

Pengana Emerging Companies Fund



September 2007 Quarterly Review

The Pengana Emerging Companies Fund posted a net return of negative 1.3% over the September quarter, compared with the benchmark performance of negative 0.5%. Excluding the resources sector, the industrials sector fell 3.2% during the quarter. Over the 12 months to September, the fund has returned 53.0% net, outperforming the smallcap benchmark by 16.3%. The results are pleasing given that the fund does not invest in resources stocks, which have rallied over 70% during the year. During the period, the fund was awarded Australian Equities (Small Companies) Fund of the Year by Standard and Poor's.

Total return performance for periods ending 30 September, 2007

	3 mths	6 mths	1 yr	2 yrs p.a.	Since inception p.a.*
Pengana Emerging Companies Fund	-1.3%	12.1%	53.0%	43.1%	39.0%
S&P/ASX Small Ordinaries Acc Index	-0.5%	10.2%	36.7%	26.3%	25.6%
Outperformance	-0.8%	1.8%	16.3%	16.8%	13.5%
S&P/ASX Small Industrials Acc Index**	-3.2%	5.2%	26.6%	20.4%	20.1%
Outperformance	1.8%	6.9%	26.4%	22.7%	18.9%

* 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 assume reinvestment of income.

Market backdrop

The September quarter was dominated by enormous volatility, with the All Ords falling as much as 12% during July and August, only to close at record highs by the end of September (up 16% from the low point). The resources sector fell 19%, then closed up a spectacular 35% from the low point. This volatility was due to credit market concerns following the increase in sub-prime defaults in the US. Central bank intervention, via liquidity assistance, and a 50pt rate cut in the US saw investor sentiment reverse very quickly. The smallcap sector fell harder than large caps due to lower liquidity (down 16%), and made up most of this ground during September; however, the industrial stocks failed to recover to the extent mining stocks did. During the period, companies also released their annual results which showed healthy profit growth and outlook comments in most domestic sectors.

Key stock moves during the quarter

Our portfolio benefited from the ongoing strength in the mining services and IT services sectors, with some of this offset by a de-rating in some of the higher PER stocks and less liquid stocks which were heavily hit during the volatility. Key mining services stocks in our portfolio include **Ausenco** (up 52%), **MacMahons** (up 31%), and **Mineral Resources** (up 12%). Our key IT services stocks include **CPT Global** (up 15%), **DWS** (up 18%), **Oakton** (up 22%), and **SMX Mgmt** (up 23%). Some of the higher growth, high PER stocks to suffer a de-rating were **Cabcharge** (down 18%), **MacMillan Shakespeare**



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(down 14%), and **Reverse Corp** (down 20%), while some illiquid stocks in which we hold small positions fell (e.g. **Wellcom** fell 29%).

Portfolio activity

During the period we reduced our positions in some stocks as they approached our valuation objectives such as **Ausenco**, **Austar**, **Dexion**, and **MacMahons**. During the heightened volatility, we took advantage of share price weakness to increase our positions in stocks such as **Australian Wealth Mgmt**, **Automotive Holdings**, **CSG Group**, **DWS**, **Fleetwood**, **Style Ltd**, **Transfield**, and **Treasury Group**. We established a new position in **Service Stream** following a major contract win and placement, and **NRW Holdings** following its IPO.

Top 5 positions in the fund	
Australian Wealth Mgmt	MacMillan Shakespeare
Bradken	Mineral Resources
CSG Group	

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Outlook

The remarkable volatility during recent months has sparked active debate over whether the equity market has seen its best, following four consecutive years of strength. On the negative side, the sub-prime issues in the US will undoubtedly unfold with further bad news over the coming months, and the US economy still appears vulnerable to slowing consumer activity due to falling house prices. On the positive side, global economic growth remains healthy, especially given the strength of India and China, the domestic economy is in very good condition and superannuation inflows are a positive impact on market liquidity which will not reverse short term. These circumstances leave room for more volatility in the market, however we are not concerned about medium term opportunities for patient investors.

There is no shortage of opposing (and well argued) views about overall market directions, which we find a distraction given that we do not try to time markets. From our perspective, the volatility is interesting, and has provided opportunities to top up some favourite holdings, but does not distract us from the research process. During the period we had contact with over 90 companies (see below) in order to assess opportunities.

Our conviction in three key areas of the economy (mining services, IT services, and financial services) remains, hence our exposure to these sectors is still high. Almost universally, companies involved in these sectors posted strong profit results in August, as well as confident outlook statements. Having said that, we saw some of the stocks reach stretched valuations, and hence trimmed positions where needed.

