

# Pengana Australian Equities Core Fund

## March 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\$1.2073	<b>Redemption Price at Month End</b>	A\$1.2013
<b>Style</b>	Fundamental	<b>FUM at Month End</b>	A\$14.7m
<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%	3.6%				<b>20.5%</b>

The Fund generated a healthy return of 3.6%<sup>3</sup> after all fees and costs during March. By way of comparison the Australian All Ordinaries returned 5.8% for the month and the prevailing cash rate during February was 0.3%. **For the 21 months since inception the Fund has protected capital and provided investors with a satisfactory total return of 24.3% (annualised 13.2%) versus the 7.4% cash rate (4.2% annualised) and a negative market return by the Australian All Ordinaries of -0.4% (-0.2% annualised).**

As at the 31<sup>st</sup> of March, the effective cash position of the Fund's NTA stands at 14%. 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. (Note that from 1 April 2010, the effective cash position is significantly higher at 30% due to the large cash inflows from new investors.)

Large positive contributors to the month's performance were Ramsay Healthcare, Westpac Bank, Customers, Resmed and NAB. The largest detractors were Credit Corp, Downer Edi and Platinum Australia.

The Fund acquired two new holdings including Tox Free Solutions and a position in BHP puts. The latter is best described as portfolio insurance against an interruption in the robust export trade with China. This is seen as the main threat to the strong economic growth drivers for the Australian economy. Several holdings were increased including Downer Edi and NIB Holdings. The Fund trimmed its holdings in Telstra, Ramsay Healthcare and Customers.

As at 31<sup>st</sup> March 2010 the top five holdings by value in the Fund were: Westpac, CBA, Ramsay Healthcare, News Corporation and Telstra.

#### Net Returns to 31<sup>st</sup> March 2010<sup>3</sup>

	Pengana	Cash Rate	All Ordinaries
<b>1 Month</b>	3.6%	0.3%	5.8%
<b>3 Months</b>	1.0%	0.9%	1.5%
<b>6 Months</b>	5.8%	1.8%	5.2%
<b>12 Months</b>	33.3%	3.3%	44.0%
<b>21 Months since Inception</b>	<b>24.1%</b>	<b>7.4%</b>	<b>-0.4%</b>
<b>Annualised return Inception</b>	<b>13.1%</b>	<b>4.2%</b>	<b>-0.2%</b>

<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 shrugged off the domestic interest rate hike, Chinese monetary tightening and a deteriorating European sovereign debt outlook to close up 5.8% for the March. The Energy (+9%), Materials (8%) and Banks (+7%) were the stand out performers while Reits (0%) Telecommunications (0%) and Utilities (+2%) were the laggards.

Corporate confidence is returning, as evidenced by a pick up in takeover activity with Corporate Express, Lihir Gold and Arrow Energy as examples. The domestic banking sector in particular appears to be experiencing better conditions as their worst fears on bad debts are proving unfounded. Investors have rewarded them with new highs in their market capitalisations (with share prices approaching record levels on top of the increased number of shares in issue) reflecting the reality of "economic Darwinism". **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.

This environment should allow Australia to leverage its competitive advantage in providing high quality, low cost coal and iron ore volumes to these nearby markets. However, the recent inflationary data out of China has provided a catalyst for an indefinite pause in Chinese bank lending. **In addition, the complex tiers of Chinese government and opaque levels of debt at each level create uncertainty around the sustainability of Chinese growth at these rates.**

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 have 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 Mitchell Communications, the leading domestic media buying group. The founder and main shareholder - Harold Mitchell - has built a robust business by providing the traditional and digital media buying services to the leading domestic companies. The company has demonstrated its resilient business model by growing its revenue and earnings in spite of the recent collapse in national advertising spend, and emerging with a solid balance sheet. Their customers prepay their advertising spend to Mitchell's generating positive working capital. This business is well positioned to benefit from the recovery in the advertising market while also largely immune to the structural changes occurring because of the its significant digital business.

Other examples of this 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.

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