

# Pengana Australian Equities Core Fund

## July 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.

**An important feature for this month was the payment of the annual distribution to unit holders. In summary it highlighted the tax efficient nature of the satisfactory returns for the year.**

### Fund Features

<b>Application Price at Month End</b>	A\$1.1645	<b>Redemption Price at Month End</b>	A\$1.1587
<b>Style</b>	Fundamental	<b>FUM at Month End</b>	A\$15.9m
<b>Investors</b>	Wholesale Clients only	<b>Management Fees</b> <sup>2</sup>	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</b> <sup>2</sup> (quarterly)	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%	-0.2%	-4.0%	-2.5%	<b>12.5%</b>
2010/11	5.1%												<b>5.1%</b>

The Fund's return for July was a satisfactory 5.1%<sup>3</sup> after all fees and cost. By way of comparison the Australian All Ordinaries was up 4.2% for the month and the prevailing cash rate during February was 0.4%.

**For the 25 months since inception the Fund has protected capital and provided investors with a satisfactory total return of 21.7% (annualised 9.9%) versus the 8.9% cash rate (4.2% annualised) and the negative market return generated by the Australian All Ordinaries of -7.7% (-3.8% annualised).**

As at the 31<sup>st</sup> of July, the cash position of the Fund's NTA stands at 19%. 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 Mitchell Communications, Westpac Bank, McMillan Shakespeare, Downer Group and CBA. The only significant detractor was Aquarius Platinum. The Fund took advantage of ongoing negative sentiment at the beginning of the month to acquire two new holdings; The Seven Group (essentially an Australian and Chinese Caterpillar franchise holder) and Downer Group. The latter was disposed of after rallying 40% off its purchase price. Similarly, the Fund's recently acquired holding in Duet was sold after its share price moved significantly above our assessment of fair value. Substantial additions to existing holdings included Ramsay Healthcare and ANZ Bank.

As at 31<sup>st</sup> July 2010 the top five holdings by value in the Fund were: Westpac, NIB Holdings, CBA, McMillan Shakespeare and News Corporation.

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

	Pengana Core	Cash Rate	All Ordinaries
<b>1 Month</b>	5.1%	0.4%	4.2%
<b>3 Months</b>	-1.7%	1.1%	-6.2%
<b>6 Months</b>	2.7%	2.0%	-0.1%
<b>12 Months</b>	14.3%	3.7%	10.2%
<b>25 Months since Inception</b>	<b>21.7%</b>	<b>8.9%</b>	<b>-7.7%</b>
<b>Annualised return Inception</b>	<b>9.9%</b>	<b>4.2%</b>	<b>-3.8%</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 Managers' 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 rebounded strongly during July (4.2%) as investors' risk appetite partially returned. This was evident as share gains were led by the more cyclical sectors including Industrials (+7%), Financials (+7%) and Materials (+5%). At the other end of the spectrum both in performance and generally defensive characteristics were Information Technology (-4%), Telcos (-1%) and Healthcare (+1%).

One of the ongoing difficulties associated with offshore flows into (and out of) our market is the fact that global investors are treating the resilience of the Australian economy (and financial systems) with high levels of cynicism. Given the ongoing structural challenges in their home economies and the risks associated with sustaining the current levels of Chinese economic growth, any signs of potential weakness in our economy provide a focal point for selling pressure. The most closely watched indicators in the domestic economy include: The sustainability of residential property market prices, the ability of the big four banks to fund their loan books offshore and the iron ore spot price.

#### Investment Outlook

The medium term economic outlook for OECD Group countries remains subdued. However the robust GDP growth forecasts for the emerging economies including China, India, Brazil and most of South East Asia stands in sharp contrast. The ability of these countries to sustain regional growth without the larger developed economies (the much discussed "decoupling effect") represents a key investment variable for Australia. Concrete evidence of Australia's competitive advantage in providing significant quantities of high quality, low cost **coal** and **iron ore**, (with **wheat** potentially bolstering FY11) to these "growth markets" was provided by the recent released June trade surplus.

These positive factors continue to drive the underlying domestic economy on an expansionary path assisted by: a stable financial system, unemployment levels which continue to defy pessimistic expectations and above trend population growth. **However, the hangover from last year's stimulus and its impact on this quarter's retail sales is highlighting the need for caution.**

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.

**An example of this investment philosophy is represented by the Fund's large holding in McMillan Shakespeare. As a provider of independent salary packaging services the business model incorporates a large pool of upfront cash payments for disbursement, negating the need for any working capital (no stock or debtors). The recent acquisition of a significant leasing business (at a very attractive price) represents a sensible addition on many levels including broadening the group's product offering, increasing the customer base and diversifying the earnings streams. Consequently the combination of an excellent management team overseeing a robust and resilient set of earnings streams is well placed to generate an attractive cash return to shareholders.**

Other examples of this can be found in several defensive companies with competent management, dominant market shares, pricing power and robust balance sheets. Lower share prices in a weak equity market provide more attractive entry points for the Fund which is focussing on after tax cash earnings yields.

### Contact Details

Pengana Capital Limited • Level 29, 20 Bond Street, Sydney, NSW 2000, Australia • T +61 2 8524 9900 • F +61 2 8524 9901  
ABN 30 103 800 568, AFSL 226566

For further information, please visit our website at [www.pengana.com](http://www.pengana.com) or contact:

<b>Private Clients:</b>	Gale Ruttanaphon	+61 2 8524 9918	<a href="mailto:gale.ruttanaphon@pengana.com">gale.ruttanaphon@pengana.com</a>
	Tom Curtis	+61 2 8524 9986	<a href="mailto:tom.curtis@pengana.com">tom.curtis@pengana.com</a>
	Juliet Dunworth	+61 2 8524 9984	<a href="mailto:juliet.dunworth@pengana.com">juliet.dunworth@pengana.com</a>
<b>Advisors:</b>	Justin Brooks	+61 3 8663 7906	<a href="mailto:justin.brooks@pengana.com">justin.brooks@pengana.com</a>