Pengana Emerging Companies Fund
December 2009 Quarterly Review

Australian Equities - Small Caps

Fund Performance

Net performance for periods ending 31 December 2009 [1]

	3 months	6 months	1 year	3 years p.a.	5 years p.a.	Since inception p.a.[2]
Pengana Emerging Companies Fund	8.4%	45.3%	70.0%	1.9%	14.8%	16.2%
S&P/ASX Small Industrials Acc Index [3]	1.9%	28.3%	44.9%	-9.6%	1.6%	2.3%
Outperformance	**6.5%**	**17.0%**	**25.1%**	**11.5%**	**13.2%**	**13.9%**
S&P/ASX Small Ordinaries Acc Index	4.9%	27.8%	57.4%	-4.8%	6.7%	7.0%
Outperformance	**3.5%**	**17.5%**	**12.5%**	**6.7%**	**8.1%**	**9.3%**

Fund Commentary

The Fund returned 8.4%[1] over the December quarter, outperforming the Small Ords by 3.5% and the Small Industrials by 6.5%. For the 12 months to December, the Fund returned 70.0%[1], which was 12.5% above the Small Ords and 25.1% above the Small Industrials. Since inception over five years ago, the Fund has returned 16.2% p.a[1,2], well in excess of the benchmarks.

We are pleased with the outcome this year, given how quickly market sentiment turned from extreme negative to positive. Our performance was driven by two key factors: 1) a recovery in sentiment towards many of our stocks which had been irrationally sold down in 2008 where the companies showed more resilient earnings than expected, and 2) our decision earlier in the year to switch a portion of the portfolio to cyclical stocks where the valuation upside more than justified the investment risk. The outcome in 2009 is especially pleasing given we do not invest in resources stocks which rose 88% in the year.

Confidence in the global economic recovery is firming, however there remain challenges, primarily in the US where debt is still very high. The Australian economy is stronger than most, and should show a more predictable recovery into 2010 and 2011, although we caution that the consumer sector is presently very strong (with low interest rates and govt stimulus), and hence at risk of falling back as interest rates rise. Corporate spending remains depressed, and is therefore a more likely source of earnings upgrades over the coming two years. China remains the critical link in Australia's outlook, and while it appears to be very strong, it is a murky economy to analyse, hence the risks of disruption cannot be ignored.

We still assess the smallcap market to be relatively uncrowded, notwithstanding the recovery so far. Many investors sat out the first phase of the recovery due to the deep wounds sustained during 2008. Without the need to take excessive risk, there remains a healthy number of stocks which have survived the downturn, are growing strongly, and are largely overlooked by the broader market. Hence stock picking opportunities remain strong.

Recent portfolio activity

During the quarter we further sold down some of the cyclical stocks where share prices have moved up strongly to reflect more likely earnings outcomes, including **APN Media**, **Premier Investments**, and **STW Communications**. Other stocks we sold or reduced where the share prices approached or exceeded our targets included **Austbrokers**, **Customers**, **Nomad** and **Thorn Group**. We also reduced our holding in **Skilled Engineering** following an earnings downgrade, but retain a position on the basis of the likely earnings recovery over the coming 2-3 years.

We increased our positions in **CSG Group** (following a highly accretive acquisition), **IOOF**, **M2 Telecommunications**, **REA Group** (realestate.com.au) and **Slater & Gordon** as our confidence in the outlook has improved. We took a relatively small position in the IPO of **Matrix Composites**, which sells flotation products to the offshore oil and gas industry, and has more than doubled from its issue price.

[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 December 2009 Quarterly Review

Key issues during the quarter

Market backdrop

Recent data confirms that the worst is likely behind global economies, which continues to drive share markets globally. Markets consolidated after a very strong September quarter, with the All Ords rising 3%, the Small Ords rising 4.9% and the Small Industrials rising 1.9%. Since the market lows in March, the Smallcap sector has markedly outperformed the largecaps, rising by 84% versus 57% 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 25%), **Domino's Pizza** (up 20%), **Matrix Composites** (up 105%), **REA Group** (realestate.com.au) (up 15%) and **Thorn Australia** (up 20%). The laggards included **Customers** (down 6%) and **Skilled Engineering** (down 16%).

