Pengana Emerging Companies Fund
June 2008 Quarterly Review

Money Management | LONSEC FUND MANAGER OF THE YEAR 2008 WINNER Australian Equities – Small Cap

FUND AWARDS 2007 AUSTRALIA WINNER STANDARD & POOR'S

Australian Equities - Small Caps

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The Australian market's 21% decline in the 2008 financial year (ASX Small Ords Index) was the worst since 1982. Behind the broad market statistics was a dramatic dispersion of returns between Small Resource stocks, which rose 20% over the year, and Small Industrials which lost 37%.

Whilst the fund fell 7% over the June quarter this was well ahead of the Small Industrials Index which fell by near 14%. In fact, we have strongly outperformed the Small Industrials Index over all time periods as indicated below. We have also outperformed the Small Ordinaries except for the past year due to the dramatic strength in resources stocks which the fund does not invest in.

In recognition of this our fund was recently awarded the 2008 Small Cap Fund of the Year by Money Management.

Investor nerves are being seriously tested at the moment. We firmly believe that the current cheap valuations and extreme bearish sentiment has created very strong opportunities for those prepared to take a medium term view. Many stocks have been sold down on emotion, irrespective of quality. The price earnings ratio of the Small Industrials market is at a twelve year low, and the stocks in our portfolio are cheaper again.

We remain absolutely vigilant to the increased earnings risk, but experience shows that often the best time to buy is when the herd is selling.

The fund managers are personally heavily invested in the fund, and have recently increased their investment.

Net performance for periods ending 30 June 2008[1]

	3 months	1 year	2 years p.a.	3 years p.a.	Since inception p.a.[2]
Pengana Emerging Companies Fund	-7.0%	-29.5%	+9.7%	+18.3%	+18.6%
S&P/ASX Small Industrials Acc Index [3]	-13.5%	-36.5%	-6.3%	+1.7%	+3.1%
Outperformance	**+6.5%**	**+7.1%**	**+16.1%**	**+16.6%**	**+15.5%**
S&P/ASX Small Ordinaries Acc Index	-4.6%	-20.5%	+7.2%	+13.0%	**+12.8%**
Outperformance	**-2.5%**	**-9.0%**	**+2.6%**	**+5.3%**	**+5.8%**

[1] Net performance figures are derived from Manager's records and are shown after both management fees and performance fees, and assume reinvestment of income.
[2] Since November 2004
[3] The fund does not invest in resource stocks.

Market backdrop

The All Ords fell 1% during the June quarter, however during that period the market had recovered strongly, only to give this back quickly in June (down 7.6% for the month). The Small Ords was down 4.6% for the quarter and almost 12% in the month of June. During April and May it seemed the panic selling had subsided, only to return during June due to concerns over the effect of the spiraling oil price, and the lingering effects of the credit market collapse.

Key stock moves during the quarter

Key successes during the period included **Mineral Resources, Fleetwood, Radio Rentals and HFA Holdings**. Key detractors were **McMillian Shakespeare** and **Transfield Services.**

The 37% rally in **Mineral Resources** shares reflected the strengthening opportunities in the ore crushing operations, plus the company's indirect exposure to iron ore and manganese prices which have been very strong. **Fleetwood** (up 12%) also benefited from its exposure to the resources sector via its remote site accommodation operations. **Radio Rentals** rallied 16% after posting 66% profit growth, which confirmed its position as a highly defensive retail outfit. **HFA Holdings** rose 18% from an oversold position as the market regained confidence that it's earnings are nowhere near as volatile as global markets.

MacMillan Shakespeare fell 24% as minor changes introduced during the budget crimped two new immaterial revenue generating opportunities. In this market small items of "bad news" are dealt with severely, however the company remains debt free and generates quality cashflows hence we are happy holders. **Transfield Services** fell 33% after warning of lower profits due to the rising A$ and a range of smaller issues. We cleared our position very quickly, which protected us from the majority of the downside.

Portfolio activity

During the period, we reduced our exposure to **Transfield Services**, and **Mineral Resources**. We also further reduced our exposure to the IT services sector as we believe corporate spending is vulnerable into FY09. We increased our exposure to defensive businesses such as **Austbrokers**, **Dominos Pizzas**, and infrastructure stocks such as **Spark Infrastructure** and **Duet**. Having sold down financial services stocks earlier this year, we recently bought into **WHK Group** in the belief the current share price ignores the defensive nature of the accounting division (70% of earnings), with the financial planning division also too heavily discounted.

