

Pengana Emerging Companies Fund September 2010 Quarterly Review



Australian Equities - Small Caps

1 of 4

Fund Performance

Net performance for periods ending 30 September 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	14.1%	3.9%	16.1%	-3.8%	12.8%	15.4%
S&P/ASX Small Industrials Acc Index ³	12.6%	-1.8%	-1.3%	-13.9%	-1.5%	1.5%
Outperformance	1.5%	5.7%	17.4%	10.1%	14.3%	13.9%
S&P/ASX Small Ordinaries Acc Index	16.8%	3.3%	6.6%	-9.5%	3.4%	6.4%
Outperformance	-2.8%	0.7%	9.5%	5.7%	9.4%	9.0%

Fund Commentary

The Fund rose 14.1%¹ over the September quarter, outperforming the Small Industrials Index by 1.5%¹ but underperforming the Small Ordinaries Index by 2.8%¹ due to the very strong rally in resources stocks which we do not invest in. **For the 12 months to September, the Fund returned 16.1%¹ (after fees), which was 17.4%¹ above the Small Industrials Index and 9.5%¹ above the Small Ordinaries Index.**

During the September quarter, global markets recovered strongly following the volatility in prior months. Again, global economic issues dominated markets. Fears of a double dip recession in the US faded, and the US Treasury's indication of further liquidity enhancements ("quantitative easing") saw confidence return. European economies had dominated headlines in April/May, however these issues have somewhat receded from investor's attention. China also continued to post strong economic data which allayed fears of a slowdown.

In this environment, it is not surprising to see resources stock outperform in the short term as commodity prices are so closely tied to global economic growth expectations. Many of the stocks which we own benefit from a stronger resources sector, without taking on the direct commodity price exposure. During the quarter some of these stocks were our best performers.

Results season in August was largely positive with many of our favourite stocks enjoying strong rallies after solid profits. This was especially true of **MacMillan Shakespeare, M2 Telecommunications, Mineral Resources, REA Group, and Slater & Gordon.**

The domestic economy is in reasonably strong shape, however it is heavily reliant on China's ongoing growth. The outcomes with the US and European economies are less certain, however given the amount of bad news already absorbed, we believe investors are wary enough already of the poor situation.

Equities remain out of favour globally. US fund flow data shows an exodus from equities to bonds accelerating in FY10 (the financial year just ended). The exact reverse happened in the late 1990's when funds flows into equities happened *after* the bull run, which was exactly the worst time to be allocating to equities. While difficult to draw a definitive conclusion, contrarian investors will draw confidence from this.

While many individual investors are averse to the current volatility, longer term investors are clearly seeing an opportunity. Takeover activity has increased dramatically, with over 15 takeover offers in industrial smallcaps since May. This indicates that long term investors (ie companies and private equity funds) see great value in the sector, are well funded, and are confident enough to take the plunge. We believe this will continue as most investors remain very short term in their thoughts.

Our portfolio is still heavily skewed towards stocks which can grow irrespective of the economic outlook. The domestic smallcap sector remains relatively uncrowded, and the opportunities for stock pickers are strong given the modest valuations.

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.

Pengana Emerging Companies Fund

September 2010 Quarterly Review



Recent portfolio activity

New stocks added to the portfolio over the quarter included **Amcom** and **Southern Cross Media**. In addition we increased our weighting in **Breville**, **Kathmandu**, and **Slater & Gordon**. We reduced our holdings in **ARP Corp**, **Flight Centre**, and **Matrix Composites**, due to share price strength.

Amcom is a telecommunications provider offering fibre connectivity to corporate customers in Perth, Adelaide and Darwin. We are attracted to the recurring nature of the revenue, and its ability to grow as penetration rises. **Southern Cross Media** owns a range of high quality regional TV and radio assets which should continue to enjoy a recovery in media spending. We believe the stock is particularly cheap as many investors have not returned since the change of management and rationalisation of loss making divisions.

