

**About this Review**

Sector reviewed	<b>Small Cap Australian Equities</b>
Total Funds rated	30
Date of this Sector Review	March 2010

**About this Fund**

Fund reviewed	<b>Pengana Emerging Companies Fund</b>
Fund Size	\$309 (Sept 2009)
Responsible Entity	Pengana Capital Limited
Fund Commenced	November 2004
Management Fee (p.a.)	1.3325% + performance fee of 20.5% of Fund return above index (with 'high watermark')
Structure Availability	Platforms, Wholesale
Fund Manager	Pengana Capital
Ownership	50% by Pengana Holdings, 50% by the two portfolio managers
Assets managed this sector	\$309 (Sept 2009)
Years managing this asset class	15

**Investment Team**

Team size dedicated to this Fund	2
Portfolio Manager (s)	Steve Black, Ed Prendergast
Additional Support (Large Cap Analysts, Dealer etc.)	0
Departures/Team Ratio (past 2 yrs)	0%

**Investment Process**

Style	GARP
Targeted Value Add above Index (p.a.)	5%
Typical Tracking Error (p.a.)	6.0% - 9.0%
Typical Stock Numbers	50-60
Typical Capitalisation Bias (as at Sept. 2009)	7% Mid Cap, 40% Small Cap 50% Micro Cap, Cash 3%
Franking Level (FY09)	30%
Tax efficiency - Income in Total Distribution (FY09)	100%
Discount Gains as % of Total Capital Gains (FY09)	0%
Maximum of Portfolio in any One Stock	7%
Maximum of Portfolio in any One Sector	No Hard Limit
Sectors Excluded from Investment	Resources, Biotechs, LPTs
Maximum of issued capital of any one stock	10%
Minimum Market Capitalisation	Min. \$25m - \$30m
Max Size Limit of Fund	0.5% of market cap of small cap index

**Rating history**

March 2010	Highly Recommended
April 2009	Highly Recommended
May 2008	Highly Recommended

**What this Rating means**

➤ The Highly Recommended rating indicates that Lonsec has high conviction that the fund or product can achieve its objectives and, if applicable, outperform peers over an appropriate investment timeframe. The manager or product has strong competitive advantages in people, process and product design and has no areas of material weakness. The investment is a preferred entry point to access this asset class or strategy.

**Fund Risk Characteristics**

	Low	Moderate	High
Capital Volatility			▲
Corporate Risk		▲	

*Risk categories are based on Lonsec's qualitative opinion of the risks inherent in the product's asset class and the risks relative to other products in the relevant Lonsec sector universe.*

**Using this fund**

- This is General Advice only and should be read in conjunction with the Disclaimer, Disclosure and Warning on the final page.
- Small cap funds invest in a market that is less liquid and more volatile than the large cap Australian equity market. This Fund should be used to complement large cap exposure in clients' portfolios, rather than replace it, up to 8% of the total portfolio depending on client risk preferences. Lonsec's model portfolio asset allocation to domestic small cap funds is limited to 'Growth' and 'High Growth' risk profiles.
- The Fund is subject to equity market risk and movements (both positive and negative) in the share prices of the underlying securities in the portfolio. Investors should therefore be aware that the Fund may experience periods of negative returns and that there is a risk of potential capital losses being incurred on their investment.

**Changes since last Review**

- There have been no major changes to the manager's team or investment process since the last Lonsec review.

**Lonsec Opinion of this Fund****Philosophy (Style)**

- The manager's investment philosophy has not changed since the inception of the Fund in 2004. The manager is described as broadly employing a Growth at Reasonable Price (GARP) investment style. Lonsec's holdings based analysis at the time of this review indicated that the portfolio is consistent with this style.
- Given the managers investment style and Industrials bias the Fund is likely to underperform versus the S&P ASX Small Ordinaries Index in 'momentum' driven markets and when the resources sector is performing strongly.

## People and Resources

- Lonsec continues to be impressed with the quality of Pengana's investment team. Portfolio Managers, Steve Black and Ed Prendergast are highly experienced investment professionals, with a proven track record in the analysis and portfolio management of small caps.
- The two-person team has remained unchanged over the Fund's five year history and is considered sufficiently resourced and qualified to continue to effectively implement this strategy as it has in the past. The manager has signalled to Lonsec that there are no intentions to hire additional staff at this point in time. From Lonsec's observation the team continues to function well and the expanding of the team is not considered to be critical.
- Given the boutique nature of the manager, the investment team does not have access to the range of in-house resources generally enjoyed by larger, institutional peers (such as quant teams or dedicated dealers). That said, this fund is the sole focus for the small cap team and it has no other major responsibilities that could potentially serve as a distraction. For example, the outsourcing of back office functions to BNP Paribas allows the team to focus on research and portfolio management rather than non investment functions.
- The boutique structure promotes a strong alignment of interests between the business, the investment staff and investors. This is driven by the portfolio managers' 50% ownership of the business, their co-investment in the Fund and the performance fee structure.

