

# Pengana Emerging Companies Fund September 2008 Quarterly Review



Australian Equities - Small Caps

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## Fund Description

The Pengana Emerging Companies Fund seeks to combine the skills of highly experienced small company investors (30 years experience) with a limited fund size to provide above market returns over the medium term. Our benchmark is the S&P/ASX Small Ordinaries Accumulation Index. The fund managers Steve Black and Ed Prendergast are part owners of the business and investors in the fund, providing a strong incentive to perform. The Fund has strong research ratings from all major research houses and over the period since its inception has delivered returns well above benchmark.

## Fund Commentary

Our fund posted a mild negative return in the September quarter (-2.6%) versus the Small Ordinaries down 18.1% and Small Industrials down 4.1%. This is a pleasing result given the extraordinary global volatility. Also during the quarter most companies posted their FY08 results and outlook commentary, which is typically a time when share prices are driven by facts rather than emotion, and on balance our companies performed very well.

Clearly global events dominate the current environment. While the US rescue package is now approved, over-gearred households, falling house prices and tight credit availability will constrict economic growth. European economies are also under pressure. Australia will not be immune, however falling interest rates and petrol prices, our full employment and strong non-residential spending outlook will cushion us somewhat.

In this environment we remain wary of cyclical stocks, those with high gearing and/or heavy capital requirements. As earnings risk increased earlier this year, we repositioned the portfolio towards more defensive businesses and those which have the ability to grow irrespective of the economic cycle. If the predictions of a global recession are proven correct, our fund will also be insulated by not owning any resources stocks which will no doubt be hit hardest in such a scenario.

We are certainly not brave enough to call the bottom of the market in the short term, but recent observations suggest capitulation is upon us. Investors are ignoring value and selling purely on the fear that the short term momentum is maintained. This can be dangerous and is the reverse of the type of irrational behaviour which drives people to blindly buy stocks in extreme bull markets. We explore this below in more detail.

**We urge patience and remind investors that markets typically recover well ahead of the economy. There are some highly attractive investment opportunities for patient investors, and keeping a level head in such times is critical. At some point hysteria will die down, and investor's time horizons will extend beyond what the Dow did overnight. In the meantime we believe we are very well positioned to ride out the storm through a defensive portfolio and highly experienced investment team.**

### Net performance for periods ending 30 September 2008<sup>1</sup>

	3 months	6 months	1 year	2 years p.a.	3 years p.a.	Since inception p.a. <sup>2</sup>
<b>Pengana Emerging Companies Fund</b>	-2.60%	-9.40%	-30.40%	3.20%	12.60%	16.50%
<b>S&amp;P/ASX Small Industrials Acc Index<sup>3</sup></b>	-4.10%	-17.00%	-37.10%	-10.80%	-3.00%	1.80%
<b>Outperformance</b>	1.50%	7.60%	6.80%	14.00%	15.60%	14.70%
<b>S&amp;P/ASX Small Ordinaries Acc Index</b>	-18.10%	-21.90%	-34.50%	-5.40%	1.50%	6.30%
<b>Outperformance</b>	15.60%	12.50%	4.20%	8.60%	11.10%	10.20%

<sup>1</sup> Net performance figures are derived from Manager's records and are shown after both management fees and performance fees, and assume reinvestment of income. Past performance is not a reliable indicator of future performance.

<sup>2</sup> Since November 2004

<sup>3</sup> The fund does not invest in resource stocks.

## Portfolio activity

Earlier this year we highlighted our belief that earnings risk had increased in a range of sectors due to the financial uncertainty. Since then we have removed many stocks from the portfolio where this risk had increased – more recently Cabcharge, Dexion and Treasury Group. We also recently took advantage of the strength in Mineral Resources and reduced our position above the \$6.00 level.

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We have continued to build on our positions in more defensive stocks and those capable of growing irrespective of the overall economy. In most instances poor overall sentiment has seen such stocks sold down to highly attractive valuations. Recently we topped up our holdings in Austbrokers, DUET Group, Hastings Diversified, Metcash, Probiotec, Slater & Gordon, Webjet and WHK Group.

Given the current uncertainty, and likelihood of further bargains, we are maintaining a higher than usual cash balance towards 10%.

