

Resources: Not a Lump of Coal in Your Christmas Stocking.

August 2010

Introduction

The first half of 2010 was a challenging period for Resources equities and the broader market as investors grappled with a number of headwinds including the European sovereign debt crisis, bank stress tests, a disappointing recovery in U.S. housing and employment growth and China's attempts to curtail more speculative elements of its economy and bring growth to a more sustainable level.

From this juncture, our view is that the relative outlook for Resources is strong. We consider that the global economic recovery will be moderate and uneven with emerging economies carrying the developed world. The "Fear Trade" is abating and as such, in our view, the near to medium term outlook for gold is negative. High investor cash levels, robust earnings versus expectations and strong corporate balance sheets igniting merger and acquisition activity in the sector are all expected to drive undervalued resource equity prices higher in the near term. We consider that the longer term story for Resources, sketched out herein, is strong and easier to understand than many alternate investments.

The proposition that Resources carry undesirable risk for investors is not supported by the evidence. While there is no doubt that resource equities can be volatile, it is worth putting the volatility and absolute performance of the resources market in context. To this end, the S&P/ASX 300 Resources Accumulation Index has substantially outperformed both the All Ordinaries Accumulation Index and S&P/ASX 200 Industrials Accumulation Index since January 2001 with only slightly higher volatility and significantly lower draw-downs.¹

Ironically many Australian equity investors are under-exposed to the Australian Resources sector. We believe this is unwarranted based on the characteristics of the sectors, and that Australian equity investors should act to remove unwarranted biases to Industrials.

Since its inception on 23 March 2007, the Pengana Global Resources Fund ("Fund") has delivered class leading absolute performance of 13.3%p.a¹ (after fees and assuming re-investment of distributions), well above the Australian Resources Sector, with lower risk. The Fund has demonstrated the ability to strongly participate on the upside of global resource market movements, while limiting downside movements. The September quarter is a seasonally quiet time for the sector and we consider it an opportune time to invest leading into the December quarter in which we expect resources to deliver higher relative and absolute returns.

The Economy

Consumption demand is the primary driver for a sustained rally in commodity prices and as such the direction in near term metal prices is largely linked to the current juncture of the global economic cycle. Longer term, the key drivers for global economic growth and as such commodity prices will be growth, development and wealth creation of emerging economies.

¹ Past performance is not a reliable indicator of future performance. The value of investments can go up and down.

Emerging Economies

The world's top four emerging economies; Brazil, Russia, India and China, the so-called BRIC countries account for 50% of global growth, 16% of world output and are home to 40% of the world's population. By 2014, the International Monetary Fund (IMF) estimates that the BRIC economies will account for 61% of global GDP growth.

Of these four nations, China is by far the largest in terms of GDP, estimated at US\$5.3 trillion in 2010 by the IMF of a total of US\$9.5 trillion for the BRIC countries. Over the last decade, China's GDP has increased roughly US\$3.5 trillion, while, in comparison, GDP in the US rose \$4.7 trillion. In other words, China has added about 75% of what the US has to global GDP, even though it started the decade at about 1/9th the size.

Goldman Sachs estimate that the BRIC economies together could become larger than those of the world's six most developed countries (G6) in US dollar terms in less than 40 years.

China

As China is the world's largest raw material consumer, fears have arisen that recent policy moves to moderate growth from unsustainable levels will significantly impact world commodity demand.

Chinese GDP increased 8% per annum in the June 2010 quarter on a seasonally adjusted basis, the slowest sequential expansion since the March 2009 quarter, but still a strong performance as the economy is managed to a sustainable growth path. With headline inflation of 2.9% in June and a recent loosening of the currency peg to the US dollar, it is unlikely that further tightening in credit controls or monetary policy will be needed. In this vein, it is important to note that China's bank lending expansion target for this year is 18%, which still means significant credit growth, albeit at a rate of expansion less than last year's when the world was recovering from recession.

The key themes of urbanisation, industrialisation and consumerism of emerging economies will continue to drive commodity demand in China which has a low natural endowment in many raw materials. The following serves to illustrate China's growth potential:

- The GDP per capita in China is still only 14% of that in the United States.
- With over 1.3 billion people, China is the world's most populous country.
- There are on average 33 vehicles for every 1000 people in China compared to 800 in the United States.
- By 2025, it is estimated that 221 Chinese cities will have a population of at least a million people. Of these, 23 will have over 5 million people.
- China will build between four and five million new buildings between 2005 and 2025: Roughly equal to 50,000 skyscrapers or the equivalent of up to ten cities the size of New York.

Given the enormity of China's population, a small change in spending patterns at the margin will generate significant demand for raw materials as standards of living improve. For instance, if every Chinese citizen increased their spending a single Yuan a day (A\$0.16/day), total consumption would grow by roughly A\$85 billion per annum. If each Chinese spent an extra 10 Yuan per day (A\$1.63/day), the added annual consumption would be roughly equal to Australia's GDP. China currently has total household savings equivalent to A\$3.5 trillion.

On an even broader scale, the combination of population growth and growing personal incomes as Asia's adolescents move into a higher consuming demographic, will see the estimated pool of discretionary consumers in non-Japan Asia grow on average between 8-9% per annum over at least

the next decade. Therefore, by 2020, there could be one billion discretionary consumers in non-Japan Asia, which is more than the combined population of the OECD countries.

