RALTON ASSET MANAGEMENT

Quarterly Report December 2014

Ralton Smaller Companies

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

Investment Profile

A Professionally Managed Portfolio of Australian Shares

The Ralton Smaller Companies 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 Smaller Companies SMA is to provide investors with long-term capital growth and some tax effective income from a concentrated portfolio of smaller capitalisation ASX listed shares. The Portfolio aims to deliver a return superior to that of the market over periods of five years or longer while at the same time seeking to minimise the risk of investment capital loss.

Key Portfolio Features	
Inception	1 February 2008
Benchmark	S&P/ASX Small Ordinaries Accumulation Index
Authorised Investments	ASX listed companies that are not included in the S&P/ASX 50 Index
Number of Stocks	25-40
Cash Allocation	0% to 15%
Tracking Error	5% to 9% per annum
Investment Horizon	At least 5 years
Ratings	MORNINGSTAR ★★★★ ; Approved Lonsec Research

The Portfolio is designed for investors who...

- Seek long term capital growth & some tax-effective income
- 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	Fisher & Paykel Healthcare Corporation	FPH
2	iSelect Limited	ISU
3	Sky Network Television Limited	SKT
4	Fletcher Building Limited	FBU
5	News Corporation	NWS
6	Virtus Health Limited	VRT
7	Aristocrat Leisure Limited	ALL
8	IRESS Limited	IRE
9	Skycity Entertainment Group Limited	SKC
10	Cash Converters International Limited	CCV

GICS Sector	Ralton	Index	+/-
Consumer Discretionary	34.9%	23.8%	11.1%
Health Care	13.5%	5.3%	8.1%
Utilities	3.5%	0.8%	2.7%
Consumer Staples	6.0%	3.8%	2.2%
Information Technology	3.6%	4.1%	-0.5%
Energy	3.5%	4.5%	-1.0%
Industrials	15.0%	16.4%	-1.3%
Materials	12.6%	14.6%	-2.0%
Financials (ex-Property)	5.2%	8.9%	-3.7%
Telecommunication Services	2.3%	7.3%	-5.0%
Property	0.0%	10.5%	-10.5%
Total	100.0%	100.0%	

Performance

Return %	1m	3m	1yr	3yrs	5yrs	Incept*
Ralton Smaller Companies	2.79	1.70	8.35	19.22	10.76	6.65
Income Return	0.13	0.24	3.17	3.65	3.68	3.86
Growth Return	2.67	1.46	5.18	15.57	7.08	2.79
S&P/ASX Small Ords Acc Index	0.47	-3.89	-3.81	0.58	-2.01	-3.56
Difference	**2.33**	**5.59**	**12.16**	**18.65**	**12.77**	**10.21**

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

Quarter in Review

Performance Summary

- The S&P/ASX Small Ordinaries Accumulation fell heavily across the December quarter, losing 3.89%, weighed down by Energy and Materials stocks
- The Ralton Smaller Companies Portfolio made a solid gain of 1.70%, outperforming the benchmark by 5.59%
- The portfolio's Industrial and Healthcare stocks added to portfolio returns across the quarter, as did being underweight the Metals & Mining sector

Portfolio Commentary

Quarterly Performance Attribution

Top Contributors	Positioning	Key Detractors	Positioning
Fisher & Paykel Healthcare	Overweight	Beach Petroleum	Overweight
Orora Limited	Overweight	Mermaid Marine	Overweight
Recall Holdings	Overweight	iSelect Limited	Overweight

Positive Contributors

Fisher and Paykel Healthcare (FPH, +28.1%) was the portfolio's top contributor for the quarter. The stock has recorded a capital return of 65.8% for calendar 2014. FPH continue to deliver good sales growth in both their respiratory (RSA) and sleep therapy (OSA) divisions. In particular, we believe that FPH has a particularly strong industry position in the respiratory segment, where their products are gaining traction for use in the home care setting. Keeping patients out of high cost hospitals and reducing readmissions is a key theme in the global search for healthcare savings. FPH's devices are proving very effective in this regard and we look for them to continue to penetrate this very large market for indications such as Chronic Obstructive Pulmonary Disorder, or COPD. The company's first half profit results for financial year 2015 confirmed the momentum in the business and the basis of our investment thesis.

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 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.

Recall Holdings (REC, +28.4%) was also a strong contributor to portfolio returns during the quarter. The key driver was thay 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

The reluctance of global oil cartel OPEC to cut production saw the oil price fall more than 40% across the quarter. This in turn impacted our Energy stocks, with Beach Petroleum (BPT, -25.9%) falling heavily across the quarter.

