

# Pengana Asian Equities Fund (Onshore) September 2010 Update



1 of 6

## Pengana Asian Equities Fund (Onshore)

The Pengana Asian Equities Fund (Onshore) (the "Fund") provides investors with equity exposure to companies within the Asia Pacific region. The Fund is managed out of Sydney, Australia. The Fund utilises a core strategy of being both long and short securities in order to reduce volatility and generate stable long-term absolute returns.

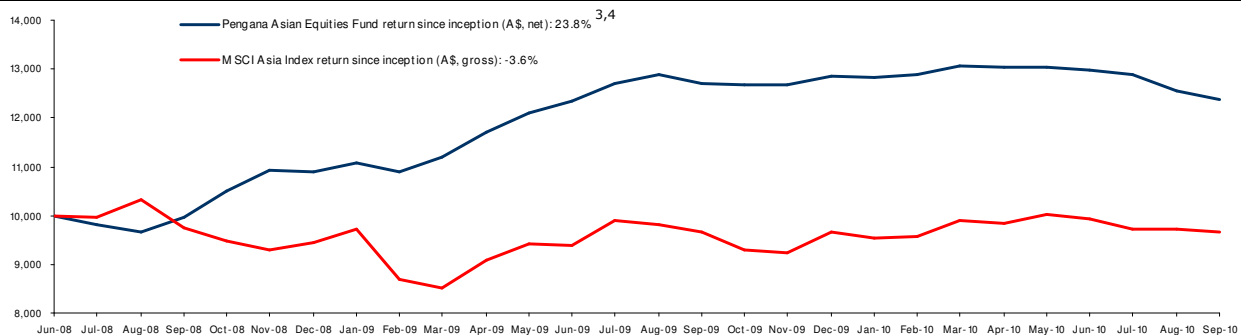
## Fund Features

<b>Style</b>	Long/Short Equity	<b>Management Fees <sup>1</sup> (monthly)</b>	1.54% p.a.
<b>Comparative Benchmark</b>	MSCI AC Asia Index	<b>Performance Fees <sup>1</sup> (semi-annually)</b>	20.5% of any increase in Net Asset Value subject to RBA target cash rate hurdle
<b>Investors</b>	Open	<b>AUM at Month End</b>	A\$13.8m
<b>Minimum Initial Investment</b>	A\$20,000	<b>Application Price at Month End</b>	A\$1.0002
<b>Inception Date</b>	01 July 2008 <sup>2,4</sup>	<b>Redemption Price at Month End</b>	A\$0.9952

## Fund Commentary

### Fund Performance (A\$, %, net of fees) <sup>3,4</sup>

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2010	-0.1	0.3	1.6	-0.3	-0.2	-0.4	-0.5	-2.6	-1.4				<b>-3.6%</b>
2009	1.4	-1.5	2.7	4.6 <sup>4</sup>	3.5	2.0	3.0	1.2	-1.3	-0.2	-0.1	1.3	<b>17.7%</b>
2008							-2.0	-1.5	3.3	5.4	4.1	-0.2	<b>9.1%</b>
MSCI AC Asia Index (A\$, %)													
2010	-1.0	0.1	3.5	-0.5	1.8	-0.8	-2.3	0.0	-0.7				<b>0.0%</b>
2009	2.8	-10.5	-1.8	6.6	3.6	-0.3	5.3	-0.9	-1.5	-3.8	-0.5	4.4	<b>2.1%</b>
2008							-0.3	3.5	-5.6	-2.8	-1.8	1.6	<b>-5.6%</b>



<sup>1</sup> All percentages include GST net of reduced input tax credits. Please refer to the PDS for a more detailed explanation.

<sup>2</sup> On 26 August 2009 the Fund became a registered scheme, with a PDS. Identification codes for the Fund are: ARSN: 138 943 709; APiR: PCL 0002AU

<sup>3</sup> Net performance, after all fees and charges, and assuming reinvestment of all distributions. Past performance is not a reliable indicator of future performance.

<sup>4</sup> On 22 April 2009 the Fund expanded its investment universe from the Asia region to the Asia Pacific region.