India

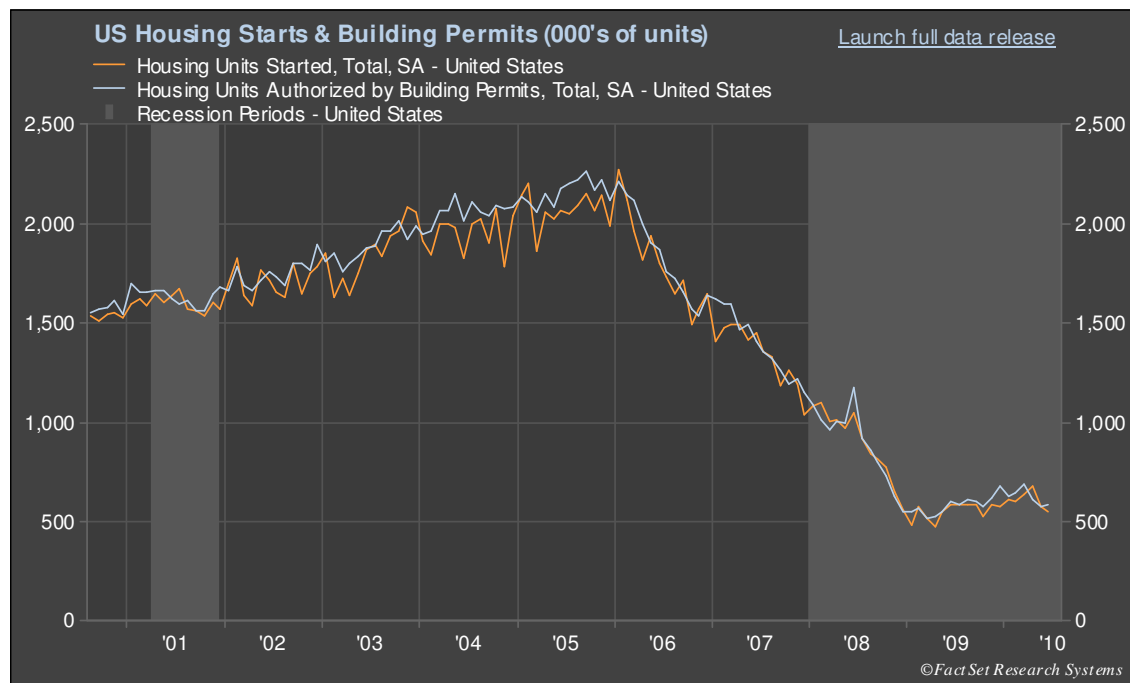
While much continues to be penned on the outlook for China, in our view India is a key source of commodity demand growth over the medium to longer term and will bolster metals intensive growth in concert with a developing China. At present:

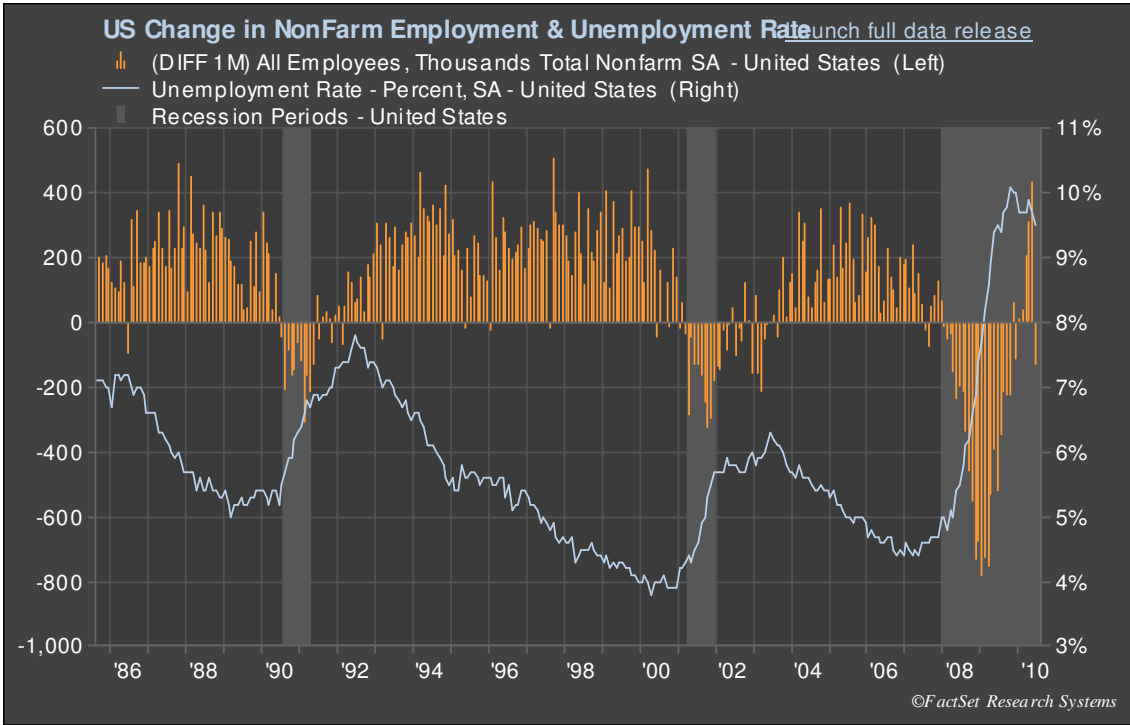
- India's GDP per capita is estimated to reach where China is today in 15 years time.
- India has a population of 1.2 billion, (vs. China at over 1.3 billion)
- Steel, copper and aluminium consumption per person in India during 2009 was 1/10th of Chinas.
- India grew at 5.6% last year. According to the World Bank, it is on track for 7.7% growth this year.

