Quarterly Report December 2014

Ralton High Yield Australian Shares

Winner of the 2010 Standard & Poors' Fund Awards
- Separately Managed Accounts Category

Investment Profile

A Professionally Managed Portfolio of Australian Shares

The Ralton High Yield Australian Shares model portfolio is a separately managed account, or SMA, actively managed by Ralton Asset Management (Ralton). SMAs are professionally managed portfolios of direct shares whereby the investor receives beneficial ownership of the underlying securities.

Investment Objective

The objective of the Ralton High Yield Australian Shares SMA is to provide investors with consistent, tax-efficient and growing cash dividend yield, and long-term capital growth. The Portfolio aims to deliver a return superior to that of the market over periods of five years or longer and an above market yield.

Key Portfolio Features	
Inception	1 February 2008
Benchmark	S&P/ASX 300 Accumulation Index
Authorised Investments	Companies in the S&P/ASX 300 Index or those amongst the top 300 by size.
Number of Stocks	20-35
Cash Allocation	0% to 10%
Tracking Error	2% to 5%
Investment Horizon	At least 5 years
Ratings	

Performance

Return %	1m	3m	1yr	3yrs	5yrs	Incept*
Ralton High Yield	4.03	7.02	13.00	20.91	10.05	7.63
Income Return	0.22	0.79	4.71	4.86	4.95	5.05
Growth Return	3.81	6.23	8.29	16.05	5.10	2.57
S&P/ASX 300 Acc. Index	2.04	2.94	5.30	14.70	6.48	3.78
Difference	**1.99**	**4.08**	**7.70**	**6.21**	**3.57**	**3.85**

**Since Inception p.a., Feb 2008*

The Portfolio is designed for investors who...

- Seek an above market, tax-efficient cash dividend yield and long term capital growth
- Expect consistent above market returns
- Have a long term investment horizon of at least five years and accept the risk of equity markets

Portfolio Structure

No.	Company Name	ASX Code
1	Commonwealth Bank of Australia	CBA
2	Telstra Corporation Limited	TLS
3	ANZ Banking Group	ANZ
4	Amcor Limited	AMC
5	National Australia Bank Limited	NAB
6	BHP Billiton Limited	BHP
7	Incitec Pivot Limited	IPL
8	Woodside Pertroleum Limited	WPL
9	Westpac Banking Corporation	WBC
10	Brambles Limited	BXB

GICS Sector	Ralton	Index	+/-
Industrials	15.2%	7.9%	7.2%
Materials	19.2%	14.8%	4.3%
Telecommunication Services	9.0%	6.0%	3.0%
Consumer Discretionary	8.2%	5.4%	2.8%
Energy	6.0%	5.7%	0.3%
Utilities	2.0%	1.9%	0.1%
Health Care	5.5%	6.3%	-0.7%
Information Technology	0.0%	1.0%	-1.0%
Consumer Staples	2.7%	7.1%	-4.4%
Property	2.9%	7.8%	-5.0%
Financials (ex-Property)	29.4%	36.1%	-6.7%
Total	100%	100%	

Quarter in Review

- The S&P/ASX 300 Accumulation Index finished up 2.94% for the quarter, with strong performances from the Healthcare and Telecoms sectors offset by significant losses from both the Energy and Consumer Staples sectors
- The Ralton High Yield Model Portfolio returned 7.02% for the quarter, outperforming the benchmark by 4.08%
- The portfolio's overweight position in Industrials and underweight position in the Metals and Mining segment of Materials were the key contributors to the portfolio's outperformance

Portfolio Commentary

Quarterly Performance Attribution

Top Contributors	Positioning	Key Detractors	Positioning
Incitec Pivot	Overweight	QBE Insurance	Overweight
Amcor Limited	Overweight	Origin Energy	Overweight
Orora Limited	Overweight	Mermaid Marine	Overweight

Positive Contributors

Incitec Pivot (IPL, +17.7%) was the portfolio's top contributor for the quarter. The stock had traded in a tight range for some time, however the release of the company's annual profit results in November, the continuing decline in the Australian dollar and easing US gas prices appears to have changed sentiment towards IPL. The results were largely in line with expectations, although investors were pleased to see that the operating performance and projected manufacturing output for both the Moranbah and Phosphate Hill plants were on track – issues at each of these plants have certainly weighed on investor confidence in recent times. Further, construction of the company's Louisiana-based Ammonia plant continues on budget and on time. Once this plant comes on line, in a little under two years, we expect IPL to produce a significant increase in free cash flow, which in turn is expected to flow back to shareholders in the form of dividends or capital returns.

Amcor Limited (AMC, +19.9%), one of the portfolio's largest and longest held positions, also boosted portfolio returns. The company's AGM in November highlighted the attractiveness of the Amcor investment, as steady growth in western markets is well supported by growth in the company's emerging market operations. It is worth noting that Amcor's emerging market exposure is well diversified, with operations in nearly 30 countries across the three key regions of Asia, Latin America, and Eastern Europe. This diversity limits the profit impact in any given period of political, weather, or currency fluctuations destabilising any particular emerging market. We also noted management's positive tone at the AGM in relation to potential acquisitions. Given AMC's excellent acquisition track record under CEO MacKenzie, we are comfortable that any significant transaction should meet the company's return hurdles.