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, this uncertainty prompted us to sell outright some of our Energy exposures. For both Horizon Energy (HZN) and Whitehaven Coal (WHC) - the coal price is somewhat linked to the oil price as both are interchangeable sources of heat - lower energy prices mean lower profitability and will limit their ability to fund their operations to complete projects, start new ones or alternatively reduce or refinance debt. On this basis, we took the decision to sell these positions and potentially revisit once the oil markets have stabilised and we can get a better picture on future funding requirements.

Service provider Mermaid Marine (MRM) also detracted significantly from portfolio returns. We took the pragmatic view that lower oil prices would reduce both exploration expenditure and also potentially see production shut-ins across the industry. Both effects would reduce the demand for MRM's services. In addition, there is a risk that if there is a protracted slowdown MRM may need to sell assets or raise equity given its current level of debt. 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.

iSelect Limited (ISU, -9.2%) also underperformed the market and detracted from portfolio returns. During the quarter ISU's co-founder and Executive Chairman, Damien Waller, announced his intention to resign as Executive Chairman of ISU, effective December 2014. Waller intends to remain on the ISU Board, however a new independent Chairman will be sought. CEO Alex Stevens will also be appointed to the Board of Directors as part of these changes. We believe that this change is positive and continues efforts by ISU to rebuild investor confidence in the company's governance structure following a poorly received IPO in 2013. The company's AGM in November highlighted the strength in current trading conditions with particularly strong progress and growth in ISU's offerings in the Energy and Life Insurance segments. This will in turn reduce the reliance on Health as a contributor to operating profits.

Portfolio Adjustments

During the Quarter we...

SOLD: Horizon Oil Ltd (HZN), Mermaid Marine Australia (MRM), Ozforex Group Ltd (OFX), Whitehaven Coal (WHC)

BOUGHT: Ardent Leisure Group (AAD), Greencross Limited (GXL)

Portfolio Additions & Material Adjustments

We added two new stocks to the portfolio across the quarter, Ardent Leisure (AAD) in October and Greencross Limited (GXL) in November.

AAD own a reasonably diverse series of entertainment assets in Australia and the United States. The key attraction is the 'roll out' of the Main Event business in the United States. Main Event is a big box entertainment complex that offers bowling, laser tag, and video games along with food and function facilities. The business has been highly successful in its home state of Texas and is now rolling out its offering both within and beyond Texas. AAD also own theme parks on the Gold Coast and so will benefit from any strengthening in domestic and inbound tourism, both of which are likely should the Australian dollar continue to weaken. The falling oil price will likely negatively impact the Texas based consumer given the importance of the oil industry to this US state, however we believe that medium term, the US-wide format will reduce the concentrated exposure to this key state.

We also began to build an initial position in Greencross Limited (GXL). GXL have two pet-focused businesses, a veterinary services division and pet retailer division. Originally a pure veterinary business, GXL merged with Petbarn in late 2013 and has since continued to expand both divisions. We believe that exposure to the 'pet' theme is a positive as growth in expenditure by pet owners typically exceeds GDP. GXL is also a consolidation play, with management to date having demonstrated a strong track record of adding value through acquisitions.

We have built up reasonable cash holding in the portfolio from dividend payments and recent stock sales, so we saw the market weakness across the quarter as an opportunity to add to several of our existing holdings. Notably on this front, we increased our holdings in recent stock additions Pact Group (PGH) and Super Retail Group (SUL) along with increasing our position in Cash Converters (CCV) following a small acquisition-driven equity raise.

Portfolio Disposals & Material Adjustments

As discussed earlier in our report, we took a pragmatic approach in regard to some of our energy stocks, exiting positions in HZN, MRM and WHC during November.

Ozforex (OFX) was the only non-Energy stock sale from the portfolio in the quarter. The company has, in a relatively short space of time, built a strong brand and reputation as a price leader in online international payments. This market has historically been dominated by large banks that charge high fees and have faced limited competition. Although OFX's progress and market share gains have been impressive, our further due diligence suggests its market position is more tenuous than we had thought. OFX does not have a "brand name" like a bank, so bids for "Keywords" in Google. As a result, it is exposed to margin compression as the "Keywords" go up in price as others enter the market. Given this concern about the strength of OFX's position, we elected to capitalise on the recent share price strength and sell the stock.

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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