Having shown incredible resilience through the GFC, **CSG Group** acquired the largest photocopier operation in NZ which is highly complimentary to its existing Australian operations. **Domino's Pizza** posted an earnings upgrade following stronger than expected sales in its domestic operations. **Matrix Composites** was a keenly priced IPO and has already posted an earnings upgrade within 2 months of the listing. **REA Group** continues to re-rate as the market appreciates the company's ability to generate new revenues streams from its client base of real estate agents. **Thorn Australia** posted its half year result showing a 36% lift in earnings per share. **Customers** lagged following a strong run during the earlier part of this year, while **Skilled Engineering** suffered following an earnings downgrade in December.

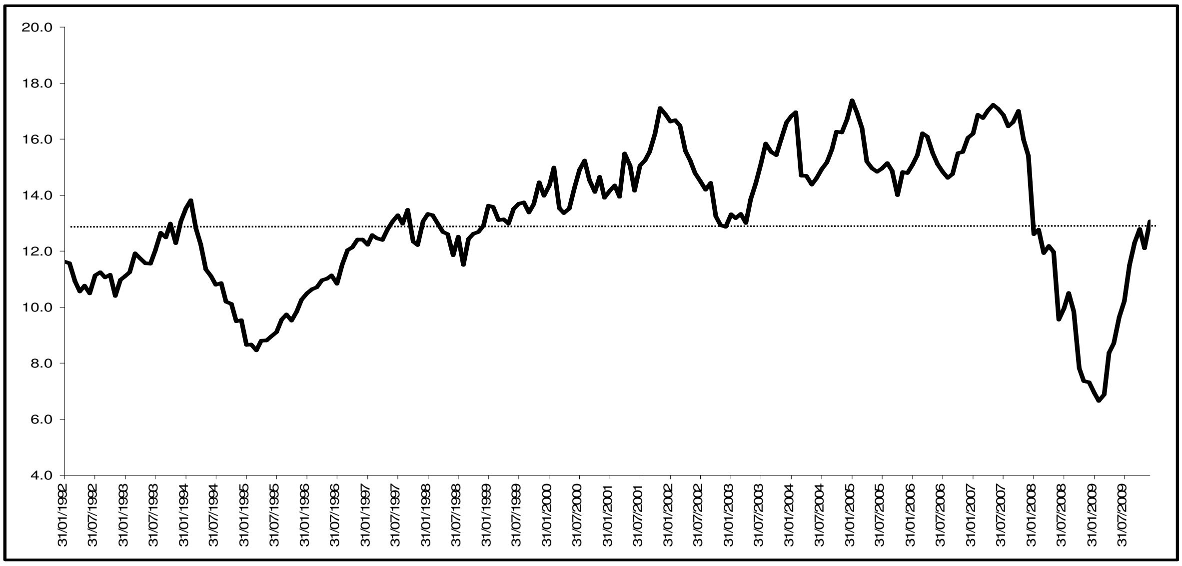
Outlook

Markets will need earnings growth from here

Global markets have consolidated the strength shown in the June and September quarters. There has been a sense that the pace of share price recovery may have outstripped the likely recovery in earnings, and this remains an open question.

History shows that the first part of a recovery in markets is the re-rating of stocks (ie PER expansion) as investors regain confidence that earnings are not in perpetual decline. This rally is typically the fastest and is usually concentrated to the lowest quality stocks (ie those which had fallen fastest on the way down). Based on Macquarie forecasts, the average Smallcap PER is now back to long term averages (c13x), hence it is likely this phase has largely played out, unless earnings forecasts prove too conservative. Note this PE is based on 2010 forecasts, which is unlikely to reflect the true earnings recovery as the cycle matures into 2011, hence further PE expansion is possible as the market looks one year further out.

Figure 1: Small Industrials PER chart



Source: Macquarie Bank

The second phase of a market recovery is driven by earnings growth, while PER's typically stabilise. So from here, the key question is how quickly earnings will recover, and whether they will recover more than expected. We would argue that in many sectors (and more interestingly, stocks), there is scope for earnings to bounce further than is currently forecast, allowing upside to shareprices in many instances. Analysts typically underestimate the downside to earnings in downturns, and equally underestimate the upside as prospects improve.

Risks are still large, and varied

The key risks from here are:

1) rising interest rates impacting on consumer activity,
2) rising oil prices impacting consumer spending and margins in fuel-reliant industries,
3) delays to the large projects planned in Australia due to skills shortages,
4) high debt levels in the US,
5) current reliance on govt stimulus in many economies, and the impact of a removal of such stimulus,
6) the Chinese economy seems to be strong, however it is difficult to determine how much is reliant on stimulus, and speculation within the economy, versus true economic activity.

