

Pengana Emerging Companies Fund

March 2010 Quarterly Review



Australian Equities - Small Caps

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Fund Performance

Net performance for periods ending 31 March 2010 ¹

	3 months	6 months	1 year	3 years p.a.	5 years p.a.	Since inception p.a. ²
Pengana Emerging Companies Fund	3.0%	11.7%	75.5%	-1.3%	14.6%	16.1%
S&P/ASX Small Industrials Acc Index ³	-1.3%	0.5%	54.3%	-11.9%	1.3%	2.0%
Outperformance	4.3%	11.1%	21.2%	10.6%	13.3%	14.1%
S&P/ASX Small Ordinaries Acc Index	-1.6%	3.2%	58.1%	-7.5%	5.8%	6.4%
Outperformance	4.6%	8.5%	17.4%	6.2%	8.8%	9.7%

Fund Commentary

The Fund returned 3.0% over the March quarter, outperforming the Small Ordinaries index by 4.6% and the Small Industrials Index by 4.3%. **For the 12 months to March, the Fund returned 75.5% (after fees)**, which was 17.4% above the Small Ordinaries and 21.2% above the Small Industrials. We are very pleased the Fund has been able to deliver returns above the market over all published time periods in both strong and weak markets. The Fund's outcomes are particularly pleasing given we do not invest in resources stocks which have strongly outperformed small industrial stocks since inception of the Fund.

The earnings outlook for industrial companies is being supported by **stronger than expected economic data**. The recent reporting seasons in both Australia and the US tend to support the view that for most countries the worst of their economic woes are behind them. That said there remain concerns over the extent of sovereign debt globally, Greece being the obvious recent example, and the sustainability of China's economic strength; remembering that China's demand for natural resources nearly single handedly kept Australia from following the rest of the world into recession. Given this we are wary of having too great an exposure to cyclical stocks.

As we have been saying in all our recent correspondence we find the current market as being **particularly attractive for stock pickers**. A silver lining from the GFC is how dislocated the market has become. We are still finding a lot of companies share prices to be trading well below where we would expect, given their recent profit releases. This can in part be explained by small cap stocks still being largely overlooked by certain quarters of the market as memories of recent large losses continue to resonate. As a generalization the hurdle for a stock to be included in our portfolio has in the past needed to show in the vicinity of 30-40% upside whereas at the moment our valuations (based on discounted cashflow modeling) on stocks are requiring 40-50% upside before inclusion is considered – we look to invest in only our best 50 stock ideas. It is in this environment that our research efforts are best rewarded and hence we continue to actively visit companies – over the March quarter we conducted 84 one-on-one company interviews of management.

Recent portfolio activity

New stocks added to the portfolio over the quarter included **Restaurant Brands (NZ), RP Data, Oroton and Mastermyne**.

After nearly six years of researching New Zealand stocks our patience paid off with the purchase of **Restaurant Brands**, our first New Zealand stock in the portfolio. Restaurant Brands operates the KFC, Pizza Hut and Starbucks businesses under long-term franchise arrangements in NZ. We were attracted to the quality of the company's management, competitive niche in the takeaway chicken market (where unlike Australia there are few national competitors) and the very cheap valuation it was trading on.

RP Data is a provider of property information in Australia and New Zealand to real estate agents, brokers and banks. With around 90% of the company's revenue being derived from customers paying subscription fees to access the company's extensive database we have good confidence in forecasting the company's future prospects. Our position in the company came via a large founding shareholder exiting at a large discount to the prevailing share 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.

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We continue to be impressed by the resilience of the **Oroton** Brand and calibre of management to navigate their business through the (GFC). Oroton delivered a very strong profit result during February, renewed the Polo Ralph Lauren licence and provided an upbeat assessment of the store roll out opportunities for the group.

Mastermyne is a float we have recently taken up. It provides underground coal mining services to mine owners in the Bowen Basin region of QLD. Our key attractions to the company are its very long period of success in the region and the growth potential from further expansion into the NSW Hunter Valley coal mining district. Mastermyne is due to float in early May.

In addition we increased our weighting in **Photon Group** after the share price reacted negatively to the departure of the company's CEO, thus providing us a very cheap entry point into the media advertising company which trades on a PE (Price Earnings Ratio) of around 6 times 2010 cyclically depressed earnings. After subscribing to the **Kathmandu** float in November last year we continued to add to our position post listing as the share price was caught in the market malaise caused by the disappointing Myer float (which we did not invest in). Fundamentally we are very attracted to this high growth speciality retailer which is still in its infancy in terms of store roll out across New Zealand and Australia.

