

Pengana Emerging Companies Fund



September 2006 Quarterly Review

The Pengana Emerging Companies Fund posted a net return of 10.1% over the September quarter, compared with the benchmark performance of 5.1%. Since inception in November 2004, the fund has returned 71.0% outperforming the smallcap benchmark by 28.8%. The fund does not invest in resources stocks, which have rallied 72% since formation of the fund. The outperformance in an environment of strongly performing resource companies is particularly pleasing, with the fund beating the *industrial* benchmark by 36.1%.

The fund has strong research recommendations, with an “A” rating from **Van Eyk**, a “**Highly Recommended**” rating from **Lonsec**, a “**Strong Buy**” from **InvestorWeb**, and a “**Recommended**” rating from **Morningstar**. The fund is also well rated by **Mercer**. The fund is accessible either directly or through a number of platforms, including **BT Wrap**, **Macquarie Wrap**, **Symetry**, **Asteron**, **Aust Choice**, **Beacon** and the **MasterKey Custom Investment Service**, as well as through various margin lending providers. The fund now has around \$110m of assets under management.

Total return performance for periods ending 30 September 2006

	3 months	6 months	1 Year	Since inception*
Pengana Emerging Companies Fund	10.3%	13.2%	33.8%	71.0%
S&P/ASX Small Ordinaries Acc Index	5.1%	3.0%	16.7%	42.2%
Outperformance of benchmark	5.2%	10.2%	17.1%	28.8%
Pengana Emerging Companies Fund	10.3%	13.2%	33.8%	71.0%
S&P/ASX Small Industrials Acc Index**	5.7%	3.0%	14.6%	34.9%
Outperformance of benchmark	4.6%	10.2%	19.2%	36.1%

* 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 September quarter was dominated by results season, which contained few genuine surprises. The areas of disappointment (housing, selected retail sectors, and companies affected by rising input costs) had been well flagged hence expectations had already been adjusted in most cases. Corporate activity and speculation drove many underperforming stocks higher (eg Repco, API, Colorado, DCA Group), fuelled by aggressive private equity demand for under geared companies.

Key stock moves during the quarter

Key successes for the fund during the period included **Cabcharge**, **Clive Peeters**, **DWS Advanced**, **Mineral Resources**, **Oakton**, and **The Reject Shop**.

The 28% rally in **Cabcharge** was driven by a very strong result (profits up 36%) due to increased penetration of the company's payment system in the taxi network. Whitegoods retailer **Clive Peeters** rose 44% on delivery of a very strong profit outcome (profits almost tripled) based on successful integration of newly acquired and opened stores. **DWS** is a recent IPO in the IT services sector, and rallied 33% during the quarter after posting a result slightly above prospectus. **Mineral Resources** is another recent IPO which is primarily engaged in contract crushing for the resources sector. **Oakton** rose 23% as its result showed profit growth of 55%, confirming the strength in the IT services sector and success from management initiatives to grow service capacity. Shares in **The Reject Shop** rose 33% following 40% profit growth in FY06 which was especially pleasing in a tough retail environment.

Portfolio activity

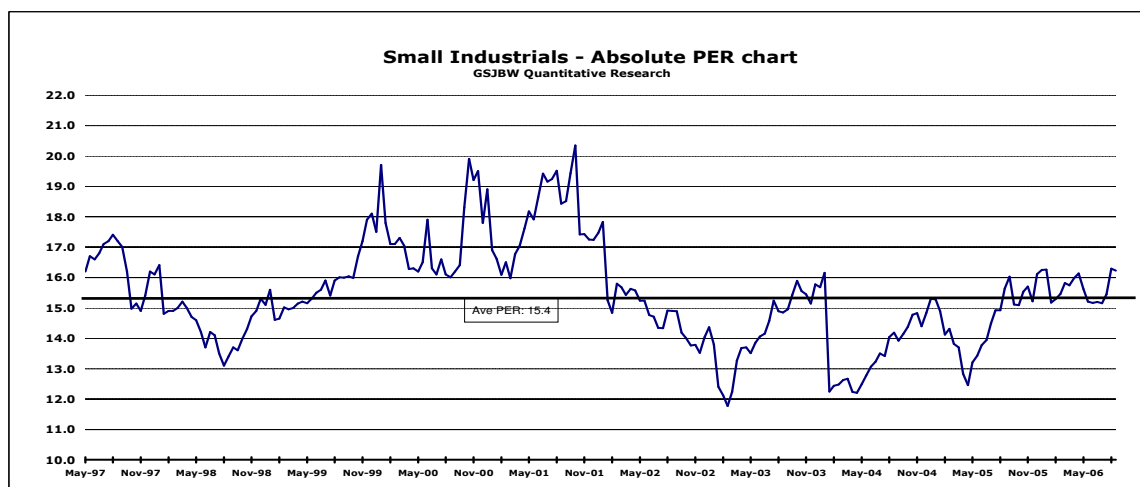
During the period, we reduced exposure to some stocks which had reached our valuation objectives such as **Ausdrill**, **Macquarie Leisure**, **MFS Ltd**, **Resmed**, and **S8**. New additions to the portfolio include recent floats such as **DWS** and **Mineral Resources**, and other stocks such as **Ausbrokers**, **GBST**, **Peoplebank**, and **Toxfree Systems**. We also increased our weighting in existing holdings such as **Australian Wealth Management**, **FKP Corp**, **Reverse Corp** and **The Reject Shop**.

