



Pengana Emerging Companies Fund

March 2005 Quarterly Review

The Pengana Emerging Companies Fund returned a healthy 3.8% net over the March quarter, outperforming the benchmark by 1.2%. Since inception in November 1 2004, the fund returned 13.3% outperforming the smallcap benchmark by %.

While the smallcap market reached record highs, this was primarily driven by resources stocks, which are not in our investible universe. Excluding these stocks, the fund outperformed the industrial sector by 3.5% in the March quarter.

The fund now has \$26m under management, and during the quarter we were approved for **BT and Macquarie Wrap platforms**, and recommended by independent research house, Lonsec.

Total return performance for periods ending 31 March 2005

	3 mths %	Since inception* %	1 yr %	3 yrs %
Pengana Emerging Companies Fund	3.8	13.3	n/a	n/a
S&P/ASX Small Ordinaries Acc Index	2.6	5.1	n/a	n/a
Outperformance of benchmark	1.2	8.2	n/a	n/a

* Since Nov 1, 2004

Total return performance figures are derived from the Manager's records and are shown after the management fees, but before performance fees, and assume reinvestment of income.

Market backdrop

While the overall market reached record highs during the March quarter (up 2.7%), the rally was not particularly broad, with resources stocks driving most of the strength. Over the period the Small Ordinaries Accumulation rose 2.6%, with resources stocks up 14.0% versus industrials 0.3% (note resources represent around 20% of the Small Ords). We believe the "hot money" chasing smallcap resources stocks is a shorter term event, and discuss this further below.

The interim results season confirmed the strong underlying economic conditions, however, many companies operating in consumer related industries noted mild weakness into Christmas and the Jan/Feb trading period. Companies exposed to business spending generally experienced strong underlying trading conditions.

Review of quarterly performance

The Pengana Emerging Companies Fund generated a return of 3.8% net over the three months. Key successes during the period were Candle, Energy Developments, Investor Group, IWL Ltd, Transonic and Transurban. See below for further comment on each of these stocks.

Candle's interim profit growth of 39% was above market expectations and cements our view that the IT services cycle remains in firm up-trend. **Energy Developments** is a classic turnaround story which is gradually ticking off milestones, and hence regaining investor confidence. A strong interim result saw analyst upgrades, plus new renewable energy projects have boosted the growth profile. **Investor**

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Group upgraded its full year profit forecasts based on strong equity markets feeding into its financial planning operations. **IWL Ltd** has seen a re-rating following an earnings upgrade driven by strong equity markets. **Transonic** also saw mild upgrades following a 47% increase in interim pretax profits as the travel industry continues to recover. **Transurban's** bid for Hills Motorway, combined with the promise of increased dividends saw further price strength.

The recent strength in smallcap resources stocks, which account for 20% of the index, is worthy of comment. Our investment philosophy is based on investing in companies where we can back quality management and make sound assessments of the earnings potential of the business for valuation purposes. Given that the share prices of small resources stocks are largely driven by factors beyond management control (commodity prices, currency, exploration success, speculation etc), we do not believe the risks justify investing.

A dramatic illustration of the risks inherent in the resources sector was the 40% decline in Fortescue Metals Group during March. The company plans to develop an iron ore project and was capitalised at \$1.2bn prior to news emerging that contracts with its key partners and customers were not binding, putting the project into doubt.

Portfolio activity

During the period, we reduced exposure to some stocks which had reached our valuation objectives including Atlas Group, IWL Limited, and SMS Mgmt and Technology. Recent purchases include Colorado Group, Energy Developments, Salmat, and SAI global. **Colorado** is a relatively defensive retailer with significant internal growth drivers: **Energy Developments** is a renewable energy turnaround story, **Salmat** is a direct mail and outsourcing group showing very strong growth, and **SAI Global** offers exposure to a high quality growth franchise in the publication and auditing of industrial standards.

The weighted average PER of our portfolio for the FY06 year is estimated at 11.9x, compared with the overall smallcap average of 14.1x. The dividend yield on our portfolio is 4.5%.

Top 5 positions in the fund
Brazin
Investor Group
Energy Developments
Alesco
Primary Healthcare

Outlook

The smallcap market is firmly in "stock picking" mode, which leaves us comfortable that money making ideas remain for those prepared to look - our active company contact program aims to unlock these opportunities (see below).

The domestic economy is strong, however as mentioned above, spending from the business sector is likely to offset weakness in consumer spending, hence our portfolio is skewed accordingly. Our only retail exposure is via companies with internally generated profit drivers (Brazin and Colorado). The outlook for business spending remains strong, hence our skew to industrial services, especially IT services such as recruitment and project management.

We also favour underlying growth sectors such as financial planning/fund administration driven by the regulated growth in superannuation, and see strong opportunities in the telecommunications sector as smaller player continue to take market share from Telstra, and the non-residential construction market driven by both private and public sector spending.

Valuations in our view are mixed and while the overall rating of smallcaps has certainly risen over the past 18 months, there is a large discrepancy between earnings quality. In a buoyant market, investors risk over-pricing riskier earnings streams only to be punished by significant price declines once volatile earnings streams are exposed through earnings downgrades – for example AV Jennings, Village Life, Capral. Our skew towards businesses with relatively predictable cash flows is aimed at avoiding such

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high risk situations. As mentioned above, our the PER of our portfolio is 18% below the Smallcap average, demonstrating our relatively conservative stance on valuations.

Company visits

Our central belief is that contact with management is the key to unlocking value within the smallcap sector, hence during the March quarter we made face-to-face contact with 79 companies and unlisted competitors of listed stocks. The table below shows the listed companies with which we had direct contact during the period.

ASG Group	Destra	ITD Ltd	Real Brands
Alesco	Dexion	IWL Ltd	Record Inv
Atlas Group	DKN Ltd	JB Hifi	Repco
Austar	Domino Pizza	Lipa Pharmaceuticals	SAI Global
Aust'n Education	Emitch	M2 Telecomms	Service Stream
Aust'n Energy	Equity Trustees	Macmillan S'peare	Sigma Alpha
Aust'n Pharma Ind	Frigrite	Melb IT	SMF
Baycorp	Futuris	Mortgage Choice	SMS Tech
Brazin	Gropep	Multi e media	Snowball
Candle	GUD	MYOB	Sunland
Cardno	Hastie	Noni B	Tassal
Challenger	Hostworks	Nylex	Traffic Tech
Cheviot Bridge	Hutch Childcare	Nufarm	Transfield
Coffey	IBT Education	Oakton	Transonic
Colorado	IMF	Orion Telecomms	UXC
Computershare	Institute of Drug Tech	Palm Springs	Volante
Conventry	Integrated Group	PCH Group	Webcentral
Cool or Cosy	Integrated Research	Peopletel	Webjet
Corp. Express	Investor Group	Primary Health	Webster
CPT Global	ISS Group	Promedicus	

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