## Research and Portfolio Construction

- A key component of the manager's research effort is maintaining a high level of company contact and speaking directly with management. The company visitation schedule is considered to be extensive (approximately 300 one-on-one company meetings per year) and draws directly upon the team's knowledge base within the small cap sector which has been developed over a number of years.
- Overall, Lonsec is pleased with the volume of company contact, believing that with small cap companies, the quality of management and their ability to deliver on business strategy to be important drivers of returns in this sector.
- Although the investment process is less structured relative to other small cap managers assessed this is not considered a weakness of this strategy. In the case of Pengana, the quality and experience of the investment team outweighs these factors. The manager does however model all stocks in which it invests (cash flow, profit & loss, and balance sheet) in order to derive its own company valuations and price targets.
- The two portfolio managers are equally accountable for portfolio construction which is driven by the judgement and skill of the portfolio managers rather than by a specific set of rules. This 'judgement based' approach is appropriate, given the experience and track record of the investment team. Furthermore, Lonsec believes that in determining stock weights, the portfolio managers utilise an appropriate variety of factors, ranging from qualitative considerations to valuation metrics, diversification and liquidity.

- The portfolio is constructed in a relatively conservative manner by excluding resource companies and loss making companies (e.g. start up bio tech stocks). The managers' avoidance of highly geared companies throughout the recent market downturn is testament to this conservative approach and their understanding of the risks associated in investing in the small cap sector.

## Risk Management

- The manager has adequate risk management parameters and tools to sufficiently manage portfolio risks such as stock and sector exposures. In addition to compliance checks undertaken by Pengana Capital, risk management is augmented via weekly exception reporting to BNP Paribas.

## Performance

- The Fund has outperformed versus the benchmark (as measured by the S&P/ ASX Small Ordinaries Index) over the one, three and five year periods ending 31 January 2010.
- The Fund aims to achieve an 'Excess Return' of 5.0% p.a. above its internal benchmark being the S&P/ ASX Small Industrials Index. The Fund has met this objective over each of the one, three and five year periods ending 31 January 2010.

## Fund Size

- The manager has strict views on limiting the size of its funds under management (FUM) and is aware of the issues resulting from managing a large amount of money in the small cap sector, which can be relatively illiquid. The manager's strict approach to capacity management was evidenced with the Fund's 'soft closure' in 2007. This ultimately allowed the Fund to be more nimble during 2008, enabling the manager to capitalise on opportunities that presented as a result of significant market volatility. It should be noted that at the time of Lonsec's review the Fund remained opened to investors following the removal of the 'soft closure' in 2008.

## Overall

- Lonsec has maintained its 'Highly Recommended' rating of the Fund following the most recent review. The Fund is one of Lonsec's preferred entry points for investors wishing to access the small cap sector. Further, the re-opening of the Fund provides a window of opportunity to access this capability whilst the Fund has sufficient capacity. The rating continues to be underpinned by Lonsec's assessment of the quality and experience of the portfolio managers (Steve Black and Ed Prendergast). The team has worked together for a number of years and continues to demonstrate a high level of skill and enthusiasm in the management of this Fund.
- The conservative style used in portfolio construction (which excludes resource stocks), whilst providing a point of differentiation, means that the Fund would not be suitable for investors seeking exposure to small cap resource stocks.

## People & Resources

### Size and Experience

The Pengana Emerging Companies investment team consists of two portfolio managers, namely Steve Black and Ed Prendergast. The team has an average of 15 years investment management experience and have worked together in the management of this fund since its inception in 2004.

Prior to joining Pengana, Black spent nine years investing in the small caps sector at Goldman Sachs JBWere, including seven years as portfolio manager of the Emerging Leaders Fund. Performance of the Goldman Sachs JB Were Fund was very strong over a long time period under Black's management.

Before Pengana, Prendergast spent 10 years in the broking industry, with approximately nine years at ABN AMRO and Citigroup. During his time at Citigroup, Prendergast was highly rated by industry peers, including being the number one rated small cap analyst in 2003 and 2004 (as reported by the BRW industry survey).

### Team Structure

Pengana employs a flat team structure with Black and Prendergast equally responsible for managing the portfolio. From Lonsec's observations there is a very collegiate environment at Pengana with the two team members working closely in both stock research and portfolio construction.

