

Pengana Emerging Companies Fund

September 2009 Quarterly Review



Australian Equities - Small Caps

1 of 5

Fund Performance

Net performance for periods ending 30 September 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	34.0%	57.1%	10.2%	-12.4%	5.5%	15.2%
S&P/ASX Small Industrials Acc Index ³	25.9%	53.4%	2.9%	-19.6%	-6.4%	2.1%
Outperformance	8.1%	3.7%	7.3%	7.2%	11.9%	13.2%
S&P/ASX Small Ordinaries Acc Index	21.8%	53.1%	6.3%	-16.6%	-1.7%	6.3%
Outperformance	12.2%	4.0%	4.0%	4.2%	7.2%	8.9%

Fund Commentary

The fund returned 34% over the September quarter, outperforming the Small Ords by over 12% and the Small Industrials by 8%. This is particularly pleasing given that the period featured "results season" where companies release their annual results and share prices tend to be driven by facts rather than sentiment and rumour.

Some of our key holdings posted very strong results, such as **CSG Group**, **Customers**, **Mineral Resources**, **REA Group** (realestate.com.au), and **Transfield Services**. Our patience has paid off in many stocks which were aggressively sold down during the 2008 calamity despite there being no underlying collapse in earnings. Also, our switch earlier this year into some cyclical stocks which had been very heavily sold down on the fear of a total economic apocalypse has proven highly rewarding with stocks such as **APN Media**, **McPhersons**, **Pacific Brands**, and **Premier Investments** performing very strongly. We have been actively taking profits where we see the value gap close quickly in many situations.

Since the lows in early March, the unit price of our Fund has recovered 73%¹, which is slightly less than the overall market in that time frame. The early phase of the "recovery trade" was 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. In more recent months, however, the rally has broadened from a junk rally into a more discerning rise which better suits our process.

Global economic data remains in early recovery mode, and is therefore encouraging without being 100% convincing. Australian data is however more convincing, showing that decisive monetary and fiscal responses, combined with a reliance on the Chinese economy which has recovered very quickly have served us well. Many industries remain heavily depressed, which leaves scope for further earnings upgrades as the recovery broadens in 2010 and beyond.

The opportunities for focused stockpickers like us remains highly favourable. Given last year's catastrophe, many investors left the sector (some promising never to return). This leaves 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

Recently we have sold down in some of the cyclical stocks where share prices have moved up strongly to reflect more likely earnings outcomes, including **McPhersons** (up 120% since purchasing), **Pacific Brands** (up 100%), **Premier Investments** (up 85%), **STW Communications** (up 90%), and **Transfield Services** (up 210%). Other stocks we sold or reduced included **ASG Group**, **Macquarie Leisure**, **Neptune Marine**, **Webjet** (which all achieved price target), and **Sonic Healthcare** (which moved into the top 50 index). We established, or increased positions in some quality stocks not reliant on an economic recovery such as **Customers**, **Reckon** and **Slater & Gordon**. We participated in capital raisings which involved balance sheet remediation and meaningful upside including **Photon Group**, and **Skilled Engineering**, buying more stock after the raising.

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.

Pengana Emerging Companies Fund

September 2009 Quarterly Review



2 of 5

Market Commentary

Market backdrop

Recent data has confirmed that the worst is likely behind global economies, which continues to drive share markets globally. During the September quarter, the All Ords rose 20%, the Small Ords rose 21.8% and the Small Industrials rose 25.9%. Since the market lows in March, the Smallcap sector has markedly outperformed the largecaps, rising by an incredible 77% versus 52% for the All Ords. This is very much in line with previous recoveries in markets, about which we have written often.

Key stock moves during the quarter

Key successes in the portfolio during the period included **CSG Group** (up 69%), **Customers** (up 57%), **M2 Communications** (up 107%), **Mineral Resources** (47%), and **Transfield Services** (up 89%). The laggards included **Slater & Gordon** (down 3%), and **Resmed** which was flat.

CSG Group continues to recover from oversold levels as the market absorbs the low risk nature of the maintenance style revenue base. **Customers** revealed that the usage of its ATM machines had not overly suffered from the \$2 direct charge introduced in March. **M2 Communications**, which we have held for some time, rallied strongly as the market appreciates the upside from the recent acquisition of the Commander business. **Mineral Resources** continues to rise as the outlook for contract crushing services and commodity prices improves. **Transfield Services** rallied strongly as the recent result showed a largely resilient core business and confidence in the new CEO rises. **Slater & Gordon** and **Resmed** both drifted as the market focuses on the recovery of cyclical businesses, leaving some less cyclical stocks behind in the short term. Both remain core holdings.

Outlook

Markets continue to price in a recovery

Global markets have bounced very hard in the past six months, leading many to conclude that the market has run well ahead of fundamentals. This recovery trade is in line with historical examples, where markets run well ahead of actual proof that economies have returned to growth. In many instances, market rise even though earnings forecasts continue to fall, and unemployment (a lagging indicator) rises. In such recovery trades, there are no shortage of analysts and strategists hosing down the market as having run ahead of itself, forgetting that the market always moves ahead of the current situation.

The global economic picture remains clouded. Recent data shows that a recovery of sorts is under way, driven initially by an end to the de-stocking cycle. In short, many industries cut production in the anticipation of tough times, preferring to sell inventory rather than maintain production. This exacerbated the negative data during late 2008, and indeed painted a picture far worse than reality. A classic case of this is the car industry, which almost ceased production as yards of unsold cars built up. As this inventory was sold (quicker than first expected) the industry perversely went into a shortage, with production yet to catch up. Therefore, a simple replenishing of inventories is enough to kickstart many industries.