# Pengana Asian Equities Fund (Onshore) September 2010 Update



2 of 6

	Fund Features since Inception	Index Features since Inception
Annualized Return	10.0%	-1.6%
Annualized Volatility	7.4%	12.2%
Sharpe Ratio <sup>5</sup>	0.7	-0.5
Maximum Drawdown <sup>6</sup>	-5.3%	-17.3%
Max. Recovery Period <sup>7</sup>	1 months + <sup>8</sup>	18 months + <sup>8</sup>
Best Monthly Return	5.4%	6.6%
Worst Monthly Return	-2.6%	-10.5%
% of Up Months	48%	37%
Correlation to Index	0.23	

## Summary

- Global financial markets continued to see so-called 'risk on, risk off' trading orientated behaviour, performing strongly for the month after a sharp sell-off in August. The Fund's equity portfolio produced strong returns but the sharp appreciation of the Australian Dollar against regional currencies offset the gains.
- The Australian Dollar's rising correlation with regional equities markets, currently above 90% compared to a ten-year-average of 60%, has created new challenges for using the currency as a hedging tool to reduce short-term volatility. However, we expect this relationship to gradually break down as the driver of China's future growth will shift from capital formation, as in the past decade, to consumption moving forward. This will slow demand growth for natural resources and materials, the main factor behind the recent link between the Australian Dollar and Asian equity markets. For comparison, in the 1990s, when Chinese demand for Australian resources was not a major market influence, the Australian Dollar's correlation with Asian equities was a mere 30%.
- During this quarter, two key events in the region are likely to determine regional equity market performance going forward: Japan's central bank policy meeting in early October and China's new Five Year Plan, to be formalised in mid-October. Specifically, the adoption of aggressive monetary easing by the Bank of Japan could trigger a reversal of currently underweight Japan positions by international investors. China's new economic agenda for the next five years is likely to focus on a re-balancing of its economy and the beneficiaries of economic growth, leading to an upward re-pricing of wealth generating factors such as labour, capital and natural resources. As all of these will attract a higher cost moving forward, we would avoid companies and industries that have until now benefited from government protection through allocation of cheap capital and subsidies, such as financials, steel and cement industries.
- Across the region, we focus on companies exposed to alternative energy as well as equipment manufacturing companies, while using the materials sector as a hedging source.

The Fund returned -1.4%<sup>3</sup> net of fees for September 2010, compared to the -0.7% return of the MSCI Asia Index. Since inception in July 2008, the Fund has returned 10.0% p.a.<sup>3,4</sup> net of fees, compared to the Index's -1.6% p.a. return.

Global equity markets continued to see so-called 'risk on, risk off' short-term focused trading orientated behaviour, and after a sharp sell-off in August, they rebounded strongly in September, fuelled by the belief

<sup>5</sup> Using 5% risk-free rate for Sharpe ratio

<sup>6</sup> The worst period of 'peak to valley' performance, regardless of whether or not the drawdown consisted of consecutive months of negative performance

<sup>7</sup> Time taken to eclipse prior peak following Maximum Drawdown

<sup>8</sup> Not yet returned to prior peak level

# Pengana Asian Equities Fund (Onshore)

## September 2010 Update



3 of 6

that the US central bank will soon start its government bond purchase program to support its economy (dubbed 'Quantitative Easing 2'). This fuelled a liquidity-driven rally, particularly in emerging market assets, including government debt, equities and currencies, as the US Dollar fell sharply against all major currencies. An interesting feature of the month's currency markets was the sharp appreciation of growth currencies in developed markets, including the Australian Dollar, the Euro and the British Pound, which appreciated on average about 8% against the US Dollar. On the other hand, the defensive currencies in developed markets, such as the Swiss Franc and the Japanese Yen, as well as ASEAN country currencies underperformed, returning about 3% on average against the US Dollar. Some of the underperformance can be explained by government interventions such as in the case of the Yen, whose upside was capped by the Japanese government's Yen selling intervention to stabilise its sharp appreciation in previous months. However, the underperformance of the ASEAN country currencies, major beneficiaries of the US Dollar's weakness year-to-date, is of note. This may provide a better indication of the global growth outlook, particularly in developed countries, as the Euro's strong performance was achieved in the midst of sovereign credit concerns around Ireland's bank bail-out. The positive currency outlook implied by the Euro's resilience, particularly if followed up with better economic data from the US, may lead to a reversal of the emerging markets' recent outperformance. This in turn will lead to an abrupt adjustment of return expectations and trigger short-term volatility. Hong Kong and the ASEAN markets are most exposed to such risk, while North Asia such as China, Taiwan, South Korea and Japan are likely to benefit most from a global economic recovery. For that reason, we prefer North Asian equities relative to South East Asian equities.

