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 its benchmark over rolling three year periods.

Benchmark

S&P/ASX Small Ordinaries Accumulation Index.

Value

$26,496,972

Performance

	Trust %	Benchmark %
3 months	-2.15	-0.60
1 year p.a.	-15.36	-21.43
3 years p.a.	18.58	11.83
5 years p.a.	-0.32	-5.18

Past performance is no indication of future performance.

Market Review

After a strong performance during the month of October, equity markets came once again under selling pressure, on the back of rising risk aversion. Despite further evidence of the resilience of the US economy, investors continued to be concerned about a potential meltdown of the Eurozone. Volatility reached high levels but global equity markets ended the quarter on a positive note.

For much of the period, the Australian share market was very volatile. With investors looking for safety, defensive stocks outperformed more cyclical stocks. The Australian small companies sector lost 0.6 % over the quarter, as measured by the S&P/ASX Small Ordinaries Accumulation Index.

Australian economic data released during the quarter continued to highlight softness in the economy. Retail sales remained weak and employment fell further. The Reserve Bank of Australia cut the target cash rate by 50 basis points to 4.25%, reflecting the slowing momentum in the domestic economy. The market has priced in a few potential rate cuts by June 2012.

The Australian dollar rallied against the U.S. dollar at the beginning of the quarter. Despite some volatility, it ended the December quarter at US1.014 cents, up 4.1US cents.

Performance

The Legg Mason Australian Small Companies Trust underperformed its benchmark by 1.5% over the quarter. Performance over the past year was 6.1% ahead of benchmark.

At a stock level, positions in Transpacific Industries, AWE limited and Spotless Group added value during the quarter.

Transpacific Industries was the best contributor to performance during the quarter as shares rallied on the completion of a capital raising. We have been holders of TPI on the basis of its strong underlying businesses, primarily in the waste management sector, and have been supportive of the strategic direction espoused by the new Chief Executive Officer. Although willing to hold through the process of reducing debt levels with strong cash flows we took advantage of the recent capital raising which immediately improved the balance sheet and eliminated part of a discount being applied by the market.

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The portfolio benefited from the overweight to Spotless Group (+32.2%). During the quarter, Pacific Equity Partners approached Spotless with a conditional proposal to acquire the company at a premium to the current price. This is the second attempt to gain control and again the board of Spotless have stated its belief that the price undervalues the company in the context of a change of control.

The underweight to Medusa Mining (-34.7%) aided performance as well. Shares dropped as its operation had been affected by a strong tropical storm in the Philippines and general de-rating of gold stocks.

In terms of negative contributors, the main detractors were Collins Food (-41.1%), Flexigroup (-15.3%) and Kathmandu (-22%). Collins Foods announced a shock profit downgrade after being listed only in August of this year. While never good news, negative surprises in such quick time, after being sold out of private equity are always taken poorly by the market and Collins was no different.

Outlook

While markets continue to be dominated by events in Europe we would expect volatility to remain a feature. Australian Small companies have also been hit from a sentiment perspective and there has been evidence of slower business activity as companies seem to be taking a more cautious approach and waiting for the dust to settle. The consumer has also been relatively quiet and on the resources front lower commodity prices have suppressed returns in those sectors.

On a positive note however, successive rate cuts will have an impact on activity at some point and share prices have become a lot more attractive from a pure valuation perspective. Corporate balance sheets are in good shape and the wave of project spending is still very much intact and so we expect there will still be a range of opportunities to enhance portfolio returns over the medium term.

Further Information

Top Ten Holdings

- Transpacific Indus
- Bradken Limited
- Flexigroup Limited
- Qube Logistics
- Adelaide Brighton
- Ioof Holdings Ltd
- Premier Investments
- Flight Centre
- Emeco Hold Limited
- Mcmillan Shakespeare