

Pengana Emerging Companies Fund

July 2009 Update



Australian Equities - Small Caps

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Fund Performance

Net performance for periods ending July 31 2009 ¹							
	1 month	3 months	6 months	1 year	2 years p.a.	3 years p.a.	Since inception p.a. ²
Pengana Emerging Companies Fund	7.7%	15.7%	28.5%	-11.8%	-22.3%	1.2%	10.6%
S&P/ASX Small Industrials Acc Index³	7.6%	15.4%	28.4%	-17.8%	-26.3%	-9.2%	-1.2%
Outperformance	0.1%	0.4%	0.0%	6.0%	4.0%	10.4%	11.8%
S&P/ASX Small Ordinaries Acc Index	9.0%	20.7%	40.9%	-17.6%	-20.9%	-3.5%	4.1%
Outperformance	-1.3%	-5.0%	-12.4%	5.9%	-1.4%	4.7%	6.5%

Fund Commentary

The Fund returned 7.7%¹ in July as markets continued to rebound globally. From the lows in early March, the Fund has returned 36.3%¹. Smallcaps continue to outperform in the recent bounce, rising by 59% since early March versus 35% for the All Ords. In this time, mining stocks (which we do not invest in), have outperformed dramatically (up 72%).

Investors continue to seek exposure to the potential economic recovery, taking account of small positive data points which indicate the rate of decline in global economies is slowing. There certainly has been firm evidence that the worst may be behind us, however the visibility remains reasonably low. The Australian economy is demonstrably stronger than most.

Our portfolio is far less defensively positioned than it was during the downturn. We now have a balance of high quality growth stocks, some with exposure to the potential economic recovery, and many whose earnings are not strongly tied to the economy. Now that the panic selling has dried up, we are starting to see share prices in many of our core holdings reflect closer to fair value, and have taken profits accordingly. Notwithstanding the rally we still believe there remains strong value in the sector.

While the overall direction of the market might be hard to predict with confidence, we feel much more confident about our ability to identify and analyse stocks which are potentially very cheap, and more importantly, overlooked. The smallcap marketplace in Australia remains uncrowded and therefore potentially highly fruitful for those with experience, discipline and a medium term investment horizon.

Key stock price moves

Key successes during the month included Pacific Brands (up 39%), CSG Group (30%), McPhersons (27%), Transfield Services (22%), Asciano (20%) and Toxfree (13%).

Key detractors were REA Group (realestate.com.au) (down 9%), Sonic Healthcare (5%), Webjet (9%), Resmed (5%), and DKN Group (5%).

¹ Net performance figures are derived from Manager's records and are shown after all fees and expenses, and assume reinvestment of distributions. Past performance is not a reliable indicator of future performance. The value of investments can go up and down.

² Since November 2004

³ The fund does not invest in resource stocks.

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Market Commentary and Outlook

Over the past five months global markets have recovered faster and more strongly than most, including us, have predicted. This, however, is not out of line with historical examples of recoveries. The lows made in March were based on absolute capitulation, and since then those prepared to take the risk that earnings will recover at some point have been handsomely rewarded. Recent data points from most economies, most importantly the US and China, indicate that the worst may be behind us. In the US the June quarter earnings reports were not as bad as feared, as cost cutting measures cushioned a drop in sales in most sectors. Perversely, a lower cost base makes the potential for profit recovery stronger once/if the sales outlook improves. History shows that economies typically recover in a "V" shape, and that the faster the decline, the more dramatic the recovery.

The Australian economy looks to have defied the recession. The stimulus packages have clearly worked, and consumer sentiment has improved, which suggests that the current strength in activity is not solely based on short term (and therefore unsustainable) stimulus. Our economy also has a housing shortage (as opposed to over-build in the USA), is less exposed to distressed financial assets, and has a closer reliance on the Chinese economy, which is showing signs of a meaningful bounce in activity.

There remain significant challenges though. The US has too much debt (government and consumer), which will challenge the extent to which a recovery will flow through. This in turn presents hurdles to the Chinese and Australian economies after the effect of fiscal stimulus wears off. So while the outlook has absolutely improved, there remain obstacles and uncertainties.

The smallcap sector of late has outperformed larger companies which is in line with our expectations based on history. Assuming markets continue to recover this outperformance can be expected to continue.

The best performing stocks since the March lows have been those which benefit from an economic recovery, and those with highly geared balance sheets (these were the worst performers on the way down). We remain averse to stocks with too much debt if there is a risk they can go broke. While the share prices can rise spectacularly from oversold levels, the risks are too high. The bankruptcy this year of Timbercorp and Great Southern are timely reminders of the dangers of taking on too much risk.

We do however invest in stocks with cyclical earnings where we believe the share price is implying a much worse earnings outcome than is likely. To this end we own shares in APN Media, Premier Investments (which owns Just Jeans, Portmans etc), Asciano (which we bought **after** the balance sheet was fixed), Pacific Brands, and Billabong.

The bulk of our portfolio however has not changed, and consists of companies with highly predictable earnings and cash flows, with the ability to grow meaningfully over the medium term. While such stocks might be seen as slightly "boring" in a market where very low quality stocks are running hard, we believe quality and risk control is much more important than chasing speculative stocks for short term gains.

The smallcap market remains uncrowded, which provides a major advantage to experienced, disciplined stock pickers. When most people have given up on the sector following the pain of last year, value can go unrecognised for longer, which allows those remaining to find, analyse and buy stocks which are overlooked and undervalued. To this end we remain highly active in visiting companies and assessing value.

Top 10 Positions (in alphabetical order)	
CSG Group	Sonic Healthcare
Customers	Slater & Gordon
Mineral Resources	Tox Free Solutions
McMillan Shakespeare	Transfield Services
REA (realestate.com.au)	WHK Group

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Fund Description

The Pengana Emerging Companies Fund combines the skills of highly experienced small company investors (collectively 30 years experience) with a limited fund size and an objective of providing 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	1.3325%
Benchmark	S&P/ASX Small Ordinaries Accumulation Index	Performance Fees	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	A\$ 235m
Inception Date	1 November 2004	Application Price at Month End	A\$ 1.3285
Identification Code(s)	APIR PER0270AU ARSN 111 894 510	Redemption Price at Month End	A\$ 1.3205

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