



10 July 2012

PO Box R718
Royal Exchange
NSW 1225

Dear Investor,

**Smallco Investment Fund
Six-monthly newsletter to 30/06/12**

In what was a volatile six months for equity markets it is pleasing to report a strong positive return of 22.1%. The closing unit price was \$2.0210, before the 2.81¢ distribution.

Smallco Investment Fund outperformed the Small Industrials Accumulation Index over the past six months by 13.4% (22.1% versus the Index's 8.7%) and by 17.2% over the past 12 months (14.5% versus the Index's negative 2.7%).

A major contributor to the Fund's performance over the last six months is Magellan Financial Group (MFG). MFG is an international fund manager whose main offering, the Magellan Global Fund, has outperformed its peers and the MSCI index across all periods since inception (July 2007). The Magellan Global Fund's performance, supported by a large experienced marketing team, has resulted in MFG's funds under management growing tenfold from \$400m to \$4b in the past three years. This is doubly impressive in that this has been a period when MFG's peers have struggled to maintain positive net inflows.

We have been meeting with management and following the stock since mid 2007 and made our first investment in MFG in late 2009. Our initial investment was made at \$0.80 when MFG's cash and cash equivalents were \$0.55. We have added to this position over time with our average buy-in price being \$0.90. The current share price is in excess of \$2.

The stock is not cheap on a short term view given it trades on a price earnings ratio in excess of 25 times our forecast earnings for FY12 and FY13. Indeed, due to the large position it has grown to in our portfolio and the near term valuation, we have recently sold a small portion of our holding. In the longer term, however, as an international fund manager MFG has the potential to grow its funds under management and its future profits significantly. Consequently, it remains one of Smallco Investment Fund's largest holdings.

We have spoken a number of times about carsales.com, the leading website for Australian automotive classifieds. Carsales.com's dominance comes from the fact that 75% of time spent looking at automotive classifieds websites around Australia is at carsales.com owned sites. Because most buyers are on carsales.com websites, the sellers go there as well, creating a cycle which over time increases carsales.com's dominance.



In mid 2011, a number of large car dealers and News Corporation formed a joint venture (JV) aimed at reducing carsales.com's website dominance. News Corporation contributed its classified car website, Carsguide, \$15m cash and a rumoured \$30-50m of advertising over a number of years, while the dealers contributed \$15m in cash and agreed to put their used cars on the Carsguide website. However the dealers are allowed, and have continued, to use the carsales.com website. At the time of this newsletter anecdotal evidence is that the JV is yet to make an impact, having troubles with its new website and personnel. We were always sceptical that this JV would have a significant impact on carsales.com and, as time goes by, this view appears likely to be vindicated. The underperformance of this JV, despite support from many of the major car dealers and the marketing might of News Corporation again highlights how strong the competitive position is for a business like carsales.com and the reason we expect it to continue to perform well.

The European sovereign debt crisis continues and is likely to persist in dominating the headlines for some time to come. Recent downward revisions to European GDP forecasts are disappointing although not unexpected. However, as long as Europe does not implode and GDP does not become significantly negative, Australian and world growth should continue to be solidly positive albeit below the long term trend.

Over the last six months we have reduced the number of stocks in the portfolio to be more concentrated in companies in which we have a higher level of confidence there will not be negative short term earnings surprises. Consequently, we continue to be cautiously optimistic about the medium term earnings outlook of the portfolio of quality companies in which the Fund is invested.

On behalf of the Smallco team, I would like to take this opportunity to thank you for your continued support and I look forward to giving you an update in six months. The Fund remains open for investment.

Please note that as well as providing regular six-monthly newsletters we are available during business hours to discuss any relevant issues or to provide ongoing fund updates. Please feel free to contact Craig Miller, one of our investment managers, on 02 8256 1000 should you have any queries with regard to your investment.

Yours sincerely

Rob Hopkins
Managing Director
Smallco Investment Manager