## Market Commentary

### Market backdrop

The continuing debacle in the US financial system, and signs of weakness in Chinese growth rates saw the All Ords fall 13.2% during the September quarter, and indeed 11.2% in the month of September. The Small Ords was down 18.1% for the quarter driven primarily by an astounding 37.2% fall in the resources sector as investors quickly reassessed lofty valuations in light of the declining global economic environment. The Small Industrials which represents our primary investment area was down 4.1% for the quarter.

### Pengana's key stock moves during the quarter

Key successes in the portfolio during the period included Ammtec, APA Group, Campbell Brothers, Hastings Diversified, Toxfree and The Reject Shop. Key detractors were HFA and Saferoads.

The 35% rally in Ammtec (mineral testing services) followed a strong full year result, and the sale of a loss making division for a very favorable price. APA Group (up 17%) and Hastings Diversified (up 20%) both rallied as the relative investment appeal of defensive gas pipeline assets, backed by solid yields was realised in a volatile market. Campbell Brothers (mineral testing) rose 18% following its AGM outlook statement predicting 60% EPS growth this year. Industrial waste treatment outfit Toxfree rose 14% following a solid result, with organic growth of 25%. The Reject Shop was up 14% again following a strong result and an appreciation of the relatively resilient customer base despite weakness in other retail sectors.

Hedge fund manager HFA fell -43% as global fears related to its industry peaked. Despite the fears, the actual funds are performing relatively well and HFA is one of the only fund managers in the country actually attracting inflows. In this nervous market, however, fundamental analysis takes a back seat to fear based selling. Saferoads fell 30% over the quarter despite a reasonably solid result, suffering primarily from its small market cap (under \$50m) in a risk adverse market.

## Outlook

### Global growth under pressure

The recent developments in the US finance sector have dramatically increased short term volatility and medium term earnings risk in many sectors. Given that our fund is not an aggressive trading fund, we are far more interested in changes to earnings risk than short term share price gyrations.

Markets may take some comfort from the rescue package approved by Congress and interest rate cuts; however, the key issue is the likelihood of a global slowdown. Australia will no doubt be affected by lower consumer and business confidence, and tighter credit conditions. Offsetting this, Australia has a housing shortage, which should help protect prices, and our employment market is much tighter than the US.

### Hence our low risk approach

As we mentioned in our March and June quarterly reports earlier this year, we saw an increased risk to earnings in many cyclical areas of the economy such as retail, media, housing and financial services. Accordingly we removed stocks with the greatest exposure. This caused some pain to begin with, but has clearly protected our investors from some of the more recent volatility.

During 2008 we have also increased our exposure to businesses which are less reliant on the economic cycle. It is important to note that the share prices in many cases had been hit with the overall market, which provided attractive entry prices. A few examples of this are Slater & Gordon (personal injury lawyers), Austbrokers (insurance brokers), Metcash (grocery retailing), Austar (pay TV which has proven somewhat immune from other downturns), Probiotec (over the counter pharmaceuticals/supplements), Sonic Healthcare (pathology), Navitas (tertiary education) and the low risk pipeline owners APA Group, DUET, and Hastings Diversified.

### Impact of a recession on our portfolio?

If the domestic economic situation worsens dramatically, investors need comfort about the impact on our portfolio. The table below shows our top ten holdings (which makes up 32% of the total). We provide the valuation (PE and yield), gearing level, interest cover, and a description of the impact. In most cases the impact is mild due to our focus on less cyclical stocks, and companies with a high proportion of revenue based on long term contracts. This theme continues through the balance of our portfolio. We also show the gearing and interest cover to stress the importance we place on companies with conservative debt levels.

