

Analysts: Tara Bell; James Gunn

Products Facts

Manager	Pengana Capital Limited	Fund type	Retail	Boutique	No
APIR code	PER0270AU	Specialisation	—	Multimanager	No
Fund status	Open	Peer group	Australian Equities - Small Cap	Inception date	Nov. 1, 2004
Min. investment (A\$)	25000			ICR (% pa)	-

Standard & Poor's View

S&P rates this fund four stars, reflecting our high conviction that the manager will consistently generate risk-adjusted returns in excess of both its relevant investment objectives and its peers.

Pengana's partnership of experienced industry stalwarts Stephen Black and Ed Prendergast remains staunch, and S&P affirms its rating accordingly. Commencing as a friendship developed over a number of years through industry connections, the relationship was formalised when the fund was created in late 2004, and the portfolio managers continue to deliver strong risk-adjusted returns overall through testing markets. While key person risk is heightened in a small team, the managers have a significant personal stake in the venture and incentives are, and will, continue to be appropriately aligned with the fund - even after it has closed. At this stage, there are no concerns with fund capacity.

The portfolio composition is distinguished from most other managers in its considerable deviation from the benchmark. The scope is somewhat broadened by permitting investment in mid-cap stocks, while New Zealand small-caps may also be held to a maximum of 15% of the portfolio. Yet some key sectors are excluded; resources, biotechs, and listed property trusts. Reasons for exclusion are considered to be valid, for Pengana is pragmatic in its recognition of its relative strengths and weaknesses; however, it can be challenging to produce competitive performance when one of these sectors is strong – typically, resources. Pengana has no intention of hiring a sector expert to complement its skills and expand its opportunity set, which S&P considers could be useful. Instead, it is believed a further person could dilute and inhibit the pair's efficient decision-making process.

Product Features

Pengana's investment approach is benchmark-unaware and focused on capital preservation; however, with a 10% cash constraint and without a shorting capability, the fund may experience negative performance in the event of a market downturn. The fund objective is also related to a benchmark, and the target return of 5% above benchmark over rolling three-year periods is considered to be appropriate for the peer group, accompanied with 6%-9% tracking error.

The management expense ratio (MER) is in line with other fund managers in the peer group, and a performance fee is also charged. This is calculated as 20.5% of fund returns above the benchmark index (with high water mark), payable at the end of each half-year. While S&P would prefer a lower MER to accompany a performance fee, Pengana claims its incentives will remain better aligned with investors after the fund has closed.

The manager has been committed to closing the fund when it reaches 0.5% of the S&P/ASX Small Ordinaries Index, or A\$300 million since

the fund's inception. At A\$190 million, the fund remains some way from this level, and capacity is not expected to unduly impede the manager reaching objectives.

Fund Objectives

Benchmark	S&P/ASX Small Ordinaries Accum Index
Target return (% p.a.)	Benchmark + 5% over rolling 3 year periods

Investment Style

Pengana applies a fundamental bottom-up approach to investment, and postulates that smaller companies stocks are often mispriced because of a lack of broker research, resulting in opportunities for active management to add value. It believes that portfolio risk is largely stock specific, and this is reflected in a strongly qualitative research approach which focuses as much on screening out companies with weak management as identifying potential candidates for inclusion in the portfolio.

The portfolio typically exhibits a growth bias, which Pengana attributes to the emphasis on Porter-style qualitative analysis – particularly quality of management. There is an active company visitation programme to supplement and improve the rigour of the internal research effort.

The investable universe is distinguished from most other managers, in both its inclusions and exclusions. New Zealand small-caps are permissible investments, to a maximum of 15% of the portfolio; Pengana believes these stocks offer an additional alpha source due to a lack of research coverage. The team may also invest in mid-cap stocks, or those in the top 50-100, and in microcaps with a minimum market capitalisation of A\$30 million.

