LEGG MASON
GLOBAL ASSET MANAGEMENT

Legg Mason
Australian Small Companies Trust

Objective

The Trust aims to earn a before fees and taxes return of 5% p.a. in excess of the benchmark over rolling three year periods.

Benchmark

S&P/ASX Small Ordinaries Accumulation Index.

Value

$11,707,619.

Performance (before fees and taxes)

	Trust %	Benchmark %
3 months	11.59	11.20
1 year	20.57	13.05
3 years p.a.	-0.75	-5.89
5 years p.a.	9.30	5.54

Past performance is no indication of future performance.

Profile

Value Added	Active Weight %	Quarterly Return %	Quarterly Alpha %
Tower Australia	+4.4	65.4	+1.6
Boart Longyear	+3.5	44.3	+0.9
PanAust	+2.4	36.9	+0.6
Mesoblast	+1.2	81.7	+0.4
STW Communications	+2.9	30.1	+0.4

Value Detracted	Active Weight %	Quarterly Return %	Quarterly Alpha %
Pacific Brands	+2.6	-12.5	-0.7
Sundance Resources	-1.2	+130.0	-0.6
Flexigroup	+3.0	-3.1	-0.4
Hills Holdings	+1.2	-16.7	-0.4
Kathmandu	2.4	-8.1	-0.4

Market Review

Equity markets gained ground over the December quarter as investors were generally positive on the economic outlook heading into 2011. This reflected positive momentum in macro data, particularly further quantitative easing in the U.S.

Concerns around European sovereign debt contagion and increased interest rates in China tempered the gains of a number of equity markets.

Australian small companies market gained 11.2% over the quarter, as measured by the S&P/ASX Small Ordinaries Accumulation Index. The gain over the year to 31 December 2010 was 13.1%.

The Australian small companies outperformed the broader Australian equity market by 6.8% over the quarter as a number of small cap resource stocks outperformed during December, in line with higher commodity prices and an increased tolerance for risk.

In particular, small capitalised resource firms generally outperformed. For example, PanAust (+36.9%) benefited from a higher price of copper, while Sundance Resources (+130.0%) was significantly higher.

Merger and acquisition activity was a feature of the Australian equity market during the quarter. Japanese insurer Dai-ichi Life announced it had entered into a scheme implementation deed to acquire the 71% of Tower Australia (+65.4%) that it did not already own. Meanwhile, James Packer acquired a substantial shareholding in the Ten Network (+2.2%).

Australian economic releases this quarter saw credit growth, retail sales and house prices all trend lower. However, employment growth remained robust. In October the Reserve Bank of Australia increased the target cash rate by 0.25% to 4.75%, which was quickly followed by a further 0.15% to 0.20% increase to mortgage rates by the major banks.

Meanwhile, the Australian dollar appreciated US4.96 cents against the U.S. dollar to finish the quarter at US$1.02. The Australian dollar gained US11.94 cents over the past year.

Performance

The Legg Mason Australian Small Companies Trust outperformed its benchmark by 0.4% over the quarter. Portfolio performance over the past year was 7.5% ahead of benchmark.

Performance this quarter was aided by the portfolio's exposure to the Financials ex Banks & Property, Industrials and Health Care sectors.

In the Financials ex Banks & Property sector, the portfolio's overweight exposure to Tower Australia (+65.4%) added value as the life insurer was the focus of the aforementioned corporate activity by Dai-ichi Life.

We have been overweight Tower for some time as we forecast that the company would be able to produce double digit top line growth and increased returns on equity over the medium term. The announcement by Dai-ichi is near term recognition of the significant medium term value we ascribed to Tower Australia.

In the Industrials, performance was aided by the portfolio's overweight exposure to Boart Longyear (+44.3), Qube Logistics (+41.9%) and Emeco Holdings (+25.6%).

Boart Longyear was significantly higher this quarter as it upgraded earnings guidance. The drilling company noted a more robust December trading period and improve rig utilisation rate. The company also benefited form improved exploration demand, the rally in copper and gold prices as well as more prevalent resource company equity raisings. Transport logistics business Qube was higher as investors continued to price the upside of its expanding position in freight handling and logistics. Earthmoving equipment firm Emeco gained ground as it provided upgraded earnings guidance, reflecting strong recovery in utilisation experienced across its core businesses. Importantly, the holding of Emeco provides the portfolio with exposure to growth in the resource sector without direct exposure to commodity price volatility.

Meanwhile, choices in the Health Care sector added value as the portfolio was overweight Mesoblast (+81.7%) and specialty pharmaceutical company QRxPharma (+40.0%).

Biotechnology firm Mesoblast was higher as it benefited from a U.S. Government decision to award grants for development of adult stem cell products; the firm was also cleared to proceed with its acquisition of U.S. firm Angioblast Systems. QRxPharma, a clinical-stage specialty pharmaceutical company, was higher as it also received grants from the U.S. Government; the firm also completed a capital raising during the quarter.

A further portfolio positions to aid portfolio performance this quarter was an overweight position in PanAust (+36.9%) in the Metals & Mining sector. As it benefited from a higher price of copper.

Outlook

We remain favourably disposed to Australian small companies at this time as improved corporate earnings, strong balance sheets and favourable underlying economic fundamentals should allow Australian small companies to move higher on a medium term view.

In respect of stock specific investment opportunities, we continue to observe a valuation spread between the most attractive and least attractive stocks in the investment universe that is well above historical averages. This signals to us that opportunities for stock selection are abundant and that active management should be handsomely rewarded.

Further Information

Overweight Positions	Active %
Tower Australia	+4.4
Boart Longyear	+3.5
Emeco Holdings	+3.1
Atlas Iron	+3.0
Flight Centre	+3.0

Underweight Positions	Active %
Aquila Resources	-1.4
Whitehaven Coal	-1.4
Monadelphous Group	-1.3
Mount Gibson Iron	-1.2
ING Industrial	-1.2

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