

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 Leaders	0.34	0.03	3.83	12.09	8.35	12.73	10.36	6.89
Income return	0.84	0.96	2.10	3.88	3.94	4.04	4.30	4.52
Growth return	-0.50	-0.93	1.73	8.22	4.41	8.69	6.06	2.37
S&P/ASX 100 Accum. Index	0.54	0.55	2.11	10.28	5.10	10.81	8.85	5.08
Difference	-0.20	-0.52	1.73	1.81	3.25	1.92	1.51	1.81

Performance review

- The S&P/ASX 100 Accumulation Index was up only slightly in August, gaining 0.54%. Solid gains from Energy and Consumer Staples were offset by a large fall in the Telecommunications sector.
- The Ralton Leaders portfolio added 0.34% in August, underperforming the benchmark by 0.20%.
- For the month of August, being overweight the Energy and Consumer Discretionary sectors added value for the portfolio, offset by stock selection amongst Industrials.

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
Evolution Mining	Overweight
Treasury Wine Estates	Overweight
IOOF Limited	Overweight

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.

Treasury Wine Estates (TWE, +18.9%) – Michael Clarke led TWE continued its recent record of delivery in FY17, with investors rewarded accordingly. The new brand-led TWE has optimized its supply chain, improved the quality of its mix of wines and is now far more accomplished at directing its higher quality wines to optimal regions and channels across the world. This has driven an improvement in margins and reduced the volatility in profits that many would expect from a wine company.

Under Clarke's leadership, sales trends in each region have improved or stabilized, including in the 'problem child' US market. A stock of aged wine, kept in store and marked at cost on the balance sheet, provides TWE with a buffer against the vagaries of agricultural production. Going forward, TWE has raised the bar further, targeting another material uplift in EBIT margins. Although a date has not been set for this achievement, Clarke's track record and continued ability to over deliver on targets saw the shares well supported in August.

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 has 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.

Key detractors

Key detractors	Positioning
QBE Insurance Group	Overweight
Healthscope limited	Overweight
Boral Limited	Overweight

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.

Healthscope Limited (HSO, -16.4%) – the hospital operator disappointed investors with soft operating results in the second half of the financial year and outlook for basically flat EBITDA in the coming year. The key issue was its Victorian hospitals, where high wage growth for its nursing staff and a series of ramp-up issues at new or relocated facilities offset reasonable operating performance across the balance of the portfolio. New CEO Gordon Ballantyne also highlighted a (largely one-off) rise in corporate costs for the coming year, in what is somewhat expected behaviour for an incoming CEO. We don't believe that these developments will detract from our core thesis for HSO, namely that it is capable of growing admissions around 2-3% per annum and driving some margin improvement as its new brownfield developments ramp up. On this basis we see HSO as reasonable value over the medium term, although as with many turnaround investments, progress in the early stages may be slow and headwinds may persist in the short term. On a positive note, HSO is seeing very solid volume growth in its recently opened brownfield developments outside of Victoria.

Boral Limited (BLD, -3.4%) – fell in value across August despite what we saw as a very solid FY17 profit result. Conditions in Australia for the key construction materials division were very strong as BLD's margins continue to benefit from ongoing demand from the surge in east coast infrastructure. Similarly, returns from the Asian joint venture (USG) confirmed solid growth, benefitting from ongoing penetration of light weight plasterboard in several high growth Asian countries. The legacy US business was a slight disappointment, though minor in the scheme of BLD, post the recently completed acquisition of Headwaters.

Looking forward, the company's guidance for the coming year largely matched our expectations. FY18 will be a critical year for BLD with key deliverables focusing on the merger and successful capture of synergies from the Headwater's acquisition. We have a positive view on the potential for BLD's merged US operations and highlight the positive outlook for FlyAsh, including recent price rises which are expected to benefit the coming year. In Australia, as our regular readers will be aware, we have a constructive view of the ongoing east coast infrastructure pipeline and demand in turn for concrete, quarries and the like. Rising energy costs remain a headwind and will

eat into some of the enthusiasm for profit growth in Australia, as the need to recover material input cost rises does consume some of the pricing benefits that were expected to accrue at this stage of the cycle.

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.

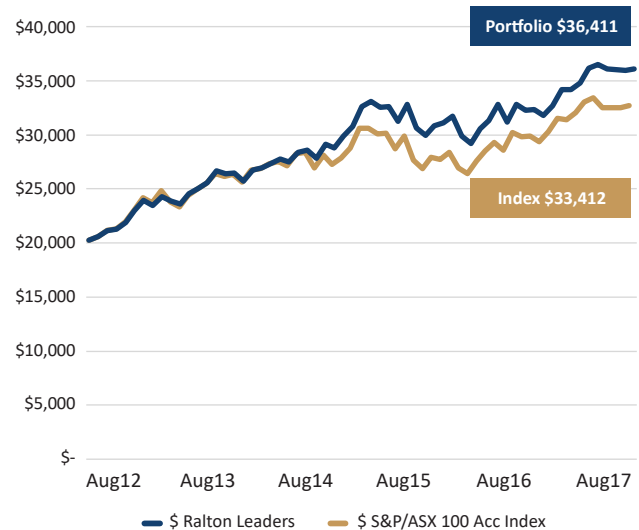
Sector allocation

GICS sector	Ralton	Index	+/-
Energy	8.2%	4.1%	4.1%
Consumer Staples	11.1%	7.1%	4.0%
Information Technology	4.4%	1.0%	3.4%
Consumer Discretionary	5.7%	3.4%	2.3%
Telecommunication Services	3.3%	3.4%	-0.1%
Materials	16.9%	17.3%	-0.4%
Health Care	6.0%	7.1%	-1.1%
Industrials	5.3%	7.3%	-2.0%
Utilities	0.0%	2.4%	-2.4%
Real Estate	4.1%	7.7%	-3.5%
Financials	35.2%	39.4%	-4.2%
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
Wesfarmers Limited	WES
Amcor Limited	AMC
Boral Limited	BLD

Performance comparison of \$20,000*



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Performance of the Ralton Wholesale Leaders 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 100 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 in an index. There is no guarantee these objectives will be met.

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