Developed Economies

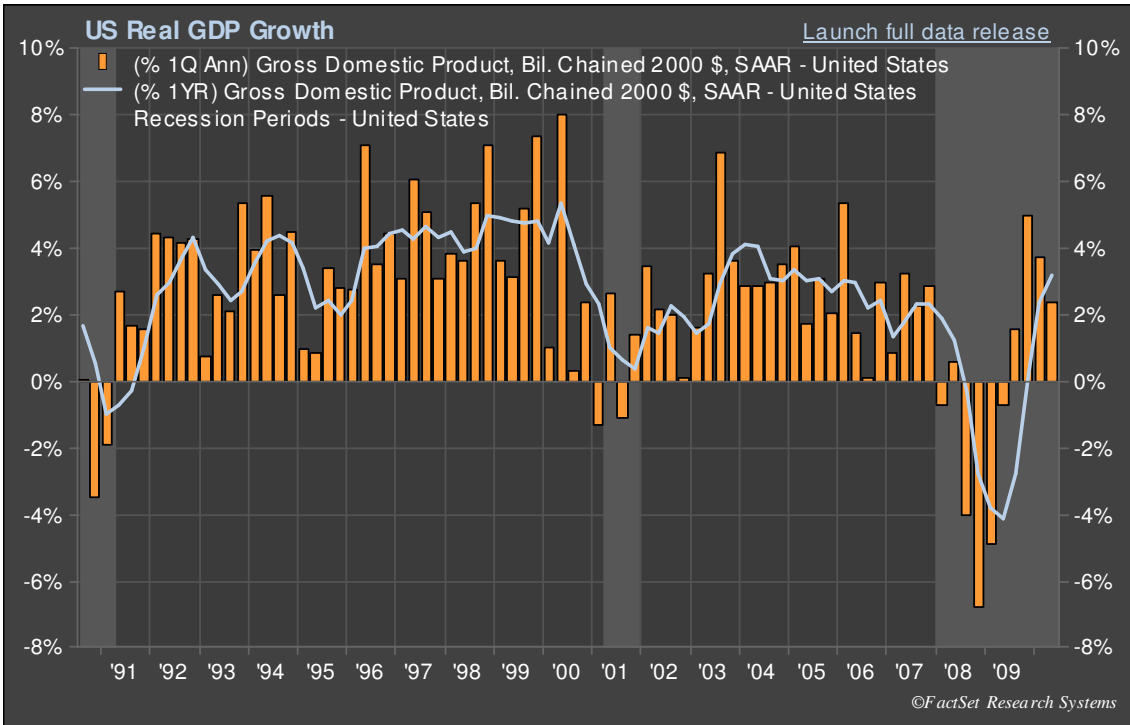
United States

The following charts put into perspective the tepid economic recovery in the United States. Whilst a bottom in activity appears to have occurred there is no "V" shaped recovery with U.S. housing starts and building permits bouncing along the bottom. Similarly, the necessary underpinning of a self-sustaining U.S. economic recovery can only occur when meaningful employment growth occurs, which in turn will lead to a less thrifty U.S. consumer. Whilst unemployment appears to have peaked, the improvement is far from impressive and may require further economic stimulus to ensure unemployment continues to fall into 2011 and beyond.



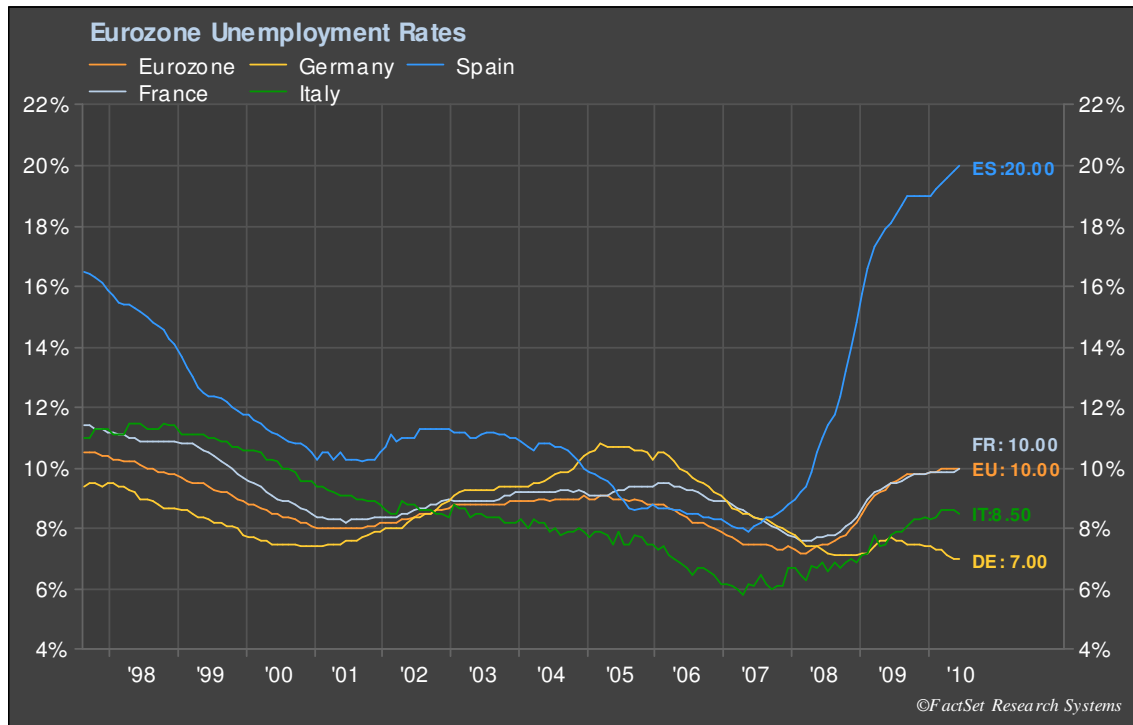


The chart below shows whilst U.S. Real Gross Domestic Product (GDP) has recovered from Global Financial Crisis lows the strength of recovery is moderating on an annualised quarterly basis. Some pundits see the deceleration in U.S. GDP growth as increasing the likelihood of a “double dip” recession. However, to put the likelihood in context the U.S economy has double-dipped once in the past 80 years and this was due to the U.S. Federal Reserve’s focus on inflation at the time. We therefore don’t subscribe to the view that the U.S. economy is headed for a double-dip recession whilst acknowledging that the recovery is fragile.



