

Pengana Emerging Companies Fund December 2010 Quarterly Review



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Australian Equities - Small Caps

Fund Performance

Net performance for periods ending 31 December 2010¹

	3 months	6 months	1 year	3 years p.a.	5 years p.a.	Since inception p.a. ²
Pengana Emerging Companies Fund	8.4%	23.6%	16.0%	-3.1%	13.8%	16.2%
S&P/ASX Small Industrials Acc Index³	5.5%	18.8%	2.2%	-11.2%	-0.9%	2.3%
Outperformance	2.9%	4.8%	13.9%	8.1%	14.7%	13.9%
S&P/ASX Small Ordinaries Acc Index	11.2%	29.9%	13.1%	-5.9%	5.5%	8.0%
Outperformance	-2.8%	-6.3%	3.0%	2.8%	8.3%	8.3%

Fund Commentary

The Fund rose 8.4%¹ over the December quarter, outperforming the Small Industrials Index by 2.9%¹ but underperforming the Small Ordinaries Index by 2.8%¹ due to the continued strength of resources stocks (which we do not invest in). Equity markets ended the year on a positive note by exhibiting their usual seasonal bias over December (the so-called "Santa Claus" rally) which saw the Small Ordinaries Index rising 7.1%. **For the 2010 calendar year the Fund returned 16.0%¹ (after fees), which was 13.9%¹ above the Small Industrials Index and 3.0%¹ above the Small Ordinaries Index.**

Over the year the Small Resources Accumulation Index rose 31% compared to only 2% for the Small Industrials Acc Index. Small resource stocks have continued to capture the imagination of investors (and speculators) as commodity prices soar in response to China's insatiable demand. Their relative performance is aptly evidenced by the fact that all top 10 stock performers in the Small Ordinaries index during 2010 were resource stocks. Whilst we don't invest directly in the resource companies themselves we do gain indirect exposure in the Fund to the China-led mining boom via holdings in lower risk industrial companies that service the mine owners.

A feature of the December quarter each year is the large number of company Annual General Meetings. These forums avail management the opportunity to update the market on how they are seeing trading conditions. It was perhaps surprising that equity markets performed as well as they did over the quarter in the face of the mostly negative and cautionary comments coming from these meetings. Some of the common themes from management were the difficulties being faced from project delays (as companies generally appear to be more cautious in committing to large capital expenditure programs than the past), reduced spending on discretionary items, a high \$A was causing greater import competition and reduced earnings being translated from overseas. Management also remains wary of the effect of rising interest rates and the patchy global economic recovery might have on their businesses.

As always, and regardless of market volatility, the single most important driver of performance remains stock picking. We firmly believe to unlock value in small caps there must be regular company contact, which is particularly critical to understand the risks surrounding the investment proposition. To this end we conducted over 300 company visits during 2010.

Recent portfolio activity

New stocks added to the portfolio over the quarter included **Boart Longyear**, **Programmed Group**, and **Australian Power and Gas Company**. In addition we increased our weighting in **Cardno**, **Slater & Gordon** and **Oroton Group**. Over the quarter we divested our holdings in **The Mac Services** (through the company being taken over), **ARB Corporation** and **The Reject Shop**.

Boart Longyear provides drilling services and products to the minerals industry, particularly to assist with their exploration programs. The company stands to benefit from a greater utilisation of its existing drill rig fleet and improved pricing over coming

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.

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years. **Programmed Group** is a diversified provider of maintenance and staffing services to both government and corporate customers across Australia and New Zealand. We purchased shares following a material slump in the share price as the company announced plans to restructure the company. **Australian Power and Gas Company (APK)** is an independent reseller of electricity and gas to retail customers in Vic, NSW and QLD. As a niche operator in the strongly growing deregulated energy market APK should exhibit strong profit growth for many years to come.

ARB Corporation was sold from the portfolio after a period of strong share price appreciation saw our target price reached. **The Reject Shop** was sold after the company issued a profit warning in December leading us to materially revise down our valuation thus triggering the sale.

Key stock moves during the quarter

Key successes in the portfolio during the period included **M2 Telecommunications** (up 26%), **Thorn Group** (up 35%), **Boart Longyear** (up 44%), and **Slater & Gordon** (up 22%). Detractors included **CSG** (down 16%), **VDM Group** (down 23%) and **Tower Australia** (up 68%).

