

Pengana Emerging Companies Fund

June 2009 Quarterly Review



Australian Equities - Small Caps

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Fund Performance

Net performance for periods ending 30 June 2009 ¹

	3 months	6 months	1 year	2 years p.a.	3 years p.a.	Since inception p.a. ²
Pengana Emerging Companies Fund	+17.2%	+17.0%	-19.8%	-24.8%	-1.2%	+9.0%
S&P/ASX Small Industrials Acc Index ³	+21.8%	+13.0%	-21.6%	-29.5%	-11.7%	-2.8%
Outperformance	-4.6%	+4.0%	+1.7%	+4.6%	+10.6%	+11.8%
S&P/ASX Small Ordinaries Acc Index	+25.7%	+23.2%	-28.6%	-24.6%	-6.4%	+2.3%
Outperformance	-8.5%	-6.3%	+8.7%	-0.2%	+5.2%	+6.8%

Fund Commentary

The June quarter showed some optimism returning to markets following last years' collapse in global confidence. While there are early signs that we have escaped economic apocalypse, it is too early to definitively call the timing of a sustainable recovery in markets. In the meantime, lower volatility certainly helps us to invest with confidence for the medium term.

Since the lows in early March, the unit price of our Fund has recovered 29%¹, which is slightly less than the overall market in that time frame. The "recovery trade" has been generally lead by riskier, lower quality stocks, hence we are not surprised to miss the full extent of the recent strength given our risk and quality controls.

For the financial year our Fund showed a negative return of 19.8%¹ which was better than the Small Ordinaries (down 28.6%) and Small Industrials (down 21.6%). While disappointed to post a negative return, we highlight that our Fund has outperformed the Small Industrials sector in every financial year since inception almost five years ago. This demonstrates that our stock selection process can deliver excess returns in both good and bad markets.

While the market outlook is clouded, there are plenty of historical examples of global share markets rising towards the end of a recession even though earnings forecasts continue to fall. In other words, the headlines will still be full of negative news, especially on unemployment which is a lagging indicator, while the stock market recovers.

Notwithstanding a clouded outlook, we are confident that the opportunities for focused stockpickers like us are currently highly favourable. At its worst in March this year, our sector had fallen 70% over 16 months, which chased investors from the sector, some of whom may not return. This creates an uncrowded market, hence high quality stocks remain ignored. On average we visit more than one company per day and believe this activity places us very well to identify opportunities where others aren't looking.

Recent portfolio activity

Earlier this year we recognised some heavily sold down stocks as offering very strong risk/reward signs given how bearish the market had become on cyclical earnings streams. Some of these positions have worked very well for us, and we have reduced or removed our holdings in stocks such as **Bradken, NRW Holdings, David Jones, Campbell Brothers, Transfield Services**, after very strong price rises. Others in that category which we retain include **APN Media, Mitchell Communications, STW Communications, Premier Investments, Pacific Brands, Automotive Holdings, and McPhersons**.

We also established new positions in **Asciano, Customers** and **REA Group** which owns Realestate.com.au. Asciano's \$2bn capital raising removed the debt problem, and was done at a highly attractive price given that earnings will recover with the economy. Customers operates the largest private network of ATM's and offers strong medium term growth potential, while Realestate.com.au is a high quality franchise with no debt, and strong medium term growth through higher prices as the internet continues to take share from traditional print advertising.

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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Market Commentary

Market backdrop

Whilst the economic backdrop remains murky, recent data shows clearly that the rate of decline has abated, and that confidence is returning to purchasing patterns (both consumer and corporate). Hence a dramatic change in investors' risk tolerance has pushed sharemarkets up sharply since early March. From the lows in March the Dow Jones has rallied 31%, All Ordinaries 27%, Small Ordinaries 41%, and Small Industrials 41%. The dramatic bounce in smallcap stocks is typical in a reversal of major bear markets, and has happened in each of the last four recessions in the US. Should markets continue to recover, this outperformance by smaller stocks is expected to continue (see chart on Page 3 – Bear Market Bounces).

Key stock moves during the quarter

Key successes in the portfolio during the period included **CSG Group** (up 65%), **Mineral Resources** (52%), **Probiotec** (36%), **Radio Rentals** (47%), and **Thinksmart** (118%).

