



4 January 2013

PO Box R718
Royal Exchange
NSW 1225

Dear Investor,

**Smallco Investment Fund
Six-monthly newsletter to 31/12/12**

In what was a solid but quite volatile six months for equity markets, it is pleasing to report a strong positive return of 35.0%. For the calendar year, the Fund reported a very strong 64.8%. The closing unit price was \$2.6906.

Smallco Investment Fund outperformed the Small Industrials Accumulation Index over the past six months by 21.8% (35.0% versus the Index's 13.2%) and by 41.8% over the past 12 months (64.8% versus 23.0%).

In our view the international economic situation remains clouded. As a consequence, international markets remain skittish despite recently posting solid positive gains. The Australian economic outlook appears weak but, with falling interest rates, cash appears to be moving from fixed interest into the equity market.

Possibly as a result of the general economic uncertainty, the Australian equity market is currently paying a significant premium for good quality industrial companies where there is reasonable confidence of positive earnings growth even in a weak economy. Conversely, lesser quality industrials and resource companies, particularly small resource companies where there is a considerable likelihood of earnings disappointment, have underperformed.

This has suited the Fund's investment style, which generally favours higher quality small industrial companies and no resources exposure, and resulted in strong performance across a significant number of stocks. Over 70% of the portfolio is up more than 15% for the calendar year and over 50% is up more than 40%. Most of the stocks that are up over 15% for the year have featured in previous six-monthly newsletters and include our core internet stocks – Carsales.com, REA Group, Seek and Trade Me – and McMillan Shakespeare, Macquarie Atlas Roads and ResMed. This reinforces our investment philosophy that as long as companies continue to deliver profit and earnings per share growth the stock market will reward them, although the timing of the share price performance is often unpredictable.

Additionally, two companies – Magellan Financial Group Limited (MFG) and Altium Limited (ALU) – have more than tripled over the year and turned what would have been a very good unit price performance into an exceptional one.



We wrote about MFG in our newsletter six months ago. Since then its shares have more than doubled in price and its funds under management, which were approximately \$4bn at June 2012, are forecast by brokers to be in excess of \$9bn by June 2013.

ALU produces computer software to assist engineers in the design of electronic products including printed circuit boards and the components attached to them. After a decade when the revenue was stuck at US\$40-\$50m and producing very little if any profit, the last four half year periods have shown steady improvement in revenue and sensible cost control, resulting in a solid operating profit for financial year 2012. This period of growth has coincided with the acquisition of Morfik Technology, and its managing director, Aram Mirkazemi, and his team joining Altium. While Altium's visionary founder and managing director, Nick Martin, recently left the company, we expect that the remaining management team, which is very experienced, will actually be more focussed on sales growth, costs and medium term profitability than under Nick Martin.

We have referred above to a significant number of companies which have performed well for the Fund over the past year. While we continue to believe these companies will have solid earnings per share growth over the medium to long term, many of them are reasonably fully priced in the short term and consequently we have been reducing the weighting in a number of them. The Fund is now approximately 30% in cash. We would prefer to have less cash but are finding it difficult to find attractive stocks at reasonable valuations and our concerns about the economic outlook mean that we are not uncomfortable with this level of cash.

On behalf of the Smallco team, I would like to take this opportunity to thank you for your support of the Fund. We will continue to work diligently over the coming period to achieve a satisfactory return and I look forward to giving you an update in six months.

Please remember that along with providing regular six-monthly newsletters we are available during business hours to discuss any relevant issues or provide ongoing updates. Please feel free to contact Craig Miller, one of our investment managers, on 02 8256 1000.

Your sincerely

Rob Hopkins
Managing Director
Smallco Investment Manager