



10 July 2013

PO Box R718
Royal Exchange
NSW 1225

Dear Investor,

Smallco Investment Fund
Six-monthly newsletter to 30/06/13

Smallco Investment Fund has delivered a strong positive return of 17.0% for the six months. The closing unit price was \$3.1484, before the 3.53¢ distribution.

The Fund outperformed the Small Industrials Accumulation Index over the past six months by 14.0% (17.0% versus the Index's 3.0%) and by 41.3% over the past 12 months (58.0% versus the Index's 16.7%).

International markets rose strongly in the first 10½ months of the financial year before falling sharply in the last few weeks of June. It appears this fall was triggered by the US Federal Reserve's comments that it now expects to cease purchasing bonds sooner than the market had expected. In our view, removing this monetary stimulus, while likely to reduce excessive short term stock market exuberance, will be done only because US unemployment is significantly lower which on a medium to long term stock market view, will be positive. This is because for the first time since the Global Financial Crisis, the world's largest economy is finally getting its unemployment rate to an acceptable level and will consequently have a chance to resume 'normal' long term economic growth.

Provided Europe continues to limp on with no major economic shocks - which appears to be the general market view - international stock markets will be supported by solid fundamental global GDP growth in the medium term despite potential volatility in the short term.

Over the last six months economic forecasts for Australian GDP have fallen and declining interest rates have resulted in investors chasing companies with higher yields and/or solid earnings growth.

The Fund's investment style, which generally favours higher quality small industrial companies and no resources exposure, has been in favour and resulted in strong performance across a significant number of stocks. Close to 60% of the current portfolio is up more than 30% for the financial year and close to 40% is up more than 50%. The vast bulk of this performance comes from stocks that have featured in previous six-monthly newsletters and include our core internet stocks - Carsales.com, REA Group, Seek and Trade Me - and Altium, Magellan Financial Group, 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.



In the last two six monthly newsletters we have written about the significant contribution to the Fund's performance of the international fund manager, Magellan Financial Group (MFG). In our last newsletter we noted that the share price had performed well because its funds under management - approximately \$4bn at June 2012 - were forecast by brokers to exceed \$9bn by June 2013. In fact by June 2013 MFG's funds under management exceeded \$14bn and, as a result, the MFG share price has again performed well, up more than 80% in the last six months alone.

The Smallco Investment Fund does not invest in resources stocks. The major reason for this policy is that small resources companies are often single-mine, single-commodity operations with a consequent high level of volatility and unpredictability and are therefore generally lower quality investments than similar industrials. For the Fund's first decade of operation to December 2010 this approach was a significant headwind with the Small Resources Accumulation Index up 21.1% pa while the Small Industrials Accumulation Index was up a mere 4.8% pa. Over the past three years, however, this has changed dramatically with the Small Industrials Accumulation Index up 9.5% pa while the Small Resources Accumulation Index was down 25.3% pa. With the decade of high commodity prices behind us we are not tempted to change our approach to resources stocks.

The Fund has maintained a cash holding of approximately 30% over the last six months. While we would prefer to have less cash, we continue to have difficulty finding attractive stocks at reasonable valuations and our concerns about the Australian economic outlook mean we are not uncomfortable with this level of cash.

As an aside, it was pleasing to be recognised by our peers during the year. In May Smallco was announced as Money Management's 2013 Australian Equities (Long Short) Fund Manager of the Year. This is the fourth year in a row that Smallco has been a finalist for this award and the second time we have won.

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.

Yours sincerely

Rob Hopkins
Managing Director
Smallco Investment Manager