CSG Group continues to recover from oversold levels as the market absorbs the low risk nature of the maintenance style revenue base. **Mineral Resources** suffered during the resources rout of late 2008, bouncing strongly recently as the outlook for contract opportunities has improved. **Probiotec** continues to successfully commercialise its meal replacement products domestically and offshore, posting 71% profit growth in the first half. **Radio Rentals** released its interim result showing 28% EPS growth and a resilient business in the tougher retail climate. **Thinksmart** is a small position for us, and rose strongly following confirmation of the earnings outlook and growth potential with retailers such as JB HiFi. Stocks which held us back of late are primarily defensives such as **Sonic Healthcare** (up 11%), **Salmat** (down 5%) and **Resmed** (down 2%) as the market chased stocks with higher risk and more cyclical earnings streams.

Outlook

Highly favourable conditions for stock pickers

While the direction of the overall market is difficult to predict, we are confident that the environment for stock picking funds such as ours is very promising. After last year's horror, many investors have sworn off smallcaps which leaves an uncrowded market in which to search. Even if the market remains flat for 2-3 years, this opens up significant opportunities.

Two years ago (it seems like 20!), the smallcap market was running hard, which attracted many part time investors. Hedge funds were highly active given the strong momentum and liquidity. Large-cap funds were attracted to the sector to boost performance. Mum and Dad investors were also attracted to the potential for high returns following three strong years. In this environment, there are plenty of eyes watching each stock, hence identifying undiscovered stories was more difficult.

From its high, the Small Industrials sector then fell 70% in 16 months, leaving deep scars across the board. Brokers sacked analysts, hedge funds struggled to remain liquid let alone focussed on the smallcap sector, large cap funds abandoned the sector in search of quality and size, and private investors were often driven to sell in panic. During this mass-exodus decisions were made quickly and emotionally, and many stocks were sold down irrespective of quality and valuation.

Our assessment now is that there are very few investors left in the sector, which is a major positive for stock pickers like us. The companies we visit are seeing far fewer investors directly, hence the value in high quality stocks can go unrecognised for some time, allowing us to do the work, and establish a position without necessarily moving the share price. The last time this happened was in 2000-2001 when the tech wreck destroyed confidence, and following this returns for stockpickers were very rewarding.

Overall market comment - markets can rise even though the news is still bad

The dramatic bounce in markets in the past 3-4 months has surprised most, with many observers seeing it as a false dawn given the extent of economic pain last year. The counter-argument is that we are likely to see a V-shaped bounce in economic activity driven primarily by a replenishment of inventories and government stimulus. It is too early to have a firm view either way on the economy. In fact, The Age Economics Survey (July 4, 2009) showed the range of GDP forecasts from 22 economists for 2010 was positive 3.5% to negative 6%, indicating a lack on conviction among the forecasters.

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However history shows that equity markets recover 4-6 months ahead of the economy, hence waiting for confirmation risks missing key gains. Recovery trades can be sharp, and occur despite ongoing bad news on earnings and employment. Importantly, unemployment is a lagging indicator and generates plenty of press coverage, hence it will seem counterintuitive that markets can rise when there remains so much bad news. The table below highlights this effect, known by Citigroup strategists as the "Twilight Zone" where markets rise despite falling earnings forecasts.

	Mid 1970s	Early 1980s	Early 1990s	Late 1990s
Share prices (MSCI World Price Index)	+54%	+49%	+36%	+40%
Earnings forecasts (MSCI World Earnings Index)	-25%	-2%	-9%	-6%
Length of market rally	16 months	10 months	33 months	9 months

