Pengana Emerging Companies Fund
March 2011 Quarterly Review

Australian Equities - Small Caps

Fund Performance

Net performance for periods ending 31 March 2011 [1]

	3 months	6 months	1 year	3 years p.a.	5 years p.a.	Since inception p.a.[2]
Pengana Emerging Companies Fund	4.1%	12.8%	17.3%	9.4%	11.7%	16.3%
S&P/ASX Small Industrials Acc Index [3]	2.2%	7.8%	5.8%	-3.2%	-2.1%	2.6%
Outperformance	**1.9%**	**5.0%**	**11.5%**	**12.5%**	**13.9%**	**13.7%**
S&P/ASX Small Ordinaries Acc Index	-1.2%	9.9%	13.5%	-0.9%	2.8%	7.4%
Outperformance	**5.3%**	**3.0%**	**3.8%**	**10.3%**	**8.9%**	**8.8%**

Fund Commentary

The Fund rose 4.1%[1] over the March quarter, outperforming the Small Industrials Index by 1.9% and the Small Ordinaries Index by 5.3%.

The market has proven very resilient given the spate of terrible natural disasters which have hit Australia, New Zealand and Japan over the quarter. In addition global equity markets have had to contend with continued political unrest in the Middle-East and the subsequent Western airstrikes against the Libyan government. Whilst the greatest cost of these events is the loss of human life and the increase in suffering they cause, there is no doubt they acted to slow the growth expectations for the economies of those countries directly affected. The Australian economy will be directly impacted by both the floods and the extent to which Japanese economic output is reduced by the Tsunami. Japan is an important trading partner, taking around 20% of Australia's goods exports each year. Equity markets brushed off the bad news with the broader ASX200 Accumulation index rising 3.2% over the quarter. However small and risky mining stocks did tend to underperform with the Small Resource Index falling 5.2% over the quarter.

The recently concluded profit reporting season demonstrated a mixed operating outlook for local small cap companies. One of the more interesting developments within the Australian economy is the imbalance between the strong mining sector and the weak household sector and the stresses and strains this is putting on various parts of the economy.

The outlook is generally favourable for small cap industrial stocks given their cyclical leverage to an improving domestic economy and their history of outperformance as investors' appetite for risk increases. On a valuation front small industrials are trading below their longer term average (based on Macquarie bank forecasts) yet are forecast to generate above average earnings growth over the next two years. With most small industrial companies having repaired their balance sheets we would expect an increasing level of corporate activity over the balance of 2011.

Recent portfolio activity

New stocks added to the portfolio over the quarter included **Skilled Engineering** and **Campbell Brothers**. In addition we increased our weighting in **Mainfreight NZ, Norfolk Group** and **Programmed Group**. Over the quarter we divested our holdings in **Resmed, Pacific Brands** and **RP Data**.

We recently participated in an equity raising by **Skilled Engineering.** With a recapitalised balance sheet the company is well placed to benefit from a strong labour market in the mining industry through its blue collar staffing business. **Campbell Brothers** is enjoying strong global demand for its mineral, environmental and coal analytical testing services. Management has demonstrated an ability to leverage off its scalable business model to deliver high incremental returns on capital expenditure.

[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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Key stock moves during the quarter

Key successes in the portfolio during the period included **FlexiGroup** (up 39%), **M2 Telecommunications** (up 30%), **Breville Group** (up 27%), and **Kathmandu** (up 25%). Detractors included **Southern Cross Broadcasting** (down 17%), **Paperlinx** (down 13%) and **Bradken** (down 11%).

Flexigroup, Breville and **Kathmandu** share prices rose after they released profit results above analyst expectations. **Flexigroup's** business has emerged unscathed from the GFC and is now seeing strong volume growth after successfully diversifying its consumer finance offering across different segments of the market. **Breville's** overseas ambitions to penetrate the large US kitchen appliance market appear to be gaining traction, with sales growth of around 30% enjoyed in the US for the six months to December. Overseas earnings now represent over half of Breville's profits. **Kathmandu** delivered profit growth of 32% in the half, helping to dispel some of the sceptics on the stock that had been questioning the company's profit outlook. We are attracted to the strength of the Kathmandu brand and the large number of stores they will roll out over the next 5 years. **M2 Telecommunications** was further rerated following the release of an ACCC determination that saw a reduction in the wholesale pricing charged by Telstra for various services.

Southern Cross Broadcasting was sold down after announcing a takeover bid for Austereo. The market remains concerned as to how the company will fund the acquisition and the strategic rationale for the acquisition. **Paperlinx's** share price continues to languish as the market focuses on the short term uncertainty of a new management team, soft European demand for paper and the rising Australian Dollar. Whilst visibility around the timing of a European recovery is challenging, inevitably it will occur, leading to a strong uplift in demand for the services of paper merchants. **Bradken** has weakened as it faces the dual headwinds of increased import competition in the rail division and the termination of a licencing agreement for the production of ESCO ground engaging tools for the mining industry. Even after allowing for these short term risks Bradken trades on a 2012 forecast Price Earnings ratio of around 11 times which we don't believe is excessive, given the company's proven management and linkages to the strongly performing mining industry.