To help fund these purchases we reduced our weightings in **Premier Investments, Navitas, Dominos Pizza, Pacific Brands** and **Carsales** after strong share price rises saw their upside potential reduce. In addition we sold our holdings in **WHK Group** and **McPhersons** as they reached fair value.

Market Commentary

Market backdrop

Economic data released globally has continued its steady improvement over the quarter. That said Greece's debt issues did provide a sobering reminder that the path to economic recovery will not be smooth. In this environment the Market continued to range trade, with the All Ordinaries Index rising 1.3%, the Small Ordinaries Index falling 1.6% and the Small Industrials Index falling 1.3%. Since the market lows in early March 2008, the Smallcap sector has markedly outperformed the largecaps, rising by 82% versus 58% for the All Ordinaries. The strong outperformance of smallcaps 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%), **The MAC Services Group** (up 23%), **Kathmandu** (up 17%), **REA Group** – owner of realestate.com.au (up 22%), **M2 Telecommunications** (up 22%) and **Navitas** (up 26%). The laggards included **Probiotec** (down 33%) and **Photon Group** (down 20%).

CSG Group continued to be rerated following the recent purchase of the Konica photocopier operation in NZ and a solid interim profit release. **The MAC Services Group** and **M2 Telecommunications** both enjoyed solid rises following the releases of profit results which exceeded analyst market expectations. **Kathmandu** delivered its maiden profit release post listing which demonstrated the company to be outperforming their own prospectus assumptions. Particularly encouraging was that sales growth at a comparable store level was greater than 10% above the same period last year. The **REA Group** profit release helped illustrate to the market how leveraged profit growth is to small price increases. With the recent release of the new improved Realestate.com.au website the company is now likely to have greater scope to increase prices further. **Navitas** benefited from the announcement of their United States expansion strategy – they have now executed four educational affiliation agreements with United States colleges.

While **Probiotec** disappointed the market with its profit result, we are happy that a large part of this disappointment can be explained by one off factors. Finally, **Photon Group** weakened following the departure of the company's long serving CEO.

Outlook

Following the strong 5.7% rise in the broader equity market in March the sharp losses of earlier this year have now been recouped; the S&P/ASX300 index climbing 1.3% over the quarter. This confidence is largely due to the key macro drivers in the economy continuing to improve as the accommodative interest rate environment remains in place. In addition market valuations remain supportive with price earnings ratios being below longer term averages, despite earnings still being cyclically depressed. Against this backdrop forward earnings risk for companies remains on the upside as initiatives undertaken by management during the GFC begin to bear fruit. In particular we believe the market will be pleasantly surprised by the improved operating leverage to an economic upturn of many companies after the aggressive cost cutting initiatives undertaken by management during the GFC.

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Over coming months we expect companies to welcome the market's relative stability by raising additional equity to help fund organic growth initiatives and consider acquisition opportunities. Private companies are also likely to tap the market for new equity by floating businesses. Whilst the Myer Holdings float was disappointing and has the potential in the short term to reduce the number of companies that might have otherwise listed we understand there is a strong pipeline of companies lining up to float.

Going forward, as volatility in global equity markets eases we believe markets will begin to focus more closely on stock-specific valuations rather than the macro driven themes which have dominated markets over the last two years. Our positioning of the portfolio continues to be built around bottom up stock selection and accordingly we tend not to have any strong over-arching themes or sector tilts running through the portfolio. We have solid weightings to both cyclical and defensive stocks.