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Stock	FY09 PE (x)	Yield (%)	Gearing	Interest cover	Impact	Comment
Austbrokers	11.3	5.3	0%	n/a	Very mild	Insurance broking has proven highly stable as it is non-discretionary spend
CSG Group	4.8	8.0	47%	11x	Medium	Long term govt contracts will offset mild weakness in copier sales
Fleetwood	9.4	8.8	0%	n/a	Mild	May impact caravan volumes, however, mining accommodation is highly defensive.
Mac Services	11.4	5.0	0%	n/a	Mild	Long term contracts with large mining houses reduces short term earnings volatility
MacMillan Shakespeare	6.2	9.5	0%	n/a	Very mild	Salary packaging in the healthcare and not-for-profit sector is highly defensive
Metcash	14.2	5.3	50%	7x	Very mild	Grocery retailing is highly defensive
Mineral Resources	6.0	7.3	0%	n/a	Mild	Long term contracts reduce risk. Lower commodity prices may make it harder to win contracts
Sedgman	9.1	6.0	22%	19x	Mild	Engineering services in high demand in the coal sector. Not related to domestic cycle
The Reject Shop	12.6	5.8	25%	17x	Very mild	Low end retailer which is likely to benefit as customers seek value
Toxfree	10.9	3.4	51%	7x	Mild	Industrial waste volumes unlikely to suffer greatly

## What about mining services?

The Australian mining sector has fallen 33% in the past three months due to soft economic data from China and fears of a US/European recession. While we do not invest in mining stocks we do invest in mining services companies, some of which have been hit on fears of a downturn in that sector. We have avoided the highly cyclical stocks in the sector such as those involved in exploration and construction as these are the most exposed to spending cuts by mining houses when commodity prices fall.

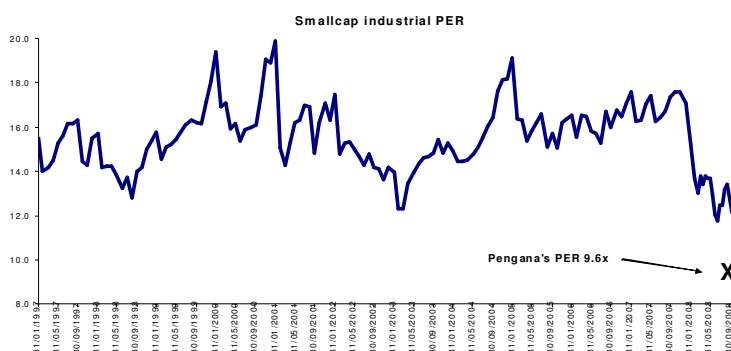
Our exposure is largely through companies exposed to mining production, which is unlikely to be cut on short term commodity price moves. We have also favored companies dealing with the larger mining companies rather than smaller ones which will now struggle to fund expansion given the nervous debt and nervous markets. The opportunities in oil and gas, iron ore, and coal remain highly positive given that the large proposed projects were committed at much lower commodity prices. We therefore remain comfortable in our positions in that sector, but remain vigilant to individual company earnings risk.

## It's not all bad news

There have been some positive developments in recent months for some stocks. The oil price has fallen 47% since July, taking some pressure off consumers and industries heavily reliant on fuel. Interest rates have fallen, and are likely to fall further. The A\$ has fallen 35% since July, which is a major boost to companies which either export product or have offshore operations such as ARB Corp, Campbell Brothers, HFA Holdings, Navitas, Resmed, Sonic Healthcare, Thinksmart, and Transfield Services.

## Valuations are supportive

Valuations remain depressed. The chart below shows the PE of the Smallcap Industrials, which is now 12.2x, well below the long term average. Note that the average PE in our portfolio is well below this at around 9.6x. Low PE's do not guarantee performance, but are a good indicator of sentiment which is obviously very poor.

