

Pengana Emerging Companies Fund June 2011 Quarterly Review



Australian Equities - Small Caps



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Fund Performance

Net performance for periods ending 30 June 2011¹

	3 months	6 months	1 year	3 years p.a.	5 years p.a.	Since inception p.a. ²
Pengana Emerging Companies Fund	-7.1%	-3.3%	19.6%	9.3%	9.5%	14.3%
S&P/ASX Small Industrials Acc Index³	-4.7%	-2.6%	15.7%	0.0%	-2.6%	1.7%
Outperformance	-2.4%	-0.7%	3.9%	9.3%	12.1%	12.6%
S&P/ASX Small Ordinaries Acc Index	-9.3%	-10.4%	16.4%	-2.6%	1.2%	5.6%
Outperformance	2.2%	7.1%	3.2%	11.9%	8.3%	8.7%

Fund Commentary

The Fund fell 7.1%¹ over the June quarter, outperforming the Small Ordinaries Index by 2.2%¹ and underperforming the Small Industrials Index by 2.4%¹. For the 12 months to June, the Fund rose 19.6%¹, outperforming the Small Ordinaries Index by 3.2%¹ and the Small Industrials Index by 3.9%¹.

June 2011 marks the seventh financial year end for our fund. We have outperformed the Small Industrials Index in every financial year⁴ and shown an annual outperformance of 12.6% above the Small Industrials Index.

Fund performance vs the Small Industrials Index (financial years)^{1,3,4}

Year to June	2005	2006	FY07	FY08	FY09	FY10	FY11
Performance vs Small Industrials ⁴	+6.6%	+17.4%	+32.5%	+7.0%	+1.8%	+26.1%	+3.9%

The June quarter saw domestic markets fall, with commodity stocks worst hit. Fears continue over the rate of recovery in the US, the European debt issues, and concerns that China's manufacturing activity is slowing. The All Ordinaries fell 4.8%, which was worse than the performance of the Dow Jones in the US which saw a slightly positive quarter. The Small Resources sector fell 15.6%, bearing the brunt of investor concerns over a potential over-heating in commodity markets during 2010.

Volatility at the individual stock level has been high of late, with some stocks sold down in the absence of any news. This is typical of June given that most companies go into "blackout" ahead of results in August. This certainly happened last year, with many share prices recovering nicely once reasonable results were released in August.

The domestic economy is heavily reliant on activity in China, primarily through its seemingly endless demand for our natural resources. It is also a key supplier of cheap imported product for our retailers. We recently spent a week in China visiting suppliers to our domestic retailers, and other companies which gave us a better insight into the outlook for the economy. In summary the economy looks capable of growing at 8%+ for a number of years to come, however inflation and a potential housing bubble are major risks. The central government is managing these risks reasonably well to date, but the potential for a sharper slowdown cannot be completely ignored.

Our fund remains invested primarily in companies that do not heavily rely on the economy. In this report, we profile five such stocks and discuss their appeal in a choppy economic environment. Our belief remains strong, that in times of uncertainty the best investment opportunities are often overlooked by investors who are spooked by short term risk.

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.

⁴ The fund only existed for eight months in the 2005 financial year

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Recent portfolio activity

New stocks added to the portfolio over the quarter included **GR Engineering** (IPO), **HFA Holdings**, **Invocare**, **Royal Wolf** (IPO) and **Swick Mining Services**. We sold down or out of **Bradken**, **Cardno**, **PaperlinX** (small position thankfully), **Southern Cross Media**, and **Toxfree**.

Key stock moves during the quarter

Key successes in the portfolio during the period included **Programmed Maintenance** (+29%), **Mainfreight** (+19%), **Amcom** (+11%), **DKN Financial** (+32%), and **Australian Power & Gas** (+16%). Detractors included **CSG Group** (-27%), **Paperlinx** (-70%) and **REA Group** (-9%).