Thorn Group reported a profit result over the quarter that was comfortably above analyst expectations leading to upgrades in earnings and valuations for the stock. **M2 Telecommunications** continued to perform well as analyst research coverage of the stock increases. **Boart Longyear** benefited from the flow on effect of strong commodity prices increasing investor expectations for mining companies to expand their exploration programs and thus demand for the company's drill rigs.

CSG's share price weakened after the market was spooked by AGM comments that one off legal costs from an unsuccessful legal case and start up costs from the Canon printing business would result in their being a stronger skew in earnings to the second half of the year, implying a soft first half result. With the company trading on a PE ratio of only 7.5 times 2011 earnings and owning very strong franchise businesses the stock remains a top 5 holding in the Fund. **VDM Group's** share price remains volatile as its prospects are highly leveraged to contract wins in the construction arm of its business. Whilst very few material contracts have recently been won we remain comfortable holding a small position given the company's high operating leverage and low debt levels. **Tower Australia** was recently bid for by the Japanese life insurance company Dai-ichi which announced a take over bid for the balance of the company it does not already own. Whilst the Fund did not own any shares in Tower Australia it does represent a relatively large weighting in the index and accordingly did weigh down relative performance.

Outlook

Following the release of economic data showing relatively benign growth in Australia analysts have begun to reign in their profit growth expectations for the 2011 financial year. In recent times we have seen a drift in business confidence and a slump in new home starts combined with weak consumer spending. Accordingly the Australian economy is entering 2011 at a lower rate of growth than many had expected. Whilst the China driven mining boom continues, for now, many other sectors are struggling under the weight of seven interest rate rises in just over a year and local manufactures are facing the brunt of a strong Australian dollar which is assisting overseas competitors gain a foothold into the Australian market.

In particular we expect the sectors of the market most at risk of disappointment will be contractors given the potential for project delays (only exacerbated by the recent wet weather across the East coast of Australia) and discretionary retailers that have had to face reduced consumer spending over the critical Christmas trading period following the Melbourne cup day interest rate hike.

That said investor's risk tolerance is increasing as many are becoming increasingly optimistic that the worst of the global economic woes have passed. The economic data coming out of the United States continues to improve, aided by the fiscal and monetary support provided by the US Government and the concerns surrounding Europe's sovereign debt issue appear to be diminishing.

We choose not to invest in the Resources sector

Our Fund continues to be conservatively managed so it does not invest in unprofitable companies, or those whose cashflows are too unpredictable to measure and thus value. Risk management at a stock level is a critical aspect of our stock selection process. This investment philosophy has steered us away from mining companies where profit outcomes are both volatile and often non existent.

Small Resource's index stocks have enjoyed a golden run since the GFC rising a staggering 155% from their lows of March 2009 to now be 10% above their pre GFC highs. In contrast the Small Industrial's index stocks are still 37% below their pre GFC peak. A lot of these gains can be attributed to speculators chasing the exciting blue sky prospects of small resource stocks without necessarily much regard for their intrinsic valuations. Since the market's low in March 2009 the large resource sector bell weathers of BHP and Woodside have seen their share prices rise by the relatively modest 55% and 22%, respectively, compared with the staggering 155% rise of the Small Resources Index. Of the top 10 resource stocks in the Small Ordinaries Index only 5 are generating a profit. With little apparent intrinsic valuation support any slowdown in China, which over the last few years has

