# Pengana Australian Equities Core Fund October 2009 Update, by Rhett Kessler



PENGANA CAPITAL

## Fund Description

The Pengana Australian Equities Core Fund aims to provide investors with an annualised return of 12 to 15% [1] over the medium term via a concentrated core portfolio of equity and interest bearing holdings. The Fund is managed out of Sydney, Australia and uses fundamental research to evaluate investments capable of generating the target return over the medium term.

## Fund Features

| | | | |
|---|---|---|---|
| **Application Price at Month End** | A$1.1549 | **Redemption Price at Month End** | A$1.1491 |
| **Style** | Fundamental | **FUM at Month End** | A$10.1m |
| **Benchmark** | The weighted average of the target Australian Cash Rate used by the RBA | **Management Fees [2] (monthly)** | 1.00% p.a. of NAV |
| **Investors** | Wholesale Clients only | **Performance Fees [2] (quarterly)** | 10% of increase in net asset value subject to the Australian Cash Rate and High Water Mark |
| **Inception Date** | 30 June 2008 | **Minimum Initial Investment** | A$100,000 |

## Fund Commentary

**Fund Performance (A$, net of fees) [3]**

| | Jul | Aug | Sep | Oct | Nov | Dec | Jan | Feb | Mar | Apr | May | Jun | **FYTD** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2008/9 | -1.0% | 3.5% | -4.7% | -9.0% | -5.3 | 3.9% | 0.2% | -1.4% | 7.9% | 4.4% | 2.2% | 3.7% | **3.0%** |
| 2009/10 | 3.5% | 6.1% | 3.8% | 1.2% | | | | | | | | | **15.3%** |

The Fund generated a satisfactory return of 1.2%[3] after all fees and costs during October against the backdrop of a -1.9% performance by the Australian All Ordinaries and the prevailing cash rate of 0.3%.

As at the 31st of October, the effective cash position of the Fund's NTA stands at 18%. Although this implies the highest level of equity content (82%) since the inception of the Fund, two important mitigating factors need to be considered with regard to the underlying exposure of this position. Firstly the increase is almost entirely due to two substantial purchases arising from deep discount placements in companies operating in the agricultural sector. This sector has a low correlation to normal business cycles. Secondly, new investor inflows (impacting on the first of the new month) continue to be strong, allowing for a reduction in underlying equity exposure to below 80%.

Importantly the Fund's investment strategy remains focussed on companies with transparent and resilient business models, run by competent management and capable of generating satisfactory returns at the current prices.

The top 5 contributors to the month's performance were Australian Wheat Board, RCG Group, NHF, Resmed and Real Estate Group. The largest detractors were Graincorp, CSL, NAB, CBA and Ramsay Healthcare. New holdings added during the month included the Australian Wheat Board, VDM Group and Aquarius Platinum while the stakes in REA Group and NAB were sold. The ongoing strong positive fund inflows saw several existing holdings being supplemented with additional investments. Of these, the larger purchases included CBA and Westpac (bear in mind that the addition to these already substantial holdings were partly funded by the disposal of the NAB shares), Graincorp (assisted by a substantial deep discount entitlement issue) and Newscorp.

As at 31st October 2009 the top five holdings by value in the Fund were: Telstra, Westpac, CBA, Graincorp and AWB.

**Net Returns to 31st October 2009 [3]**

| | **Pengana** | **Cash Rate** | **All Ordinaries** |
|---|---|---|---|
| **1 Month** | 1.2% | 0.3% | -1.9% |
| **3 Months** | 11.4% | 0.8% | 10.8% |
| **6 Months** | 22.2% | 1.5% | 26.6% |
| **12 Months** | 33.8% | 3.5% | 22.4% |
| **16 Months since Inception** | 18.8% | 5.7% | -7.2% |

[1] This is not intended to be a forecast, but merely an indication of what the Fund aims to achieve over the medium to long term. The Fund may not be successful in meeting this objective. Returns are not guaranteed.

