Ralton Leaders

Monthly Report
May 2015

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 ★★★★

Performance

Return %	1m	3m	1yr	3yrs	5yrs	Incept*
Ralton Leaders	0.44	0.26	18.18	21.24	12.32	7.58
Income Return	*0.54*	*0.98*	*3.88*	*4.20*	*4.45*	*4.47*
Growth Return	*-0.10*	*-0.72*	*14.30*	*17.04*	*7.88*	*3.11*
S&P/ASX 100 Index	0.26	-1.56	10.11	18.26	10.77	5.45
Difference	**0.18**	**1.82**	**8.07**	**2.98**	**1.56**	**2.13**

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

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.

Portfolio Structure

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

GICS Sector	Ralton	Index	+/-
Industrials	14.6%	6.7%	7.9%
Consumer Discretionary	8.9%	2.8%	6.1%
Health Care	11.0%	5.9%	5.1%
Information Technology	2.0%	0.6%	1.3%
Energy	5.2%	5.1%	0.1%
Telecommunication Services	5.7%	5.7%	0.0%
Materials	14.9%	15.5%	-0.5%
Utilities	0.0%	2.2%	-2.2%
Consumer Staples	3.2%	7.0%	-3.8%
Property	2.2%	7.6%	-5.4%
Financials (ex-Property)	32.3%	40.9%	-8.6%
Total	100.0%	100.0%	

Month in Review

Performance Summary

- The S&P/ASX 100 Accumulation Index made only slight gains for May, rising 0.26%, with Industrials the top performing sector and Consumer Staples the worst performer

- The Ralton Leaders Model Portfolio added 0.44% for May, outperforming the benchmark index by 0.18%

- Our overweight position in Industrials, together with an underweight exposure to Consumer Staples added value.

Portfolio Commentary

Monthly Performance Attribution

Top Contributors	Positioning	Key Detractors	Positioning
QBE Insurance	Overweight	ResMed Inc.	Overweight
Amcor Limited	Overweight	Aristocrat Leisure	Overweight
Lend Lease Ltd	Overweight	Oil Search Ltd	Overweight

Positive Contributors

QBE Insurance's (QBE, +6.9%) momentum continued into May as positive guidance statements at the AGM in April reaffirmed our view that the turnaround under CEO Neal remains on track. Favourable movements in global bond yields, together with the falling Australian dollar across May also supported the share price. We expect to see improvements in premium growth in the offshore businesses as the company adds new specialty business lines, particularly in the US.

Global packaging manufacturer Amcor Limited (AMC, +3.7%) also boosted portfolio returns. New Amcor CEO, and former CFO Ron Della has recently taken the reigns from long-standing CEO Ken MacKenzie. We expect little change to the Amcor strategy and note that the recent acquisition of Souza Cruz's internal tobacco packaging operations in Brazil for US$30m. We expect bolt-on acquisitions in emerging markets, together with share buybacks to continue to represent a key part of the AMC return drivers.

Diversified property and construction company Lend Lease (LLC, +3.8%) was also a positive contributor to returns. LLC has a series of high quality businesses and strong visibility on revenue and profit generation over coming years. During the month LLC finalized agreement with Crown Resorts for the Barangaroo South revised concept plan. LLC has a contract to build a $1bn integrated casino resort for Crown and with this agreement confirmed will be able to book a profit on sale of land. Also, there were pre sales at LLC's Darling Harbour apartments which exceeded expectations at $650m on the opening weekend for the project. This adds to LLC back-log of construction work and profits. This certainly highlights the strength in Sydney residential property; however it also highlights the quality of LLC's offering.

Underperformers

Shares in medical technology company ResMed Inc. (RMD, -4.6%) fell after it reported the results of a clinical trial where their breathing devices failed to show a benefit for patients with certain types of chronic heart failure. These are really sick people and it appears that the RMD treatment actually increased mortality in a statistically significant way. RMD were hoping that the use of the 'ASV' device would reduce hospital visits and improve mortality for those treated and in so doing, open up a new market for patients who were suffering from heart failure. Although disappointing, it is unlikely to impact RMD's current treatment of patients with various types of sleep apnea in the medium term, although in the short term it can cause some disruption to sales as doctors reflect on the clinical trial data. As such, we did trim the holding whilst we wait to see the short term impact on quarterly sales.

Aristocrat Leisure (ALL, -6.3%) weighed on portfolio returns, despite reporting strong profit results for the half year. The decline in the share price reflected the soft commentary from management on the outlook. ALL reported half year profit results late in May, including a 67% increase in underlying profit to $110m, by all accounts above most market estimates. The growth in profit was driven by the acquisition of VGT, market share gains in unit sales in Australia and strong profit growth in ALL's digital gaming division. We continue to see further improvement in the company's earnings outlook as it obtains the benefit of increased investment in R&D over the past few years.