The Fund's equity portfolio performed strongly in local currency terms, returning 2.6% for the month, compared to 6.5% by the MSCI Asia Index, helped by our exposure in technology and industrials. Solar power companies in China such as Suntech Power, one of China's largest solar cell and module manufacturers, and Comtec Solar, a major solar wafer manufacturer, were among the best performers. However, some of the equity performance was offset by our short positions in the material sector, particularly in Chinese steel and cement companies, which were used to hedge some market risks. These companies are listed in Hong Kong, which, through its pegged currency, benefited from a US Dollar weakness induced liquidity boost, and their high beta led to strong performance during market rallies. In contrast, their China A-market listed counterparts, underperformed.

As the Fund was unhedged with full exposure to local currencies, the sharp appreciation of the Australian Dollar against regional currencies saw its currency exposure returning -3.9%, compared to the Index's -6.7%. The Australian Dollar's rising correlation with regional equity markets, which has increased to over 90% this year from its ten-year-average of just above 60%, has created new challenges for investing in regional equities. Currently, the management of both equity and currency exposure requires a more active approach if the Australian Dollar is to be used as a tool to hedge against short-term volatility. However, the current close relationship between the Australian Dollar and Asian equities markets, even if persisting short-term because of low US interest rates, is likely to break down gradually. With China's growth in coming years likely to see a shift from capital formation as a main driver, as was the case over the last ten years, to consumption, growth in demand for energy and natural resources will slow, negatively impacting Australia's main economic engine. In the 1990s, the Australian Dollar's correlation with Asian equity markets was about 30%. In the 2000s, when fixed asset investment became the main driver of China's growth (and demand for resources increased), it rose to 60%. While the Fund remains broadly un-hedged, we continue to monitor the impact brought by currency movement due to market momentum in the short term with great care.

During the month, we reduced some of the exposure in the financial sector but kept most of the tech and industrial exposure unchanged. We increased our focus on energy, in particular alternative energy related areas, initiating some new positions in companies exposed to solar power, LED and nuclear power industries as we expect China's new Five Year Plan, due to be announced by mid-October, to focus on energy efficiency and carbon emission reduction.

# Pengana Asian Equities Fund (Onshore) September 2010 Update



4 of 6

We have also raised our investment in China's industrial equipment companies as we expect a shift from investment in hard infrastructure (such as airports, ports, toll roads and railways) to more operational areas such as the control systems that manage and monitor this infrastructure. One of the beneficiaries of such a shift is US-listed Hollysys Automation Technology, one of China's major control equipment manufacturers and a supplier of railway signal monitoring systems. In addition to having a dominant market share in signal control systems for metropolitan subway systems, it also supplies control systems to one of China's major nuclear power projects in Guangdong. Currently trading at 13x expected earnings and 2x book value, we believe its growth prospects have been underestimated. In comparison, Anhui Conch, China's largest cement company, is currently trading at 18x expected earnings and 2.8x book value. Other new positions include China High Precision Automation Group, another control equipment company. The company supplies petrochemical companies, and competes directly with Europe's ABB and US firm Emerson Electric. It is also the world's largest watch movement manufacturer, after taking market share from Seiko Epson and Citizen in Japan. Its valuation is attractive at 12x expected earnings and 2.2x book value.

Top Five Performers	Bottom Five Performers
SUNTECH POWER (China, Long)	DONGFENG MOTOR (China, Short)
QINGLING MOTOR (China, Long)	CHINA NATL BDG (China, Short)
NSK (Japan, Long)	ANGANG STEEL (China, Short)
MITSUBISHI ESTATE (Japan, Long)	NOBLE GROUP (Singapore, Short)
SWIRE PACIFIC 'A' (Hong Kong, Long)	HYSAN DEVELOPMENT (China, Short)

## Market Outlook

As we are entering the last quarter of 2010, investors are still dealing with uncertainty about the US economic recovery and the impact of the de-leveraging process on consumers in developed countries. While this uncertainty is unlikely to be addressed immediately and in a straight forward fashion, the risk of the US falling into another recession appears slim, taking into account the improvement shown by the latest economic data. For the Asian region, however, there are two events in October that will give an indication of how regional financial markets and economies will perform in the short to medium term, and more importantly, how the Australian economy, with its heavy dependence on the resource sector, will be impacted.

Early October, the Bank of Japan will hold its policy meeting to decide how to fight deflation. Local media report that the meeting is likely to see the discussion of aggressive quantitative easing, including the purchase of short-term government bonds. If implemented, this would supply ample liquidity to the system and reduce the upward pressure on its currency, the main drag on the economy and corporate earnings. As market expectations of such a policy shift are low, any sign of impending action could trigger a reversal in current underweight Japan positions by international investors.