Programmed Maintenance rose after a strong recovery in earnings in recent months. We established our position following a dramatic sell-off in November which saw the price trade well below our assessed longer term valuation. **Mainfreight** is a NZ based transport operator which posted very strong quarterly growth, and has opportunities for growth in NZ, Australia, the US and Europe. **Amcom** rose after announcing strong underlying growth and divesting its holding in II Net. **DKN Group** received a take-over offer from IOOF. **Australian Power & Gas** continued to grow its residential customer base from 150,000 in June 2010 to over 250,000 in June 2011. **CSG** has been disappointing due to poor cash flow controls and a mildly dilutive capital raising, however remains very cheap trading on a PER of under 7x FY12 forecast earnings. **PaperlinX** was a very small position in our fund, and has seen a further deterioration in paper volumes in Europe. We sold the stock at a loss, as the risk of a highly dilutive capital raising are high given poor earnings and high debt. **REA Group** drifted lower following murmurings of a competing web site to realestate.com.au backed by real estate agents. While we do not completely dismiss this threat, it is not new news, and REA has in the past seen Google (among others) abandon the space acknowledging that REA's position is highly entrenched. We will monitor the situation, but will not overreact in the short term.

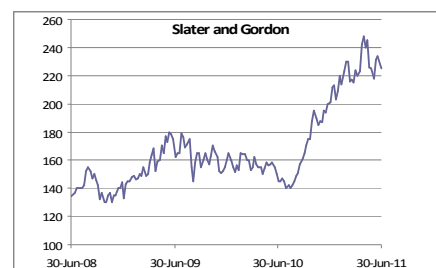
Outlook – not all stocks need a strong economy

Global markets remain volatile due to the large economic issues at play (US, Europe, China), and investors' attention span is accordingly very short term. We have long acknowledged the macro risks, and how they potentially impact sectors of the Australian economy. Hence our preference for stocks which are capable of growing cash flows in any economic environment.

Below we discuss five such stocks which have been in our top holdings for the last 2-3 years, and remain so.

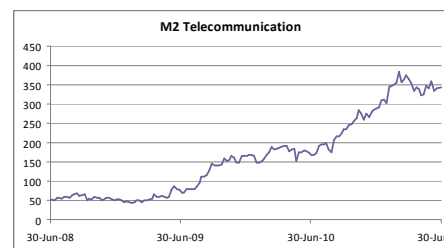
Slater & Gordon (SGH)

Australia's leading personal injury law firm. The company showed uninterrupted 10-15% organic growth during the GFC as its services are not economically sensitive, and it continues to take market share in a fragmented marketplace. SGH has approximately 30% of the Victorian market, but a much smaller share of the NSW and Queensland markets, which offer strong medium term growth. The stock has risen 54% over the past 12 months, but does not appear expensive on a PER of 9x FY12 forecast earnings (versus the smallcap average of around 12x).



M2 Telecommunications (MTU)

M2 is a reseller of telecommunications to the small business market, and has grown strongly over the past 4-5 years with very clever acquisitions. Telecomms are very resilient in tough times as small businesses cannot afford to not pay their phone bills and have them cut off! M2 is now focussed on organic growth after purchasing Peopletel and Commander Communications and integrating them successfully. The company currently has 3% market share (Telstra 80%+), and has a medium term target of 15%. Valuations are modest given the growth opportunity and resilient earnings.



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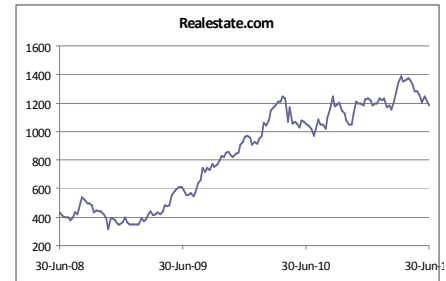
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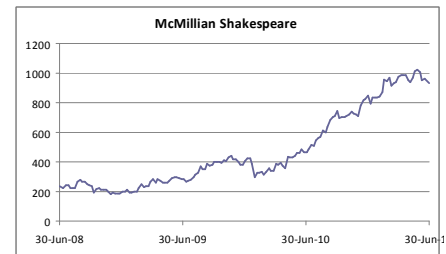
REA Group (REA)

REA owns realestate.com.au and other associated web sites. The revenue streams are primarily subscription based, and are therefore not directly linked to the property cycle. REA has over 70% share of eyeballs in the property sector, and as such agents are highly unlikely to remove properties from the site to avoid the subscription fee (which in many cases is passed onto the house vendor). Growth in earnings comes from price increases as the internet continues to replace newspapers as the advertising medium in the sector. Brand is the primary barrier to entry – even Google retreated from the marketplace recently.