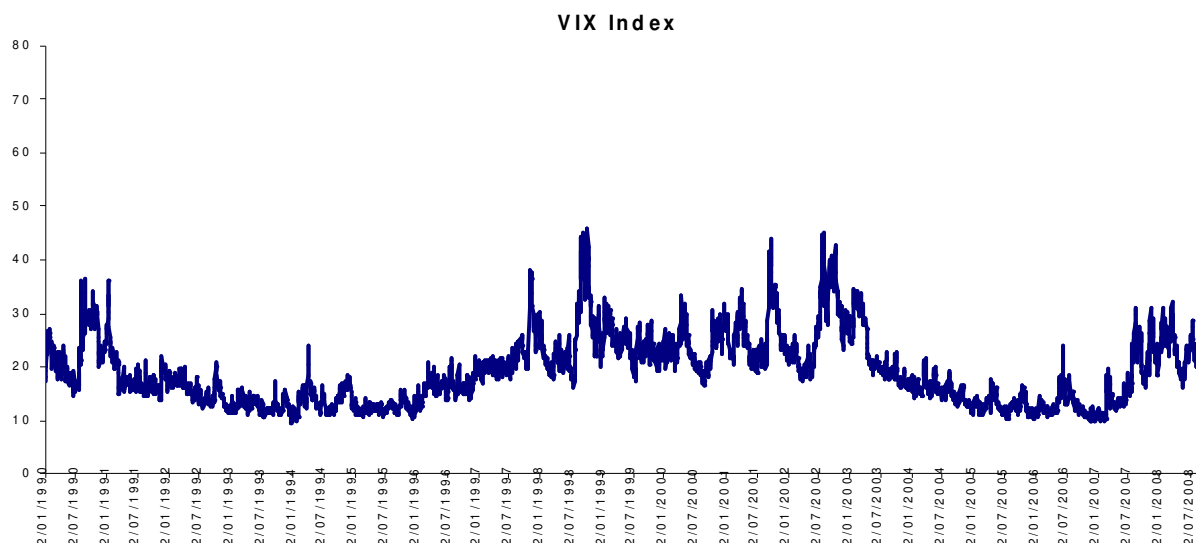


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## Are we witnessing capitulation?

Making sense of the short term market moves is difficult; however, there are some signs of capitulation emerging, which may signal an end to the pain. Market volatility has reached unprecedented highs, as measured by the VIX Index, which hit a high of 70 last week (see below). This index is an indicator of the level of fear and uncertainty in the market.



Since 1990, when the VIX was established, the S&P 500 has risen above 40 on four occasions including this week. In all of the prior three occasions, the S&P 500 had been very weak in the three months leading up to the peak in the VIX (down an average of 19%), and in all three occasions the market improved in value over 1 month (average 12%), 3 months (average 20%), and 6 months (average 19%). In no case did the market continue to fall over those time horizons.

Date of VIX peak	Market conditions	S&P move			
		3mth prior	1mth	3mth	6mth
8-Oct-98	LTCM collapse	-18%	18%	33%	40%
20-Sep-01	Sep 11 attacks	-20%	11%	16%	17%
5-Aug-02	Capitulation after long decline	-21%	8%	10%	1%
Average		-19%	12%	20%	19%

The current market is as nervous as it has been in many decades. The earnings picture has deteriorated, however, current market movements are hysterical and many investors' time frames have shortened to days and weeks which is unsustainable. Our fund is conservatively positioned, and is managed to capture value over the medium term irrespective of overall market moves. Once we emerge from the current frenzy we are highly confident in our ability to find rewarding investment opportunities.

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## 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 83 companies and unlisted competitors of listed stocks. The table on the next page shows the listed companies with which we had direct contact during the period.

AA Co	Duet Group	Programmed Maintenance
Adelaide Brighton	Emerson Stewart	Ramsay Healthcare
Ammtec	Fleetwood	RCR Tomlinson
Ansell	Greencap	Reject Shop
APA Group	Gunns	SAI Global
APN News	Hastings Diversified	Sedgman
ARB Corp	HFA Holdings	Seek
ASZ Group	Hills Industries	Sky TV NZ
ASZ Group	Index	Slater & Gordon
Atlas Steel	Industrea	Sonic Healthcare
Austar	Intrapower	Spark Infrastructure
Austbrokers	ISS Group	Structural Systems
Austin Engineering	JB Hifi	STW Comms
Australand	M2 Comms	Swick Mining
Auto Holdings	Mac Services	Talent 2
BSA Group	MacMillan Shakespeare	Tassal
BT Investment Mgmt	Macquarie Leisure	Teak Australia
Challenger	McPhersons	TFS Corp
Clough	Mermaid Marine	Toxfree
Colorpak	Mineral Resources	Transfield Services
Commquest	Mitchell Comms	Transpacific
Compass Hotels	Monadelphus	Treasury Group
Compuertshare	Navitas	Webjet
Count Financial	Nick Scali	Webster
CSG Group	Nomad	Wellcomm
Dexion	Oroton	WHK Group
DKN Group	Patties Foods	Wotif
Domino's Pizza	Probiotec	

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