

Pengana Emerging Companies Fund December 2008 Quarterly Review



Australian Equities - Small Caps

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Fund Performance

Net performance for periods ending 31 December 2008 ¹

	3 months	6 months	1 year	2 years p.a.	3 years p.a.	Since inception p.a. ²
Pengana Emerging Companies Fund	-29.6%	-31.5%	-53.8%	-21.1%	-1.1%	+6.1%
S&P/ASX Small Industrials Acc Index ³	-27.6%	-30.6%	-52.7%	-28.6%	-13.5%	-5.9%
Outperformance	-2.0%	-0.9%	-1.1%	+7.6%	+12.5%	+12.0%
S&P/ASX Small Ordinaries Acc Index	-29.2%	-42.0%	-53.2%	-26.0%	-9.7%	-2.5%
Outperformance	-0.4%	+10.6%	-0.6%	+4.9%	+8.7%	+8.6%

Fund Commentary

Global markets suffered further considerable losses during the December quarter with the Dow Jones down 19%, the Australian All Ords down 21% and the Small Ords down 29%. This caps off the worst year since the depression of 1931 and created a highly challenging environment. Our fund matched the index over the quarter, with our key defensive holdings providing a buffer against the dramatic decline in mining services stocks.

Clearly global events dominate the current environment. Over recent weeks credit markets have started to thaw, however volatility remains high due to concerns over the banking system and global economy. We believe the upcoming results season (Feb-March) will contain poor news from companies with revenues tied to the economy, and hence we remain heavily weighted towards stocks which are not reliant on the economy (e.g. healthcare).

As we move through 2009, a clearer picture will emerge as to how deep the economic downturn will be, and how effective the enormous government response packages will be. If the downturn proves to be less severe than expected, the scene could be set for a significant rally given how bad current sentiment is.

We remain wary of companies with high debt levels due to the risk of emergency discounted capital raisings if refinancing difficulties are encountered. Our banking contacts suggest that refinancing risk remains very high during 2009. Having said that, we will watch for opportunities to participate in capital raisings where the balance sheet is repaired in the process.

Many investors believe stock picking will not be rewarded in such a tough market, but we strongly disagree. In a fear driven environment, it is easy to overlook stocks with superior management teams able to grow businesses in tough conditions. We continue to be highly active in visiting companies and looking for strong investment ideas through the mess.

We urge patience and remind investors that markets typically recover well ahead of the economy. There are some highly attractive investment opportunities for investors with a medium term view, and keeping a level head in such times is critical. As the volatility subsides investor's time horizons will extend beyond the very short term. In the meantime we believe we are very well positioned to ride out the storm through a defensive portfolio and highly experienced investment team.

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. We had also reduced our exposure to the mining services sector, however our remaining exposure during this quarter was a negative. This sector is now a very small part of our portfolio following further sales in recent weeks.

We took a major position in Transfield Services through its capital raising at a deeply discounted price, and remain confident in the predictable cash flows and highly attractive valuation of the stock. We have also continued to build on our positions in more

¹ All performance figures are calculated net of fees and assume reinvestment of income distributions. Past performance is not a reliable indicator of future performance.

² Since November 2004

³ The fund does not invest in resource stocks.

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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 Astar, DUET Group, Metcash, Navitas, Slater & Gordon, and WHK Group.

Given the current uncertainty, and likelihood of further bargains, we are maintaining a higher than usual cash balance of around 9.0%.

Market Commentary

Market backdrop

Further fears of a global recession, and tighter credit conditions lead to unprecedented selling across most asset classes. The pressure was exacerbated by forced selling from hedge funds around the globe who are reducing gearing within their portfolios, fielding high levels of investors withdrawals, and in some extreme cases liquidating entire funds. This selling, combined with negative economic newsflow saw volatility at record levels, which in turn spooked many investors into selling on fear rather than longer term investment criteria.

Pengana's key stock moves during the quarter

Key successes in the portfolio during the period were the larger stocks which have a low reliance on the overall state of the economy such as Metcash (up 13%), Navitas (7%), Probiotec (3%), Ramsay Healthcare (3%) and Sonic Healthcare (11%).

