# Pengana Emerging Companies Fund

Money Management | IMCA
FUND MANAGER OF THE YEAR 2006
FINALIST
Australian Shares (Small cap)

## June 2006 Quarterly Review

The Pengana Emerging Companies Fund posted a net return of 2.8% over the June quarter, compared with the benchmark performance of -1.9%. Since inception in November 2004, the fund has returned 55.2% outperforming the smallcap benchmark by 19.9%. The fund does not invest in resources stocks, which have rallied 67% since formation of the fund. The outperformance in that environment is particularly pleasing, with the fund beating the *industrial* benchmark by 27.6%.

The Fund recently received a favourable rating from van Eyk *******, adding to existing ratings of "Highly Recommended" by **Lonsec,** "Strong Buy" by **InvestorWeb**, and "Recommended" from **Morningstar and Zenith**. The fund is approved for **BT and Macquarie Wrap, Symetry, Asteron, Austchoice and Beacon platforms**, and various margin lending providers, and now has over $82m invested.

### Total return performance for periods ending 30 June 2006

| | 3 months | 6 months | 1 Year | Since inception* |
|---|---|---|---|---|
| **Pengana Emerging Companies Fund** | 2.8% | 17.3% | 37.5% | 55.2% |
| **S&P/ASX Small Ordinaries Acc Index** | -1.9% | 10.5% | 25.5% | 35.3% |
| **Outperformance of benchmark** | **4.7%** | **6.8%** | **12.0%** | **19.9%** |
| | | | | |
| **Pengana Emerging Companies Fund** | 2.8% | 17.3% | 38.6% | 55.2% |
| **S&P/ASX Small Industrials Acc Index**** | -2.5% | 6.1% | 20.1% | 27.6% |
| **Outperformance of benchmark** | **5.3%** | **11.2%** | **18.5%** | **27.6%** |

* 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 assumes reinvestment of income.

## Market backdrop

The June quarter was volatile, with the All Ords reaching record highs in May, only to fall 9% in four weeks driven primarily by weakness in the resources and banking sectors. The small cap market moved in a similar fashion, with resources stocks a feature in the weakness during May and June. From peak to trough, the Small Resources index fell 22% (in four weeks) as base metals prices corrected sharply on fear of rising inflation exacerbated by speculative investment in direct commodities. A rally late in June saw the small resource stocks recover much of their lost ground and outperform the Small Industrials over the quarter.

## Review of quarterly performance

Key successes for the fund during the period included **Integrated Group**, **Peet & Co**, **Reject Shop**, **Reverse Corp**, **Transfield Services** and **Web Central**.

The 31% rally in **Integrated Group** was driven by underlying strength in the labour hire operations, plus the sale of two lower quality divisions in vessel charter and training. **Peet & Co** continues to re-rate (up 25%) as the market appreciates its high quality land bank, efficient capital structure, and its shorter term exposure to the booming WA housing market. Shares in **The Reject Shop** rose 15% with its low price points attractive in a struggling retail environment. **Reverse Corp** provided an upgrade to earnings forecasts, generating a 44% rally in the share price. **Transfield Services** moved 12% following two acquisitions and a proposal to sell down its infrastructure assets, potentially releasing hidden value. **Web Central** rose 26% following a proposal to merge with Melbourne IT.

**Pengana Capital Limited** ABN 30 103 800 568 Australian Financial Services Licence no. 226566
PO Box 483, Flinders Lane PO, Melbourne Vic 8009 **Phone** 03 8660 7325