Europe

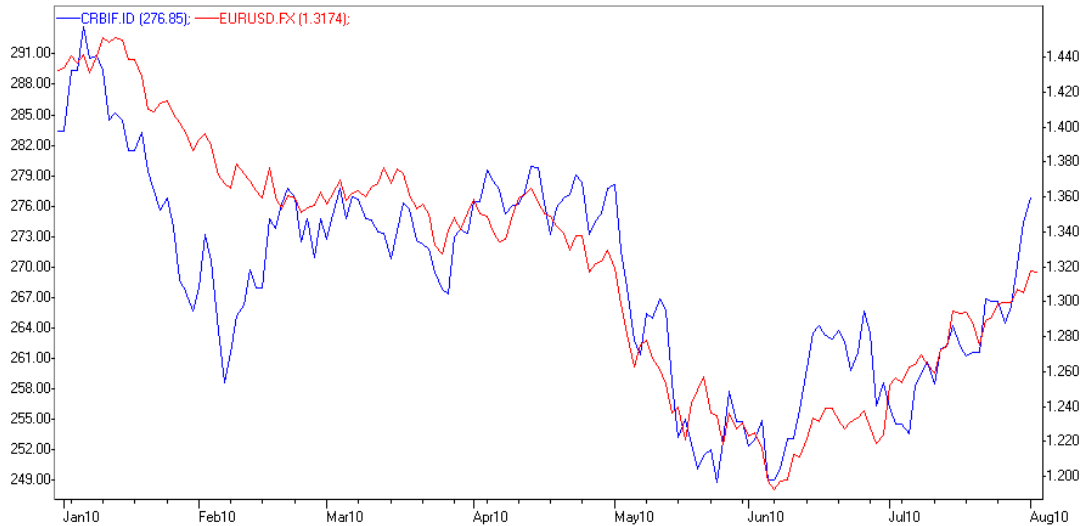
European economies are on the road to recovery. However, in our view structural issues will plague the region for some time. Austerity measures have been implemented in order to address high levels of indebtedness and ensure countries meet measures to maintain membership of the European Union. As a result, growth in many economies is likely to be muted with employment growth suffering as a consequence. It is not all bad news however. Germany, for instance, does not have the sovereign debt issues of countries such as Greece or Spain and the recovery is advancing rapidly as can be seen by the fall in unemployment relative to other European countries in the graph below.



However, with 50% of Germany's economy export driven the health of its major trading partners is important to monitor.

Markets

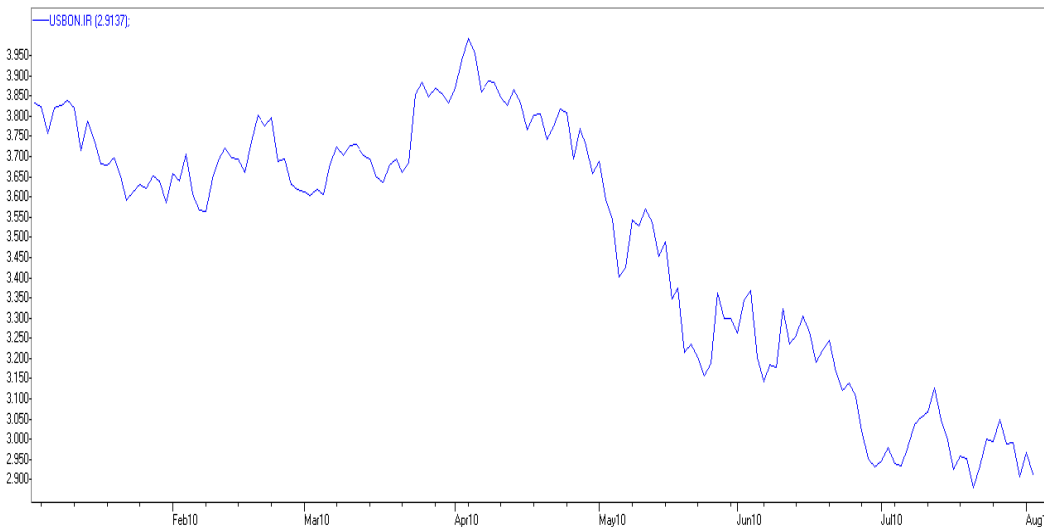
The first half of 2010 was characterised by a number of significant headwinds impeding the stellar advances that were made in both commodity and share prices through 2009. Investors had to contend with a number of significant events including the European sovereign debt crisis, attempts to curtail property speculation by Chinese authorities and a U.S. recovery that can be characterised as anaemic. Not surprisingly, we have seen markets react to an increasingly uncertain environment with a move from perceived risky to less risky assets during the first half of 2010. The so-called move from "Risk-off" to "Risk-on" can be seen in the graph below depicting the CRB Index (a global benchmark for measuring commodity price movement) and Euro expressed in US dollars.



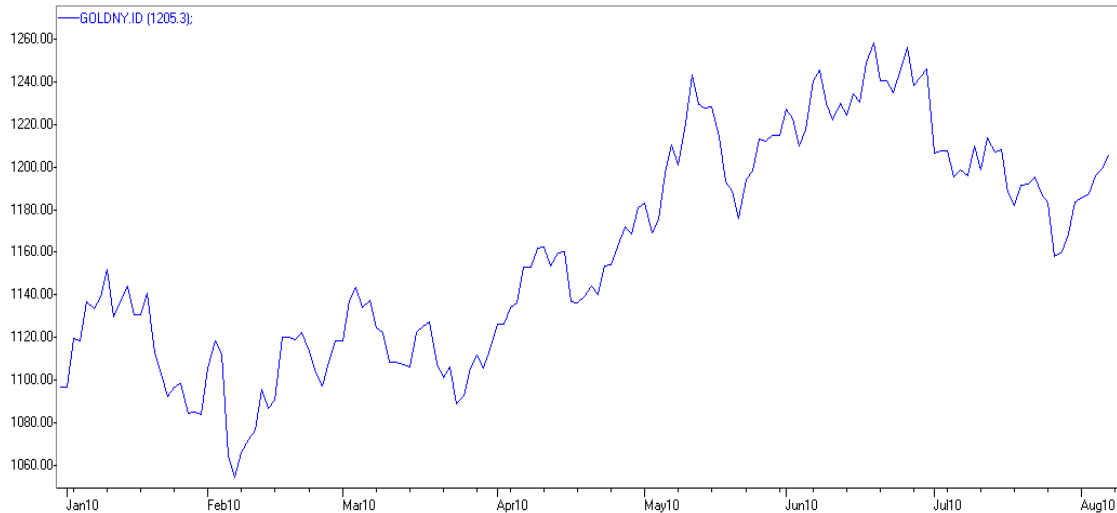
Source: IRESS

Interestingly, you can see the high correlation between the fall in commodity prices as represented by the CRB Index (Blue line) and the fall in the value in the euro (red line) and the reversal in June of this year.

