



Pengana Emerging Companies Fund

December 2004 Quarterly Review

The Pengana Emerging Companies Fund began investing on November 1, and in its first two months the fund returned a pleasing 9.1% net, outperforming the benchmark by 6.7%. Investor sentiment during the period remained strong, as evidenced by the record highs in the broad indices.

Total return performance for periods ending 31 December 2004

	1 mth	2 mths	3 mths
	%	%	%
Pengana Emerging Companies Fund	4.3	9.1	n/a
S&P/ASX Small Ordinaries Acc Index	-0.3	2.4	n/a
Outperformance of benchmark	4.6	6.7	n/a

Please note that the Pengana Emerging Companies Fund commenced on 1 Nov 2004.
Total return performance figures are derived from the Manager's records and are shown after all fees and assume reinvestment of income.

Market backdrop

During the two months to December the All Ordinaries Accumulation index rallied 8.0% to an all time high. This reflects high investor confidence, the strong domestic economy, solid global demand for commodities driven largely by China, and increasing cash allocated to equities from the growing superannuation pool. Over the same period the Small Ordinaries Accumulation rose 2.4%, underperforming the broad market following a sustained period of strong outperformance since May.

Review of quarterly performance

The Pengana Emerging Companies Fund generated a return of 9.1% net over the two months. This was broad based driven by reasonable moves in holdings such as Alesco, Candle, Commander Communications, IBT Education, Tempo Services and Transurban.

Alesco's acquisition of B&D Rollerdoors, and divestment of its lower quality auto distribution businesses shows a management team focused on driving improved returns. **Candle** upgraded its profit expectations for the first half, now expecting 40%+ growth driven by the continued recovery in demand for IT contractors. **Commander** is successfully leveraging off its strong brand in phone equipment sales to small businesses by adding competitively priced network services (ie phone calls). **IBT Education** is a long established operator of tertiary education courses predominately for overseas students. The company was floated in December, and despite an impressive debut we built on our position in the aftermarket given the impressive growth outlook, high cash generation and proven management team. A private equity consortium has made a \$1.42 takeover offer for **Tempo Services**, an 18% premium to the last price. Finally, **Transurban** continues to be re-rated as the market appreciates the rapid growth in distributions, and low risk nature of the key asset, Melbourne's Citylink road network.

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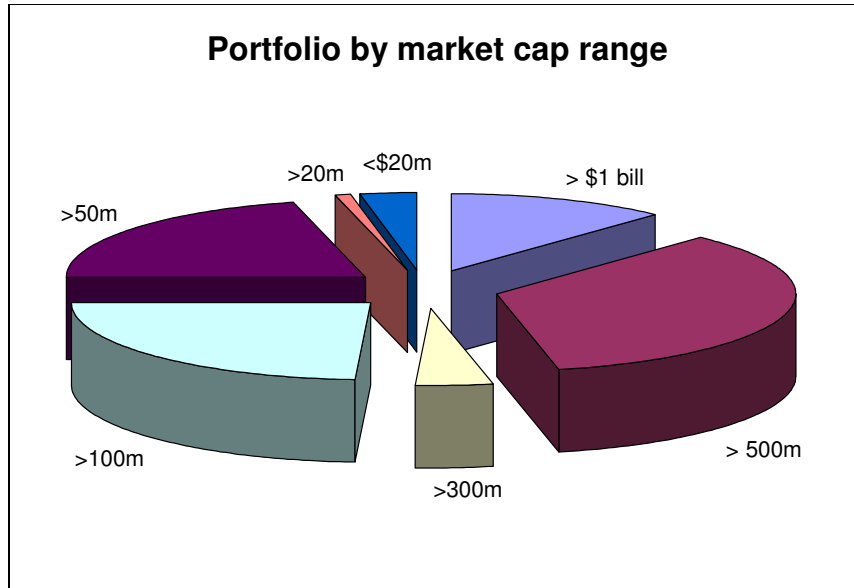
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Portfolio activity

The focus in the initial two months was to establish our portfolio, therefore by definition most of our trades were buys. Our current portfolio is a healthy mix of core holdings in high quality mid-caps such as Alesco, Baycorp, and Transurban, smaller plays including Commander, IBT Education, and Investor Group, and a well diversified spread of much smaller companies. The chart below shows the weighting in our portfolio in market cap ranges.