Conversely, resources are avoided as they are considered to have high risk or volatility traits, and require reliance on commodity price forecasts which the team does not believe it has enough competitive edge to produce. The mandate also specifically excludes investment in biotechs, which it considers to be largely speculative, and listed property trusts. These sector exclusions, most notably resources, can create a challenge for the manager to remain competitive if performance is particularly strong for a prolonged period – although this has not been evident, to date. S&P acknowledges that this shortcoming has been partly addressed by exposure to the mining services sector, which is leveraged to the resources cycle.

Passive					Active
Value					Growth
Small Cap					Large Cap

Investment Team

Pengana's investment team is smaller than some of its peers, but this is partly compensated by the level of experience of the highly regarded co-portfolio managers. As is typical of the small-cap sector, there is considerable key person risk; however, this is mitigated to some extent by the pair's personal investment in the funds and existence of a performance fee, which provides a significant incentive to outperform the index.

Co-portfolio manager Mr. Black has extensive experience as both analyst and portfolio manager in the small companies sector, having managed the successful JBWere Emerging Companies Fund for seven years prior to joining Pengana. Similarly, colleague Mr. Prendergast has a strong record in the sector, he worked previously as a small companies broking analyst with Citigroup Smith Barney and ABN Amro; also, he provided broking services to Mr. Black for five years which helped cement their relationship. Collectively, there is a sound 30 years of investment experience between them.

New					Experienced
Small					Large
Unstable					Stable

Investment Process

Pengana's investment process is clear and well-suited to its investment approach. There is a reasonably high degree of flexibility and subjectivity in portfolio construction, which is rewarded by the manager's considerable stock-picking skills. The investable universe, which has been previously described, consists of approximately 800 stocks, which are systematically screened and ultimately reduced to between 50 and 60.

The qualitative research process is intended to identify the key profit drivers of a company. The research framework is a Porter-style analysis, incorporating factors such as a company's competitive advantage and sustainability, and the strength of its financial position. Companies are ranked using a discounted cash flow (DCF) analysis, with the results cross-checked using other financial ratios, such as P/E, EV/EBITDA and dividend yield, and adjustments are made for market capitalisation and liquidity.

Stock weights tend to be driven by the forecast return of the DCF analysis, but ultimately are determined by a more subjective consensus of the portfolio managers. The final portfolio is constructed with the aim of building a "best ideas" collection of companies, while cognisant of avoiding "hype". The co-managers maintain an overall P/E ratio similar to the market by ensuring an adequate level of diversification. Historically, however, the P/E ratio has averaged a full point lower than the market. Pengana believes its confidence in the "E", or earnings of the portfolio, is much higher than for the market's "E".

Typically, a stock is sold when its price reaches target valuation - or if an investment thesis is violated when the manager will attempt to sell the stock quickly. Price weakness may be viewed as an opportunity to increase the position, subject to risk limits. Once a stock progresses into the S&P/ASX 50 Index, the manager has a 12-month time frame within which to sell.