What can be seen from the chart below (graph of U.S. 10 year bond yields) is the correlation with moves in the CRB Index and Euro/USD up until June was very high (people fleeing riskier assets and rewarding safe havens such as bonds, gold and the US dollar). However, the relationship broke down from June onwards as the euro started to strengthen, commodity prices recovered, but U.S. 10 year bond yields have remained at very low levels. This dislocation will be interesting to watch over time and is unlikely to be sustained. One possible explanation of this “break down” in relationship is the fall in the U.S. dollar. Both the euro and commodity prices are denominated in U.S. dollars, hence their prices are being impacted by a falling denominator. Should the deterioration in the U.S. dollar continue the relative attractiveness of investing in U.S. bonds may lessen and we may see bond yields move higher.



Source: IRESS



Source: IRESS

The price of gold benefited during the first half of 2010 given the prevailing uncertainties facing investors. However, given the move from “risk-off” to “risk-on” through July and August we consider that the ability for the gold price to make new highs for 2010 is questionable.

The correction we had to have?

The rebound in most asset markets through the 2009 calendar year was powerful and ultimately the rate of change unsustainable. This is evidenced in the table below which shows the returns from major equity markets for 2009, the half year to June 2010 and the month of July 2010. After most markets experienced declines during the first half of 2010 we have seen a strong rebound during July.

Market	Year to 31/12/2009	6 months to 30/06/2010	Month to 31/07/2010
FTSE 100 (Great Britain)	19.94%	-9.61%	6.71%
S&P 500 (United States)	21.07%	-7.87%	6.65%
Shanghai Composite (China)	58.77%	-31.22%	9.50%
German DAX	21.39%	0.14%	3.01%
Nikkei 225 (Japan)	17.43%	-11.69%	1.63%
S&P/ASX 300 (Australia)	31.91%	-10.63%	4.38%

It has been a similar story for commodity prices over the same time frame. Significantly, the price of gold benefited during the first half of 2010 as investor risk aversion increased.

Commodity Price Movements

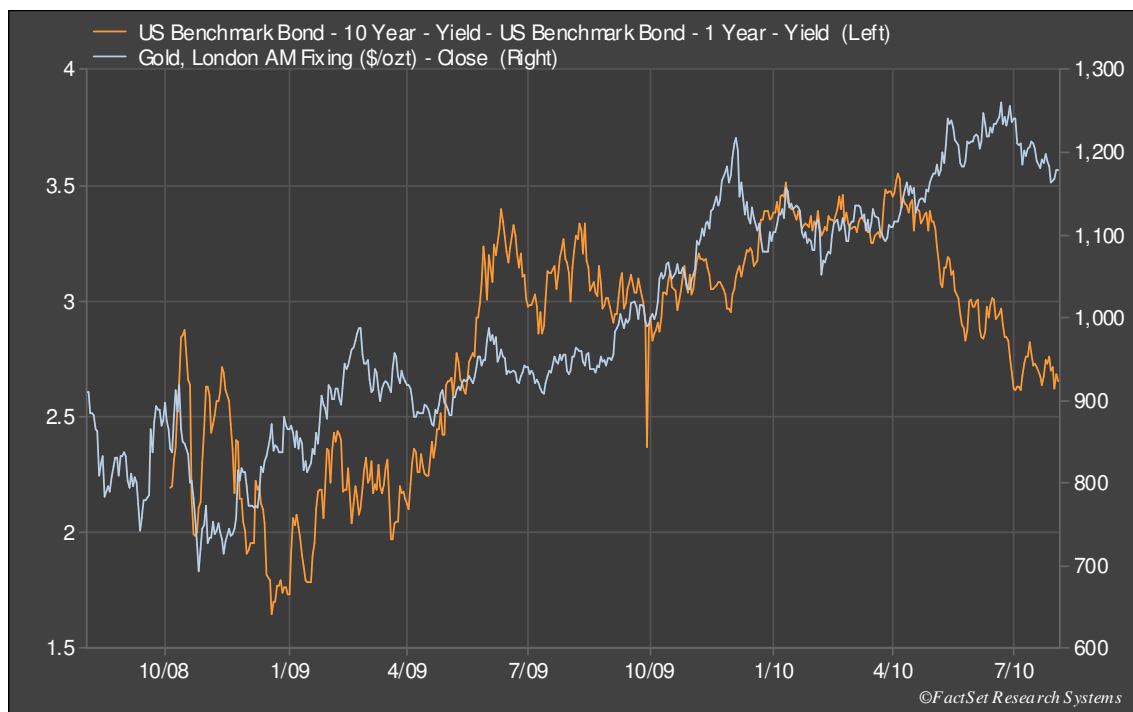
Commodity (In US\$)	Year to 31/12/2009	Half Year to 30/06/2010	Month to 31/07/2010
Aluminium	41.71%	-13.77%	10.03%
Copper	92.88%	-12.00%	9.93%
Gold	21.51%	12.77%	-5.23%
Lead	92.57%	-34.87%	20.04%
Nickel	53.62%	5.01%	5.65%
Oil	56.29%	-4.81%	4.30%
Tin	47.94%	4.39%	11.22%
Zinc	83.01%	-39.58%	13.17%