While we are not “top down” investors, current investment themes which we favour include a sustained recovery in IT spend following the post Y2K “hangover”, the regulated growth in superannuation flows driving growth in financial services, ongoing rationalization in the telecommunications industry, consolidation in the wholesale distribution sector, and ongoing strength in non-residential construction. Above all, stock picking remains the absolute key driver in smallcap investing, hence our portfolio contains a number of special situations.

Outlook

While the strength in the smallcap market over the past 18 months has seen much of the obvious value captured, we remain confident that money making ideas still exist. The domestic economy is strong, valuations in many cases are not stretched, and many companies have spent the past 2-3 years focusing on building balance sheet strength, which lowers investing risk. Our active company contact program aims to unlock these opportunities (see below).

The upcoming results season is likely to show continued strength in the economy, however growth momentum is likely to slow (esp retail) as the previous Jan-Feb period was particularly strong. We expect outlook commentary to be mostly positive, except in industries which are exposed to new housing, and those which are affected by the high oil/resin prices and a high A\$.

We are wary however, that in certain instances in the current euphoric market, valuations are expanding beyond appropriate levels in companies with relatively high earnings risk. Stark examples of this over the past three months include AAV, Globe, Henry Walker, and SDI where company profit warnings have resulted in significant price declines. So while we are not yet moving to a defensive portfolio position, we are highly wary of stocks whose valuation overstates earnings quality.

The Australian economy is likely to see a slowing in growth over the coming year as heavily indebted consumers reduce the rate at which they spend. A sharply slowing economy, whilst possible, is not the likely outcome however as high levels of spending on infrastructure projects and strong investment from the corporate sector will provide a stimulus to the economy.

As growth slows, we believe new stock themes will emerge. Yield and capital management will continue to have some importance but the market will become more discerning. We expect to see market appetite increase for companies with the ability to grow earnings organically in a more challenging environment. The companies best equipped for growth through a softening economy are those with pricing power and quality management able to execute on the company's growth opportunities.

Company visits

Our central belief is that contact with management is the key to unlocking value within the smallcap sector, hence during the December quarter we initiated face-to-face contact with over 90 companies and unlisted competitors of listed stocks. The table below shows the listed companies with which we had direct contact during the period.

Access Providers	Ellex	Keycorp	Prime Life
Adcorp	Equity Trustees	Korvest	Promedicus
Adsteam Marine	Fiducian	Kryocom	Pumpkin Patch
Adtrans	Funtastic	Lighting Corp	Realestate.com.au
Aevum	Gale Pacific	M2 Connect	Record Investments
Alesco	Great Sthn Plantation	Macmillan S'speare	Redflex
API	Gropep	Magna Pacific	SDI Ltd
Atlas Group	GUD	McGuigan Wine	Sirtex
Austin Grp	Gullivers Travel	McPhersons	SMS Mgt and Tech
Australian Energy	Hansen Tech	Mermaid Marine	SP Telemedia
Bill Express	Healthscope	Mesoblast	Stargames
Boom Logistics	Housewares Int	Millepede	Strathfield
Brazin	Harvey World Travel	National Hire	Trasonic
Bridgestone	Hyro	Nick Scali	Transurban
Chariot	IBA	Nylex	Tribeca
Cockatoo Ridge	IBT	Oakton	Trustco
Colorpak	Integrated Research	OAMPS	Undercover Wear
Commander	Investor Group	Objective	Vision Group
Compumedics	Investorweb	OFM	Vision Systems
Concept Hire	IRESS	Pacific Hydro	Web Central
Connect East	IT&E	Peopletel	Wilmott Forests
Cool or Cosy	Jetset	Plaspak	
Count Financial	Julia Ross	PMP Ltd	
DKN Group	Just Group	Primary Healthcare	

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