China will announce its 12<sup>th</sup> Five Year Plan at the conclusion of the central government committee gathering on the 14<sup>th</sup> and 15<sup>th</sup> of October. The Plan will set policy guidance for the country's economic development from 2011 to 2015. Many international investors are sceptical about the determination of China to implement the Plan's expected focus on cutting energy consumption and carbon emission. However, we are mindful of the risk of under-estimating China's will to push for a new agenda for its economic development as the government is facing pressure to re-balance the economy in order to achieve social stability.

In the last ten years, a period during which China generated its highest growth in decades, households reaped little benefit from the progress made, with their GDP income share falling to 42% in 2009 from 49%

# Pengana Asian Equities Fund (Onshore)

## September 2010 Update



5 of 6

in 1999. On the other hand, government and corporate segments benefited most, as both saw their share of GDP rise substantially in the same period: government fiscal revenue from 14% to 20% and corporate profits from 3% to 9% for the same period<sup>9</sup>. The oversupply of low-cost and low-skill workers over the past decade explains some of the corporate sector's progress, but the government's efforts to boost the global competitiveness for companies, particularly state-owned-enterprises (SOEs) by stripping many of their social liabilities also contributed to their increasing profitability. In order to support the export sector, which required sufficient infrastructure, government spending also concentrated on building hard infrastructure, such as roads and airports, rather than developing social security. All of these measures benefited China's companies and its manufacturing sector (as well as providing Western consumers with cheaper and better consumer goods), but disadvantaged Chinese consumers (which saw slow wage growth) and Western manufacturing companies (who lost market share to Chinese manufacturers).

However, as companies have become sufficiently competitive and profitable, and infrastructure requirements have largely been met, the focus is now shifting to a re-balancing of the economy and a re-distribution of wealth in order to achieve social stability. Going forward, we are likely to see more government spending on social security, in the form of building a social safety net and a healthcare system, with the corporate sector having to take on more social responsibilities and paying higher labour costs. This will in turn see household income as a share of GDP rise again.

On the policy front, we will focus on the re-pricing of wealth generating factors such as labour, capital and natural resources. Over the last decade, Chinese companies have achieved high growth and profitability through low cost of labour, capital and resources. Favourable demographics created an ample supply of low cost labour and induced investment in low end manufacturing for export, thus producing strong growth for the country. The cost of capital was set at an artificially low level as the government controlled deposit and lending rates to avoid competition between major banks. As a result, these banks enjoyed stable credit spreads and cheap capital was channelled to industries designated as strategic growth engines by the government, typically SOEs. Going forward, as the government liberalises the interest rate markets, allowing market mechanisms to set interest rates, and developing the corporate bond market, the financial industry companies will see increased competition and many risk losing previously guaranteed business, such as lending to large SOEs.

In order to support the expansion of large industrial companies, the government offered subsidies for material and utility consumption and at the same time controlled the pricing of most energy sources. To enforce energy efficiency, government has started to lift these subsidies and is gradually liberalising the utility pricing system. This will lead to an increase in material and utility costs for many heavy industries such as steel, cement, paper and non-ferrous metals.

While China's emergence over the last ten years benefited the resources sector, while increasing competition for developed world manufacturers, the country's new stage of development (five to ten years) could produce the opposite effect. We focus our stock selection on less labour, capital and resources intensive industries in China and avoid those that have, until now, enjoyed government protection, either through cheap capital or resources subsidies. We favour the technology and service sectors but avoid financials and materials. It remains to be seen whether Japan will benefit from China's new direction, after having suffered in the past from the emergence of China's manufacturing industry. We are monitoring closely whether Japan will benefit from the need of China's manufacturing companies to move up the value chain by investing in high-end manufacturing equipment and upgrading their production lines. However, above all, **energy efficiency** is likely to be the key investment theme for the region in the short to medium term.

<sup>9</sup> Source: Citigroup

# Pengana Asian Equities Fund (Onshore) September 2010 Update



6 of 6

<b>Exposure by Sector</b>	<b>Gross</b>	<b>Net</b>	<b>Exposure by Country</b>	<b>Gross</b>	<b>Net</b>
<b>Growth Sectors</b>			HK & China	58%	9%
Energy & Materials	12%	-8%	Taiwan	3%	3%
Ind., Con. Discretionary & Tech	65%	50%	South Korea	3%	3%
Financial & Real Estate	31%	1%	Singapore	11%	-7%
<b>Defensive Sectors</b>			EM ASEAN	0%	0%
Con. Staples & Healthcare	0%	0%	Japan	35%	31%
Telecom & Utilities	4%	4%	Australia	5%	5%
Futures	4%	-4%	<b>Equities</b>	<b>116%</b>	<b>44%</b>
<b>Total</b>	<b>116%</b>	<b>44%</b>			

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