Gold

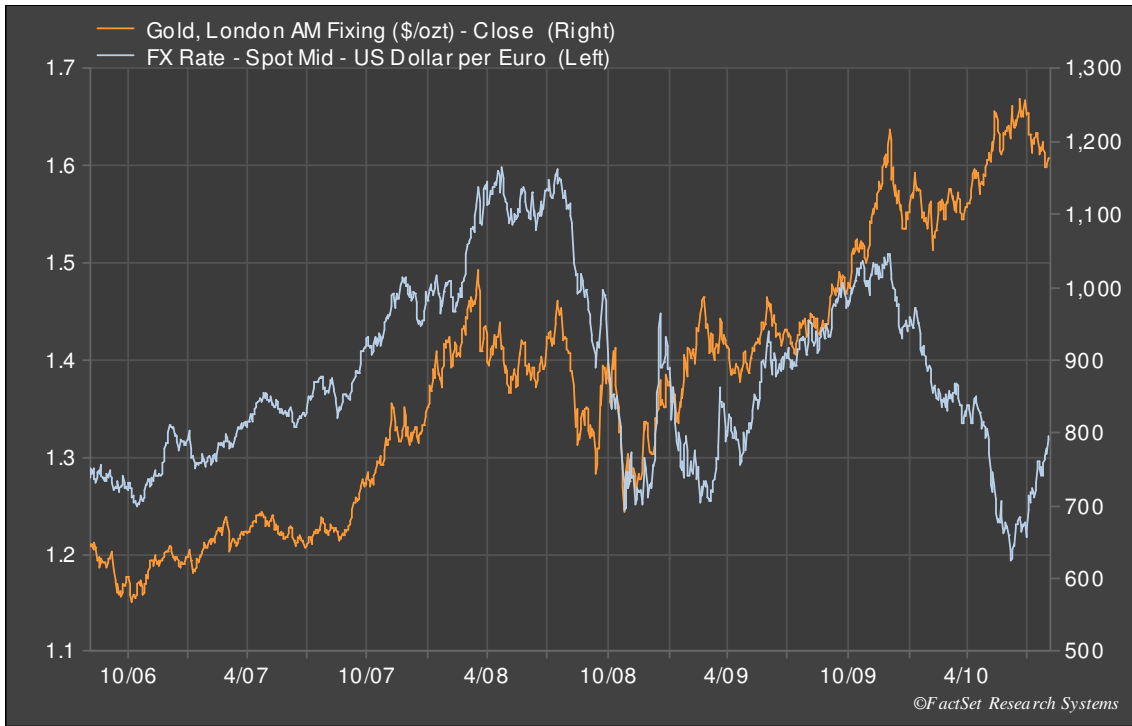
The gold price has recently run to record high levels, but has failed to convincingly breach US\$1,200 per ounce. Gold has done what investors have asked from it. It has been a safe-haven against market fear and volatility and has acted as a foil against strongly depreciating currencies of highly indebted developed economies. However, at this juncture, in our view the near to medium term outlook for gold is negative, relative to other available investments.

The recovery in global growth is moderate and uneven. Generally mixed economic data continues to improve and fears over a double dip recession continue to abate. The anaemic pace of recovery will be unlikely to spur inflationary pressures (which has a tenuous relationship with the gold price) over the near to medium term even as stimulus measures are maintained.

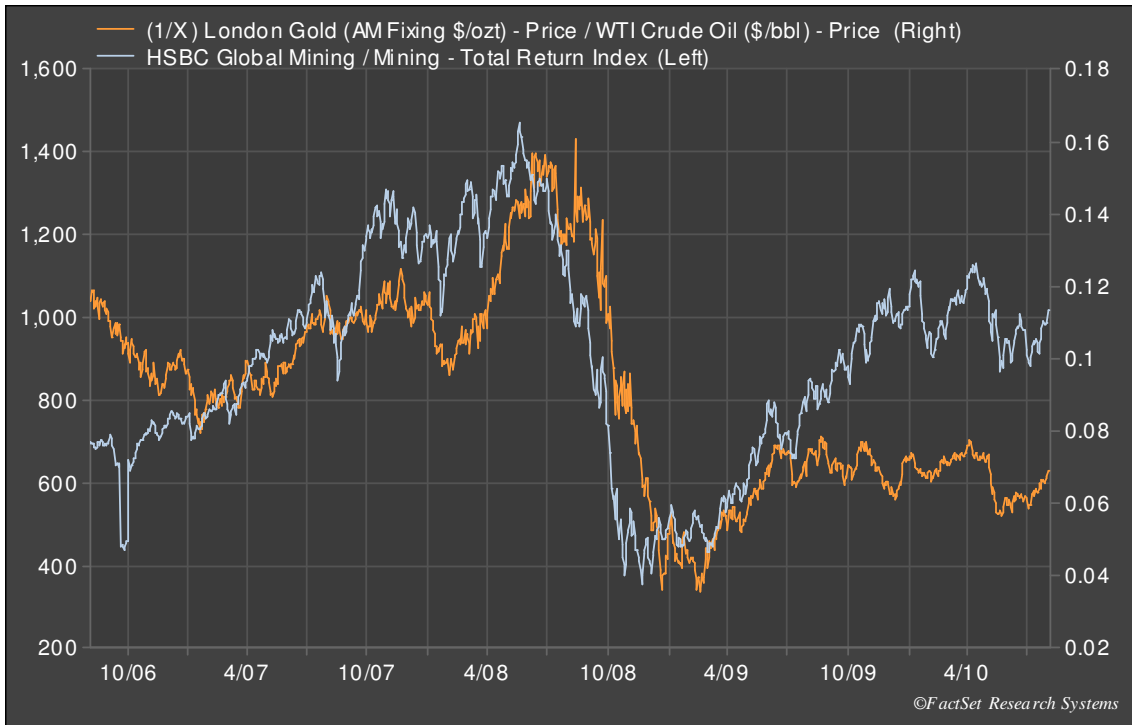
The US 10 year -1 year yield curve evidences an abatement in market fear which has not been fully reflected in the gold price.