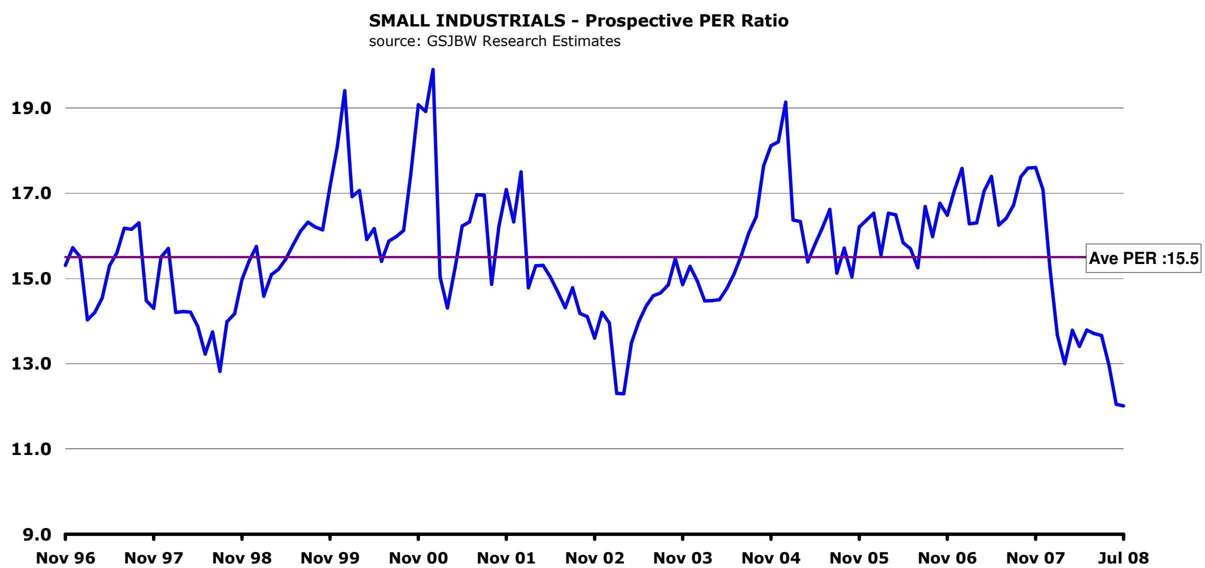
Top 5 positions in the fund:	
CSG Group Fleetwood Mac Services	Mineral Resources Spark Infrastructure

Outlook

The current investment climate is extremely challenging, however through the cloud of uncertainty we believe there are some highly attractive investment opportunities. Sentiment could not be worse, creating highly emotional behaviour, and value which has not been seen for twelve years. Earnings downgrades will continue, and there are plenty of sectors to avoid, however the highly efficient market (assisted by fast moving hedge funds) has factored in a large portion of this already.

It's not hard to see why investors' emotions have crumbled so badly in the past nine months. The banking sector has lost 40% of its value, the listed property sector 45%, and many so called "safe" infrastructure stocks have more than halved in value. The small industrials sector has also lost 40% in value. The oil price has risen almost 50% in the past six months, and the domestic economy is slowing. The headlines confirm the bad news daily, leaving investors with an insatiable appetite for bad news.

The panic selling has resulted in valuations (as shown in the PE chart below) reaching unprecedented low levels. The PE of 11.8x is the lowest since early 1996, and it is worth noting that the weighted average PE of the stocks in our fund is well below that at 9.5x. This has opened up a wide array of attractive investments for medium term investors, and may well prove in hindsight to be one of the most attractive opportunities in recent decades.



Valuations though are not enough. Earnings risk has increased dramatically in a range of sectors. Not all stocks are at risk, so this increases the importance of active analysis on a stock by stock basis. We remain highly active in our contact with CEOs of companies, completing over 307 visits and many more phone contacts in the past 12 months.

To avoid the more obvious areas of earnings risk, we retain a low (or nil) exposure to the retail, housing, and media sectors. Having reduced our exposure to financial services, we have recently revisited some of the higher quality companies whose share prices look to have more than factored in the current market malaise. We continue to avoid highly geared companies, and retain a very skeptical approach to companies which have grown aggressively via acquisition over the past 2 to 3 years. Now that access to debt and new equity has dried up, these companies are left to manage a disparate portfolio of businesses, which is often harder than first expected.

On the positive side, our portfolio is heavily skewed to the mining/infrastructure services sector, given the strength in medium term opportunities. The level of committed projects continues to rise, and the labour shortage ensures a reasonable length to the theme as not all of the committed work can be completed in the short term.

Above all, our focus will always be on relatively predictable earnings streams. We favour companies with high levels of recurring revenue which insulates from economic cycles. Such companies will not only traverse the current issues with more stability, but will enjoy premium ratings in the market once sentiment improves. Our process seeks to screen out highly geared companies. Over 80% of our portfolio is invested in stocks with an interest cover of 10x or more, which is highly conservative especially in times of tightening credit conditions.

The past nine months have seriously tested investors' nerves, and volatility is likely to continue in the short term. We believe sentiment will recover at some point in the coming 6 to 12 months, and remind investors to take a medium term view.

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

3Q Holdings	Coventry	Restaurant Brands
Abano Health	CSG Group	Runge
ABB Grain	Dominos Pizza	Ruralco
AJ Lucas	Eserve Global	Sedgman
Ambition	Essa	Skilled Engineering
APA Group	Healthscope	Sky TV (NZ)
Asciano	IBA Corp	Slater & Gordon
ASG Group	ISS Group	SMS Mgmt
ASG Group	Macquarie Media	SP Ausnet
Austbrokers	Melbourne IT	Structural Systems
Bradken	Metcash	Swick
BSA Corp	Methven	Total Staffing
Cabcharge	Navitas	Toxfree
Campbell bros	Oroton	Transfield Infrastructure
Cedar Woods	Pumpkin Patch	Transfield Services
Chandler MacLeod	Radio Rentals	Walter Diversified
Clean Seas Tuna	RCG Group	WHK Group
Commquest	Redflex	Wide Bay

For more information on the fund visit our web site on **www.pengana.com.au**

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