Australian corporate sector likely to outperform consumer sectors

The domestic consumer sectors (primarily retail), have already shown stronger than expected earnings, as Australian consumers have been assisted by cash handouts, low interest rates, falling petrol prices and improving job security. Therefore the retail sector is not currently under-earning, and the market has had almost 12 months to absorb the fact the earnings have been supported. This suggests to us that the potential for some discretionary retail stocks is fairly limited from here.

On the flipside, stocks exposed to corporate spending are in most cases still earning well below mid-cycle levels, and given that there has been no real evidence of a recovery in activity yet, many are trading below underlying value. In such instances, we see solid upside as the earnings recover from depressed levels. The lag in recovery in earnings in sectors such as blue collar labour hire, IT services, mining services has seen many of these stocks fall away in recent months suggesting that investors are losing faith in the recovery. Therein lies the opportunity.

Our recent visit to Perth and Karratha indicated that there is a major recovery underway in the resources sector, following a virtual capex freeze in FY09. This is based primarily around oil & gas, iron ore, and coal. The Gorgon project (capex estimated at over $50bn) is underway with a further round of major potential projects such as Woodside's Browse Basin likely to reach commitment soon. Since its deep discounted rights issue in June, RIO has re-opened it purse for expansion in iron ore. BHP continues to expand and Xstrata recently increased its capex budgets for 2010 and 2011 as the coal market strengthens following the jitters of 2008.

However, as mining companies dust off the plans which were shelved 12-18 months ago, there is a lag due to process, planning, labour mobilisation etc. Hence many companies exposed to the sector have actually reported weaker than expected earnings in recent months (e.g, **Skilled Engineering**, **WDS**, **Fleetwood**, **Nomad** etc). This has spooked many investors, and in some cases has provided opportunities for us to purchase stocks at better prices with more confidence, as we are highly confident in the outlook over a 12-24 months timeframe.

Not all stocks rely on the cycle

Cycles aside, the majority of our portfolio is invested in stocks which do not rely on an economic recovery to grow earnings. In fact, many of these stocks continued to show earnings growth through FY09 when most listed companies were under severe earnings pressure. Such stocks include **ARB Corp** (FY09 EPS up 15%), **CSG Group** (FY09 EPS up 21%), **Domino's Pizza** (FY09 EPS up 23%), **M2 Communications** (FY09 EPS up 38%), **Probiotec** (FY09 EPS up 19%), **Toxfree Solutions** (FY09 EPS up 17%), and **Thorn Group** (FY09 EPS up 13%). These, and many more stocks have very strong growth outlooks, are able to fund the growth adequately, and are well managed businesses.

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

Anittel	Halcygen	NRW Holdings
AP Eagers	Hastie	Port Bouvard
Asciano	Healthscope	Programmed Maintenance
Auto Holdings	Hills Industries	REA Group
AWB Ltd	I-cash	Reject Shop
Biota	Imdex	Restaurant Brands
Boart Longyear	IMF Holdings	Rock Building Soc
BT Investment	Industrea	Sedgman
Campbell Bros	IOOF	Skilled Engineering
Capral	Kathmandu	Slater & Gordon
Carsales	Keycorp	Spotless
Challenger Financial	Logicamms	Tandou
Chandler MacLeod	M2 Communications	Thorn Group
Clarius	Mac Services	Toxfree
CO2 Ltd	Macquarie Media	Transfield Services
Coote Industrial	Matrix Composites	Treasury Group
CSG Group	McPhersons	VDM Group
Elders	Mineral Resources	Virgin Blue
Fleetwood	Mitchell Comms	Vita Group
Graincorp	Mobilarm	Wattyl
GUD Holdings	Norfolk	

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 [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**	$356m
Inception Date	1 November 2004	**Application Price at Month End**	A$ 1.7918
Identification Code(s)	APIR PER0270AU ARSN 111 894 510	**Redemption Price at Month End**	A$ 1.7810

Contact Details

Pengana Capital Limited ▪ Level 29, 20 Bond Street, Sydney, NSW 2000, Australia ▪ T +61 2 8524 9900 ▪ F +61 2 8524 9901
ABN 30 103 800 568, AFSL 226566

For further information, please visit our website at www.pengana.com or contact:

Institutional Clients: Denis Carroll, +61 2 8524 9974, denis.carroll@pengana.com

Private Clients: Juliet Dunworth, +61 2 8524 9984, juliet.dunworth@pengana.com

Advisors & Retail Clients: Justin Brooks, +61 3 8663 7906, justin.brooks@pengana.com

[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.