

# Pengana Australian Equities Core Fund December 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 principally listed Australian securities. 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.

**Since inception the Fund has generated a 12.3% return per annum (net of all fees and costs), against a backdrop of low interest rates (4.3% pa RBA cash rate) and a flat share market (0.6% pa).**

## Fund Features

<b>Application Price at Month End</b>	A\$1.2771	<b>Redemption Price at Month End</b>	A\$1.2708
<b>Style</b>	Fundamental	<b>Current FUM Fund/Strategy</b>	A\$33.5m / A\$53.5m
<b>Investors</b>	Retail & Wholesale Clients	<b>Management Fees</b>	1.025% p.a. of NAV (including GST, net of RITC)
<b>Benchmark</b>	The average of the daily target Australian Cash Rate used by the RBA	<b>Performance Fees (quarterly)</b>	10.25% (including GST, net of RITC) 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\$20,000

## Fund Commentary

### Fund Performance (A\$, net of fees)<sup>2</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%	1.1%	3.6%	1.8%	-0.1%	3.0%							<b>15.2%</b>

The Fund generated a robust return of 3.0%<sup>2</sup> during December after all fees and costs. By way of comparison the Australian All Ordinaries was up 3.8% for the month and the prevailing cash rate during December was 0.4%.

**For the 30 months since inception the Fund has protected capital and provided investors with a robust total annualised return of 12.3% versus the cash rate (4.3% annualised) and the flat market return generated by the Australian All Ordinaries (0.6% annualised).**

As at the 31<sup>st</sup> of December, the cash portion of the Fund's NTA stood at **23%**. 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 included McMillan Shakespeare, CBA, Australian Power Company and Credit Corp. The larger detractors included BHP 6 month Put options (representing a capital protection strategy) and Westfield Retail Trust.

The Fund's significant additions to existing holdings included ANZ Bank, NIB Holdings, Australian Power Company and CBA. The Fund disposed of its holdings in Ramsay Healthcare.

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

### Net Returns to 31<sup>st</sup> December 2010<sup>2</sup>

	Pengana Core	Cash Rate	All Ordinaries
<b>1 Month</b>	3.0%	0.4%	3.8%
<b>3 Months</b>	4.8%	1.1%	5.3%
<b>6 Months</b>	15.2%	2.2%	14.5%
<b>1 Year</b>	8.6%	4.3%	3.3%
<b>2 years annualised</b>	<b>23.6%</b>	<b>3.8%</b>	<b>20.1%</b>
<b>Annualised return since inception</b>	<b>12.3%</b>	<b>4.3%</b>	<b>0.6%</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> 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 finished 2010 in style delivering 3.8% amidst strong company as most global indices generated mid single digit positive returns for the month of December. Information Technology (+7%); Materials (+7%) and Energy (+5%) were the strongest performing sectors while Telcos (-1%) and Reits (-0%) were the only negative sectors.

It is interesting to note that for the year ended 31<sup>st</sup> December 2010 the Australian Share market generated a return of 15.8% for US\$ investors, comfortably beating their home market return – the S&P500 returned 13%. This highlights the impact of the 14% movement in the A\$ and the importance of currency for global investors. Domestically there was a massive difference in contributions from the two major sectors - Materials (+10%) v Financials (-10%). We are pleased to report that the Fund's returns over this period were achieved without any direct investment in Resources.

### Investment Outlook

The medium term economic outlook for the OECD Group countries (appropriately grouped under the reference of "HICS" – Heavily Indebted Countries) remains subdued. However the robust GDP growth forecasts for the emerging economies (or "BRICs") including Brazil, Russia, India and China and most of South East Asia stand 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**, to these "growth markets" continues to be supported by a string of healthy trade surplus numbers. While Australians are certainly feeling wealthier at these record A\$ levels there are significant implications for the domestic economy.

**Domestic leaders and decision makers face the interesting challenge of how they apply the massive "Resource Dividend" in order to provide a non-cyclical enduring benefit to Australian citizens. Accordingly the Fund is actively pursuing investment opportunities that will be beneficiaries of this focus.** Another critical underlying investment theme remains the medium term structural wealth created by strong gainfully employed population growth.

The mining sector continues to absorb an increasing proportion of labour and other resources creating price pressures for other sectors of the domestic economy. The important export sectors of tourism and education have been negatively impacted. In addition we may be approaching the long anticipated tipping point for discretionary retailers. Due to a combination of limited competition, operating excellence and high input costs Australian retailers have been very successful in maintaining stable price points. However the recent surge in offshore based online retailers together with a sharp increase in the A\$ has raised the potential for a long period of structural gross margin pressure as retail price points move to more reasonable levels.

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 Commonwealth Bank, representing an exposure to the Australian banking oligopoly. The competent management team has demonstrated an ability to maintain and develop CBA's competitive advantages in the domestic residential mortgage market through scale, sustained leadership in customer deposits and technology platforms. While headwinds remain due to lacklustre credit growth, the company's strong national franchise is attractively priced at a high single digit after tax cash earnings yield.**

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.

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