On the flipside the portfolio suffered from a relatively high exposure to the mining services sector, which saw a dramatic change in fortunes based on the rapid collapse in commodity prices globally. We had been reducing our exposure to the sector, and had always avoided stocks with short term revenue streams, however there is no escaping pain when the global mining stocks collapse and threaten to reduce spending on mine expansion. This saw stocks such as Ausenco, Bradken, Mac Services, Mineral resources and Sedgman (all of which we had minor holdings) fall by between 60 and 80% during the quarter.

Outlook

Overall comment

As an overall comment, we still believe the coming 6-12 months will remain challenging and volatile, however, we also believe that through the current cloud there remains very strong opportunities for those prepared to take a medium term. This is especially the case in smallcaps where illiquidity in some cases has pushed valuations to well below sustainable levels.

The economic picture is not pretty, hence we remain skewed to stocks with a low reliance on the economic cycle. Even less pretty is the ability of highly geared companies to refinance debt over the coming 12-18 months, hence we are wary of these situations.

Given the extent of the damage so far, cheap valuations and poor sentiment, we find it difficult to see the market being blindsided again by poor economic news in 2009. We now know that the US and most of Europe are heading into recession, that China is slowing, and the risk of a domestic recession is reasonably high. This is why equity markets fell 40-50% during 2008. History shows that markets start to recover well ahead of the economy, so one would have to assume an outcome far worse than currently feared to envisage further major downside.

Volatility has scared many investors, as witnessed by the record level of equity fund withdrawals in the US last year. We would expect volatility to continue to abate through 2009 which will see an increasing level of "trust" in equities, and hence a slow shift back from cash (which is suffering from low interest rates) into equities.

Global growth under pressure

The markets have already assumed a major collapse in earnings in 2009-2010. Exactly how hard earnings fall is the difficult question. It is worth considering scenarios rather than being too specific at this stage.

The worst case would involve a worsening of the credit crisis creating further credit rationing, corporate bankruptcies, further falls in confidence and unemployment. Lower interest rates and massive government spending programs may not be enough to counteract such a scenario. This would likely hurt global cyclical stocks and favour defensives such as healthcare, but overall see further downside to global markets.

A mid case would involve an economic downturn, however slowly thawing credit markets (there is some early evidence of this recently) would ease the pain and allow the fiscal and monetary packages to work through into improved confidence and activity in the second half of 2009. If this occurs we would expect a reasonable bounce in the share market as investors regain confidence that we are near the bottom of the earnings cycle and the worst news is behind us.

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The best case scenario is that the credit markets return to more "normal" conditions due to the rescue packages from 2008, and that lending conditions allow a full and rapid benefit from the fiscal and monetary packages to avoid a long, deep downturn. While difficult to imagine, this scenario would create the conditions for a major share market recovery from depressed levels, and would favour the cyclical sectors over the more defensive stocks. It would also favour stocks which are currently being penalised for over-gearred balance sheets as refinancing becomes easier to achieve.

Our view is that the level of current uncertainty necessitates a slightly cautious approach to stock selection, and that it is way too early to be positioned for an economic recovery.

Hence our low risk approach

As we mentioned in our quarterly reports during 2008, 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. We had also reduced our exposure to the mining services sector though clearly not enough in hindsight. While this was disappointing given how quickly those stocks dropped during the December quarter, the speed of decline in the global mining industry was breathtaking and the volatility made it very difficult to make informed decisions. From here we believe the mining services sector will be under severe pressure due to low commodity prices, increasing cost focus by the miners, and a lack of funding available for new projects. We have therefore removed most of the stocks from our portfolio.

During 2008 we 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), Astar (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.