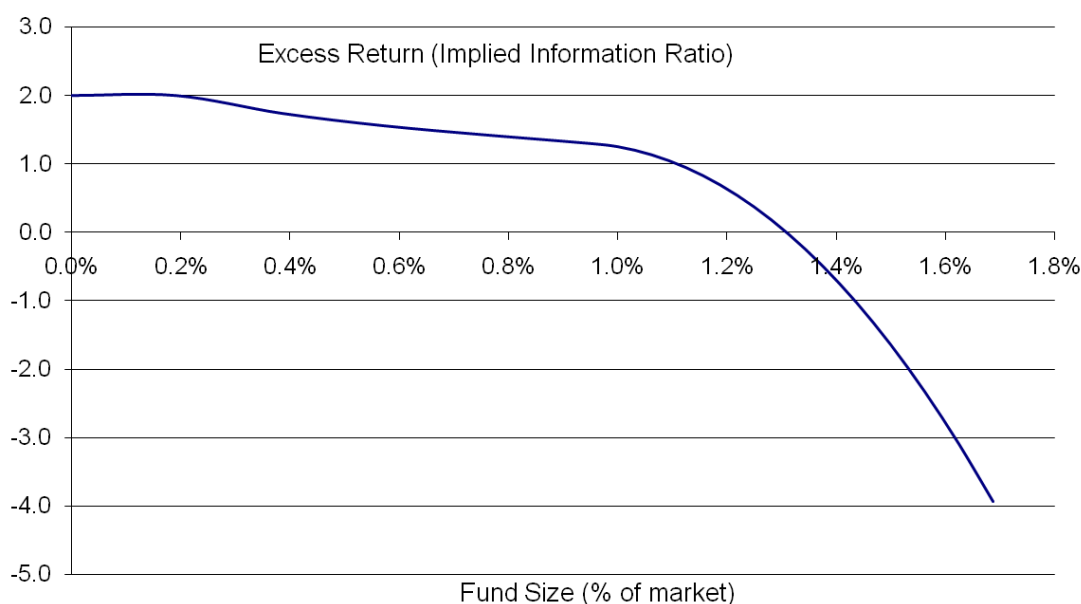
Why we do not invest in resource stocks

Whilst large mining stocks are generally highly profitable, have diversified exposure to many commodities and are not reliant on a single mine site, the smaller miners (now representing around 30% of the Small Ordinaries Index) are often single mine owners exposed to one commodity and have a checkered history of profit delivery – very much a boom bust outcome which is often dependent on where the pricing of the underlying commodity they are exposed to is trading at a particular point in time. Some small resource stocks simply own a resource reserve which is yet to be mined. Philosophically we are not of the view that we should own these more speculative stocks simply because they form part of the index. It is for this same reason we have chosen to never invest in loss making companies or biotech stocks as the skills required to value these stocks is very different to those needed to successfully analyse and invest in small industrial companies. However, quality industrial companies that can service the mining boom have proven to be very successful investments for us, particularly where they can enter long dated take or pay contracts which limit the downside should commodity prices weaken. Through the Global Financial Crisis (GFC) many of these companies earnings held up very well despite the mine owners' profits falling

The problem of size

Philosophically we are of the view that stock pickers should find relative value no matter the market conditions, provided they are not too inhibited by the size of the portfolio that they manage. What the chart below (sourced from Macquarie Bank) shows is that all else being equal the more money a small cap fund manages (the percentage of the Small Ordinaries Index which the "fund size" represents) the more difficult it becomes to outperform ("excess return"). This essentially occurs because each buy and sell decision takes longer to execute which hinders performance. As a point of reference for the chart below we are seeking to close this Fund around 0.4% of the fund's benchmark or \$450m to avoid the problems of managing too much money.

Six years ago when this Fund was established we structured it to ensure there was a strong alignment of interest between unit holders, the Fund managers and the owners of the Fund's business. The litmus test of this alignment will be the inevitable decision to close the Fund to new investors at a sensible level of funds under management (FUM). We have always been vocal on this subject and it should not surprise investors. Investors should welcome this stance as we look to preserve the ability for the Fund to continue to outperform.



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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 (one on one) with 84 companies** and unlisted competitors of listed stocks. The table below shows the listed companies with which we had direct contact during the period.

Prime Financial	Photon	Patties Foods
TPG Group	Dominos	Customers
Cellestis	Wellcom	Wide Bay
Retail Food Group	Mineral Resources	Global Construction
Retail Food Group	RCG Group	Vita Group
Paperlinx	Flexigroup	Miclyn
BSA	Industrea	Ooh Media
Navitas	Challenger Financial	McPhersons
Flight Centre	APN Media	Carsales.com.au
Aust Pharmaceutical	Thinksmart	Challenger Infrast
Over Fifties	Automotive Holdings	Seymour Whyte
Oroton	South Cross Electrical	Capral
Rubicon Water	Hostech	WDS Ltd
Mastermyne	Kathmandu	Restaurant Brands
Talent 2	Pacific Brands	Halcygen
Resmed	Emeco	Sirtex
Kaplan funds	Salmat	Treasury Group
CSG Group	Flexigroup	BT Financial
Macmillan Shakespeare	DKN Group	REA Group
DWS Ltd	Breville	Data #3
WHK Group	Toxfree	Gerrard Electrical
Reject Shop	Asciano	Chandler MacLeod
Slater & Gordon	RP Data	Paperlinx
Coffey	IOOF Ltd	Mitchell Comm
ARB Corp	Skilled Engineering	RCR Tomlinson
Probiotec	VDM Group	
Matrix Composites	Transfield	
NRW Holdings	Select Harvest	
TPG Group	Brierty	

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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	\$389m
Inception Date	1 November 2004	Application Price at Month End	A\$ 1.8354
Identification Code(s)	APIR PER0270AU ARSN 111 894 510	Redemption Price at Month End	A\$ 1.8244

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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.