

# Pengana Global Resources Fund

## September 2008 Update



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### Fund Description

The Pengana Global Resources Fund provides investors with equity exposure to companies within the global mining, energy, steel, commodities and associated services sectors. The fund is managed out of Melbourne, Australia and uses multiple strategies to profit from inefficiencies in the pricing of companies in its investment universe. Among the strategies utilised by the fund is the ability to be both long and short securities which allows market volatility to be better managed.

### Fund Commentary

Net Returns to 30 September 2008 <sup>1</sup>	Pengana Global Resources Fund	S&P ASX 300 Metals and Mining	FTSE 350 Mining	S&P 500 Metals and Mining
<b>1 Month</b>	-20.27%	-24.07%	-34.32%	-31.10%
<b>3 Months</b>	-25.21%	-32.74%	-44.10%	-45.33%
<b>6 Months</b>	-16.12%	-23.24%	-34.64%	-37.60%
<b>12 Months</b>	-12.32%	-31.47%	-33.48%	-40.54%
<b>Since inception<sup>2</sup></b>	+22.32%	-5.36%	-2.91%	-27.21%

- **The ferocity of the downturn in economic data, commodity and equity pricing in the past month was unprecedented.**
- **Valuations are compelling at current levels, more so now than when the Fund was incepted.**
- **Companies have started cutting production in response to lower commodity prices.**
- **The resources sector is ideally placed to see a rapid turnaround in fortunes.**
- **Share prices traditionally bottom well ahead of economic activity.**
- **The Fund has generated a since inception return of +22.32% while the Australian universe in which it invests has fallen -5.36%.**
- **The team has demonstrated an ability to enhance returns for investors in both rising and falling market environments since the Fund's inception.**

The downturn in economic data, commodity and equity pricing over the past month has been ferocious and indiscriminate. In context, the back-ended fall of the CRB Index over the last four months has been greater than that of the average cyclical downturn (peak to trough) which has averaged 43 months. The severity of the downwards movement in the prices of commodities and resource equities has been compounded by a combination of downgrades to economic growth, de-leveraging by hedge funds (many of which have suffered from a brutal combination of falling asset prices, increased margin requirements and increased redemptions) and the onset of panic by some investors.

The resources sector is ideally placed to see a rapid turnaround in fortunes as global policy makers move to implement expansionary policy measures aimed at averting a protracted period of global deflation. Real economic activity is likely to receive stimulus from dovish monetary policy, an increase in liquidity in the global banking sector and a range of fiscal initiatives. Such moves are likely to result in lower interest rates, higher levels of economic growth and higher levels of inflation. Importantly, investors should note that a bottoming in share prices is likely to occur well ahead (3 to 5 quarters on average) of a nadir in economic activity. Economic growth in developing economies remains healthy despite having moderated from higher levels. China, for instance, is still recording real GDP growth 9% year on year in the September 2008 quarter.

The Australian All Resources Accumulation Index has seen 7 months since June 1992 where monthly returns have been -10% or greater, two of those months have been in July and September 2008 (a record month). The average return in the 12 months following a 10% or greater monthly decline for the All Resources Accumulation Index has been +21.49% with the largest return being +44.35%.

Current share prices of some commodity producers are implying commodity prices will fall a further 40% from current levels and sustain those low levels for years to come. It is our view that despite the severity of the global financial crisis this is an overly pessimistic scenario. Whilst demand is likely to be curtailed due to the combination of a global slowdown in economic growth as well as unwinding of speculative long positions and tighter inventory controls we are already seeing evidence of a quick supply-side response with production cuts and project delays in some industries already occurring. As a result, demand-supply equilibrium is likely to transpire at prices above such levels despite a period of inventory adjustment and negative

<sup>1</sup> Performance figures are net of all fees and assume reinvestment of income.

<sup>2</sup> Inception date: March 2007, launch date: September 2007. March 2007 – September 2007: Performance of internal fund seeded by Pengana Capital. Past performance is not a reliable indicator of future performance.

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investment flows exacerbating downward price pressures in the near term. In addition, incumbent, well diversified producers are likely to find that barriers to entry such as project finance (both debt and equity) for new entrants to the sector have increased substantially as a result of the current economic climate. Therefore, incumbent, well diversified producers should be very well positioned for the next move upwards in commodity prices.

With a longer term view, the irrationality that has seen quality mining companies sold down to current levels will very likely result in once in a lifetime opportunity for those investors willing to be patient and disciplined. In the near term, as liquidity returns to the financial system and fear abates in the equity markets, the resources sector is expected to have a strong and sharp relief rally from such over-sold levels to a point where market fundamentals are re-established.