Beware stretched balance sheets

During 2008 investors learnt a painful lesson about the influence debt markets have on equity markets. Not only have there been companies collapse (e.g. ABC Learning), we are seeing deeply discounted capital raisings in the current market (e.g. Incitec Pivot, Bluescope, Transfield Services, the listed property sector) where changing debt markets have created major losses for shareholders. To further understand this dynamic, we have spent time meeting with large domestic lenders and talking again to management teams about their balance sheets and refinancing timetables. Our conclusions at this stage are that refinancing risk remains very high, no-one can be sure the extent to which the tighter credit conditions are due to short term debt market dislocation versus structural changes, banks are far from complete in repositioning their portfolios and borrowers have far less choice as many international banks have withdrawn from Australia. Therefore many companies are yet to face the issue, and unfortunately we expect significant value destruction in some stocks over 2009 as a result.

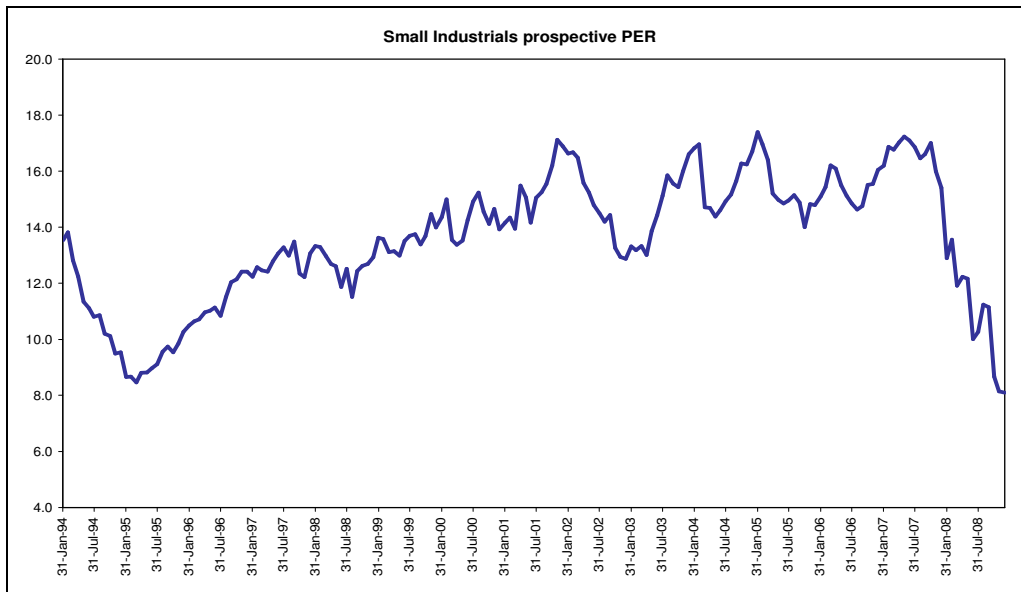
Understanding how this affects individual companies is absolutely critical given how much it can affect share prices. On the flipside, of course, we need to be prepared to capitalise on any stocks which are forced to raise equity cheaply, as this often provides an opportunity to get set in a stock at a low price, with a repaired balance sheet. One example of this is Transfield Services which was forced to raise equity in a very weak market in November. We secured a large position in the raising at \$1.25 and benefited from the 56% recovery in the share price over the five weeks since.

Less than 25% of our portfolio is invested in stocks with interest cover of under 10x (if we exclude regulated utilities companies which have highly certain income and therefore can sustain higher long term gearing). In other words the majority of our stocks either have no debt or are very conservatively geared and we will monitor this very closely.

Valuations are supportive

Valuations have been depressed further. The chart below shows the PE of the Smallcap Industrials, which is now 8.1x based on Macquarie forecasts, well below the long term average. Low PE's do not guarantee performance, but are a good indicator of sentiment which is obviously very poor.