[2] Plus GST and net of reduced input tax credits. Please refer to the information memorandum for a more detailed explanation.

[3] Total return performance figures are derived from Mangers' records and are shown after all fees and expenses, and assume reinvestment of distributions. Investments can go up and down. Past performance is not a reliable indicator of future performance. Inception date: 30 June 2008.

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## Market Commentary

### Market Review

The ASX All Ords Accumulation Index declined 1.9% over the month of October. After spending most of the month in positive territory, a re-assessment of risk resulted in sharp declines by most sectors with REITS (-9%), Energy (-5%) and Healthcare (-4.1%) registering the largest falls. The Consumer Staples Sector was up 1% while Utilities, Telecommunications and Materials all registered a flat performance. The Australian Dollar continued its rally against the US$ (+2%) and ended the month 43% higher than its 2009 low of 63c.

Although the medium term outlook for the OECD Group countries remains bleak due to consumer deleveraging extending over many years, the consensus view that the worst point in this economic cycle is now behind us, is strengthening. The recent pause after the strong gains is forcing investors to assess just how much of the optimism for a recovery is already reflected in these buoyant share prices, particularly for those companies that are more sensitive to the economy.

Investors have been pushing cash back into equity markets at an increasing rate creating an interesting conundrum. The stimulus driven economic recovery is being fuelled by exceptionally low interest rates and burgeoning government debt. In addition, the sharply weaker US$ is forcing investors to seek refuge in hard assets, namely commodities, precious metals and equities. Given the outlook for further US$ debt issuance and the inflationary risks that come with loose monetary policy one has to wonder why the interest rate curve is not steeper (and long bond prices are not weaker).

Domestically the outlook continues to surprise on the upside. Australia's economic stability has captured the world's attention for several reasons: Our financial institutions have demonstrated their robustness; unemployment continues to defy pessimistic expectations, population growth is expected to drive medium term GDP, our proximity to China coupled with the scale and mix of natural resources is likely to underpin long term economic activity. These factors have allowed the Reserve Bank to begin the process of raising interest rates from unsustainably low levels. They have also been reflected in the sharply higher A$.

### Investment Outlook

While the direction of the overall market is difficult to predict, I am increasingly confident that the environment for absolute return focussed stock picking continues to improve. The impact of the recent volatility and negative returns has created a less crowded market, priced at more realistic levels.

Many market participants seem obsessed by whether the "market" is headed higher or lower. The Pengana Australian Equities Core Fund continues to focus on finding companies whose underlying earnings and cash flows will be substantially higher in the future, irrespective of whether the markets are higher or lower.

Two years ago (it seems like 20!), many segments of the market were running hard, attracting many new entrants including cash rich hedge funds, fully staffed principal trading desks at the investment banks, highly geared momentum players and overactive retail punters. It was an environment of few and narrow windows of opportunity for acquiring attractively priced equities.

The current outlook stands in direct contrast. The much publicised margin loan fiascos (and other schemes) have removed enormous amounts of leverage from the market. Financial services industry staffing levels are down sharply - ironically at a time when experience, industry knowledge and diligent research are most likely to generate positive returns for investors.

One example is represented by the Fund's acquisition of a significant holding in AWB Group. The recent travails of this group have resulted in the loss of their monopoly export license for Australian Wheat and the subsequent significant derating of the share price. Our assessment of the underlying businesses and the Landmark Rural Services business in particular (a specialised retail business with almost $2billion in sales and a recovering margin), is that the current share price represents compelling value for shareholders.

Another example of this trend can be found in several defensive companies with competent management, dominant market shares, pricing power and robust balance sheets. Investors appear to be deserting these companies for the more leveraged plays at a time when the impact of economic Darwinism is just beginning to play out.

The Fund continues to take advantage of the value emerging in these "boring and defensive" sectors to increase its equity investments, particularly in the Healthcare, Agricultural and Banking sectors.

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