Back office and administration functions have been outsourced to BNP Paribas and Pengana Capital is responsible for marketing.

### Turnover

Since inception there have been no departures or additions to the investment team.

### Remuneration / Alignment of Interests

The manager is entitled to a performance fee of 20.5% of returns above the benchmark index (after covering the management fee), with a high watermark. Given that Black and Prendergast each own 25% of the company, the performance fee is a significant incentive to drive outperformance. In addition, both Black and Prendergast are co-invested in the Fund.

## Investment Style

### Style

Pengana is an active 'bottom up' manager that manages to a broadly GARP (Growth at a Reasonable Price) investment style. The manager has a strong focus on valuation and exhibits a bias towards 'quality' factors.

## Investment Philosophies and Beliefs

Pengana believes that due to the limited broker coverage in the small and micro caps end of the market, greater pricing inefficiencies exist relative to the large cap market. As such, Pengana is heavily focused on stocks considered 'under-researched', particularly at the low end (by market cap) of the small caps market and within the micro cap market. Capital preservation is important and the Manager will look to sell its position early if a stock's investment thesis changes.

## Research Approach

### Overview

Investment Style	GARP
No. of stocks in universe	800
No. of stocks fully modeled	~ 110 up to date, live models
Key Screens	- Min. market cap \$25m - Exclude biotech, property trusts & resource companies
Top-Down	0%
Bottom-Up	100%
Qualitative Analysis	Management quality
Research Inputs	- Extensive company contact - Industry based feedback via unlisted companies
Use of broker research	- Primarily used to assess alternative assumptions and valuations made by the investment community

### Valuation approach

Primary	Discounted Cash flow
Secondary	Price Earnings Ratio Earnings before Interest Tax and Amortisation Ratio (EBITDA) Multiples Dividend Yield

## Portfolio Construction

The portfolio is constructed by Black and Prendergast with the aim of building a 'best ideas' portfolio whilst ensuring an adequate level of diversification. Stock weights are based on Black and Prendergast's judgement, drawing primarily on discount to DCF valuation. Secondary factors are also considered and include one year forecast price earnings (P/E) multiples, one year forecast Enterprise Value / Earnings before Interest Tax and Amortisation (EV/EBITA) multiples, dividend yield, market capitalisation, and the score ascribed during the research process. The manager will also consider stock liquidity and risk.

Stocks are acquired with a three year view and portfolio turnover is typically approximately 40% - 50% pa. The

primary trigger to sell a stock is when it reaches Pengana's valuation. Pengana will not sell down a position in reaction to a falling share price unless the fundamentals of the company have changed.

Ultimate accountability for the portfolio lies equally with the two portfolio managers and stock level attribution is not undertaken. The portfolio typically holds between 50-60 stocks.

### **Risk Monitoring**

Given the focus on valuation and the exclusion of higher risk complex companies (such as biotechs and resources), risk management is to a certain extent implicit in the research and stock selection process. Portfolio risk is managed via risk limits at the portfolio construction stage.

In addition, the JBWere Risk Analytics tool is used on a monthly basis to monitor factors such as correlations amongst stocks, tracking error and stocks contributing the most risk to the portfolio.

The manager's custodian, BNP Paribas, provides weekly exception reporting, which acts as an additional and external compliance check.

### **FUM**

Pengana manages approximately \$309 million in small caps which equates to approximately 0.35% of the market cap of the S&P/ASX Small Ordinaries Index. This is a relatively small amount compared with other industry peers and Lonsec believes Pengana is less likely to be affected by size issues on a comparative basis.

Pengana believes that fund managers begin to experience diseconomies of scale when their FUM reaches a certain level and has therefore elected to cap FUM at approximately 0.5% of the market cap of the S&P/ASX Small Ordinaries Index.