In our view the Euro has bottomed as concerns over sovereign risk ease and economic data continues to improve. We consider that Gold looks overbought.



While global resource equities have rallied from the nadir of the global financial crisis, the oil price, which is highly leveraged to economic recovery, particularly in the United States, looks undervalued in terms of the gold price.

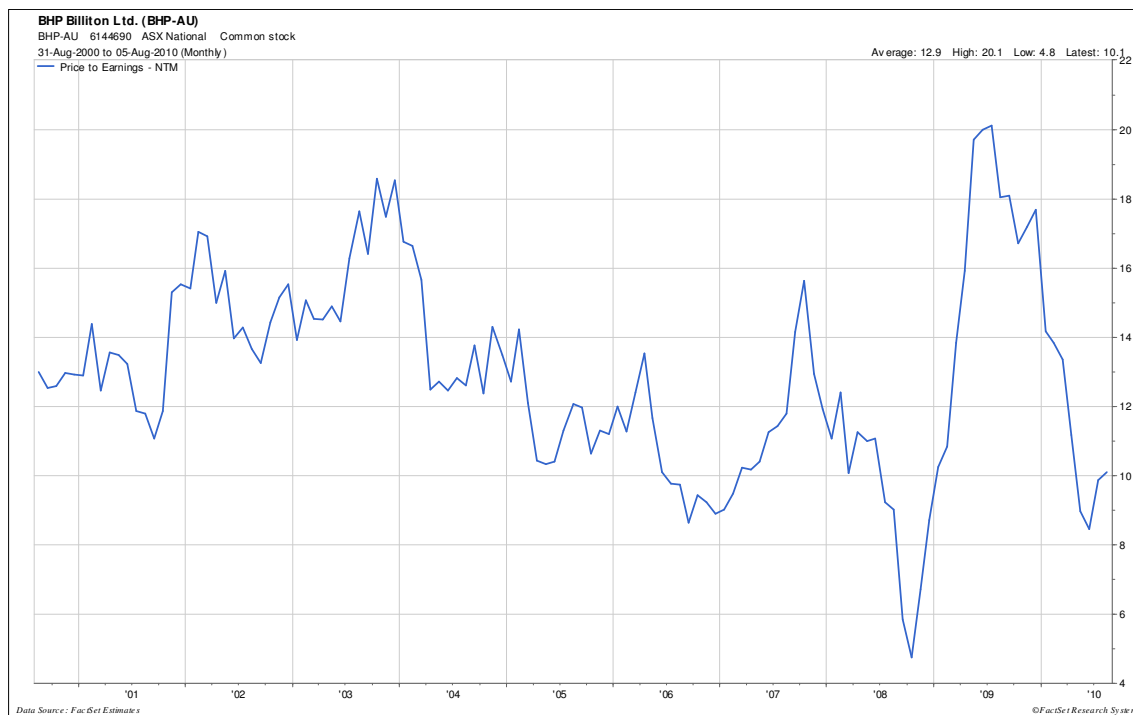


The Outlook For Resource Companies Is Favourable

Whilst there are likely to be more after-shocks resulting from the Global Financial Crisis a number of factors lead us to believe the resources sector is compelling value currently with the balance of risks appearing favourable. These include attractive valuations, large levels of cash being accumulated in investment funds and on corporate balance sheets, increased mergers and acquisition activity, downgrades to broker commodity price forecasts and risk remaining well and truly at the forefront of investor psyche.

Valuations

We consider that the Australian Resources sector is presently offering substantial value. On UBS estimates, the sector is trading at a 27% discount to Net Present Value (NPV) on a market capitalisation weighted basis. Assuming spot commodity and currency assumptions as at the end of the September quarter, 2010, this valuation discount increases to well over 50%. On (UBS) long term commodity assumptions from the end of the September quarter, 2010, the sector is presently undervalued by 15% on a market capitalisation weighted NPV basis.



Using BHP Billiton as a proxy for the resources market and consensus earnings estimates we can see that the company is trading on a prospective price to earnings multiple of 10.1 times, much lower than its historical average of 12.9 times². Indeed, looking at the graph over the past 10 years indicates

² Past performance is not a reliable indicator of future performance. The value of investments can go up and down.

BHP Billiton has on the whole traded at much higher multiples than 10 times over the past 10 years². Simplistically, the chart may be telling us either BHP Billiton is undervalued, or alternatively consensus expectations for commodity prices and hence earnings are too high.

Regarding forecast commodity prices we have seen several stockbroking firms pare forecasts back over the past 6 weeks to a point where expectations are at reasonable levels given where commodity prices have traded over the past 6 months. A more moderate expectation for commodity prices is healthy and increases our confidence that earnings expectations are reasonable and achievable.

Cash, Earnings, Mergers & Acquisitions

Whilst valuations are attractive in our eyes at present, we acknowledge that there needs to be a catalyst to close the gap between share prices and valuations. The valuation gap may close due to a number of factors. Firstly, there has been a large build up of cash by mutual funds in response to uncertain market conditions during the first half of 2010. In the U.S, money market mutual funds and equity mutual funds are sitting with a reported US\$2.8 trillion in cash, equivalent to 17% of the combined market capitalisation of the New York Stock Exchange and NASDAQ. At some stage, this cash which is earning a negligible return will be redeployed by managers. Not only are mutual funds sitting with large cash components, but corporate balance sheets remain flush with cash post the Global Financial Crisis with the majority of companies having repaired their balance sheets and many companies sitting with large cash positions. Some estimates put cash on U.S. corporate balance sheets in excess of U.S. 1 trillion dollars. This cash needs to be re-deployed at some stage either via mergers and acquisitions, share buy-backs or increased dividends or a combination of any of the aforementioned. Reporting season is just beginning in Australia but has been underway for a few weeks in offshore markets. Overall, the news flow has been positive with companies exceeding analyst estimates, which gives us greater confidence in the valuations we are ascribing to companies in the resource sector.

