

# Pengana Australian Equities Core Fund

## February 2010 Update, by Rhett Kessler



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### Fund Description

The Pengana Australian Equities Core Fund aims to provide investors with an annualised return of 12 to 15%<sup>1</sup> 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

<b>Application Price at Month End</b>	A\$1.1658	<b>Redemption Price at Month End</b>	A\$1.1600
<b>Style</b>	Fundamental	<b>FUM at Month End</b>	A\$11.3m
<b>Investors</b>	Wholesale Clients only	<b>Management Fees<sup>2</sup> (monthly)</b>	1.00% p.a. of NAV
<b>Benchmark</b>	The weighted average of the target Australian Cash Rate used by the RBA	<b>Performance Fees<sup>2</sup> (quarterly)</b>	10% of increase in net asset value subject to the Australian Cash Rate and High Water Mark
<b>Inception Date</b>	30 June 2008	<b>Minimum Initial Investment</b>	A\$100,000

### Fund Commentary

#### Fund Performance (A\$, net of fees)<sup>3</sup>

	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%	<b>3.0%</b>
2009/10	3.5%	6.1%	3.8%	1.2%	1.0%	2.5%	-3.6%	1.1%					<b>17.0%</b>

The Fund generated a return of 1.1%<sup>3</sup> after all fees and costs during February. By way of comparison the Australian All Ordinaries returned 1.8% for the month and the prevailing cash rate during February was 0.3%. **For the 20 months since inception the Fund has protected capital and provided investors with a satisfactory total return of 19.9% (annualised 11.5%) versus the 6.9% cash rate (4.1% annualised) and a negative market return by the Australian All Ordinaries of -5.9% (-3.6% annualised).**

As at the 28<sup>th</sup> of February, the effective cash position of the Fund's NTA stands at 20%. 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.

Large positive contributors to the month's performance were Westpac Bank, Ramsay Healthcare, Resmed, News Corporation and Graincorp. The largest detractors were Telstra, Sonic Healthcare and National Australia Bank.

The Fund acquired a number of new holdings including David Jones and Clarius Group. Several holdings were increased including Downer Edi and NIB Holdings. The Fund's two gold holdings, Lihir and Eldorado, were sold, realising a satisfactory profit. The exposure to Platinum was retained. Following the strong rally by the banking sector after their recent trading updates, the holdings in NAB, WBC and CBA were marginally reduced. The combined holdings in these three companies still represent a substantial portion of the Fund's NAV.

As at 28<sup>th</sup> February 2010 the top five holdings by value in the Fund were: Westpac, CBA, Telstra, Ramsay Healthcare and News Corporation.

#### Net Returns to 28<sup>th</sup> February 2010<sup>3</sup>

	Pengana	Cash Rate	All Ordinaries
<b>1 Month</b>	1.1%	0.3%	1.8%
<b>3 Months</b>	-0.1%	0.9%	-0.6%
<b>6 Months</b>	6.1%	1.7%	5.4%
<b>12 Months</b>	38.8%	3.3%	47.0%
<b>20 Months since Inception</b>	19.9%	6.9%	-5.9%
<b>Annualised return Inception</b>	11.5%	4.1%	-3.6%

<sup>1</sup> 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.

<sup>2</sup> Plus GST and net of reduced input tax credits. Please refer to the information memorandum for a more detailed explanation.

<sup>3</sup> 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 Ordinaries Accumulation Index regained a small portion of the January losses to close up 1.8% for February. Consumer Staples (+6%); Healthcare (+4%) and Utilities (+3%) and Materials (+2%) were the strongest sectors. Telstra led the Telecommunications Sector (-10%) with a disappointing half year result.

Overall the earnings releases for industrial and financial companies demonstrated a stabilisation of trading activity, positive cost focus outcomes and high levels of caution regarding the outlook. The domestic banking sector in particular appears to be experiencing better conditions as their worst fears on bad debts are proving unfounded. In the retail sector, the landscape continues to become more competitive particularly in the supermarket and discount chain areas. The non-recurrence of last year's fiscal stimulus is creating uncertainty around sustainable levels of discretionary spending. Importantly it should be noted that global investors are finding the resilience of the Australia economy hard to believe given the ongoing structural challenges in their home economies.

#### Investment Outlook

The medium term economic outlook for OECD Group countries is for an extended period of low growth (sub 2%) as consumer and now public sector deleveraging limits their ability to bounce back from the recent low point of the cycle. Asia (ex Japan) and China in particular are expected to continue growing at robust levels as governments take advantage of their massive reserves to maintain high levels of economic stimulus. However, the recent inflationary data out of China provided a catalyst for an indefinite pause in Chinese bank lending, creating high levels of uncertainty around Chinese growth outlook.

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 Asia and China in particular coupled with the scale and mix of natural resources is likely to underpin long term economic activity. These factors allowed the Reserve Bank to begin the process of raising interest rates from unsustainably low levels.

The medium term outlook for the underlying Australian and major global economies continues to improve. Several economic fundamentals, including unemployment levels, credit spreads (with the exception of Europe), housing starts and retail sales have generally stabilised providing more clarity around future earnings risk. However valuation multiples have also increased sharply, particularly in the economically sensitive sectors. Consequently, the overall investment risk remains high.

Many market participants seem obsessed by whether the "market" is headed higher or lower. The Pengana Australian Equities Core Fund continues to focus on identifying companies with competent management and resilient business models that can take advantage of secular trends to generate significantly higher earnings and cash flows in the future, irrespective of whether the markets are higher or lower.

One example is represented by the Fund's holding in ResMed, the dominant manufacturer and distributor of medical devices for sleep apnea. The company has been growing volumes and revenues at 15% plus levels for over 10 years. The long term outlook for the top line remains attractive as their penetration of the addressable market remains low. It's expertise and global scale allows for a robust and resilient business model that is not economically sensitive. In addition the structural change to the industry of home sleep testing is expected to bypass the bottleneck of sleep labs and accelerate market growth. Both management and the board have adopted a conservative approach to the balance sheet resulting in a large (and growing) cash balance which should provide an additional return to shareholders.

Other examples of this trend can be found in several defensive companies with competent management, dominant market shares, pricing power and robust balance sheets. Investors have, until recently, been 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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