



Pengana Emerging Companies Fund

January 2008 Update



Australian Equities – Small Caps

Fund Performance ¹

January 2008 was the worst month in Australian equities since 1987, and it capped off three very poor months. The Small Ordinaries fell 19.5% over the three months, while our fund fell 18.3%. Stripping out the resources sector, (which we do not invest in) our fund outperformed the Small Industrials by 4.0% for the three months.

Returns to January 2008	Pengana ¹	S&P/ASX Small Ordinaries	Value added
1 Month	-17.4%	-14.4%	-3.0%
3 Months	-18.4%	-19.5%	1.1%
6 Months	-13.7%	-14.8%	1.1%
1 year	5.3%	-1.6%	6.9%
2 years pa	31.9%	13.9%	18.0%
3 years pa	25.7%	15.4%	10.3%
Since inception pa ²	30.3%	16.6%	13.7%

Key Stock Price Moves

During January the key positive stock was Incitec Pivot (up 3%). We are not invested in stocks such as Allco, Centro, MFS, Silex, which were all down heavily during the month. Key negative drivers in January were Mineral Resources (down 22% following a 11% rally in Dec) and Mac Services (down 29% after a 21% rally in Dec).

Market Commentary and Outlook

The past three months have seriously tested investors' resolve. The volatility has also flushed out some lazy investing practices which have built up over the past four years. While our fund has been caught in this down-draught, we have not changed our investment process, nor are we in a panic to dramatically alter the portfolio. The macro issues at play in the short term relate to a deteriorating US economy (to which we are not directly exposed), and a re-pricing of risk. This is amplified by investor apathy prior to results season in February and March (i.e. a lack of firm buying support), and margin calls adding to the selling pressure.

Our investment process involves a detailed valuation approach in order to identify companies with predictable cash flows and

¹ Total return performance figures are derived from Manager's records and are shown after management fees, but before performance fees, and assume reinvestment of income. Investments can go up and down. Past performance is not a reliable indicator of future performance.

² November 2004

conservative acquisition strategies. This seeks to weed out overly risky stocks, hence we do not hold Boom Logistics, MFS, Commander Communications which have unravelled dramatically in the recent past.

In markets such as these, one minor disadvantage our fund has is its exposure to micro-caps (13% is invested in stocks with a market cap of <\$100m), which tend to be marginalised during periods of excessive volatility. This is expected to normalise once the volatility settles.

We have spent considerable time and effort in assessing the risk to earnings in our portfolio given recent events. In summary we do not fear a dramatic downturn in the Australian economy (see below), however do concede that financial services stocks are likely to face a slight headwind given the recent contraction in equity markets (although this looks to have been priced in very quickly). Otherwise we have not made any dramatic changes to the portfolio, and indeed we would be concerned if we had given our medium term investment horizon.

The US economy is vulnerable, however, the Australian economy remains robust, and insulated via its exposure to China's structural growth. Given that an estimated 6% of the Chinese workforce is involved in industries which export to the US, it's outlook remains largely unchanged. The mining services sector, for example, remains highly appealing to us. The aggressive pull-back in share prices reflects hot money exiting the stocks, rather than a deteriorating earnings outlook.

The upcoming results season is likely to refocus investors on earnings, which is the true long term driver of markets.

Fund Details

Fund size: \$397m

Redemption price at month end: \$1.968

Top Ten Positions

ASG Group	Mac Services
Australian Wealth Mgmt.	Mineral Resources
Automotive Holdings	MacMillan Shakespeare
CSG Group	Transfield Services
Fleetwood	Toxfree Solutions

Contact Details

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