Total returns

At 31 March 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 Smaller Companies	3.80	2.90	0.90	20.23	12.18	14.73	12.19	8.48
Income return	*0.82*	*1.04*	*1.27*	*2.54*	*2.97*	*3.43*	*3.51*	*3.66*
Growth return	*2.98*	*1.86*	*-0.37*	*17.70*	*9.21*	*11.30*	*8.68*	*4.82*
S&P/ASX Small Ord Accum. Index	2.66	1.46	-1.03	13.67	6.44	2.28	2.16	-0.17
Difference	**1.14**	**1.44**	**1.93**	**6.57**	**5.73**	**12.45**	**10.03**	**8.65**

Performance review

- The S&P/ASX Small Ordinaries Accumulation Index added 1.46% for the quarter, boosted by Consumer Staples and Industrials, with Materials the key detractor for the benchmark.
- The Ralton Smaller Companies portfolio added 2.90% for the quarter, outperforming the benchmark by 1.44% for the period.
- Our overweight positions in both Consumer Discretionary and Consumer Staples added value to the portfolio, offset by our cash weighting in a rising market and stock selection within Telecommunication Services.

Performance attribution

Key contributors

Key contributors	Positioning
Costa Group Holdings	Overweight
Aristocrat Leisure	Overweight
Tassal Group Limited	Overweight

Reporting season was the key driver for many of our portfolio holdings in the quarter. Listed companies report their financial progress for the completed period (half or full-year results) and provide outlook commentary on the period ahead.

Costa Group Holdings (CGC, +26.5%) – shares in horticultural company, Costa, rallied after the company announced both an increase in profit guidance for the current year and a $65m expansion of its mushroom farm at Minarto in South Australia. Costa is already the number one player in the Australian mushroom category and this expansion will further consolidate its position and allow Costa to participate in future consumption growth. Costa's basket of produce includes avocados, blueberries, raspberries, mushrooms and tomatoes and aligns with our thematic views in regard to 'premium' food categories and healthy eating. Costa has several growth avenues, including capacity expansions for most of the categories just listed, together with further acquisitions in the fast-growing avocado segment and finally, offshore growth via its berry farms in both Morocco and China.

Aristocrat Leisure (ALL, +15.9%) – shares in ALL rallied after management upgraded profit growth for the coming year to between 20 - 30% at the AGM in late February. Although the company did not detail the key drivers, we expect sales are being driven by market share gains in the US market across its participation gaming business (annuity-style income) and its outright sales segment. This upgrade has come before the company releases product into new segments of the US market, which we also expect could drive further upside. An upgrade this early in the year is a positive signal as it suggests ALL has good visibility on the outlook. ALL also confirmed the new CEO, Trevor Croker, has received all necessary regulatory approvals to take up the position. This is an important hurdle in such a highly regulated industry. Finally, with the stock having entered the ASX 50 or 'top 50' stocks during the quarter we were required to sell the ALL holding given the mandate for this portfolio.

Tassal Group (TGR, +10%) – the Tasmanian salmon producer added value during the quarter, rising 10% and is now up 19% rolling year. For TGR, the half-year profit result in February was solid, with the profit line benefiting from good pricing and higher sales volumes into the domestic wholesale market, together with solid cost control. This time last year, TGR's salmon sales were heavily biased toward retail (i.e. major supermarket chains), however its sales mix is now more balanced. TGR raised $100m via a capital raise from investors in March and will use the proceeds to buy more equipment, expand the amount of fish in the water (working capital) and finally, to stake out future lease opportunities. All of which bodes well for future growth in salmon sales and TGR's outlook for the industry. The extra capital that will be invested in stock or effectively, fish, is noteworthy. TGR has determined that it was pulling fish out of the water to satisfy retail supply contracts and fill the shelves of the supermarkets, whereas the economics of fish farming suggest that if the fish were left in the water, the yield would improve and TGR would be able to farm bigger fish, thus improving the economics of the business. Hence, the extra capital that is required to fund more livestock in the

water, and TGR's shift toward a higher mix of wholesale sales aligns well.

Key detractors

Key detractors	Positioning
Fletcher Building	Overweight
Superloop Limited	Overweight
Independence Group	Overweight

Fletcher Building (FBU, -26.9%) – a series of forecast losses in FBU's NZ construction division drove two separate profit downgrades for FBU during the quarter. Two key projects appear to have been mispriced and although the projects will complete over the next couple of years, FBU has conservatively assumed various losses and provisioned for these in the current financial year. This was a particularly frustrating outcome as the balance of FBU's divisions, buoyed by the strength of the NZ economy, were all performing well. The fall in the share price has meant FBU's construction business, which typically contributes a little over 10% of annual profit, is being valued at effectively zero. On this basis, and despite what appears to be a major mistake by the relevant management – the CEO of this division has been replaced – we have maintained our holding in FBU on the expectation that future losses of this nature are not repeated and that the balance of FBU's business, accounting for some 90% of profits, are in reasonable shape.

