

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

\$120,010,857.

Performance (before fees and taxes)

	Trust %	Benchmark %
3 months	-10.32	-11.59
1 year	24.09	11.18
3 years p.a.	-8.99	-14.20
5 years p.a.	6.75	2.74

Past performance is no indication of future performance.

Profile

Value Added	Active Weight %	Quarterly Return %	Quarterly Alpha %
Campbell Brothers	+3.2	+3.8	+0.5
Virgin Blue	-0.9	-50.0	+0.5
Bradken	+3.5	-6.2	+0.5
Healthscope	+2.1	+16.1	+0.4
Flexigroup	+3.0	+1.5	+0.4

Value Detracted	Active Weight %	Quarterly Return %	Quarterly Alpha %
Elders	*-0.2	-62.8	-1.2
Pacific Brands	+3.0	-40.4	-0.5
Riversdale Mining	-1.1	+15.3	-0.4
Coffey	+0.3	-65.3	-0.3
Worif.com	+2.5	-29.5	-0.3

*Portfolio was overweight Elders intra-quarter.

Market Review

Equity markets around the world lost ground during the June quarter as investors became concerned by European sovereign debt levels and moderating growth expectations in China and the U.S. Domestically, wrangling over the Resource Super Profits Tax generated headlines. The Australian small companies sector closed down 11.6% over the quarter, as measured by the S&P/ASX Small Ordinaries Accumulation Index. Over the past year, the sector gained 11.2% despite the recent declines.

Despite the proposed Resource Super Profit Tax and risk aversion, small capitalised Materials companies were not uniformly lower. Macarthur Coal (-14.8%) fell, as Peabody first lowered then withdrew its bid for the company, and Aquila Resources (-29.2%) lost ground. Iluka Resources (+6.0%) outperformed as it appeared to be relatively unaffected by the proposed Resource Super Profit Tax, since a significant proportion of its earnings come from its iron ore royalty.

Corporate announcements continued to drive stock performance outcomes this quarter. Riversdale Mining (+15.3%) gained ground as it announced that it had signed a non binding memorandum of understanding with Chinese group Wuhan Iron and Steel for the development of the Zambeze Coal project in Mozambique. Meanwhile, Mineral Resources of Australia (+8.6%) outperformed as it extended its takeover offer for Mesa Minerals.

On the economic front, the Federal Budget saw the announcement of a reduced company tax rate, increases to the Superannuation Guarantee levy and a forecast return to surplus by 2012/13. The Reserve Bank of Australia raised the target cash rate by 0.25% to 4.25% in April, while the Australian dollar reaffirmed itself as a "risk" currency; it lost US6.36 cents against the greenback to end the period at US85.23 cents. March quarter gross domestic product recorded a 0.5% gain, in line with market expectations.

Performance

The Legg Mason Australian Small Companies Trust outperformed its benchmark by 1.3% over the quarter. Portfolio performance over the past was 12.9% ahead of benchmark. At the sector level, portfolio exposure to the Industrials and Energy sectors added the most value.

In the Industrials sector, an overweight position to Mineral Resources of Australia (+8.6%), Campbell Brothers (+3.8%) and not holding Virgin Blue (-50.0%) aided portfolio performance.

Mineral Resources of Australia gained ground on the aforementioned extension of its takeover offer for Mesa Minerals, while Campbell Brothers gained ground as it announced upgraded profit guidance for the first half of 2011. The firm cited strong trading conditions for the majority of the company's operations. Meanwhile, Virgin Blue lost significant ground post a profit downgrade.

Other portfolio holdings to aid performance relative the benchmark this month included:

- an overweight exposure to Healthscope (+16.1%), which surged as it received a takeover bid from a private equity firm and confirmed that it had also received two further non-binding proposals;
- an overweight exposure to Flexigroup (+12.3%) in the Financials sector as the stock continued to outperform post the completion of a rights issue in March; and
- an overweight exposure to Melbourne IT (+13.0%), which gained ground as it held an upbeat AGM that flagged strong underlying growth.

The only significant detractor from portfolio performance was the portfolio's overweight exposure to Elders (-62.8%). We had initiated an overweight position in this company as the company was well capitalised, we had a favourable view of the new management team and a good crop planting season was apparent. However, the firm announced late in the period that it had downgraded underlying profit due to a lower fertiliser price and other factors. We have since liquidated our holding in this company.

Outlook

Our view is that the recent market weakness is significantly overdone and that it may partially be explained by memories of 2008, when investors that were slow to factor in the impact of the global financial crisis were hit hard.

We maintain that there remains significant value on offer in selected underlying Australian small company securities and that the sector should be able to move higher on a medium term time horizon. This view is supported by evidence that a number of small companies have reduced their risk profiles over the past year. As such, a number of firms are poised to produce strong margin expansion once revenue growth returns.

Stock specific developments are likely to be a critical driver of Australian equities over the remainder of 2010, as the valuation spread between the most attractive and least attractive names in the investment universe remains significantly higher than their historical averages. As such, we have positioned the portfolio to benefit from stock specific opportunities and we continue to expect to produce above normal portfolio returns over the medium term.

Further Information

Overweight Positions	Active %
Bradken	+3.9
Henderson Group	+3.7
Boart Longyear	+3.7
Flight Centre	+3.6
Campbell Brothers	+3.2

Underweight Positions	Active %
ResMed	-2.1
Ramsay Health Care	-1.9
Macarthur Coal	-1.7
Riversdale Mining	-1.5
Aquila Resources	-1.3