Amcor spin-off Orora Limited (ORA, +18.9%) was the portfolio's next-best contributor. The company's maiden AGM occurred during the quarter, with a trading outlook well received by the market. ORA is benefitting from various cost savings derived from a capital investment program and operational improvement initiatives started by its former parent. The new B9 pulp mill in Botany continues to 'ramp-up' production and management confirmed that B9's multi-year commissioning is proceeding broadly in line with expectations. The US operations make up some 30% of revenues, and they provide growth opportunities as that market place is more fragmented than Australia. ORA will be benefitting from this exposure as the US economy continues to improve, and also as the Australian currency weakens, benefitting conversion of US$ profits.

Underperformers

QBE Insurance (QBE, -3.9%) was weaker across the quarter, against a modest rise in the market overall. This decline was likely due to the substantial fall in global bond yields across the quarter. A fall in bond yields is a negative for QBE as it reduces the expected re-investment rate on their massive investment book and increases their liabilities (through its impact on the discount rate). We also held a number of stocks that benefited from the decline in yields during the quarter, such as Telstra, Transurban and Sydney Airports. QBE held a series of investor briefings in November, covering their European and US operations. The underlying message was one of business simplification and cost cutting. QBE continues to exit what it considers marginal insurance businesses and to focus on its core business. This has been a clear message since CEO Neal took the reins more than 2 years ago, and supports our continued investment.

During the quarter we have seen oil prices decline by more than 40%. Some have speculated Saudi Arabia is not prepared to perform its role as swing producer for a range of reasons. These include: (1) to punish ISIS; (2) to assist the Americans with Russia; and (3) to slow the growth in US shale production. Alternatively, it is a sign the emerging market and European demand for oil is slowing along with a deterioration in economic growth.

The truth likely lies somewhere in between. The World Bank has recently downgraded global growth again the past couple of weeks. Further, Saudi Arabia likely wants a contribution, in the form of production cuts from OPEC, American shale producers and the Russians. The pain just has to get enough for all the groups to agree, which may take some time yet. Out of this we expect to see increased opportunities to invest selectively in energy stocks in the coming quarters.

For energy stocks, the lower oil price leads to lower profits and cash returns. Origin Energy (ORG, -22.0%) was the key detractor from portfolio returns. We elected to reduce our holding in ORG during the quarter. ORG is entering a critical phase, with cash flows from the large Gladstone APLNG plant likely to start around mid 2015, but the company still spending capital as the project moves toward completion. The lower oil price is pressuring ORG's financial position and may see the company raise further capital if the oil price weakness is sustained for an extended period.

We also chose to sell our holding in WA-based energy service provider, Mermaid Marine (MRM), which also detracted significantly from portfolio returns during the quarter. The decline in the oil price will likely see companies defer new capital projects and delay maintenance. This will have flow on effects for service providers, such as MRM, across the whole energy sector. Revenue and profit margins will be under pressure and we could well see companies such as MRM either sell assets or raise equity to shore up their balance sheets. We will continue to monitor the stock however as we have a favourable view of MRM's strategy of diversifying away from a pure Australian focus and their recent Jaya transaction.

Portfolio Adjustments

During the Quarter we...

SOLD:	Automotive Holdings (AHE), Blackmores Limited (BKL), Chandler Macleod Group Ltd (CMG), Wesfarmers Ltd (WES)
BOUGHT:	Pact Group Holdings Ltd (PGH), ResMed Inc. (RMD)

Portfolio Additions & Material Adjustments

We added two stocks to the portfolio during the quarter, starting with an initial position in the recently listed Pact Group (PGH). Pact are a packaging and manufacturing company with multiple manufacturing plants across Australia, New Zealand and Asia, producing a broad range of simple and specialised packaging products for clients who are largely in the food industry. PGH has dominant market share in their industry segments, where typically there are few competitors of scale and concentrated market share. If you look in your fridge you are highly likely to find a milk, yoghurt or orange juice package manufactured by PGH. Pact had a strong track record of growth by acquisition when in private hands, and we would expect this to continue. When PGH first listed on the stock exchange in late 2013 it was, in our opinion, carrying too much debt, however those debt levels have reduced over subsequent reporting periods, making the stock an attractive investment.

The second new stock was ResMed (RMD), which delivers a strong growing yield rather than being a more traditional high yielding stock, was trading at an attractive valuation and also boosted exposure to the falling Australian dollar for this portfolio. RMD is a global manufacturer and distributor of machines and masks for the treatment of sleep apnea, and hospital- and home-based treatments for other respiratory conditions. Manufacturing initiatives, new and improved patient masks, and an expanding share of the sleep apnea market will all help drive RMD's future growth. Recent regulatory changes in the United States relating to home sleep testing and diagnosis for people suspected of sleep apnea (previously all patients had to attend overnight sleep centre) together with requirements around testing of truck drivers for sleep apnea are positives for RMD. Future clinical trials looking into links between sleep apnea and various other conditions such as cardiovascular disease could also further expand the market.

