



Pengana Emerging Companies Fund

March 2006 Quarterly Review

The Pengana Emerging Companies Fund posted a net return of 14.2% over the March quarter, compared with the benchmark performance of 12.7%. Since inception in November 2004, the fund has returned 51.1% p.a. net, outperforming the smallcap benchmark by 13.1%. The fund does not invest in resources stocks, which have rallied 66% since formation of the fund. The outperformance in that environment is particularly pleasing, with the fund beating the *industrial* benchmark by 20.2%.

During the period, **Lonsec** upgraded its rating to “Highly Recommended”, adding to our “Strong Buy” rating from **InvestorWeb**, and positive recommendations from **Morningstar and Zenith**. The fund is approved for **BT and Macquarie Wrap platforms**, and various margin lending providers, and now has over \$75m invested.

Total return performance for periods ending 31 March 2006

	3 months	6 months	1 Year	Since inception*
Pengana Emerging Companies Fund	14.2%	18.3%	33.4%	51.1%
S&P/ASX Small Ordinaries Acc Index	12.7%	13.3%	31.3%	38.0%
Outperformance of benchmark	1.5%	5.0%	2.1%	13.1%
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Pengana Emerging Companies Fund	14.2%	18.3%	33.4%	51.1%
S&P/ASX Small Industrials Acc Index**	8.9%	11.2%	25.8%	30.9%
Outperformance of benchmark	5.3%	7.1%	7.6%	20.2%

* Since Nov 1, 2004

** The fund does not invest in resource stocks

Total return performance figures are derived from Manager's records and are shown after all fees and assume reinvestment of income.

Market backdrop

The March quarter saw the All Ords again reach record highs, up 8.0% over the period. Smallcaps rallied 11.5% during the quarter, with the resources component rising 25% versus industrials at 8%. The key driver during the quarter for industrial stocks (our key market) was a healthy profit reporting season.

Review of quarterly performance

Key successes for the fund during the period were in the financial services sector (**Australian Wealth Management** and **DKN Group**), the IT sector, (**Candle** and **Oakton**), and mining services (**Bradken** and **MacMahon**). We also highlight **MacMillan Shakespeare** and **UndercoverWear** as contributors.

Superannuation administration remains a strong growth sector, however a merger proposal between Select Managed Funds, and **Australian Wealth Management** drove a 47% increase in the latter's shares. **DKN Group** was also re-rated as the market realises the strategic value of its administration platform. Earnings releases from the IT services sector were very positive, benefiting **Candle** and **Oakton**, which rallied c30% each in the quarter. Similarly, mining services results were very strong, with outlook comments bullish, aiding a 20% and 36% rally in **Bradken** and **MacMahon** shares. Salary packaging outfit **Macmillan Shakespeare**, and lingerie group **Undercoverwear** both reported stronger than expected results, leading us to boost our existing holdings in the stocks.

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Portfolio activity

During the period, we reduced exposure to some stocks which had reached our valuation objectives such as, **SAI Global**, **Skilled Engineering** and **Smorgon Steel**.

New additions to the portfolio include whitegoods retailer **Clive Peeters**, engineering outfit **VDM Group**, brokers **Mortgage Choice**, and diversified advertising group **STW Communications**.

The weighted average PER of our portfolio for the FY06 year is estimated at xxxx%, compared with the overall smallcap average of xxxxx%. The dividend yield on our portfolio is xxx% which suggests a slightly defensive stance in the portfolio. Our top five positions are listed below.

Top 5 positions in the fund
Oakton
Australia Wealth Mgmt
Candle
WHK Group
Primary Healthcare

Outlook

The overall strength of the market continues, and obviously requires caution given the level of short term momentum. However, we do not see valuations as unreasonably stretched, and with healthy corporate balance sheets and a strong underlying economy, investing risk remains neutral on the whole. Many companies have raised their dividend payouts in recent times, with high dividend yields providing support to share prices.

While the retail sector remains patchy, we mildly increased our exposure to the sector, having identified three high quality growth stories at reasonable prices, **Clive Peeters** (a new position), **The Reject Shop**, and **Nick Scali** (adding to existing holdings). There are other potential opportunities in the sector we are working on, given the poor sentiment (hence modest valuations), and potential for tax cuts to re-ignite sales momentum throughout 2006.

We are wary of companies with a high exposure to the New Zealand economy given the delayed impact of a series of interest rate increases over the past 18 months. Fixed interest rate loans are much more popular in New Zealand, which delays the impact of rate increases, hence current activity levels (especially housing and consumer) are potentially under threat.

We remain heavily exposed to companies benefiting from the strength in business/government spending. Key sectors here include IT services, mining services, and non-residential construction. Reported earnings, and outlook sentiment from most companies in the IT services remains very strong given the ongoing recovery in spending since the Y2K "hangover". The mining services sector appears even more bullish, with mine construction and expansion based on rising base metals and iron ore prices. We prefer companies selling consumable products to this sector, rather than contractors which rely on less predictable project related revenue. Non-residential construction is primarily driven by catch up expenditure by state governments in the transport, power and water sectors, which looks like remaining strong into 2008.

Financial services remains fertile, especially companies which derive income from the superannuation sector which has government mandated growth. Our favoured stocks are **Australian Wealth Management**, **DKN Group**, **MacMillan Shakespeare** and **WHK Group** (formerly Investor Group).

Our exposure to the healthcare sector remains high. The attractions to this sector include a lack of economic sensitivity, exposure to the aging population, and consolidation opportunities. These opportunities are strongest in pathology, ophthalmology and hospital sectors, benefiting **Ramsay**, **Sonic** and **Vision Group** which we hold stock in.

Company visits

Our central belief is that contact with management is the key to unlocking value within the smallcap sector, hence during the quarter we made face-to-face contact with 92 companies and unlisted competitors of listed stocks. The table below shows the listed companies with which we had direct contact during the period.

ABC Learning	Clive Peeters	Jumbuck	Sonic Healthcare
Adelaide Bank	Coates Hire	Legends	Structural Systems
Adelaide Brighton	Cochlear	M2 Comms	STW Comms
AI Engineering	Colorado	MacMahon	Talent Two
Alesco	Computershare	Macmillan Shakespeare	The Reject Shop
Alinta	Crane Group	Macquarie Leisure	Timbercorp
Ammcom	Dark Blue Sea	MFS Group	Transfield Services
Ansell	DCA group	Mortgage Choice	Transpacific
APN Ltd	Dexion	My Net Fone	TSV Group
APN Property Group	DKN Group	MYOB Ltd	United Group
ASG Group	Dyno	Oakton	Village Roadshow
ASX Ltd	Energy Developments	Peet & Co	Vision Group
Austar	FKP Ltd	Ramsay Healthcare	Waste Mgmt
Austereo	GBST Holdings	RCR Tomlinson	Wattyl
Baycorp	GPS online	Record Investments	Web Central
Billabong	Gropep	Resmed	Webster
Bluechip Financial	GUD Holdings	S 8 Group	Wellcom
Bradken	HFA Ltd	Salmat	WHK Group
Brandrill	IBT Education	Seek	
Candle	Imdex	SFE Ltd	
Cardno	Integrated Group	Skilled Group	
Cash Converters	Integrated Research	Sky City	
Cedar Woods	ITL Ltd	SMF Group	
Challenger	Jetset	Smorgon Steel	

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

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