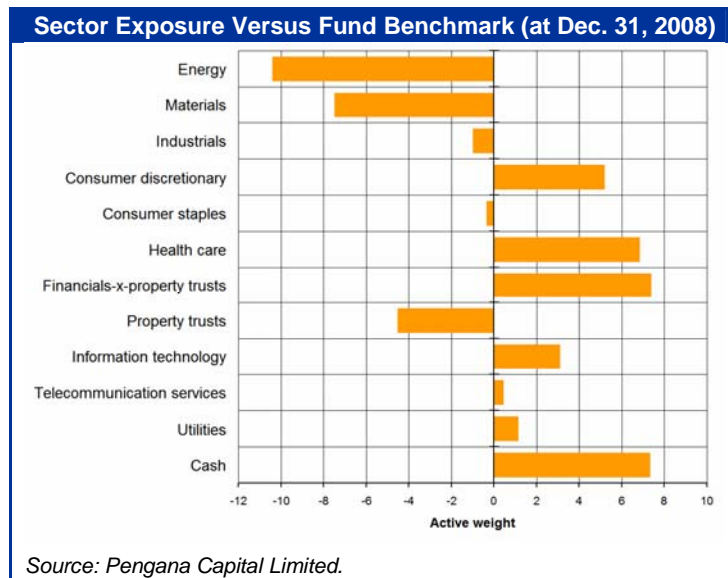
Performance

Pengana has produced robust performance since inception, with several months of negative returns in 2008 marring an otherwise consistently strong return profile. The underperformance in the early part of 2008 was most greatly impacted by the continued strong performance of the small resources sector, which experienced strong gains through June 2008, while the small industrials experienced heavy declines.

The current portfolio reflects a cautious approach to economic recovery, with a gradual shift toward cyclicals. The largest overweight positions are in health care, financials (ex property trusts), and consumer discretionary, while there is a significant underweight to energy (zero weight, compared with benchmark 10.4%) and materials. A large proportion of 50% of the portfolio is currently invested in microcaps, while 16% is exposed to mid-caps.

Performance Measures	
Average portfolio turnover (%)	40
Typical number of stocks in portfolio	50 - 60

Source: Pengana Capital Limited.



Risk Management

Portfolio construction constraints are looser than most of the peer group, as befits a high alpha strategy. This approach demands a high level of portfolio manager oversight to ensure there are no unintended risks in the portfolio. Quantitative risk measurement is undertaken using the GSJBWere software; however, the portfolio managers believe their prime risk management tool is knowledge of the portfolio stocks gained through comprehensive fundamental research.

There are no formal limits on sectors; however, there is a 7% maximum stock position relative to the index. The tracking error target of 7%-9% has been exceeded recently, with 14% ex post, which largely may be attributed to high market volatility, and is likely to resume more normal levels.

Pengana may hold up to 10% of a company by market capitalisation and currently has four substantial holdings. Cash is limited to 10% of the portfolio and has drifted upwards to more than 7% recently. A higher cash level can benefit performance during down markets; however, the

manager does not appear to be engaging in opportunistic asset allocation strategy.

Management Group Profile

Pengana Capital is a diversified funds-management company, founded in 2003, and offering a range of investment strategies across five asset classes. Pengana is headquartered in Sydney, with additional offices in Melbourne, Singapore, London, Chicago and Lakeville (Connecticut) and has more than 35 investment professionals.

In May 2008, nabInvest, National Australia Bank's direct investment management business, took a significant minority stake in Pengana, although the company remains majority-owned by directors and staff.

Market Share

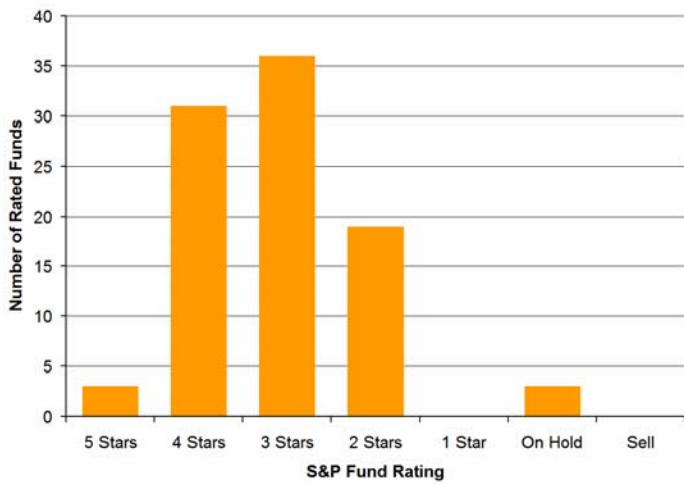
At Dec. 31, 2008, Pengana managed A\$190 million in small-cap FUM, compared with expected capacity of A\$300 million.