Portfolio Disposals & Material Adjustments

We sold four stocks outright from the portfolio during the quarter, namely Automotive Holdings (AHE), Blackmores (BKL), Wesfarmers (WES) and Chandler Macleod (CMG), largely reflecting our view of each stock's fair value, along with a decision to reduce our overall exposure to consumer sensitive stocks.

Starting with Automotive Holdings (AHE), we note the modest declines in new passenger car sales over recent months. At this stage, the decline is being lead by government and fleet buyers, although we feel that the consumer may well begin to feel the pinch in coming months. AHE has a geographic bias to WA, which given the pressures on this resource-focused state may continue to struggle. Around the levels we sold the stock at we felt we could find better opportunities elsewhere in the market. Going forward, we would highlight that the company is targeting an improvement in portfolio returns from their cold storage division. Thus far, AHE has lacked scale and has faced integration headwinds. Progress on this front would certainly see us reconsider an investment in AHE, subject of course to price.

With vitamin manufacturer and distributor Blackmores (BKL), we had benefitted from a re-rating of the company in recent times as the industry seemed to have entered a more rational pricing phase. Key competitor Swisse has reduced both its discounting and its blanket, high cost advertising, allowing for BKL and others to stablise their prices, margins and market share. BKL has and will continue to benefit from its efforts to grow distribution in Asia, however the current market valuation did not appear to reflect any risk that consumers might reduce their expenditure in what is actually a somewhat discretionary consumer purchase.

With WES, the company was trading at what we considered a reasonably full valuation in the current market. WES has been successful in turning around the top line sales growth and margins at their key business, Coles supermarkets. The easy gains here have been made however and the outlook for this key division is moderating. As highlighted in recent market updates by Woolworths (WOW) and Metcash (MTS), the supermarket industry in Australia is becoming increasingly competitive. Discounters Aldi and (to a lesser extent) CostCo are gaining market share and the consumer is becoming far more cost conscious.

Finally, with Chandler Macleod (CMG), as mentioned a few months ago we have been cautious on the Australian economy in terms of its influence on demand for contract and short-term labour, a key plank of CMG's offering. Given our continued cautiousness on this front, we took the recent increase in the share price as an opportunity to exit the stock and deploy the cash into stocks where we felt the risk/reward was superior.

RALTON
ASSET MANAGEMENT

Investment Approach

A Three Stage Investment Process

Intensive bottom-up research is the cornerstone of the entire process, supplemented by top-down economic and thematic views. The process is disciplined and consistently applied, using a number of proprietary qualitative and quantitative techniques to ensure that targeted companies have been thoroughly scrutinised. The aim is to uncover undervalued businesses. The companies that Ralton typically invests in are those with strong and reliable management, good profit and dividend growth expectations, reasonably predictable future profits and cash flows, and a very clear business model.

Stage 1: Defining the Investment Universe (Screening)

The first stage of the process is to narrow the number of stocks in the investment universe by applying a number of screens. This approach systematically eliminates companies that do not meet certain minimum standards, allowing the Investment team to focus more intensely on companies of potential interest.

Stage 2: Bottom-up Fundamental Company Research

Ralton's research programme is focused on understanding the key drivers of business performance and returns, namely people, operations, products and services, and market dynamics. For companies remaining in the Investment Universe, a detailed assessment is made of executive management, interviews competitors and suppliers, reviews financials, and forms a clear view on the outlook for the company's industry.

Stage 3: Portfolio Construction

Risk management and capital preservation are key themes underlying the portfolio construction framework. With a focus on actively managing down-side portfolio risk for investors, Ralton constructs an efficiently diversified portfolio of high quality, undervalued companies, and invests for the long term (typically 3 to 5 years) in an effort to maximise after tax-returns.

About the Manager

Ralton Asset Management is part of the OC Group, a boutique investment specialist majority owned by members of its investment team and key executives.

Ralton is a Value manager with a fundamental investment approach designed to identify quality businesses trading at a considerable discount to valuation. The process is guided by three fundamental beliefs:

- Markets are not perfectly efficient and the true value of a business is not always reflected in its share price;
- Undervalued companies can be identified through detailed and intensive research; and
- Capital preservation is critical to wealth creation.

The Investment Team

Andrew Stanley *BEc, LLB, ACA, FFin, MA AppFin*
Portfolio Manager, Ralton Model Portfolios

Andrew Stanley is the lead portfolio manager for the Ralton portfolios. He is supported by a dedicated and highly experienced team of investment professionals each with an average 18 years investment experience. Andrew has been working in financial markets for more than 19 years, including the past 5 years managing the Ralton portfolios. Prior to Ralton, he was an Executive Director at UBS in Hong Kong, and over the course of his career has held senior positions with major investment institutions in Melbourne, Hong Kong, Tokyo and New York. Andrew started his career at Arthur Andersen in Melbourne.

Roger Walling *BOptom, MBB* Portfolio Manager, Ralton Model Portfolios

Stephen Evans *B Com, ACA*, Portfolio Manager

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