Superloop Limited (SLC, -16.4%) – shares in telecommunications company, Superloop, were weaker across the quarter. Although difficult to be precise, investors were perhaps expecting either faster progress on sales growth in Asia, or perhaps the company to set more concrete sales targets in the market for the coming period. Regardless of others' expectations and somewhat irrespective of short-term growth rates (off a low base), SLC is certainly now entering the sales execution phase in both Hong Kong and Singapore. Future sales of SLC's dark fibre services to key customers in Singapore and Hong Kong will be a key determinant of the SLC share price. Finally, we would note the recent deal that SLC's Australian business, BigAir, announced with Vocus Group (VOC) in Australia for fibre capacity access. The deal involved an upfront payment to Vocus Group, but is expected to yield material cost savings each year to SLC, as well as increasing its strategic capability in chasing business.

Independence Group (IGO, -17.1%) – a delay in mining production during commissioning of IGO's world-class Nova-Bollinger mine was the key reason for IGO's weakness during the period. Specifically, one of IGO's contractors on site had issues providing sufficient staff over the recent December-January period, resulting in delays to underground mining development or quite simply 'earth moved'. The impact has been a two to three-month delay to mine commissioning. This 'personnel' issue appears to have been addressed with the contractor making every effort to restore earth moved to the targeted levels. The delay will however see IGO fall short of its targeted nickel and copper production targets for the current financial year. The company is adamant no further issues are anticipated in the ramp-up to full mine production. We will be looking to IGO's April update to confirm this is the case. Our investment thesis remains that Nova-Bollinger will ultimately deliver value to investors despite this early hiccup in commissioning.

Portfolio changes

Key additions and material adjustments

We added several new positions to the portfolio during the quarter and discuss several of these below.

Bought
Tox Free Solutions (TOX)
Japara Healthcare (JHC)
Melbourne IT (MLB)
Mayne Pharma Ltd (MYX)
Blackmores Limited (BKL)
SKYCITY Entertainment Group Limited (BKL)

Tox Free Solutions (TOX) is a stock we have owned previously in this portfolio. TOX has undergone considerable change in the last five years. Once a WA-focused waste service provider to the mining, energy and industrial sectors, TOX now has a far greater exposure to east coast Australia. In part, reflective of the cyclical shift in the Australian economy itself, as WA-focused construction projects wind down, but also a strategic decision by TOX to reduce its exposure to cyclical earnings streams from the mining and energy sectors. TOX has largely expanded via acquisition, including the acquisition of Worth and Daniels Health Australia, funded by equity raisings in 2016. Daniels, in particular, appears to our vantage to be a quality acquisition. Daniels is a service provider to the healthcare industry with ownership of key strategic incinerators and associated licences used in the burning of medical waste. Recent stock weakness appears driven by the ongoing decline of WA-focused construction-related earnings streams – these are about to shrink to zero – and also investor weariness in regard to ongoing equity raisings. With a positive view on Daniels and seeing the end of the WA-focused earnings as an inflection point, we have begun to build a position in TOX.

Japara Healthcare (JHC) – we have purchased a position in aged care operator, JHC, providing the portfolio with exposure to the strong thematic of Australia's ageing population and its need for high acuity care that many

Australians will require. Aged care, unlike retirement village living, is not a discretionary decision for many. JHC is also seeking to grow its total bed numbers via expansion of its own existing facilities or through the construction of new facilities. The latter requires the award of bed licences from the government and JHC has received approximately 1,000 of these so far. Also, we are seeing a shift in consumer behavior as many residents (and family) are now expecting to pay for a higher level of comfort and care in the final years of life. This provides an additional revenue opportunity for JHC.

We note two sources of recent share price weakness for the aged care sector. First, peer company, **Estia Health Ltd (EHE)** experienced a high-profile change in management and dilutive capital raising owing to its poor balance sheet after a debt-fueled string of acquisitions. We do not believe JHC has any such concerns, given the conservative positioning of its balance sheet. Second, a series of government-driven fee changes and focus on resident service levels in 2017, ensuring nursing home operators are not overcharging for services provided (care level) to patients, weighed heavily on the sector. Regulatory risk will always be a concern with an investment in this sector, particularly given the government is a major funder and people tend to blame politicians for every issue in the sector! However, we are of the view our entry price compensates for the risk. History tells us that fee pressures and regulatory risk are supportive of corporate players over the medium term as corporate players bring operating scale and funding capability to the sector, can benefit from consolidation as smaller players and have an interest in protecting their reputations. At present, aged care is largely a cottage industry, with the market dominated by smaller players and not-for-profits.