**Quantitative Representative Performance Analysis**  
**Annualised after-fee % Returns as at 31 January 2010**

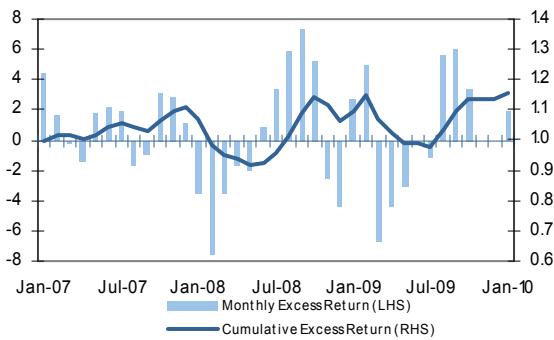
	1 Year		2 Years		3 Years		5 Years	
	Fund	Peer Group	Fund	Peer Group	Fund	Peer Group	Fund	Peer Group
Performance (% pa)	64.0	60.6	-4.8	-5.5	-1.9	-3.6	12.0	7.1
Standard Deviation (% pa)	17.7	18.2	26.7	27.6	25.5	25.1	21.6	21.0
Excess Return (% pa)	11.2	7.7	5.9	5.3	5.9	4.2	7.8	2.9
Outperformance Ratio (%)	41.7	55.1	45.8	54.9	50.0	55.7	58.3	53.6
Worst Drawdown (%)	-5.5	-5.8	-45.7	-47.4	-56.5	-55.3	-56.5	-54.7
Time to Recovery (mths)	-	-0.3	-	2.0	-	0.4	-	0.4
Sharpe Ratio	3.4	3.2	-0.4	-0.4	-0.3	-0.4	0.3	0.1
Information Ratio	0.8	0.6	0.4	0.5	0.5	0.4	0.7	0.4
Tracking Error (% pa)	14.0	10.9	14.8	11.7	12.6	10.1	10.7	8.6

Peer Group: Average among Lonsec rated Australian Small Cap manager universe

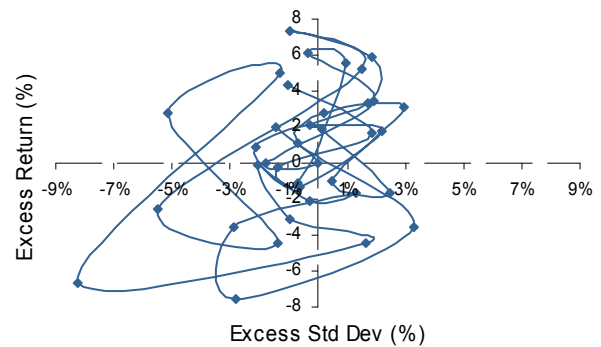
Benchmark: S&P/ASX Small Ordinaries Accumulation Index

Fund Benchmark: S&P/ASX Small Industrials Accumulation Index

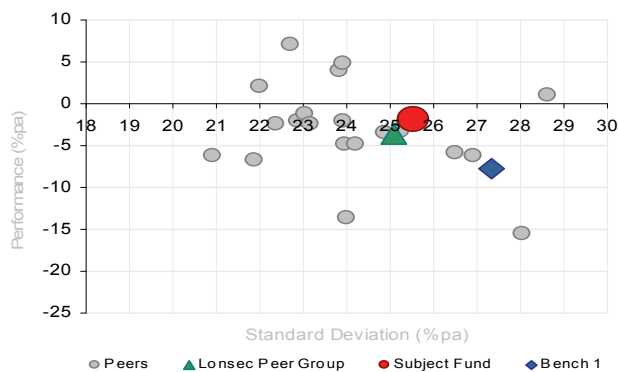
**Cumulative Performance over three years**



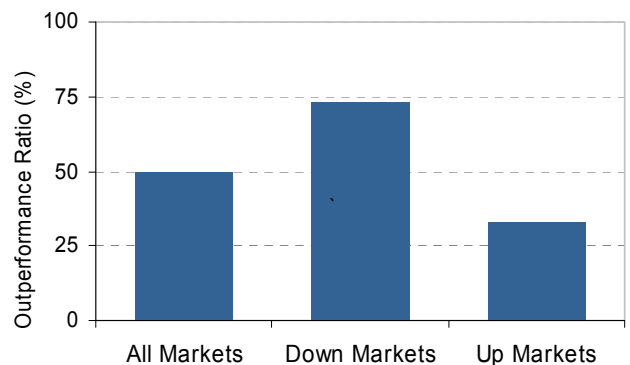
**Snail Trail over three years**



**Risk-return Chart over three years**



**Outperformance Consistency over three Years**



Glossary	
<b>Absolute Return</b>	'Top line' actual return, after fees
<b>Excess Return</b>	Return in excess of the benchmark return (Alpha)
<b>Standard Deviation</b>	Volatility of monthly Absolute Returns
<b>Tracking Error</b>	Volatility of monthly Excess Returns against the benchmark (the Standard Deviation of monthly Excess Returns)
<b>Sharpe Ratio</b>	Absolute reward for absolute risk taken (outperformance of the risk free return (Bank Bills) / Standard Deviation)
<b>Information Ratio</b>	Relative reward for relative risk taken (Excess Returns / Tracking Error)
<b>Worst Drawdown</b>	The worst cumulative loss ('peak to trough') experienced over the period assessed
<b>Time to Recovery</b>	The number of months taken to recover the Worst Drawdown

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**Date Prepared: March 2010**

**Analyst: Andrew Scifo**

**Release Authorised by: Lin Ngin**

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