During recent weeks, we visited 17 companies in Western Australia to more closely inspect the enormous opportunities in the mining services sector. Iron ore offers the best opportunity with BHP and RIO Tinto planning to more than double production from a combined 300MT p/a over the medium term to capture the burgeoning demand from China's steel making sector. In addition, Fortescue Metals is planning to ramp up to 200MT per annum over the coming 2-3 years, at a capital cost north of \$3bn. Given strong share prices and cash flows, the funding for these projects is highly secure.

This activity provides opportunities for smaller companies in both the mine and infrastructure construction phase, and the ongoing mine operation. We prefer to invest in companies which derive revenue from ongoing mine activity, reflecting the inevitable downturn in construction activity once the new production levels are achieved.



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The chronic labour shortage is a double-edged sword. It has seen capital costs blowing out and increases the risk of mis-quoting for some service providers. On the flipside, it ensures a longer, less volatile up-cycle as there is simply not enough capacity for the proposed activity to happen in a short time period.

To capture this upside we own shares in **Ausenco** (mine engineering and design), **Bradken** (rail wagons and consumable parts for mine operations), **Fleetwood** and **Mac Services** (which provides remote site accommodation for the mine workforce), **MacMahons** (contract mining), **Mineral Resources** (which provides contract crushing operations on the mine site), **NRW Holdings** (which is currently building Fortescue's rail infrastructure), **Structural Systems** (ground support engineering), **Swick** (underground drilling services), **Toxfree** (processes waste materials in the Pilbara), and **Transfield Services** (provides maintenance services on mine sites).

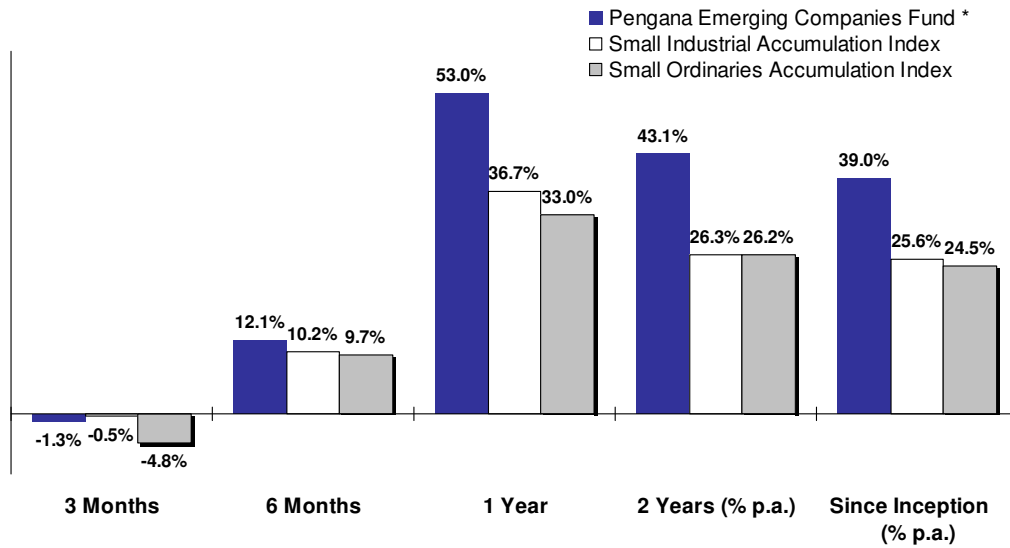
Company visits

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

APN Property	Hastie	RCG Corp
ARB Corp	Hastings Diversified	RCR Tomlinson
ASG Group	HFA Holdings	Reckon
Ausenco	Integrated Legal	Reverse Corp
Austar	Intrapower	Saferoads
Austin Engineering	Invocare	seek.com.au
Australian Wealth Mgmt	IOOF	Service Stream
Automotive Holdings	Iress	SMS Mgmt
Blue Freeway	K2 Asset Mgmt	Snowball
Boart Longyear	Kresta	Spark Infrastructure
Bradken	M2 Communications	Storm Financial
BSA Group	Mac Services	Structural Systems
Cabcharge	MacMahons	Style Ltd
Candle	MacMillan Shakespeare	Sunland
Cardno	MacPhersons	Tassal Group
Centrebet	Mariner Financial	The Reject Shop
Chandler MacLeod	McGuigan Wines	Toxfree
Colorpak	Mineral Resources	Transfield Services
Commquest	Mortgage Choice	Treasury Group
Count Financial	NRW Holdings	VDM Group
CPT Global	Oak Hotels	Village Roadshow
Crane Group	Oakton	Watpac
CSG Group	Oroton	Wattyl
Dexion	Patties Foods	Webjet
DKN Group	Peet & Co	Webster
DWS	PIS Financial	Wellcom
Fiducian	Plan B	WHK Group
Fleetwood	Primary Healthcare	WRF
Flexigroup	Probiotec	ZLG Group
GBST	Q Ltd	
Greencap	Ramsay Health	

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Performance to 30 September 2007 (After Management Fees & Performance Fees)



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

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