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 High Yield Australian Shares	-0.42	-0.21	3.34	12.45	9.13	14.01	11.91	7.92
Income return	*0.93*	*1.07*	*2.37*	*4.46*	*4.47*	*4.57*	*4.84*	*4.99*
Growth return	*-1.35*	*-1.28*	*0.97*	*8.00*	*4.67*	*9.44*	*7.07*	*2.93*
S&P/ASX 300 Accum. Index	0.75	0.99	2.43	9.54	5.16	10.41	8.40	4.62
Difference	**-1.17**	**-1.20**	**0.91**	**2.92**	**3.98**	**3.60**	**3.52**	**3.30**

Performance review

- The S&P/ASX 300 Accumulation Index finished 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 High Yield portfolio returned -0.42% for the month, underperforming the benchmark by 1.17%.
- For the month of August, being overweight Consumer Discretionary stocks added value to the portfolio, offset by stock selection within Consumer Staples 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
IOOF Holdings Ltd	Overweight
Regis Resources	Overweight
Caltex Australia	Overweight

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.

Regis Resources (RRL, +8.4%) - 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. Regis' operating results for FY17 were solid, with more than 300,000 ounces of gold produced at a 'cash cost' of $945 per ounce. Solid operating results were supportive of consistent financial results and payment of 15c in dividends across the year. Expectations are for dividends to rise again materially next year. Regis also continues its progress with the defined feasibility study (DFS) for its McPhillamy's Gold Project in NSW, with progress in terms of resource definition, water rights and mine plan all advancing. RRL is targeting first gold production in 2019.

Caltex Limited (CTX, +7.2%) – investors responded warmly to CTX's strategic update and half year results. CTX is advancing plans to separate its business into two inter-related, but independent operating divisions, 'Fuels and Infrastructure' and 'Convenience Retail.' Caltex believes that a more distinct separation and enhanced focus will ensure that the two divisions can deliver optimal results. CTX is somewhat unusually targeting $60m of cost savings and efficiency gains from the separation, although this is being driven by an adjacent program termed Quantum Leap. CTX's Convenience retail offering is of key interest to Ralton, and we note that the company continues to fine tune its pilot stores with a view to finalizing a format and commencing a broader rollout next year. Plans to potentially divest some infrastructure assets in the business are also being considered but the company is yet to form a clear view. We continue to expect that reasonable value can be unlocked at CTX by a very competent management team.

Key detractors

Key detractors	Positioning
Japara Healthcare	Overweight
QBE Insurance Group	Overweight
Boral Limited	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.

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

There were no new stock additions to the portfolio in August.

Key disposals and material adjustments

We made two outright exits for the portfolio in August.

Sold
Coca-Cola Amatil (CCL)
Orora Holdings (ORA)

Following a positive and well received profit results, we took the share price strength as an opportunity to sell our position in **Orora Holdings (ORA)**. This is a very well-run company that, since the demerger from Amcor, has executed on its business model in a near faultless manner. With the share price having performed well in recent times, we felt the stock reflected fair value and sold down our position. Given the quality of management, we would look to revisit ORA at a future date should the share price appear attractive.

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 increase our investment in WES.

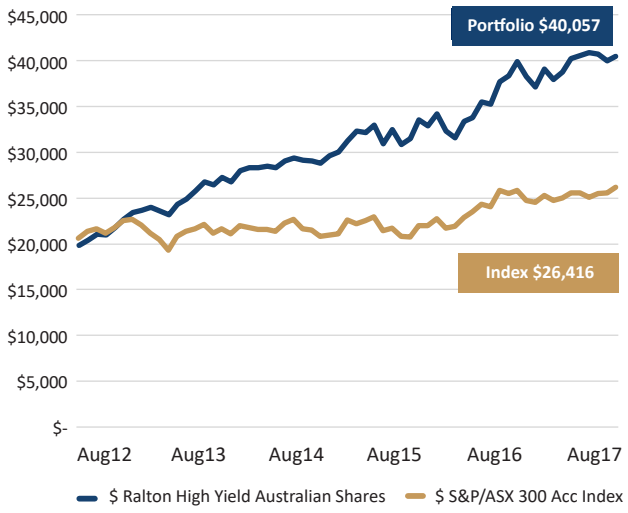
Sector allocation

GICS sector	Ralton	Index	+/-
Materials	21.3%	17.3%	4.0%
Consumer Staples	10.1%	7.4%	2.7%
Energy	6.8%	4.3%	2.5%
Information Technology	3.2%	1.5%	1.7%
Consumer Discretionary	6.0%	5.1%	1.0%
Telecommunication Services	4.1%	3.2%	0.9%
Financials	35.4%	36.3%	-0.9%
Health Care	4.7%	6.9%	-2.2%
Utilities	0.0%	2.2%	-2.2%
Real Estate	6.0%	8.3%	-2.3%
Industrials	2.3%	7.5%	-5.2%
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
National Australia Bank Limited	NAB
Woolworths Limited	WOW
Telstra Corporation	TLS
Aristocrat Leisure Limited	ALL
QBE Insurance Group Limited	QBE
Caltex Australia Limited	CTX

Performance comparison of $20,000*



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Performance of the Ralton Wholesale High Yield 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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