Melbourne IT (MLB) – is a leading provider of IT services in Australia. Its services encompass domain registration, web hosting, cloud services, data analytics and a wide range of online solutions to SMBs, large enterprise and government clients across Australia. Of key interest to us is its capability in design and implementation of mobile and digital services, for example apps for mobile devices. Implementation includes integration of the customer-facing app with all the functional tools that underpin the corporate services. For example, a power company needs to link its digital interface with its billing, network connection capability and also network service providers. In our discussions with large corporates, accessing and interacting with customers has become a key area of both service differentiation and productivity gains. MLB's strategic positioning in this segment under CEO, Martin Mercer, has been achieved via both an internal focus and via acquisition. Mercer has also stabilised the legacy 'domains' business which was the origin of the business and positioned MLB as a leading provider in the fast-growing digital and relate-services segment. The latter is the growth arm of the business whereas domains is now a steady, reliable cash driver. We would expect MLB to rebrand accordingly, in the near term.

Mayne Pharma Ltd (MYX) – recent share price weakness, largely driven by concerns that regulatory change under new US President Trump would aggressively target the pharmaceutical industry, provided an opportunity to purchase MYX for the portfolio. In recent years, MYX has amassed a series of assets that now position the company as a mid-tier specialty pharma/generics company, focused largely on the US. MYX's branded treatments in dermatology (acne treatments) and recently acquired US generics assets both offer solid growth for shareholders in our view. In terms of US policy change, we would highlight that major reform of the US health system appears politically challenging (despite the logic!) and that generic companies such as MYX that seek to produce cheaper copycat medicines that typically drive industry cost deflation, would appear the least capricious target of such reform. Philosophically, even if Trump is unsuccessful in regulating the broader pharmaceutical industry in any meaningful way, we have no doubt the blowtorch of public opinion and presidential rhetoric will impact industry behaviour and likely cap any rogue pricing that the industry has been pilloried for and made itself such a target.

Key disposals and material adjustments

Sold
Aristocrat Leisure (ALL)
Freedom Foods (FNP)

We sold two stocks outright from the model portfolio this quarter, with **Aristocrat Leisure (ALL)** already detailed above and **Freedom Foods (FNP)** discussed below.

Freedom Foods Group Limited (FNP) – having sold down our holding earlier in the quarter, we exited the last of our position in FNP late in the quarter. FNP continues to position itself as a scale producer of premium foods across milk, cereal and seafood, with a focus on various dietary specialties such as gluten free. FNP sells mostly to domestic markets, however exports to Asia are growing. Positive news flow in the premium or 'healthy living' focused food sector in recent times, particularly any company with sales into the growing Chinese markets for such consumer goods, no doubt contributed to investor interest in FNP. We believe these positives are largely reflected in the share price and hence our decision to take profits.

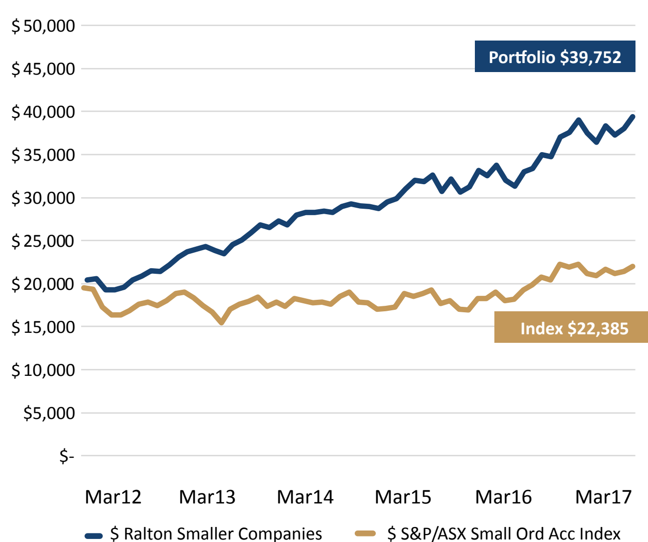
Sector allocation

GICS sector	Ralton	Index	+/-
Health Care	16.7%	7.2%	9.5%
Materials	21.8%	17.5%	4.3%
Telecommunication Services	4.6%	1.7%	2.9%
Information Technology	4.8%	4.7%	0.0%
Financials (ex-Property)	10.0%	10.1%	0.0%
Energy	5.8%	6.0%	-0.3%
Industrials	8.4%	8.7%	-0.3%
Utilities	0.0%	0.7%	-0.7%
Consumer Staples	7.6%	8.5%	-1.0%
Consumer Discretionary	18.0%	20.8%	-2.9%
Real Estate	2.4%	14.1%	-11.7%
Total	**100.0%**	**100.0%**	**0.0%**

Top 10 holdings#

Company name	ASX code
Fisher & Paykel Healthcare Corp Ltd	FPH
Evolution Mining Ltd	EVN
Steadfast Group Ltd	SDF
Japara Healthcare Ltd	JHC
Macquarie Atlas Roads Limited	MQA
Worleyparsons Limited	WOR
Nextdc Ltd	NXT
iSelect Ltd	ISU
Fletcher Building Limited (Australia)	FBU
Australian Pharmaceutical Industries Ltd	API

Performance comparison of $20,000*



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Performance of the Ralton Wholesale Smaller Companies 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.

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