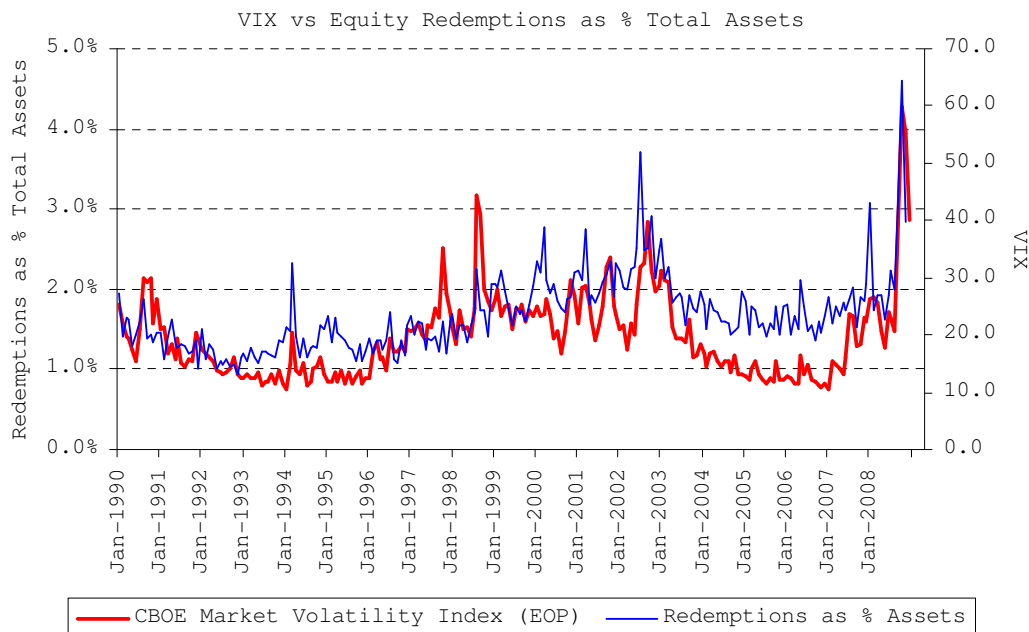
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Source: Macquarie

Volatility an important driver of investor flows

The chart below shows the impact of volatility on investor confidence, as measured by flow in and out of equity funds in the US. It shows that investors tend to withdraw their funds during periods of volatility, which adds to the selling pressure as fund managers raise cash to hand back to investors. As volatility (i.e. the VIX index) ballooned, so did redemptions. Indeed during 2008, investors withdrew US\$320bn, which is a record in both dollar terms and as a % of total industry assets. Notably, as the market settled in December, the net flows turned mildly positive, albeit over a very short sample period. The VIX index has fallen in recent weeks, and if this continues we would anticipate the outflows to continue to wane, hence providing some support for markets.



Source: Citigroup

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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 51 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.

ABB Grain	Australian Wealth	Invokecare	Realestate.com.au	Spotless
Adelaide Brighton	AWB Ltd	JB Hifi	Redflex	Super Cheap Auto
Amcom	Billabong	Jetset	Resmed	Tatts Group
Ammtec	Cabcharge	Lion Nathan	Ridley Corp	Technology One
API Group	Clean Seas Tuna	M2 Comms	RP Data	Transfield Services
ASG Group	CSG Group	Mac Services	Runge	Watpac
Ausdrill	David Jones	Metcash	Salmat	WHK Group
Ausenco	Energy Developments	Pacific Brands	Sedgman	
Austar	Fleetwood	Probiotec	Seven Network	
Austbrokers	Flexigroup	Radio Rentals	Sigma Pharmaceuticals	
Australian Infrastructure	Healthscope	Ramsay Healthcare	Southern Cross Electrical	

Fund Description

The Pengana Emerging Companies Fund seeks to combine the skills of highly experienced small company investors (30 years experience between the two fund managers) 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 Features

Style	Bottom up stock picker	Management Fees ⁴	1.3325%
Benchmark	S&P/ASX Small Ordinaries Accumulation Index	Performance Fees ⁴	20.5% of the performance above the Benchmark
Investors	Open	Fund raising	Maximum of 0.5% of the Benchmark capitalisation
Minimum Initial Investment Amount	A\$25,000 (direct)	FUM at Month End	\$190m
Inception Date	1 November 2004	Application Price at Month End	A\$ 1.1073 (pre distribution)
Identification Code(s)	APIR PER0270AU ARSN 111 894 510	Redemption Price at Month End	A\$ 1.1067 (pre distribution)

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⁴ All percentages are on a GST inclusive basis less applicable reduced input tax credits. Please refer to the Product Disclosure Statement for a more detailed explanation.