The weighted average PER of our portfolio for the FY07 year is estimated at 14.0 times, compared with the overall smallcap industrial average of 16.4 times. The dividend yield on our portfolio is an estimated 4.1% which suggests a slightly defensive stance in the portfolio. Our top five positions are listed below.

Top 5 positions in the fund
Cabcharge
Australian Wealth Management
Mineral Resources
Reverse Corp
Oakton

Outlook

We remain confident in the medium term opportunities in the domestic smallcap sector. Valuations remain in line with long term averages (refer chart below) and corporate balance sheets are healthy. The underlying economy is broadly strong, notwithstanding the poor NSW housing market, and patches of softness in the retail market. With unemployment at record lows, short term swings in consumer sentiment are not enough to dramatically undermine the economy in our view. Many companies have recently raised their dividend payouts, with high dividend yields providing support to share prices.



The recent spike in corporate activity, driven in many cases by aggressive private equity funds has two key messages for us. First, the short term speculative frenzy is driving up share prices of many low quality companies which is a slight concern. Second, it supports a view that the market is not overvalued, and that corporate balance sheets are conservative. Notwithstanding this, we find the speculation a distraction, and ignore it for the purposes of valuing companies.

Three investing themes which have proved beneficial to us in the past two years remain very firmly in place: financial services, IT services and non-residential activity. We expand on these below.

Within financial services we favour companies which derive income from the superannuation sector which has government mandated growth. In most cases the companies derive predictable recurring revenue, have fixed costs bases, and do not require capital to grow. Our favoured stocks are **APN Group**, **Australian Wealth Management**, **DKN Group**, **MacMillan Shakespeare**, and **WHK Group**.

The recent reporting season confirmed the strength in IT services as the industry continues to recover from the post Y2K hangover. Our key positions (**ASG Group**, **Candle**, **CPT Gopal**, **DWS** and **Oakton**), all showed very strong profit growth in FY06 and contact with management suggests the outlook remains healthy for the foreseeable future. As the cycle matures, corporates (especially banks and telcos) are increasingly using IT and the internet to retain and grow customers, rather than purely replacing outdated hardware, which provides added impetus for growth.

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 (such as **Bradken**, and **Integrated Group**), rather than contractors which rely on less predictable project related revenue.

While the retail sector remains patchy, we retain a selective exposure through three high quality growth stories at reasonable prices, **Clive Peeters**, **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 opportunity is very strong.

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

AA Co	Data #3	Mermaid Marine	Sonic Healthcare
ABC Learning	Dexion	MFS Ltd	Sthn Cross Broadcasting
Aevum	DKN	Mortgage Choice	Super Cheap Auto
Aevum	Dolomatrix	Nomad	Talent 2
Allomark	Dominos Pizza	Noni B	Tasmanian Perpetual
APN Group	DWS Ltd	Oaks Hotels	Tassal
ASG Group	Emitch	Oakton	Technology One
ASX Corp	Energy Developments	OAMPS	The Reject Shop
Ausbrokers	Everest Babcock	Optima	Timbercorp
Ausenco	FKP Group	Patties Foods	Toxfree Systems
Austal Boats	Fletcher Building	Peet & Co	Transfield Services
Aust'n Infrastructure	Flight Centre	Peoplebank	Transpacific Industries
Aust's Wealth Mgmt	Fone Zone	Perpetual	travel.com.au
Becton	Freightways	Pipe Networks	Treasury Group
Bendigo Bank	Freshtel	PMP Corp	Trinity Consolidated
Boom Logistics	GBST	Primary Healthcare	Tutt Bryant
Bradken	Graincorp	Prime Life	UXC Ltd
Bravura	IBT Education	Promentum	VDM Group
Cabcharge	Incitec Pivot	QM Technologies	Vision Group
Campbell Bros	Integrated Group	Ramsay Healthcare	Walter Diversified
Candle	Integrated Research	Reckon	Webster
Cardno	Invocare	Retail Food Group	Wellcom
Centrepont Alliance	IOOF	Reverse Corp	WHK Group
Challenger	ITL Corp	RP Data	Wotif
City Pacific	Kresta	Saferoads	XRF Scientific
Clive Peeters	Lycopodium	SAI Global	
Coffey	M2 Comms	Select Harvests	
Commander	MacMillan Shakespeare	Senetas	
Concept Hire	Macquarie Leisure	Service Stream	
CPT Global	Maxitrans	Skilled Group	
Customers	Melbourne IT	SMS Mgmt	

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

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