



Pengana Emerging Companies Fund

February 2008 Update



Australian Equities – Small Caps

Fund Performance¹

Wild volatility continued in global markets in February, with sentiment and liquidity driving share prices, rather than valuations. Our fund net underperformed the Small Industrials by 2.2% over the month, and over three months, the fund has fallen in line with the industrial benchmark (down ca. 21%). **Since inception, the fund has outperformed the Small Industrials in 32 of the 40 months.** Resources stocks, which we do not invest in, are now 37% of the Small Ords and have dramatically outperformed, this distorts our performance vs. the Small Ordinaries Index.

Net Returns to 29 Feb 2008	Pengana ¹	S&P/ASX Small Industrials	S&P/ASX Small Ords	Relative to Small Industrials
1 Month	-3.7%	-1.5%	3.8%	-2.2%
3 Months	-22.0%	-20.7%	-13.2%	-1.3%
6 Months	-13.2%	-19.5%	-8.0%	6.2%
1 year	-2.5%	-13.8%	0.9%	11.3%
2 years p.a.	23.1%	4.2%	14.8%	18.9%
3 years p.a.	23.6%	9.2%	17.3%	14.4%
Since inception p.a.²	26.6%	9.7%	17.5%	16.9%

Key Stock Price Moves

During February the key positive stocks were Flight Centre (16%), Incitec Pivot (23%), Macmahons (27%), Structural Systems (15%) and Wellcom (23%). Key negatives were APN Property (-33%), DWS (-25%), Oakton (-25%) and SMS Management (-21%).

Market Commentary and Outlook

The global market correction has been unbelievably rapid and severe, with markets now trading on very short term news flow, rather than fundamentals. The volatility has resulted in capitulation in many cases, with investors disregarding valuation and selling on fear. Such emotional behaviour has opened up many highly attractive opportunities for medium term investors. Emotions will ease in time, and earnings will once again drive share prices into the long term.

The average forward looking PER in our portfolio is now under 10x, this being the cheapest witnessed by the fund and well below the long term small cap average of around 15x. With such cheap valuations, the first step is to identify areas of earnings risk, and avoid stocks which look cheap, but are exposed to downside earnings risk or have less predictable cash flows.

Our process seeks to exclude companies with opaque business models (hence no exposure to Allco, MFS, Credit Corp etc). We also avoid highly geared companies where the downside risk to

equity valuations is amplified (hence no ABC Learning or Commander). **Over 80% of our portfolio is in companies with interest cover of over 10 times (i.e. no debt, or very little).**

The key areas of earnings risk over the coming 12 months are in consumer related stocks (given recent interest rate rises and the wealth effect of a falling stock market), building stocks (with a delayed recovery in NSW activity), and financial services companies deriving income from the equities market. To this extent we have reduced our weighting in anticipation of earnings pressure.

Conversely, the mining services sector has a very strong outlook, which is largely unaffected by the US recession, rising domestic interest rates, and falling equities markets. We made contact with over 20 stocks in this sector during February results season, with unanimous confidence in the outlook into the medium term. Despite this rosy outlook, many stocks in the sector have been sold down by over 40%, and now trade on very modest valuations. We have around 20% of our fund invested in this sector, and see its recent performance as symptomatic of a volatile market rather than any deterioration in the earnings outlook.

The current lack of interest in microcaps, is not particularly surprising given overall market conditions. Most stocks with a market cap of under \$200m are now trading on single digit PER's, and full franked dividend yields of over 7%, which shows them to be very cheap indeed.

With the recent correction, valuations are the lowest they have been in many years, as is evidenced by the forward PER of the fund being under 10 times and supported by a fully franked yield of over 6% p.a. This suggests the de-rating has been overdone and potentially presents an excellent opportunity to invest the long term.

Fund Details

Fund size: \$367m

Redemption price at month end: \$1.90

Top Ten Positions

ASG Group	Mineral Resources
Automotive Holdings	MacMillan Shakespeare
CSG Group	Transfield Services
Fleetwood	Treasury Group
Mac Services	Toxfree Solutions

Contact Details

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¹ Total return performance figures are derived from Manager's records and are shown after all 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