Quarterly Report December 2014

RALTON ASSET MANAGEMENT

Ralton Leaders

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

Investment Profile

A Professionally Managed Portfolio of Australian Shares

The Ralton Leaders 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 Leaders SMA is to provide investors with long-term capital growth and tax effective income from a portfolio of blue-chip Australian shares. The portfolio aims to deliver returns that are consistently above the S&P/ASX 100 Accumulation Index over a three to five year period.

Key Portfolio Features	
Inception	1 February 2008
Benchmark	S&P/ASX 100 Accumulation Index
Authorised Investments	Companies in the S&P/ASX 100 Index or those amongst the top 100 by size.
Number of Stocks	25-40
Cash Allocation	0% to 10%
Tracking Error	1.5% to 3.5%
Investment Horizon	At least 3 to 5 years
Ratings	MORNINGSTAR ★★★★

The Portfolio is designed for investors who...

- Seek long term capital growth & tax-effective income
- Expect consistent above market returns
- Have a long term investment horizon of at least 3-5 years and accept the risk of equity markets.

Performance

Return %	1m	3m	1yr	3yrs	5yrs	Incept*
Ralton Leaders	3.95	7.64	13.38	18.88	8.52	6.64
Income Return	0.10	0.71	4.00	4.21	4.38	4.49
Growth Return	3.84	6.92	9.38	14.68	4.14	2.14
S&P/ASX 100 Index	2.17	3.54	6.13	16.00	7.25	4.51
Difference	**1.78**	**4.10**	**7.25**	**2.89**	**1.26**	**2.13**

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

Portfolio Structure

No.	Company Name	ASX Code
1	Commonwealth Bank of Australia	CBA
2	ANZ Banking Group	ANZ
3	Telstra Corporation Limited	TLS
4	BHP Billiton Limited	BHP
5	National Australia Bank Limited	NAB
6	Amcor Limited	AMC
7	CSL Limited	CSL
8	Aristocrat Leisure Limited	ALL
9	Westpac Banking Corporation	WBC
10	ResMed Inc.	RMD

GICS Sector	Ralton	Index	+/-
Industrials	13.2%	7.0%	6.2%
Health Care	12.1%	6.4%	5.7%
Consumer Discretionary	8.5%	3.2%	5.3%
Materials	16.9%	14.8%	2.0%
Energy	6.7%	5.8%	1.0%
Telecommunication Services	6.8%	5.9%	0.9%
Information Technology	0.0%	0.7%	-0.7%
Utilities	0.0%	2.1%	-2.1%
Property	2.6%	7.5%	-4.9%
Consumer Staples	1.2%	7.4%	-6.3%
Financials (ex-Property)	32.1%	39.2%	-7.1%
Total	100.0%	100.0%	

Quarter in Review

Performance Summary

- The S&P/ASX 100 Accumulation Index finished 3.54% higher for the December quarter, with strong performances by the Healthcare and Telecoms sectors offset by significant losses in both the Energy and Consumer Staples sectors

- The Ralton Leaders Model Portfolio returned 7.64% for the December quarter, outperforming the benchmark index by 4.10%

- This outperformance was driven by our overweight exposure to both the Industrials and Consumer Discretionary sectors, offset to some degree by our underweight to the Financial sector

Portfolio Commentary

Quarterly Performance Attribution

Top Contributors	Positioning	Key Detractors	Positioning
Incitec Pivot	Overweight	QBE Insurance	Overweight
Amcor Limited	Overweight	Origin Energy	Overweight
Recall Holdings	Overweight	Oil Search	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.

Recall Holdings (REC, +28.4%) was also a strong contributor to portfolio returns during the quarter. The key driver was that Iron Mountain (IRM) had made a non-binding, indicative proposal to acquire REC. The cash and scrip based offer was rejected by the REC board. The Board claim that IRM should pay a further premium as this acquisition would represent a significant opportunity for IRM to realise synergies by combining the two groups. REC's share price was already appreciating on what we would describe as continued execution of strategic initiatives, a point we have emphasised repeatedly in recent portfolio reports.

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.

From a portfolio perspective, both Origin Energy (ORG, -22.0%) and Oil Search (OSH, -11.6%) detracted from portfolio returns. We elected to reduce our holding in ORG during the month. 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.

Portfolio Adjustments

During the Quarter we...