Pleasingly, since the fund's inception in March 2007 we have been able to clearly demonstrate an ability to add value for investors in both rising and falling market environments. For instance, in the 12 months to June 2008 the Pengana Global Resources Fund achieved a return of 26.21% compared to the 23.73% achieved by the S&P/ASX Metals and Mining Accumulation Index. For 2008 calendar year to date, the Pengana Global Resources Fund has returned -18.0% compared to the S&P/ASX Metals and Mining Accumulation Index which is down 28.2%. Our rigorous investment process, proven team capabilities and disciplined assessment of a rapidly changing environment should continue to serve investors well in a rapidly changing environment.

### Market Commentary

September 2008 was tumultuous for stock-markets globally as the sub-prime credit problems of the United States degenerated into a global financial crisis.

The extent of problems with the US financial sector became apparent early in the month when the US government decided to nationalise mortgage providers Freddie Mac and Fannie Mae. Following closely on the news of the bailout of "Fannie" and "Freddie" was news that investment bank, Lehman Brothers, had suffered from a combination of downgrades to its debt, a plummeting share price and what was now a siege mentality amongst investors.

The consequences of the US Federal Reserve allowing Lehman Brothers to fail (after the failure earlier in the year of Bear Stearns) were that mistrust and scepticism of investment banks had manifested into outright panic by investors. Mid-September Bank of America announced a US\$50 billion merger with Merrill Lynch. The deal would allow Merrill Lynch access to liquidity only afforded commercial banks. Later in the month the US Federal Reserve would allow other investment banks such as Goldman Sachs and Morgan Stanley the ability to transition to commercial bank funding arrangements. In addition to the problems with US Investment Banks, the markets had to contend with the potential failure of the world's largest insurance company, American International Group (AIG). Following a downgrade of the company's credit rating the US Federal Reserve provided emergency funding of up to US\$85 billion to AIG to prevent its collapse in what amounted to a complicated debt for equity swap.

With such rapid change taking place in the United States, debt and equity markets were thrown into a state of flux. Investors were looking to avoid any impending catastrophe by withdrawing capital from the system at a time when inter-bank lending had dried up. This placed further pressure on banks globally and as a consequence it also placed pressure on the ability of corporations (many large, well-run and solvent) to refinance debt. A protracted bout of de-leveraging and equity liquidation ensued leading to sharp downward movements in share prices. The liquidation moved beyond the finance sector globally to other sectors of the economy.

In an effort to stem the outward flow of capital from equity markets and the finance sector in particular, the US Securities and Exchange Commission (SEC) implemented a ban on the short selling of 799 financial companies on 19th September, effective immediately. Similar bans were implemented on other bourses with the Australian regulator, the Australian Securities and Investment Commission implementing a blanket ban on short-selling (both covered and naked sales) for a period of at least 30 days effective from the 22nd September. The intention of regulators in these instances was to mitigate the volatility and downward pressure to share prices and restore confidence to the system. Arguably such moves may have inadvertently highlighted an "Achilles heel" of markets, compounding the crisis of confidence and reducing market liquidity simultaneously.

The events of the past few weeks are likely to have consequences for economies and markets for years to come. Thankfully, the motivations of policy makers globally are largely aligned in working towards renewed, sustained global economic prosperity. The initial signs are encouraging in that policy makers are seeking a global solution to what is now a global problem.

### Portfolio Action

Since the peak in the Australian Resources Market in May 2008, the fund has been positioned more defensively (gross and net) in large, well capitalised companies. Following an 11% fall in the S&P ASX 300 metals and mining index in July 2008 and a small (1%) subsequent recovery in August 2008, the managers incrementally started to lock in gains from short positions. The ferocity and magnitude of the subsequent fall in September, with the index already 20% off its high at the start of the month

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was a surprise given the Fund’s fundamental investment style. While the relative return of the Fund in September versus the Australian Index was respectable, it is worth noting that around 50% of the Fund is currently invested in the US and UK markets that returned materially less for the period.

During such uncertain times we continue to favour companies that are well capitalised, have industry leading operations capable of producing profits at cyclical low points and management that will adapt quickly to a rapidly changing environment. Over the past month we have increased the weighting in gold producers and currently have exposure to four listed gold producers: Barrick Gold Corporation, Newmont Mining Corporation, Lihir Gold and Newcrest Mining. It is common during times of uncertainty for investment demand for gold to surge and we believe it is prudent to have an increased level of exposure to gold producers as a result. It is difficult during such unprecedented volatility to pick a bottom in share prices. We therefore continue to act cautiously holding a high proportion of cash in the portfolio with no gearing and remain biased towards large, liquid, well diversified companies. Equities are trading at compelling valuations, even after factoring in trough-cycle pricing scenarios.

We continue to monitor closely a number of key signposts such as interbank borrowing rates, freight rates, policy initiatives and currency levels, along with company valuations to ensure we do not miss this compelling opportunity for our investors.

