



4 January 2008

PO Box R718
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**Smallco Investment Fund -
6 Monthly Newsletter to 31/12/07**

In the 6 months to 31 December 2007 the fund returned -18.6% with the unit price ending the year at \$2.5727. For the last year the fund returned -9.7%. We are disappointed by these results and they are in stark contrast to our 3 year return of +19.1% per annum and 5 year return of +28.2% per annum.

The Smallco portfolio has a large exposure to diversified financial companies, where it is often possible to achieve high return on funds employed and strong earnings per share (EPS) growth. Unfortunately with the US credit squeeze, and the resulting negative sentiment, this exposure has been a big negative for the fund over the last 6 months as a wide range of financial companies have been directly or indirectly impacted. In particular: - Rams Home Loans – where a vibrant 10 year old business was effectively destroyed almost over night, when one of it's major funding sources, the XCP market in New York shut down; – and Keybridge Capital (KBC formerly known as Mariner Bridge) which had a small direct exposure to some US sub-prime loans. The fund has totally sold out of Rams. However we have retained our position in KBC, where the share price remains depressed despite the small US sub-prime exposure having been fully written off and the majority of the portfolio performing above expectations.

The fund's performance has not been helped by a negative return from the Small Industrial's Index over the period which has had a negative impact on the share price of high growth stocks in the fund. For example, Iress (IRE), which continues to be a major investment for the fund, reported profit up 28% for the period and continues to have a very strong profit outlook. However, the share price has declined by approximately 15% over the period. In August, the fund increased its holding in IRE when the stock was particularly weak. To varying degrees, this example is typical of a number of our stocks.

The fund has invested in a number of mining services companies recently and we may increase our exposure if further well priced opportunities arise. Our research suggests that volume increases for resource commodities will continue for at least the next 5 years, driven by strong demand from China. However, the outlook for commodity prices over the next few years is less certain due to large increases in both supply and demand for most commodities. Consequently, we will continue to avoid the more volatile small resources stocks, where commodity prices are a major issue. This is despite their recent strong performance. Instead we will continue to carefully select mining services companies which should benefit from continued volume increases for a number of years.

Our continuing aim in stock selection is to buy stocks which we expect to approximately double earnings per share (EPS) on a 3 year view i.e. 26% EPS growth per annum for 3 years. The fund's current portfolio has forecast EPS growth in excess of 30% for the 2008 financial year. While some stocks will inevitably disappoint and others (hopefully) do better, given reasonable market conditions we expect solid medium term returns as the share prices ultimately reflect the strong underlying profit and EPS growth.



Over the period, the manager (at no cost to the fund) appointed a fourth fund manager, Andrew Hokin. Andrew is a very senior analyst with over 13 year's stockbroking research experience. He has fitted into the team well and is making a very positive contribution to our performance. This appointment of a fourth fund manager to manage a small - \$170m fund, which is now closed to new investors - is indicative of Smallco's focus on long term performance rather than increasing funds under management.

On behalf of the Smallco team, I would like to take this opportunity to thank you for your support of the fund. My business partner, Bill Ryan and I continue to be significant unit holders and have continued buying over the past 6 months*. We are very focussed on improving the funds unit price and, with the rest of the Smallco investment team, will continue to work diligently over the coming period to achieve a satisfactory return.

We provide regular 6 Monthly Newsletters, but we are always available during business hours to further discuss any relevant issues of the fund and provide ongoing fund updates. Please feel free to contact Craig Miller on 02 8256 1000.

Yours sincerely,

Rob Hopkins
Smallco Investment Manager

* Bill and my further investment in the fund is an indication of our on-going commitment to the fund. It is not intended to be personal investment advice, which under our licensing arrangements we are unable to offer.