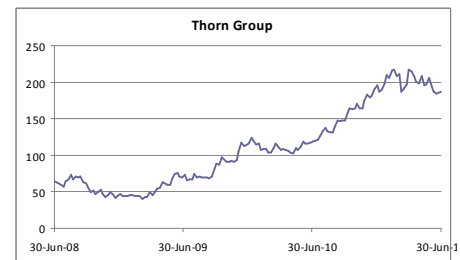
McMillan Shakespeare (MMS)

MMS administers salary packaging services, primarily for the not-for-profit, healthcare and education sectors. Fee income is mostly recurring in nature and its client base is not heavily affected by economic cycles. To illustrate, the company maintained earnings growth of 18% during FY09, the height of the GFC. The company continues to expand its range of services and recently acquired a car leasing business which fits well with the core business. Barriers to entry are very high given the required investment in technology and processes to qualify for government and large corporate accounts. The stock trades at a slight premium to market valuations, however displays higher growth and less volatile earnings than most.



Thorn Group (TGA)

TGA operates the Radio Rentals branded stores, which provides whitegoods, furniture, and other household goods on a rental basis to the lower socio-demographic segments of the community. The appeal of its services actually increases in slower economic times, hence it has shown uninterrupted growth over the past four years where most other retailers have shown volatile earnings as consumers have struggled with the GFC, followed by higher interest rates. The company has grown earnings through expanding its product range, and rolling out new stores. It has also shown very tight credit controls with bad debts falling consistently since listing in 2007. The stock trades on a PER of 9x forecast earnings, which we consider to be cheap given the certainty of earnings.



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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 57 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).

Acrux	Magellan Financial	Runge
Austbrokers	Mainfreight	SAI Global
Barmingo	Michael Hill	SMS Mgmt
Boom Logistics	Miclyn Express	Snowball
Breville	Navitas	Somnomed
BT Investment	Neptune Marine	Southern Cross Media
Campbell Bros	NLC Corp	STW Comms
Chandler MacLeod	Nomad	Super Cheap Auto
CMA Corp	Norfolk	Swick Mining Services
Coventry	Nufarm	Symex
CSG Group	Oak Hotels	Talent 2
Fantastic	Oakton	Technology One
Finbar	On The House	Thorn Group
Flexigroup	Oroton	Transfield Services
Hastings Diversified	Patties Foods	United Group
Hendersons	Programmed Maintenance	UXC Corp
HFA Holdings	RCR Tomlinson	VDM Group
II Net	RGM Media	Vita Group
Logicamms	Royal Wolf	WDS Ltd

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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 0.5% of the Benchmark capitalisation
Minimum Initial Investment Amount	A\$25,000 (direct)	FUM at Month End	\$490m
Inception Date	1 November 2004	Application Price at Month End	A\$ 1.9846
Identification Code(s)	APIR PER0270AU ARSN 111 894 510	Redemption Price at Month End	A\$ 1.9728

Contact Details

Pengana Capital Limited, Level 12, 167 Macquarie Street, Sydney, NSW 2000, Australia • T +61 2 8524 9900 • F +61 2 8524 9901
ABN 30 103 800 568, AFSL 226566

For further information, please visit our website at www.pengana.com or contact:

Advisors & Retail Clients: Justin Brooks, +61 3 8663 7906, justin.brooks@pengana.com
Institutional Clients: Damian Crowley, +61 2 8524 9970, damian.crowley@pengana.com
Private Clients: Juliet Dunworth, +61 2 8524 9984, juliet.dunworth@pengana.com

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.

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