES)** to the portfolio in August. Although perhaps needing little introduction, we would remind investors that WES owns retail operations across Coles supermarkets, 'category killer' Bunnings, Kmart, Target and Officeworks, in addition to industrial, chemical and coal mining operations. Coles and Bunnings are the biggest contributors, each accounting for nearly 30% of annual WES profits.

The shares have traded sideways in recent period, impacted by the resurgence of Woolworths' supermarkets under Brad Banducci and Aldi's expanding footprint in Australia. This competitive dynamic has seen Coles somewhat on the back foot, with sales and margin momentum pressured. Assuming that a price war does not break out amongst the supermarket majors, we expect Coles to be able to re-focus its own business and produce solid profitable returns. Bunnings and Kmart remain market leaders, which together with a potential turnaround in Target and reasonable outlook for Asian coal pricing, informs our positive view on WES. WES retains a very healthy balance sheet, is paying out a high portion of annual profits as fully franked dividends and trades at an attractive valuation in the current market.

Key disposals and material adjustments

Sold
Coca-Cola Amatil (CCL)

Having made the decision to invest in Consumer Staples company Wesfarmers, we took the decision to exit our underperforming position in **Coca-Cola Amatil (CCL)** in August. As we discussed last month, a public contract loss and speculation of supermarket ranging issues recently weighed on CCL shares. Firstly, CCL has lost its small but noteworthy contract to supply Domino's Pizzas to competitor Asahi (Pepsi and Schweppes brands). Secondly, it appears that Woolworths has at this stage elected not to stock CCL's new 'Coca-Cola No Sugar' product. Further, speculation persists that Woolworths is limiting shelf space of branded water products, including CCL's Mount Franklin mineral water products. In the short term, such outcomes will reduce CCL's ability to drive volumes via its 'stills' (non CSD products) and delay the re-balancing of its business. Reflecting these concerns, we elected to sell our CCL position, preferring to invest in WES.

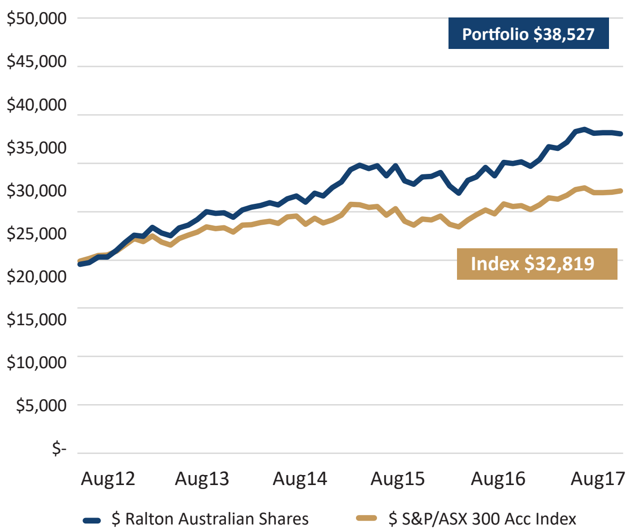
Sector allocation

GICS sector	Ralton	Index	+/-
Energy	8.8%	4.3%	4.5%
Consumer Discretionary	8.4%	5.1%	3.4%
Consumer Staples	9.8%	7.4%	2.4%
Information Technology	3.7%	1.5%	2.2%
Materials	18.1%	17.3%	0.9%
Telecommunication Services	2.9%	3.2%	-0.3%
Health Care	5.0%	6.9%	-2.0%
Utilities	0.0%	2.2%	-2.2%
Real Estate	5.8%	8.3%	-2.5%
Financials	33.1%	36.3%	-3.1%
Industrials	4.3%	7.5%	-3.2%
Total	**100.0%**	**100.0%**	**0.0%**

Top 10 holdings#

Company name	ASX code
Commonwealth Bank of Australia	CBA
BHP Billiton Limited	BHP
Westpac Banking Corp	WBC
ANZ Banking Group Limited	ANZ
Woolworths Limited	WOW
National Australia Bank Limited	NAB
Aristocrat Leisure Limited	ALL
Computershare Ltd	CPU
QBE Insurance Group Limited	QBE
Boral Limited	BLD

Performance comparison of $20,000*



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Performance of the Ralton Wholesale Australian Shares Model Portfolio is based on a model portfolio and is gross of investment management and administration fees, but net of transaction costs. The total return performance figures quoted are historical and do not allow the effects of income tax or inflation. Total returns assume the reinvestment of all portfolio income. Past performance is not a reliable indicator of future performance.

*The performance comparison of $20,000 over 5 years is for illustrative purposes only. Performance is calculated on a gross basis. Actual performance will vary depending on the amount of fees charged by the relevant platform that a client uses to implement the portfolio. The comparison with the S&P/ASX 300 Accumulation Index is for comparative purposes only. Index returns do not allow for transaction, management, operational or tax costs. An index is not managed and investors cannot invest directly an in 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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