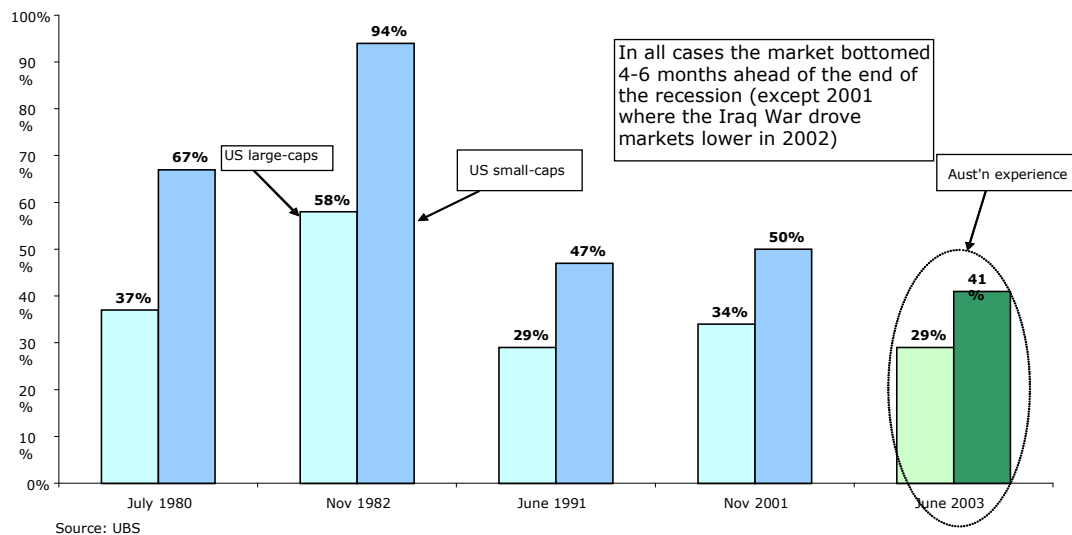
Source: Citigroup

Smallcaps likely to outperform if the market continues to recover

We initially published the following chart in March, showing that in previous US recessions Small Caps have historically had greater falls than the broader market leading into recessions, but have outperformed the broader market during the recovery phase. So far, this has shown to be true with Australian Smallcaps outperforming Large Caps domestically by 14% from the lows in March.

The chart below shows the performance of the US stock market in the last four recessions, plus the performance of the Australian market following the market lows reached in early 2003 during the Iraq war. In each case for the US market, the chart represents the 12 month performance from the market low, with large caps measured by the S&P 500, and Small Caps measured by the Russell 2000 index.

Chart One – Bear Market Bounces⁴



⁴ performance is not a reliable indicator of future performance.

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Our process has been proven in good and bad markets

Our conservative approach has so far delivered excess returns in good and bad markets, as shown in the table below. For the past five financial years we have delivered a return in excess of the Small Industrial benchmark. We believe investors with a medium term view will be rewarded by our process and risk controls which are based on the following:

1. Management contact is critical – we meet roughly 7 companies per week
2. Cash is king – we value companies on their cashflow rather than profits which can be distorted
3. We don't invest in resource companies – valuations are too susceptible to small changes in commodity prices
4. No loss making companies – without an earnings track record, meaningful valuations are impossible to derive
5. Avoid highly geared stocks – equity holders carry all the risk
6. Sell mistakes quickly – no room for emotion when investing
7. Our fund size is limited – this is critical to remain nimble and an active stock picker
8. Diversification - by stock and sector alleviates specific risk factors

Net performance of the fund for periods ending June 30.

	FY05 ⁵	FY06	FY07	FY08	FY09	Since inception p.a. ⁶
Pengana Emerging Companies Fund⁵	+12.9%	+37.5%	+70.7%	-29.5%	-19.8%	+9.0%
S&P/ASX Small Industrials Acc Index⁷	+6.3%	+20.1%	+38.2%	-36.5%	-21.6%	-2.8%
Outperformance	+6.6%	+17.4%	+32.5%	+7.0%	+1.8%	+11.8%

Source: Pengana

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

ABB Grain	Dexion	Orbital Engine
Adelaide Brighton	Elders	Pacific Brands
Adtrans	Energy World	Pacific Energy
ASG Group	Entertainment Media	Pallane Medical
Aspen	Fantastic Furniture	Photon
Austin Engineering	Fisher & Paykel Health	Programmed Maint
Automotive Holdings	Flexigroup	Radio Rentals
Bendigo Bank	Greencap	Realestate.com.au
Billabong	Imdex	Repcol
Brickworks	IRESS	Sonic Healthcare
BT Investment	MacMillan Shakespeare	STW Communications
Carnegie Corp	McPhersons	Swick Mining
Cash Converters	Metcash	Tower Australia
Clean Seas	Mortgage Choice	Toxfree
Codan	Neptune Marine	WA News
Customers	Nuplex	Walter Diversified

⁵ The fund started in November 2004, hence this figure is not a full financial year

⁶ Since November 2004

⁷ The fund does not invest in resource stocks

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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 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 ⁸	1.3325%
Benchmark	S&P/ASX Small Ordinaries Accumulation Index	Performance Fees ⁸	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	\$217m
Inception Date	1 November 2004	Application Price at Month End	A\$ 1.2557
Identification Code(s)	APIR PER0270AU ARSN 111 894 510	Redemption Price at Month End	A\$ 1.2481

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⁸ 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.