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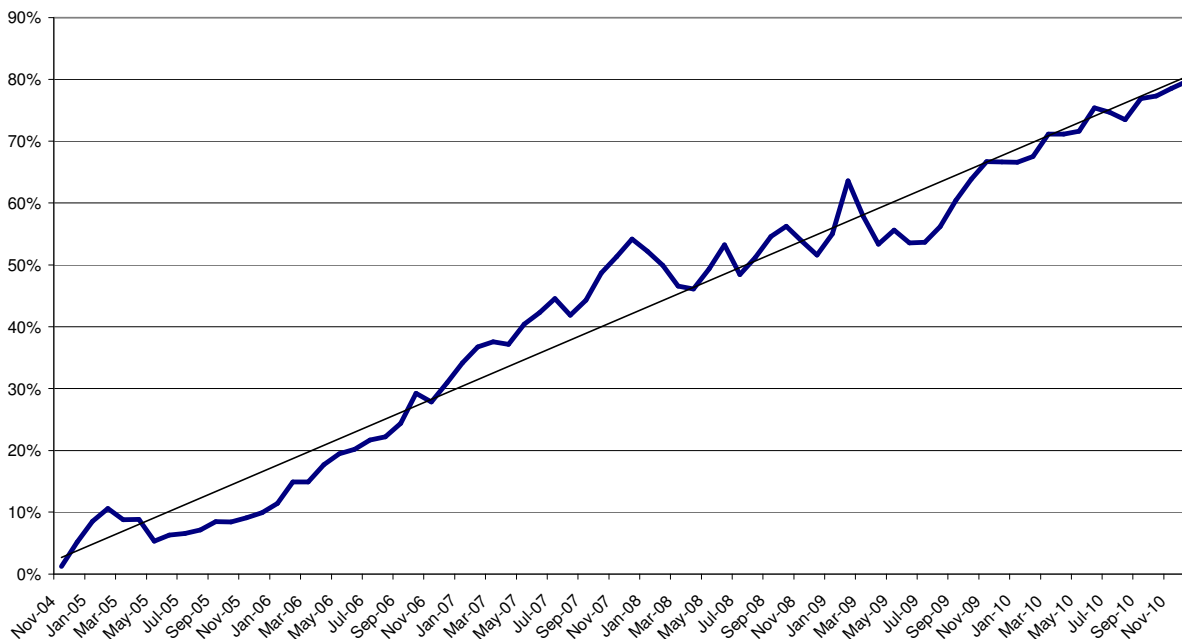


almost single-handedly driven base metal markets, is likely to see a sharp fall in these stock's share prices. Whilst Chinese economic growth will likely remain strong in the short term, markets are becoming increasingly concerned at the country's rising level of inflation, necessitating a tightening in monetary policy and inevitably a slow down in the economy.

When investing we believe it is important to stand by a philosophy and process of stock selection that has proven itself through all market cycles over time to add value. This approach has seen us consistently generate returns above benchmark without having to bear the very large investment risks of investing in small resource stocks. It is possible to gain access to excellent growth stocks without having to subject the portfolio to the risks of unknown commodity price movements and exploration programs of these mine owners. We are not of the view that we need to own resource companies simply because they represent a large part of the Small Ordinaries Index, this being a very arbitrary way to invest, but preferring to invest based on each stock's individual investment merits.

With the higher risk resource stocks removed the chart below helps illustrate the excess returns investors have enjoyed (assuming the reinvestment of distributions) in the Fund since inception when compared to the Small Industrials Acc index. We believe this to be a better barometer of returns given the risks being taken.

Cumulative Excess Return vs Small Industrials Index



Source: Management records and after all fees

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

APN News and Media	Coventry Group	Imdex	OOH Media	Skilled Education
ARB Corp	CSG	Invokecare	Oroton	Slater and Gordon
Ausdrill	CTM Travel	Legend Corp	Paperlinx	Snowball
Aust Power and Gas	DKN Financial	M2 Telecommunications	Patties Foods	Southern Cross Media
Australia Infrast Fund	DWS	Macquarie Atlas Roads	Platinum Asset Manage	Spotless
Boart Longyear	ERM Power	Mainfreight	Program Maintenance	Talent Two
Bradken	Finbar	Mastermind group	Redhill Education	The Mac Services
Breville	Fleetwood	Matrix Composite	Resource Equipment	Thorn Group
BT Invest Management	Flexirent	McMillan Shakespeare	Restaurant Brands	ToxFree Holdings
Candle	G8 Education	Michael Hill	Rock Building Society	VDM Group
Cardno	Gerard Lighting	Navitas	Salmat	Vocus
Chandler Macleod	Hastings Diversified	Neptune Marine	Service Stream	
Clover Corp	Hunter Hall	Norfolk Group	Sirtex	

Fund Description

The Pengana Emerging Companies Fund seeks to combine the skills of highly experienced small company investors (over 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 ⁴	20.5% of the performance above the Benchmark
Investors	Existing only	Fund raising	Maximum of 0.5% of the Benchmark capitalisation
Minimum Initial Investment Amount	A\$25,000 (direct)	FUM at Month End	\$515m
Inception Date	1 November 2004	Application Price at Month End	A\$ 2.0568
Identification Code(s)	APIR PER0270AU ARSN 111 894 510	Redemption Price at Month End	A\$ 2.0445

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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.