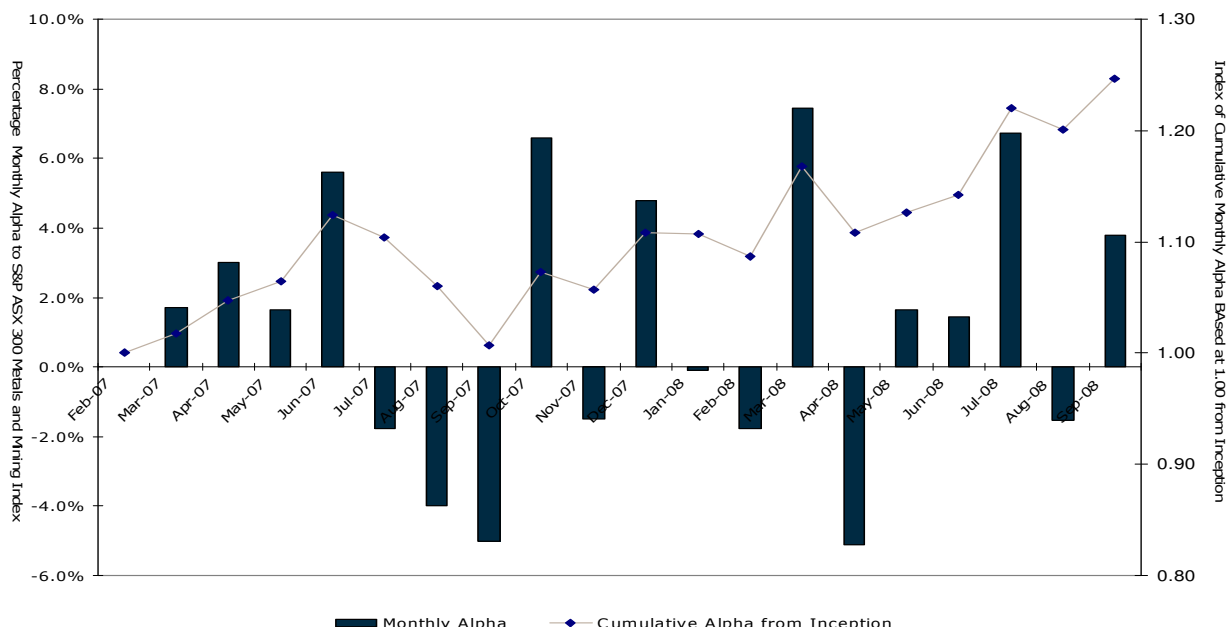
Domestically, the S&P/ASX Metals and Mining Accumulation Index ended September down an incredible 23.3%. Share prices fell due to a combination of events including an increased chance of recession in G3 economies, lower commodity prices, downward revisions to profit forecasts by stock broking analysts and hedge fund de-leveraging. However, metals and mining shares in other markets fared even worse. In the United States, the S&P Metals and Mining Index fell 31.10% in September. In London the FTSE 350 Mining Index ended the month down 34.32% whilst the S&P/TSX Global Mining Index fell by 25.88%.

In September the S&P/ASX 300 Energy Accumulation Index dropped 13.03%. The record levels of profitability exhibited by many constituent companies in the August reporting season were distant memories as investors focussed on the impact to future profitability of lower commodity prices. The mindset of “stronger for longer” which had evolved to “stronger forever” in some instances changed to investors embracing the possibility that peak oil prices and peak profitability may have been seen and that cyclical nature of earnings was indeed a feature of the sector. Consequently, oil and gas producers and explorers suffered de-ratings and negative share price movements. Continued falls in the spot prices of uranium, thermal and metallurgical coal also contributed to the sector’s poor performance despite many producers selling the majority of their production into more stable fixed price contracts.

### Key Contributors

Key contributors to the portfolio’s performance during September included Newcrest Mining (+32.2%), Lihir Gold (+40.05%), Freeport McMoRan Copper & Gold (-36.35%), Vale (-27.87%) and Arch Coal (-39.36%).

## Pengana Global Resources Fund – Monthly and Cumulative (A\$) Alpha versus S&P ASX 300 Metals and Mining Index



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## Commodity Price Changes for September 2008:

Commodity	US\$ Price Change	A\$ Price Change	€ Price Change
Oil	-13.17%	-5.51%	-9.24%
Gold	5.97%	13.63%	9.90%
Copper	-14.53%	-6.87%	-10.60%
Aluminium	-10.72%	-3.06%	-6.79%
Zinc	-4.10%	3.56%	-0.17%
Nickel	-22.39%	-14.73%	-18.46%
Lead	-8.07%	-0.41%	-4.14%
Tin	-13.93%	-6.27%	-10.00%

## Portfolio Structure

As at the end of the month, the portfolio was structured as below:

Portfolio Structure (as at end of September 2008)	
Number of Stocks	27
Gross Exposure	84.5%
Net Long Exposure	64.3%
Breakdown by Strategy	Pairs: 17.5% Directional Long/Short: 82.5%

Top 5 Positions (in alphabetical order)
Anglo American
BHP Billiton
Rio Tinto
Vale
Xstrata

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