Key stock moves during the quarter

Key successes in the portfolio during the period included **Matrix Composites** (up 88%), **McMillan Shakespeare** (up 62%), **M2 Communications** (up 38%), **Mineral Resources** (up 32%), and **Southern Cross Media** (up 30%). Detractors included **Thinksmart** (down 32%), **Paperlinx** (down 29%) and **Resmed** (down 6.5%).

Matrix Composites, **McMillan Shakespeare**, **M2 Telecommunications** and **Mineral Resources** all posted strong results and look to have very strong growth outlook. **Southern Cross Media** is a relatively new position for the fund (see above) and also posted strong results.

Thinksmart surprised the market with a discounted capital raising to fund its growth in the UK. While this pressured the shareprice in the short term, the potential upside over the medium term is very strong, hence we increased our holding at the low price. **Paperlinx** remains friendless in the short term due to its exposure to the European economies and negative impact from currency moves. While a small position for us, we believe this stock is priced off unsustainably low earnings and should conditions stabilise the upside to the share price is considerable. **Resmed** is priced in USD therefore fell as the A\$ rose.

Outlook

While the recent market strength is encouraging, the volatility so far in 2010 reminds us that changes in short term economic data still have major effects on markets. A recovery in the US and European economies is far from assured, hence taking a strong view is still fraught with risk.

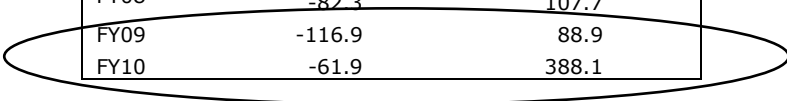
Acknowledging these risks it is worthwhile pondering "who is left to sell equities if the data turns negative?" Sentiment towards equities is already poor, and investors' remain under-exposed to equities. The funds flow data in the US is a stark reminder that many investors sell assets *after* they have fallen, and buy them *after* they have risen. The table below shows the net flow of funds over the past six years in equities and bonds funds.

The FY10 number show investors still abandoning equities, and chasing the relative "safety" of bonds in enormous numbers following three strong years of performance in bond funds, and with very low interest rates.

Table 1 - US fund flows (US\$bn)

	US Equities	US bonds
FY05	54.1	27.3
FY06	29.5	36.7
FY07	-8.5	127.3
FY08	-82.3	107.7
FY09	-116.9	88.9
FY10	-61.9	388.1

Investors abandon shares after the collapse and chase bonds after three strong years.



Source Goldman Sachs

Pengana Emerging Companies Fund

September 2010 Quarterly Review



3 of 4

	US Equities	US bonds
FY98	149.3	74.6
FY99	176.3	-5.5
FY00	259.6	-49.7
FY01	53.7	-87.7
FY02	-24.7	140.3

Investors chase shares into the tech boom (and bust in early 2000) and abandon bonds due to "boring" returns. Back to bonds after the tech bust.

Source Goldman Sachs

While individuals have left equities in droves, the dramatic increase in corporate activity is showing the longer term investors such as companies and private equity funds are prepared to look through the current volatility. In the domestic smallcap industrial sector alone there have been more than 15 takeover offers made since May (we would usually assume around 5-10 per annum!). Many companies raised capital during 2009 to repair their balance sheet (or "just in case"), with previously cautious boardrooms only now prepared to actually deploy this capital to grow. Banks are also prepared to lend again for the right deal, hence this takeover activity is likely to continue until the value gap is closed.