M&A Activity

Merger and acquisition activity has been ongoing in the resources sector throughout 2010. For instance, in the oil and gas sector Apache Corporation has done three significant deals during the year. Apache Corporation purchased from Devon Energy oil and gas assets in the shallow waters of the Gulf of Mexico for U.S. \$1.05 billion. In addition, Apache Corporation announced a US\$2.7 billion merger with Mariner Energy and most recently the company announced the purchase of a variety of BP's assets for US\$7 billion. Activity has not been confined to the oil and gas sector with large deals being announced in other sectors such as gold and coal. Earlier this year, Newcrest Mining announced its intention to merge with Lihir Gold to create a globally significant, internationally diversified gold company with a market capitalisation in excess of \$24.5 billion. Last week Kinross Gold Corporation announced its intention to acquire Red Back Mining Inc for US\$7.1 billion. The coal sector has seen a torrent of corporate deals in recent times. Last week, Linc Energy announced the sale of its Galilee Coal Tenement for \$3 billion, comprising cash of \$500 million and an indexed royalty of \$2 per tonne. Nathan Tinkler's Aston Resources which purchased the Maules Creek Coal Project from Rio Tinto last week announced it was proceeding with an initial public offering after initially receiving a luke-warm reception from investors and subsequently needing to be re-priced. In July, Centennial Coal received a takeover offer by Banpu plc at \$6.20 per share for all of its shares. Earlier in the year Macarthur Coal was the subject of takeover offers by Peabody Energy Corporation and New Hope Corporation.

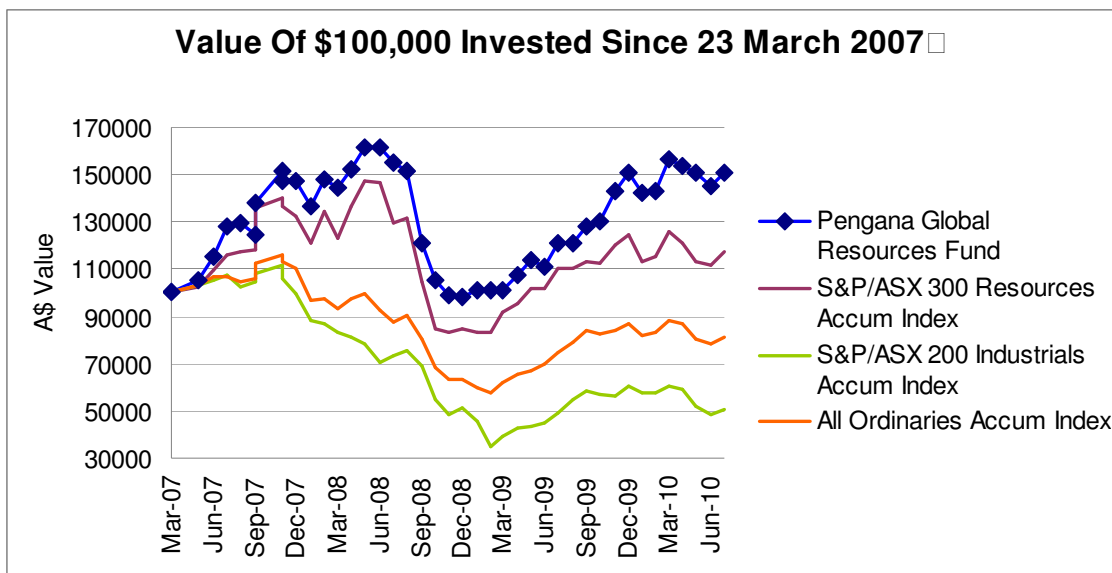
Resources Relative to the Australian Market

The table and chart below may be a surprise for some investors. There is no doubting the share prices of resource companies can be volatile. However it is worth putting the volatility and absolute performance of the resources market in context. The table below provides some statistics for the Australian Resource and Industrial sectors from January 2001 to July 2010³.

Jan 2001 to July 2010	Annualised Return	Annualised Standard Deviation	Maximum Drawdown	Sharpe Ratio (Rfr -5%)
S&P/ASX 300 Resources Accumulation Index	17.5%	21.4%	-43.4%	0.6
S&P/ASX 200 Industrials Accumulation Index	3.6%	19.1%	-65.9%	0.0

Although the volatility of returns is slightly higher for Resources rather than Industrials, this is more that adequately compensated for by the significantly higher performance, resulting in a far superior Sharpe Ratio³. In addition the maximum drawdown, a measure of absolute risk, is much lower for the Resources sector.

Over the period since the Fund's inception on 23 March 2007, the Resource sector has outperformed the Industrials sector with lower volatility³. Also worth noting is the strong outperformance of the Australian Resources sector by the Pengana Global Resources Fund ("PGRF") over the same time frame, something that most of our competitors have failed to do³. The Fund has achieved this with lower than market risk.



Source: IRESS, Pengana Capital

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However, in many personally and professionally managed portfolios (by investment generalists), investors are underweight or inadequately represented in Resources as they are seen to be “risky.” Yet, over the past three and a quarter years a portfolio tilt to Australian Industrials has destroyed value for Investors. Furthermore, over this “testing” time, the Industrial sector has underperformed the Resources sector despite government stimulus spending on: infrastructure, residential construction, the consumer, healthcare and guaranteeing personal bank holdings, while conversely proposing to lift the tax impost on the Resources industry. Which industry here is truly most defensive?

For more information on the Pengana Global Resources Fund and how to invest, please visit:

www.pengana.com/investment-funds/global-resources-fund

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