



Pengana Emerging Companies Fund

June 2005 Quarterly Review

The Pengana Emerging Companies Fund posted a net return of -0.3% over the June quarter, versus the benchmark performance of 2.6%. Since inception in November 2004, the fund has returned 12.9% outperforming the smallcap benchmark by 5.1%.

The June quarter was characterised by high volatility in cyclical stocks, strength in resources stocks, and strong performance in the mid-cap sector. In this environment, our slightly defensive stance and aversion to resources stocks saw relatively mild performance versus the benchmark.

The fund now has over \$28m invested, and was recently rated "Recommended" by **Morningstar** adding to the similar recommendation by **Lonsec**. The fund is approved for **BT and Macquarie Wrap platforms**, and various margin lending providers.

Total return performance for periods ending 30 June 2005

	3 mths %	Since inception* %	1 yr %	3 yrs %
Pengana Emerging Companies Fund	-0.3	12.9	n/a	n/a
S&P/ASX Small Ordinaries Acc Index	2.6	7.8	n/a	n/a
Outperformance of benchmark	-2.9	5.1	n/a	n/a

* Since Nov 1, 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

The June quarter was highly volatile with the All Ords falling sharply in April, only to recover to record highs by mid June. The smallcap sector proved even more volatile, falling 5% in April, only to rally 8% during May and June. The sharp fall in April was precipitated by a series of profit warnings primarily from companies exposed to the consumer and housing markets, combined with a shift in sentiment away from higher risk earnings stories.

The rebound during May/June was primarily liquidity driven, with domestic institutions reinvesting cash raised from the Newcorp index removal, cash from the takeovers of WMC, Southcorp etc, and a high level of dividends. Falling bond yields added to the relative valuation appeal in equities. In the smallcap market, the strength was largely felt in the larger more liquid stocks as fund managers moved to reinvest funds quickly, plus stocks with defensive earnings streams such as healthcare, infrastructure etc. Resources stocks outperformed the industrials strongly during the quarter.

Review of quarterly performance

The Pengana Emerging Companies Fund generated a return of -0.7% over the three months. Key successes during the period were Candle, Energy Developments, Oakton, Primary Healthcare, Prime Infrastructure, and SAI Global (see below). As we do not invest in resources stocks, and our weighting to midcaps is relatively low, the fund's performance fell short of the benchmark during the period.

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Candle provided an upgrade to profit expectations based on strong demand for IT temporary staffing. **Energy Developments** moved higher due to its low risk revenue streams, and news of an extension to the NSW Gas Abatement Scheme which financially rewards the company for reducing greenhouse gas emissions. **Oakton** continues to benefit from the increased demand for IT services as corporate Australia finally looks to replace IT systems installed in the lead up to Y2K. **Primary Healthcare** (GP centres), **Prime Infrastructure** (regulated infrastructure assets) and **SAI Global** (standards publishing and auditing) are benefiting from improving sentiment towards low risk earnings streams.

Portfolio activity

During the period, we reduced exposure to some stocks which had reached our valuation objectives such as **Salmat** and **IWL**, and other stocks exposed to slowing demand such as retailers **Brazin** and **Colorado**. We established positions in a range of stocks with relatively low risk revenue streams such as **Adsteam Marine**, **Cabcharge**, and **Prime Infrastructure**. Taking note of the dramatic skill shortage in the domestic economy we also built positions in blue collar labour hire companies **Chandler MacLeod** and **Skilled Engineering** which also benefit from the strength in the mining sector and non-residential construction.

The weighted average PER of our portfolio for the FY06 year is estimated at 12.7x, compared with the overall smallcap average of 14.7x. The dividend yield on our portfolio is 4.5%. Our top five positions are listed below.

Top 5 positions in the fund
Investor Group
Energy Developments
Candle
Primary Healthcare
Prime Infrastructure

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). Valuations in most cases remain reasonable in our view.

While the domestic economy is broadly strong, we believe consumer and housing related industries will struggle to match the growth of the past 3-4 years, and that industries exposed to business and government spending (mining, IT, commercial services) will grow more quickly. The mining sector has record amounts of committed project expenditure, while various state government budgets have highlighted the massive catch-up expenditure now committed to infrastructure such as power, water, public transport, and ports.

While we favour stocks exposed to mining and infrastructure, many are contract based companies which have high risk earnings streams due to fixed price/lump sum contract payments. The valuations of many of these companies are stretched, and we prefer more diversified companies such as Skilled Engineering, Chandler MacLeod and Korvest which are cheaper and lower risk in our view.

The IT services sector remains in strong uptrend due to catch-up expenditure in the corporate sector following a four year lull post Y2K. We hold a spread of companies in this sector where valuations do not currently reflect the improving underlying story. The federal budget highlighted the structural growth in the superannuation sector, with the removal of the contribution surcharge levied on high income earners. Hence we remain strongly exposed to the financial planning and superannuation administration industries through Investor Group and DKN Group.

Into the upcoming results season we believe the slowing consumer and housing markets are likely to result in commentary leading to lower earnings expectations in the medium term. As a result we are maintaining a high weighting towards lower risk industries such as infrastructure and healthcare.

Company visits

Our central belief is that contact with management is the key to unlocking value within the smallcap sector, hence during the June quarter we made face-to-face contact with 57 companies and unlisted competitors of listed stocks. The table below shows the listed companies with which we had direct contact during the period.

AAV Ltd	HPAL Ltd	Seek
Adelaide Bank	IBT Education	Select Managed Funds
Adsteam Marine	Integrated Research	Skilled Engineering
APN Group	Investor Group	Smorgon Steel
ARB Corp	IOOF	STW Comms
ASG Group	Keith Harris Foods	Sunland
Austar	Lipa Pharmaceuticals	Symex
Becton	MacMillan Shakespeare	Tattersalls
Boom Logistics	Macquarie Comms Infra.	Timbercorp
Chandler MacLeod	Magna Pacific	Total Communications
CMA Corp	McPhersons	Transol
Crane Group	Metcash	Transpacific
Customers	MFS Ltd	TZL
Destra	Onesteel	Village Roadshow
DKN Financial	Penrice	Vision Group
Domino's Pizza	Photon	Waste Mgmt
Energy Developments	Prime Infrastructure	Wellcom
Environmental Solutions	Promentum	
Funtastic	RuralAus	
Healthscope	Salmat	

For more information on the fund visit our web site on <http://www.pengana.com.au/>

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