The Australian economy is well positioned

Domestically, our economy is in relatively good shape, however the outlook differs depending on the sector. Approximately 35% of our portfolio is positioned in stocks whose earnings are reasonably dependent on the domestic economy, and the points below summarise our views on some of the relevant sectors:

- **Retail looks patchy** – following last year's stimulus and a series of interest rate increases, retail remains challenging. This has already seen many share prices collapse; hence we have recently increased our exposure where the current weakness is more than reflected in the share price (eg **Fantastic Furniture**).
- **Housing activity may wane** – following a boost from the first home owners' grant and low interest rates through 2009, the housing data of late is showing weakness due to higher interest rates and prohibitive development costs. We believe earnings will be under pressure into 2011.
- **Corporate spending should continue to recover** – boardroom confidence has increased dramatically over the past 12 months, hence decisions approving staff hires, IT projects, factory expansions, etc should come through and feed into the staffing, IT and other service sectors.
- **Mining development activity is increasing dramatically** – with major expansions in coal, iron ore, natural gas and coal seam gas all planned over the coming 3-5 years. Uncertainty around the proposed taxation changes saw many projects put on hold in May, however recent feedback suggests most are coming back on stream. We believe this is yet to be reflected in selected stocks in the mining services sector.
- **Infrastructure spending should increase** – the increasing population has highlighted areas where government has under-spent on infrastructure such as power, water, public transport, roads etc. We expect these sectors to receive funding for expansion over the coming 3-5 years.
- **The labour market is tightening** – as mining and infrastructure activity increases, and with unemployment already low at 5.1%, this places pressure on our labour pool. This will push the price of labour up, and will also benefit staffing stocks through increased demand for temporary labour.
- **The A\$ changes the game** – the dramatic rise recently in the A\$ is negative for exporters and those companies subject to import competition, and positive for importers. This will be a major theme over the coming AGM and reporting season.
- **China remains our single biggest risk** – any disruption to the Chinese economy has significant ramifications for Australia. Commodity prices, (hence the A\$) are heavily tied to Chinese demand, which remains strong, however difficult to forecast with pinpoint accuracy given the command nature of the Chinese economy.

We prefer to leave the majority of our portfolio in stocks which can maintain and grow earnings in any economic situation. We are encouraged that eight of our top ten holdings were able to grow earnings through 2008 and 2009 despite the GFC.

Pengana Emerging Companies Fund

September 2010 Quarterly Review



4 of 4

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 87 companies** and unlisted competitors of listed stocks. The table below shows the listed companies with which we had direct contact during the period.

Adelaide Brighton	Carsales.com	Infratil NZ	Oroton	Slater and Gordon
Alesco	Challenger Financial	IOOF	Pacific Brands	Southern Cross Media
Allmine	Coventry	Kathmandu	Paperlinx	Specialty Fashion Group
Ammcom	CSG Group	M2 Tele	Photon	Talent Two
APN News and Media	Customers	MACA	Probiotec	The Mac Services
Asciano	Diploma Group	Macquarie Telecom	Ramsey Healthcare	The Reject Shop
ASG Group	DKN Financial	Mastermind group	RCG Corp	Thinksmart
Ausdrill	Domino Pizza	Matrix Composite	Realestate.com	Toxfree
Ausenco	DWS Advanced	McMillan Shakespeare	Reckon	TPG Telecom
Aust Power and Gas	Fantastic Furniture	McPhersons	Redhill Education	Transfield Services
Austin Engineering	Flexirent	Miclyn Express	Resmed	VDM Group
Australian Edu Trust	Flight Centre	Mineral Resources	Retail Food Group	Vita Group
Automotive Holdings	G8 Education	MyATM	Ridley Corp	Wellcom Group
BigAir Group	Greencross	Navitas	RP Data	Wotif
Boom Logistics	GRG Int	Netcomm	Salmat	Xero NZ
Bradken	GUD Holdings	Norfolk group	Sedgman	
Breville	iiNet	NRW Holdings	Select Harvest	
Cardno	Industrea	Oakton	Silver Chef	

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	\$447m
Inception Date	1 November 2004	Application Price at Month End	A\$ 1.8981
Identification Code(s)	APIR PER0270AU ARSN 111 894 510	Redemption Price at Month End	A\$ 1.8867

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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.