Analyst(s): Tara Bell; James Gunn.

Release authorised by: Mark Hoven.

S&P Fund Rating Reference Information

Australian Equities - Small Cap (at May 13, 2009)



Reference Material

Sector Reports

www.standardandpoors.com.au/funds

Reader's Roadmap

www.standardandpoors.com.au/funds

Glossary

www.standardandpoors.com.au/funds

Guide to S&P Qualitative Fund Ratings

www.standardandpoors.com.au/funds

Fund Rating Team Biographies

www.standardandpoors.com.au/funds

Fund Rating Peer Groups by Sector

Australian Equities	International Equities	International Fixed Interest	Alternative Assets
Large Cap Diversified	Diversified Equities	Diversified Fixed Interest	Commodities
Large Cap Income	Emerging Markets	Diversified Fixed Interest Income	Multi-Sector
Large Cap Indexed	Emerging Markets Asia ex Japan	Fixed Interest	Private Equity Listed
Large Cap Industrials	Emerging Markets China	Fixed Interest High Yield	Private Equity Unlisted
Long Short	Emerging Markets India	Fixed Interest Income	Infrastructure Listed
Small Cap	Large Cap Diversified	Mortgages	Infrastructure Unlisted
Specialist	Large Cap Income	Mortgages High Yield	Alternative Strategies
Australian Fixed Interest	Large Cap Indexed	Mortgages High Yield Hybrid	Single Strategy Funds Multimanager
Cash	Large Cap Industrials	Mortgages Conventional	Single Strategy Funds Single Manager
Cash Enhanced	Long Short	Mortgages Hybrid	Multi-Strategy Funds Multimanager
Fixed Interest	Long Short Specialist	International Property	Multi-Strategy Funds Single Manager
Fixed Interest Income	Long Short Regional	Direct Commercial	Multi-sector
Mortgages	Regional Japan	Direct Development	Capital Guaranteed
Mortgages High Yield	Regional UK/Europe	Direct Diversified Direct	20
Mortgages Conventional	Regional US	Direct Industrial	40
Mortgages High Yield Hybrid	Regional Asia	Direct Residential	60
Mortgages Hybrid	Small Cap	Direct Retail	80
Australian Property	Specialist Healthcare	Direct Rural	100
Direct Commercial	Specialist Information Technology	Direct Specialised	Equity
Direct Development	Specialist Resources	Diversified Property	Other
Direct Diversified Direct		Listed	
Direct Industrial			
Direct Residential			
Direct Retail			
Direct Rural			
Direct Specialised			
Diversified Fixed Interest Listed			








Fund Rating Philosophy

A star rating is a forward-looking qualitative assessment of a manager's ability to consistently generate risk-adjusted fund returns (net of fees) in excess of both its relevant investment objectives and its peers.


Fund Rating Process

In assigning a star rating to a fund, Standard & Poor's evaluates: the size, skill, and stability of the manager's investment team; the clarity, implementation, and risk management of the investment process; the fund's objectives, fee structure, and portfolio characteristics; and the manager's business management.

Fund Rating Definitions

	Standard & Poor's has very high conviction that the manager will consistently generate risk-adjusted fund returns in excess of its relevant investment objectives and relative to its peers.
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	Standard & Poor's has conviction that the manager will not generate risk-adjusted fund returns in excess of its relevant investment objectives and relative to its peers.
	Standard & Poor's has high conviction that the manager will not generate risk-adjusted fund returns in excess of its relevant investment objectives and relative to its peers.
	Issues that may affect the fund's management have emerged; and the fund rating is temporarily suspended, pending clarification.
	Significant issues exist that potentially will adversely affect the fund's performance. Investors should consider obtaining advice on switching or redeeming funds.

Fund Rating Subscript

 The investment process, fund manager, or the fund has a relatively short history, or the analytical team has changed significantly, but a relevant and demonstrable track record is shown on similar funds.

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