Outlook

What the recent profit reporting season has shown is the continuing challenging environment that companies have to operate within during 2011. With the extreme volatility in exchange rates, overseas economic prospects, natural disasters and a hesitant Australian consumer, stock picking will be very important in the year to come. When analysing companies some of the key issues and themes we will be monitoring include:

- **The timing of the next interest rate rise** by the RBA. Stocks that stand to benefit from rising rates include McMillan Shakespeare and Flight Centre given their large cash balances.
- **The rise and rise of the $A**. The winners will be importers where competition is not so intense that the cost savings are competed away. Oroton, Kathmandu and Flight Centre stand to benefit.
- **Rising input costs**. The cotton price is up 170% since August 2010 and oil prices have risen more than 15% since the start of 2011. These increases raise earnings risk during the second half of 2011 for companies such as Pacific Brands and Virgin Blue.
- **Floods and cyclones**. Whilst many companies have acknowledged there will be disruptions to their businesses from these natural disasters it remains difficult to quantify. Companies affected include Retail Food Group and Reject Shop. Stocks that stand to benefit from the rebuild are Cardno and Thorn Group.
- **Labor shortages**. Whilst labor shortages in the mining industry in particular are not yet at critical levels the pipeline of tenders currently being released suggests that the crunch to industry capacity is likely to occur sometime in 2012 or 2013. Staffing companies Programmed Group, Skilled Engineering and Talent Two will benefit.
- **Capital management** initiatives to deploy excess cash on balance sheets.
- **Takeover activity.** We expect this will increase over 2011, particularly as macro risks recede and credit markets continue to improve. The small cap sector is likely to be quite appealing given the attractive valuations on offer.
- **Mining Contractors**. Margins are recovering as lower priced contracts written though the GFC roll off and a tightening market is seeing a shift in the pricing power from the mine owner back to the contractor as miners look to capitalise on historically strong commodity prices. RCR Tomlinson and Programmed Group are enjoying this improvement.
- **Downward trend in the Australian building industry.** Building approvals for February were 21% below those of February 2010 and with three of the last four months having seen declines this supports the downward trend as Government stimulus rolls off and private sector spending remains fragile after recent interest rate hikes. With approvals usually leading starts by three to six months this doesn't bode well for building material stocks such as Alesco and GWA.
- **Retail still subdued.** The retail sector is suffering from weak consumer confidence, a rising consumer savings ratio and product price deflation. On-line competition whilst topical for the future has yet to have a large impact on retailer's prospects. Premier Investments, Specialty Fashion and The Reject Shop have been most affected.
- **Regulatory and tax uncertainty**. Policy changes are likely to have been slowed with a minority government and a Green controlled Senate.

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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 over 81 companies**. The table below shows the listed companies with which we had direct contact during the period (note that for many of these we had multiple meetings).

Adelaide Brighton	Chandler Macleod	GR Engineering	Pacific Energy	Skilled Group
Alesco	CSG Group	IOOF	Paperlinx	Slater and Gordon
Allmine	CTM Travel	Kathmandu	Platinum Asset Mgt	Southern Cross Media
Ammcom	Decmil	M2 Telecommunications	Programmed Group	Talent Two
APN News and Media	DKN Financial	MACA	Ramsey Healthcare	Thinksmart
Ardent Leisure	Domino Pizza	Mainfreight NZ	RCG Corp	Thorn Group
Ausdrill	Duet	Maryborough Sugar	Realestate.com	ToxFree Holdings
Ausenco	Engenco	Mastermind group	Reckon	Transfield Infrastructure
Aust Power and Gas	Fantastic Furntiture	Mayne Pharma	Resmed	Treasury Group
Boart Longyear	Finbar	McMillan Shakespeare	Resource Equipment	VDM Group
Bradken	Fleetwood	Miclyn Express Offshore	Retail Food Group	Village Roadshow
Breville	Flexirent	Mineral Resources	Rock Building Society	Vita Group
Cabcharge	Flight Centre	Mystate	Salmat	Vocus
Cardno	Folkstone	Norfolk group	Seymour Whyte	Wellcom Group
Cellestis	G8 Education	Oroton	Silver Chef	WHK Group
Challenger Financial	Global Const Services	Pacific Brands	Sirtex	Yellow Brick Road

Fund Description

The Pengana Emerging Companies Fund seeks to combine the skills of highly experienced small company investors (over 32 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 approximately 0.5% of the Benchmark capitalisation
Minimum Initial Investment Amount	A$25,000 (direct)	**FUM at Month End**	$554m
Inception Date	1 November 2004	**Application Price at Month End**	A$ 2.1365
Identification Code(s)	APIR PER0270AU ARSN 111 894 510	**Redemption Price at Month End**	A$ 2.1237

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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.