## Portfolio activity

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

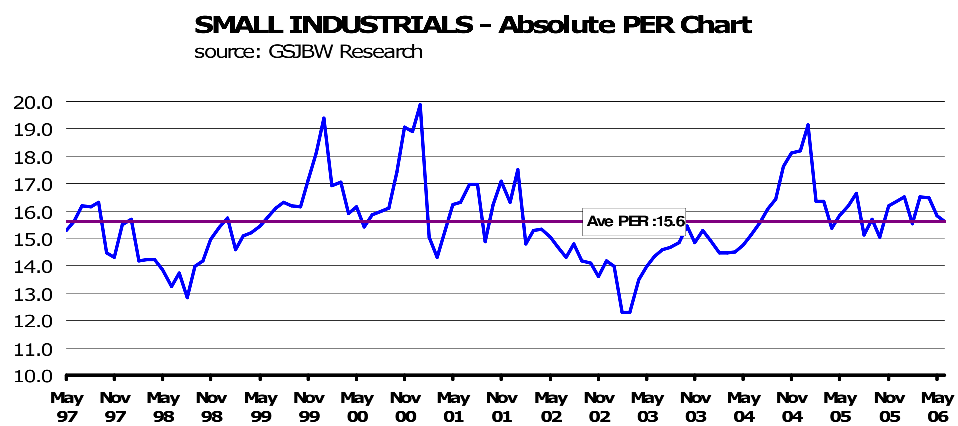
New additions to the portfolio include recent floats such as **Ausenco**, **Bravura**, **Retail Food Group**, and other stocks such as **Energy Developments**, **Reverse Corporation**, **S8**, and **Saferoads**.

The weighted average PER of our portfolio for the FY07 year is estimated at 13.6 times, compared with the overall smallcap industrial average of 15.5 times. The dividend yield on our portfolio is an estimated 4.8% which suggests a slightly defensive stance in the portfolio. Our top five positions are listed below.

| **Top 5 positions in the fund** |
|---|
| Candle Australia |
| Oakton |
| Primary Healthcare |
| WHK Group |
| Reverse Corp |

## Outlook

The short term volatility in markets is not surprising given the very positive momentum of previous quarters. Overall, we do not see valuations as overly stretched (refer chart below), 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 retain a selective exposure through three high quality growth stories at reasonable prices, **Clive Peeters** (a new position), **The Reject Shop**, and **Nick Scali**. The latter is suffering short term pressure due to weak furniture sales, however valuations remain modest, and the store roll out path is very strong. 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 through 2006.

Our exposure to companies benefiting from the strength in business/government spending remains high, reflecting our confidence in the theme. 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, Timbercorp**, and **WHK Group** (formerly Investor Group).

# 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 68 companies and unlisted competitors of listed stocks. The table below shows the listed companies with which we had direct contact during the period.

| | | | |
|---|---|---|---|
| ARB Ltd | Emeco | McArthur Cook | S8 Ltd |
| Ausenco | Environmental Group | McPhersons | Saferoads |
| Austral Waste | Espreon | Melbourne IT | Sedgeman |
| AV Jennings | Finbar | MFS Leisure | Select TV |
| AVFM Ltd | Fisher & Paykell Health | Mineral Resources | Servcorp |
| Babcock and Brown Infra. | FKP | Nufarm | SMS Mgmt |
| Brainz Instruments | Fletcher Building | Oakton | Snowball |
| Bravura | GPS Online | Pacific Brands | STW Communications |
| Cabcharge | HFA Ltd | PCH Group | Ten Network |
| Campbell Bros | Housewares | Pipe Networks | Toxfree Systems |
| Centrebet | IBA Ltd | Praemium | Traffic Technologies |
| Centrepoint Alliance | Imdex | Primary Healthcare | Tutt Bryant |
| CPT Global | Incitec Pivot | Prime TV | VDM Group |
| David Jones | Incitec Pivot | Programmed Maint. | Wellcom |
| DKN Group | Integrated Group | Record Investments | |
| DWS Ltd | Iress Technologies | Resmed | |
| Ellex Lasers | K&S Corp | Retail Food Group | |
| E*Trade | Legends Corp | Reverse Corp | |

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

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*** van Eyk Research Limited (ABN 99 010 664 632 AFSL 237917) ("van Eyk") rates investment management capabilities rather than individual products. Ratings can change or cease at any time without notice and should not be relied upon without referring to the meaning of the rating as well as the full manager report available at www.iRate.vaneyk.com.au. van Eyk has not directed the publication of Pengana’s rating. The rating is not intended to influence you and your client’s decision in relation to any products managed by Pengana and does not take into account your client’s individual financial situation, needs or objectives. We recommend that you or your client obtain the current product disclosure statement from the responsible entity before making any investment decision. Rating current as at June 2006.