From here the sustainability of the recovery relies heavily on the effect of government stimulus. Further, we are yet to really comprehend the level of long term damage done through excessive use of debt. In some ways, the US Government has used debt to solve a debt problem, which raises obvious questions about the medium term. Europe has similar issues. China, on the other hand, is a net saver, has a Government willing and able to sustain economic growth above 8%, and has a sustainable growth driver based on the urbanisation of its massive population. Thankfully, Australia's success is heavily tied to the Chinese economy.

Australia has shown a remarkable resilience during this downturn. Not only have we avoided a recession, but we are now seeing interest rate rises, and open talk of labour shortages given the large queue of projects in the iron ore and natural gas sectors. It's incredible that we have gone from predictions of 9%+ unemployment to a potential labour shortage in less than six months.

Our discussions with over 100 companies over the past 3 months suggests that, excluding retail, things are still reasonably tough out there, but showing mild signs of recovery. Retail has benefited directly from lower interest rates and cash payments from Canberra. Most other industries suggest that business was appalling from October 2008 until April 2009. In many industries we saw de-stocking in different ways where the subdued activity was due to customers refusing to commit to anything, rather than a true reflection of the new lower demand levels. For example, **Skilled Engineering** saw a 27% drop in revenue in its blue collar labour hire business in the June half. Since listing in 1994, Skilled has never seen negative sales growth in labour hire, which indicates just how bad the recent period was. We suggest most of its decline in revenue was simply customers sending all contractors offsite until the picture cleared, rather than a 27% drop in the size of the market. If this is correct, we would anticipate a strong recovery in revenue and earnings, even if customers do not return to full throttle. The key point here is that most of these companies are still earnings way less than "maintainable" earnings.

Pengana Emerging Companies Fund

September 2009 Quarterly Review



3 of 5

Share prices in most cases have also recovered very strongly given the positive newsflow from the economy. While this suggests the recovery is priced in, we certainly do not concur in many cases. Many stocks have risen over 100% from well oversold levels, but still trade at major discounts if we assume the recovery in earnings will last into 2011 and 2012. Analysts typically underestimate the downside to earnings in downturns, and equally underestimate the upside as things improve.

Many stocks we own have seen little impact on their businesses from the GFC including **CSG Group** (IT maintenance), **Customers** (ATM machines), **Dominos Pizza** (fast food), **Navitas** (tertiary education), **Probiotec** (weight loss products), **Slater & Gordon** (lawyers), **Toxfree** (industrial waste treatment), **The Reject Shop** (bargain retailer) and most healthcare stocks.

Highly favourable conditions for stock pickers

While the direction of the overall market is difficult to predict, we are confident that the environment for disciplined stock pickers such as us 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.

This effect cannot be underestimated. We believe our key advantage lies in our ability to actively search for, analyse, and monitor stocks for the best medium term investment opportunities. On average, we visit over 7 companies a week, allowing us to find the best 50 or so investments in a field of over 500 stocks.

In a bull market, many "part-time" smallcap investors crowd the space. Hedge fund, large-cap funds, stockbrokers, and individual investors are drawn in by the seemingly easy gains. In this environment stock prices tend to reflect fair value more quickly as more eyes are on the sector. However, these part time investors were deeply scarred by the collapse in the market, and have since left, which creates an uncrowded market for us to methodically identify the prime opportunities.

While difficult to express in numbers and graphs, we assess the market is still uncrowded, and are genuinely excited by the investments which we hold where the value is still very attractive despite some impressive gains to date. Medium term investors in our fund (the fund managers included) should be encouraged by this, even if the overall market goes sideways from here.

Pengana Emerging Companies Fund

September 2009 Quarterly Review



4 of 5

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 **direct contact with 93 companies** and unlisted competitors of listed stocks. The table below shows the listed companies with which we had direct contact during the period.

Alesco	HFA Ltd	RCR Tomlinson
Allco Equity Partners	II Net	Reckon
Ammcom	Intermode	Reject Shop
Ammtec	IOOF Ltd	Resmed
Aneaco	I-Soft	Ridley
APN Media	Jetset	Runge
ARB Corp	Kaplan Infrastructure	Salmat
Asciano	M2 Comms	Servcorp
ASG Group	Macquarie Leisure	Service Stream
Austbrokers	McMillan Shakespeare	Sirtex
Ausdrill	McPhersons	Skilled Engineering
Ausenco	Mineral Resources	Slater & Gordon
Auto Holdings	Mitchell Comms	Smart Salary
Billabong	Myer	Sonic Healthcare
Capral	Navitas	Specialty Fashion
Cardno	Neptune	Structural Systems
Carsales	Nick Scali	STW Comms
Cash Converters	Nomad	Talent 2
CSG Group	Oakton	Thinksmart
Customers	Pacific Brands	Toxfree
Decmil	Peet & Co	Transfield Infrastructure
DKN Group	Photon	Transfield Services
Dominos Pizza	Pipe Networks	Transpacific
Downer	PMP Ltd	Treasury Group
DWS Ltd	Premier Investments	WA News
Fantastic Furniture	Primary Health	WDS Corp
Fletcher Building	Probiotec	Webjet
Flexigroup	Pumpkin Patch	Wellcomm
Flight Centre	Quickflix	WHG Group
Greencap	Ramsay Healthcare	White Energy
Healthscope	RCG Group	Wotif

Pengana Emerging Companies Fund

September 2009 Quarterly Review



5 of 5

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	\$309m
Inception Date	1 November 2004	Application Price at Month End	A\$ 1.6524
Identification Code(s)	APIR PER0270AU ARSN 111 894 510	Redemption Price at Month End	A\$ 1.6426

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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.