SOLD: Fletcher Building Australia (FBU), Wesfarmers Ltd (WES)

BOUGHT: Bank of Queensland Ltd (BOQ), Caltex Australia Ltd (CTX), Navitas Limited (NVT)

Portfolio Additions & Material Adjustments

Navitas Limited (NVT) was one of three new stock additions to the portfolio during the quarter. NVT is an education service provider whose core business is providing 'pathway' courses for students ahead of university entrance. NVT have a global network of 'colleges' across four continents. These 'colleges' provide NVT courses, typically on campus at a 'host' university. NVT source the bulk of their students from international markets, via their own recruitment networks. The share price pulled back mid-2014 following the loss of a contract with one major partner or host university. We believe, as this contract was terminated as part of the host university's branding strategy, this does not threaten the long term business model of NVT. With a growing presence in the US, established patiently over recent years, and improving performance from NVT's technology-focused CAE division, we believe the outlook for NVT is favourable.

We have also begun to build a position in Caltex (CTX) in the portfolio. The business has undergone considerable structural change in recent years, highlighted by the recent closure of CTX's largest fuel refinery in Sydney. With this volatile element removed from the business, CTX is now principally a distributor of fuel (diesel, petrol and specialist products) to the transport sector and to retail customers through its petrol stations (either company-owned or franchised). We believe that the Caltex of tomorrow offerssteady growth prospects that are GDP-like and capital light (as compared to running a refinery which requires a large investment in oil inventory). We expect the company's share price to continue to re-rate as the transition unfolds.

Finally, we added a small position in Bank of Queensland (BOQ) after the bank sector as a whole had sold off significantly. BOQ's operations had improved considerably under former CEO Stuart Grimshaw and potentially, BOQ should be a net winner from proposed changes flowing from the Murray inquiry into the financial services industry – assuming that the competitive advantage that the big four banks hold over regional banks is somewhat reduced.

We also added selectively to existing holdings Amcor Limited (AMC) and CSL Ltd (CSL) during the quarter. Late in October, CSL struck a deal to acquire Novartis' seasonal influenza (flu) vaccine business for US$275m. Novartis was a forced seller for regulatory reasons, having acquired various assets as part of an asset swap with fellow pharmaceutical major, GSK. For CSL the deal appears to have been done at an exceptional price, acquiring mostly new assets, a strong R&D pipeline and consolidating CSL's position as clear No 2 in the global flu market. Subject to deal completion and various milestones being met, it appears that CSL will make very strong returns on their purchase.

Portfolio Disposals & Material Adjustments

There were two outright sales from the portfolio during the quarter, namely Fletcher Building (FBU) and Wesfarmers (WES), with both sale decisions largely based on the stock trading at fair value. In addition, each business has a heavy exposure to the Australian economy, and we remain concerned about the outlook for the domestic economy in 2015 given the impact of further falls in the terms of trade and likely measures required by the Federal Government to improve the position of the budget.

Starting 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 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.

FBU has been a beneficiary of both the strength in the NZ economy, driving a strong housing cycle, and a cost and efficiency focus directed by CEO Adamson. Going forward, our sense is that the NZ housing and construction cycle is at or near peak and that in Australia, FBU's leverage to a housing recovery is muted given the product mix of businesses that FBU own. FBU will be only a modest beneficiary of any infrastructure boom in Australia, and our preference is to play this thematic through Lend Lease (LLC).

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)

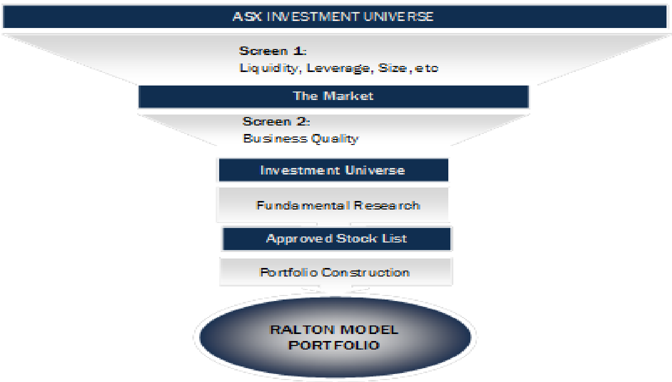
The first stage of the process is to narrow the number of stocks in the investment universe by applying a number of screens. This approach systematically eliminates companies that do not meet certain minimum standards, allowing the Investment team to focus more intensely on companies of potential interest.

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.

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