Oil Search (OSH, -6.1%), one of April's top performers, reversed course in May and weighted on portfolio returns, largely following the direction of the oil price, with Brent crude oil down approximately 3% for the month. OSH has reacted to the falling oil price by focusing on reducing costs and reprioritizing capital expenditure. The company does remain focused on progressing two key projects which will deliver an uplift in earnings growth later this decade. Firstly, there is a third LNG train with Exxon at the existing PNG LNG facility and secondly, development of the ELK/ Antelope gas fields for either a 1 or 2 LNG train development with partners, TOTAL and InterOil.

Portfolio Adjustments

During the Month we...

SOLD: South32 (S32)

BOUGHT: Woolworths Limited (WOW)

Portfolio Additions & Material Adjustments

We added Woolworths (WOW) to the portfolio in May. The company has had a considerable fall in share price over the past 18 months, triggered by deteriorating profit growth at the company's core supermarket's business, together with ongoing losses from the rollout of the poorly performing Master's Hardware chain. Whilst it takes time to change momentum in businesses of this scale, we are of the view management are putting into place the right strategies to transform both businesses.

Taking these in turn, the core supermarket business "Woolworths" has lost its focus on delivering value to its customers and instead appears to have become focused on driving profit growth by increasing its already industry leading margins. This was not a sensible strategy in light of the turnaround at Coles. The new supermarket CEO has highlighted a series of poor decisions that led the business down the wrong path. Going forward, Woolworths will seek to restore customer faith in its low prices by investing heavily in prices', increasing store service (labour) and an improved look and feel to the stores with an accelerated refurbishment program. The investment in price is being driven by a cost reduction program of $500m initially with more to follow. We ultimately expect this will restore volume growth for the business. A key metric for us to monitor will be how much more investment in price is required to drive this volume growth

Masters store format, version 1.0, heavily influenced by joint venture partner Lowe's has been unsuccessful in Australia and the losses have been building. In 2014, WOW brought in Matt Tyson as group CEO of Masters. He has had considerable success with big box hardware formats in several countries. Tyson is leading the changes with Masters 2.0 store format. In simple terms the store format includes more products, stronger brands and has been rejigged to include more exposure to garden and basic hardware. Early signs are positive with two new stores built in 2.0 format and several refurbishments either complete or underway. We believe that Masters 2.0, together with better branding and promotions, can improve its profitability. Like most investors, the board will not tolerate circa $200m loss for ongoing periods. Tyson will either succeed or the division will be sold. Either way, the profit drain will be reduced.

Touching on capital, we expect WOW to reduce the capital directed toward Masters until the 2.0 proves its stripes, together with lower capital directed toward new supermarkets. Instead, additional refurbishment dollars spend will be spent on aged or tired looking stores and is expected to drive an improvement in returns on capital. This underinvestment in the supermarket stores is also a contributor to the problem this business faces.

In summary, with a solid dividend yield and a clear strategy in place to turnaround these operating issues, we felt that the valuation was sufficiently attractive to start buying. Like most turnarounds, we do not expect improvements to occur in a 'straight line' however we do have confidence that it can be achieved.

Finally, we added to our position in National Australia Bank (NAB), via both an increase in the portfolio weighting and taking up our rights for investors in the NAB entitlement offer (capital raise). NAB has raised $5.5bn to deal with legacy issues. The proceeds are to be used to support capital requirements for the IPO of the Clydesdale Bank in the UK and to increase capital in anticipation of new regulatory requirements. We are of the view the management team under Thorburn are finally addressing the legacy issues of the bank and looking to improve the poor culture.

Portfolio Disposals & Material Adjustments

South 32 (S32) was demerged from BHP Billiton (BHP) mid-month, with BHP investors receiving a 1:1 entitlement in the new stock. S32's assets include mining and upstream (processing) facilities across several commodities, including aluminum, thermal coal, manganese and nickel. The assets are non-core to BHP, though represent reasonable quality on a global scale. At this stage, we saw no compelling reason to hold the stock and with the share price trading higher upon listing, we elected to sell the position.

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 partnered with Copia Investment Partners, an administration and distribution specialist providing a range of tailored services to each of our leading boutique investment partners.

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*
Head of Australian Equities, 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 24 years, including the past 7 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

Roger Walling is responsible for stock coverage of several industry sectors and assists with the portfolio management process. He has over 12 years of direct funds management experience, including the past 7 years managing the Ralton portfolios. Previous to Ralton, Roger was a shareholder and employee of Cinnabar Equities, a Global Healthcare Fund. In his role as a Senior Analyst, he had sub-sector and stock investment decision responsibility. Prior to his career in financial markets, Roger practiced as an Optometrist.

For Further Information

Financial advisers seeking additional information can contact Ralton Adviser Services at:

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