



6 January 2012

PO Box R718
Royal Exchange
NSW 1225

Dear Investor,

**Smallco Investment Fund
Six-monthly newsletter to 31/12/11**

Smallco Investment Fund returned -6.2% in the six months ended 31 December 2011 and slightly better than that for the calendar year at -6.0%. This was 4.3% ahead of the Small Industrials Accumulation Index for the six month period and 6.8% ahead for the calendar year.

The European debt situation is providing a cautious tone to the outlook for World and more particularly Australian economic growth. It is making debt funding more difficult, has weighed heavily on equity markets over the last 6 months and dominates the outlook.

While there remains much work to be done in Europe, we are heartened by the initial disciplined and aggressive moves by the Governments of Italy and Spain (the largest problem economies) to directly address their debt problems. Time will tell if these measures are enough to stabilise the situation, but current broker economic forecasts are for a mild European recession followed by a return to very modest economic growth. Provided the European situation does not become significantly worse than this, in our view, equity markets appear modestly priced and so provide reasonable medium term upside potential. However, in the short term we are likely to get considerable volatility as the equity markets react to any European news.

REA Group Limited (REA) is one of our larger holdings and has been one of SIF's best performing stocks in the last period. It owns the dominant Australian website for Australian real estate agents to display their listings - realestate.com.au. Like most other internet businesses, it has low incremental costs so a high proportion of any increase in revenue goes to profit. As the leading real estate website in Australia, it has good pricing power because it is such an important selling tool for agents. The company has benefited from the move from print to online advertising and this still has further to go, particularly in the area of display advertising. In the last few years REA has been successful in getting house vendors to start paying for priority advertising.

The company recently acquired the outstanding 31% of Casa.it, its Italian subsidiary. Marginally the largest Italian online website, Casa.it is yet to achieve the market dominance and profitability of REA's Australian operations. Casa.it is however gaining market share and losses have consistently reduced over the past 18 months. Market forecasts are for Casa.it to be profitable going forward and this provides another significant growth leg for the business. Despite the subdued real estate market over the last few years REA's earnings per share (EPS) growth has been an impressive 30% or higher for each of the last five financial years. For financial year 2012, broker forecasts are for this rate of EPS growth to slow, but still be in excess of 15%, a solid result.



In our letter six months ago, we mentioned that we had a major position in Macquarie Atlas Roads (MQA). The stock has fallen approximately 30% from its May 2011 highs. We believe this fall has primarily been caused by concern surrounding the re-financing of the debt on the holding company for APRR, the French toll road operator and the principal asset of MQA. Despite the tighter European funding situation we expect that the re-financing will happen because it involves a reduction in the bank debt and gearing as well as higher margins for the banks. Additionally, despite the weak French economy, APRR has continued to increase revenue and profits over the year. In its 30 year history APRR has grown revenue and EBITDA every year including through the Global Financial Crisis. To us this has been a good buying opportunity and we have added to our position in the stock over the period.

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
Smallco Investment Manager