

Pengana Emerging Companies Fund



December 2006 Quarterly Review

The Pengana Emerging Companies Fund posted a net return of 20.3% over the December quarter, compared with the benchmark performance of 15.6%. Since inception in November 2004, the fund has net returned 39.5% p.a. outperforming the smallcap benchmark by close to 14%. The results are pleasing given that the fund does not invest in resources stocks, which have rallied 112% since the formation of the fund.

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**, **Asteron**, **Aust Choice**, **Beacon**, **Strategy**, **Symetry**, and the **MasterKey Custom Investment Service**, as well as through various margin lending providers. The fund now has around \$180m of assets under management.

Total return performance for periods ending 31 December 2006

	3 mths	6 mths	1 yr	2 yrs p.a.	Since inception* p.a.
Pengana Emerging Companies Fund	20.3%	32.5%	55.4%	37.3%	39.5%
S&P/ASX Small Ordinaries Acc Index	15.6%	21.5%	34.2%	26.7%	25.8%
Outperformance	4.7%	11.0%	21.2%	10.6%	13.7%
S&P/ASX Small Industrials Acc Index**	13.1%	19.6%	26.9%	21.3%	21.6%
Outperformance	7.2%	12.9%	28.5%	16.0%	17.9%

* 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 December quarter proved a very strong period for equities, with the All Ords rallying 10.4%, and the Small Ordinaries rising 15.6%. Within the smallcap sector, the resources sector outperformed the industrials strongly, with a 23.5% rally. The key drivers for the market were strong commodity prices, continued corporate activity (especially private equity), and broadly positive feedback from companies during the AGM season.

Key stock moves during the quarter

Key successes for the fund during the period included **Ausenco**, **Bradken**, **CPT Global**, **Dexion**, **Mineral Resources**, and **Tassal Group**.

The performance of **Ausenco** (up 37%), **Bradken** (up 33%), and **Mineral Resources** (up 47%), can largely be attributed to the strength in spending in the mining sector. All three companies have delivered earnings upgrades in recent times, and the market is becoming increasingly comfortable with the idea that the mining capex cycle will be “stronger for longer”. We visited the NW Shelf in W.A. during the period, and came back with added confidence in the medium term growth prospects for such companies. **Dexion** rallied 39% following two small acquisitions and increased market awareness of



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the stock as it breached the \$100m market cap barrier. IT services outfit **CPT Global** rose 55% following bullish outlook comments at its AGM, while salmon producer **Tassal** ran up 63% due to strong sales growth, and improved economics through a focus on breeding larger fish.

Portfolio activity

During the period, we reduced exposure to some stocks which had reached our valuation objectives such as **FKP Corp**, **Melbourne IT**, **Oakton** and **Retail Food Group**. New additions to the portfolio include recent float **Blue Freeway**, and other stocks such as **Broadcast Services**, and **Kresta**. We also increased our weighting in existing holdings such as **Australian Wealth Management**, **GBST**, and **Reverse Corp**.

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

Outlook

While the recent short term strength in the market suggests that a pull back is in order, we remain confident in the medium term opportunities in the domestic smallcap sector. Valuations remain reasonable, the broad economy robust, and the increased flow of money into superannuation funds provides a favourable tailwind by way of buying support for equities.

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. Recent favorable changes to allowable superannuation contribution levels and the removals of taxes from withdrawals will further aid this sector in 2007, as will the strong performance of the equities market. Our favoured stocks are **APN Group**, **Australian Wealth Management**, **DKN Group**, **HFA Holdings**, **MacMillan Shakespeare**, **Treasury Group**, 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 Gobal**, **DWS**, **Oakton** and **Peoplebank**), 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. Our recent visit to the key operating areas in Western Australia increased our confidence in the outlook. We favour companies which derive revenue from ongoing mining activity (such as **Bradken**, **Integrated Group** and **Mineral Resources**), rather than companies purely exposed to mine site construction which is less predictable and can be more easily affected by timing issues which create earnings volatility.

While themes can be important, many of the stocks we own do not fit neatly into any strict investment theme. For example our third largest position, **Reverse Corporation**, which owns the 1800-REVERSE brands and services in Australia and the UK. The company grew profits in 2006 by 25% to \$14.4m, while spending less than \$0.2m in capital expenditure. Medium term growth opportunities are strong



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through increased penetration of the mobile phone market, and the low capital requirements result in 100% of profits being paid out in dividends.

Another interesting stock which we have recently established a position in is **Kresta**. The company is the largest domestic manufacturer and supplier of blinds and curtains, under the Kresta and Vista brands. The stock performed very poorly during 2005 and early 2006 due to successive profit warnings as a result of the distractions around merging acquisitions and warehouse facilities. Results in more recent times have proven promising, with a new CFO making an impact on costs and systems. With a conservative balance sheet, and leverage to a potential recovery in the Victorian and NSW housing markets, the stock is a clear turnaround candidate.

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

AI Group	Fiducian	Peoplebank
Amazing Loans	Fleetwood	Powertel
Ausenco	Flexirent	Probiotec
Blue Freeway	Funtastic	Programmed Maintenance
Broadcast Services	GBST	QM Technologies
Cabcharge	Healthcorp	Quickflix
Cash Converters	Home Building Society	Radio Rentals
Centrebet	Industrea	realestate.com.au
Challenger	IRESS	Rebel Sport
Chandler MacLeod	Kresta	Reverse Corp
Clive Peeters	MacMahons	RP Data
Clough	MacMillan Shakespeare	Sedgeman
Cockatoo Ridge	Magellan Financial	Structural Systems
Coote	Medical Developments	Sunland
CPT Global	Mermaid Marine	Tassal
Credit Corp	Mineral Resources	Technology One
Cromwell	Money 3	Timbercorp
Data #3	National Gaming	Toxfree
Dexion	Nomad	VDM Group
Dolomatrix	Pacific Turbine	Village Roadshow
Evirozel	PCH Group	WHK Group

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

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