



ANNUAL INVESTOR LETTER

Performance for the Financial Year ended 30 June 2011

The returns for investors over the 12 month period ended 30th June 2011, net of all fees and costs was 17.4%¹.

For the three year period since inception, the Fund has returned 10.8%¹ compounded per annum against a backdrop of 4.2% cash rate and -0.2% for the Australian All Ordinaries Accumulation Index.

The unit price increased from \$1.1029 at the beginning of the year to close at \$1.2867. In addition a dividend of \$0.0079 per unit was paid during the year.

The table below shows the returns for the Pengana Australian Equities Core Fund for the three years since inception using the value of a \$100,000 investment in the Fund on the 1st of July 2008 compared to the same amount invested in the All Ordinaries Accumulation Index and in Cash.

Financial Year Ending	Pengana Core Fund ¹	All Ordinaries Accumulation Index (Dividends included)	RBA Cash Rate	Pengana Core Fund Compounded value of \$100,000 Investment	All Ordinaries Accumulation Index Compounded Value of \$100,000 Investment	RBA Cash Rate Compounded Value of \$100,000 Investment
30-Jun-09	3.0%	-22.1%	4.8%	\$102,980	\$77,854	\$104,831
30-Jun-10	12.5%	13.8%	3.7%	\$115,885	\$88,580	\$108,763
30-Jun-11	17.4%	12.2%	4.6%	\$136,034	\$99,363	\$112,800

¹ The performance of the Core Fund is shown after all fees and expenses, and assumes reinvestment of distribution. Investments can go up and down. Past performance is not a reliable indicator of future performance.

Our Activities in the 2011 Financial Year

The primary contributors to the full year result are provided in the Table below:

<u>Investment</u>	<u>Contribution</u>
McMillan Shakespeare	3.9%
Credit Corp	2.2%
Seven Group Holdings	1.9%
NIB Holdings	1.9%
DUET Holdings	1.4%
Mitchell Communications	1.2%
Graincorp	1.2%
Commonwealth Bank	1.1%
Australian Power Company	1.1%
Ramsay Healthcare	0.8%
Telstra	0.8%
RCG Group	0.7%
ANZ Bank	0.6%
Westpac Bank	0.5%
Resmed	-0.6%
BHP Put Options	-0.6%
CSL	-0.9%
CSG Group	-2.0%
Other Investments	1.2%
Net Interest Income and Co	1.0%
	<u><u>17.4%</u></u> ¹

“Tax-Aware” Investment Returns

Our definition of Tax-Aware Funds Management takes into account the philosophical paradox that while investors prefer to pay tax because it means they have made a profit, they wish to manage their affairs in the most tax efficient manner. We are sympathetic to this view.

The following table details the different components of the returns for each year since inception.

Investor Returns (Composition) ¹ Using \$100,000 as investment Example										
Financial Year Ending	Unit price as at		Distribution per unit	Net Investor Returns		Unrealised Capital Growth	Franked Dividends	Discounted Capital Gains	Other Capital Gains	Other Income (Interest)
	Start of Year	End of Year		\$	%					
	\$	\$	Cents	\$	%	%	%	%	%	%
30-Jun-09	1.00	1.00	3.1	\$3,210	3.2%	0.2%	0.9%	0.0%	0.0%	2.1%
30-Jun-10	1.00	1.11	1.9	\$12,560	12.5%	10.5%	0.2%	0.5%	1.3%	0.1%
30-Jun-11	1.11	1.26	4.0	\$18,945	17.4%	13.2%	0.6%	1.0%	1.3%	1.2%

After tax reporting is problematic due to the myriad of different tax circumstances pertaining to each investor. As a result, many reports stop at the pre-tax stage. As a unit trust, the Fund distributes all income at the end of the year with each income stream retaining its tax nature.

Note that Franking Credits add additional returns of approximately 1.0% and 0.5% for financial years ending 30 June 2011 and 2010 respectively².

² Investors need to obtain their own taxation advice. We do not provide taxation advice to investors.



Pengana Australian Equities Core Fund Investment Ethos

Our clients trust us with their hard earned money. In return we seek to provide peace of mind and a meaningful contribution to their goal of achieving/maintaining financial independence.

Accordingly we offer a relationship where the interests of the client and the principal Fund Manager are aligned. I am one of the largest investors in the Fund and since inception of the Fund, do not invest in listed securities outside the Fund.

We have an investment mandate that is focused on protecting capital while generating real (as opposed to nominal), Australian Dollar returns on a consistent and repeatable basis over the medium term.

Several key tenets underpin our investment strategy:

1. We focus on absolute returns (not relative market returns)
 - a. The RBA cash rate is used as a proxy for the risk free rate available to investors. While it is acknowledged that government bonds or the big four bank term deposits may offer alternative measures, using the RBA Cash Rate avoids any “noise” arising from duration and/or credit risk issues.
 - b. The long term equity risk premium of 6% above the risk free rate is used as the base hurdle against which we judge all equity investments.
 - c. In other words, unless we consider that an equity investment opportunity offers a return in excess of the RBA Cash Rate plus 6%, (i.e. 12% plus per annum) we stay in cash. Importantly there is no limit to the amount of cash we can hold.



2. A clear investment thesis with identifiable milestones is required for each investment. If we can't understand how we get paid as shareholders (or how a critical industry dynamic plays out) we will avoid making the investment.
3. Binary outcomes are not for us. So if we have to choose between generating very high returns and preserving capital we will choose to preserve capital.
4. We are agnostic about whether our returns come from capital growth or income. However we are cognisant that franking credits and unrealised capital gains have significant after tax benefits.

Is it a good time to be in the market?

One of the most frequent questions we get asked as fund managers is "What's your view on the market?" This is a difficult question for us to answer in a constructive way because of our fundamental approach. Our ability to assess the valuations of the diverse constituents of the Australian Share market (Resources, Financials and Industrials), weight them accordingly and then make a meaningful aggregated assessment is limited. And we don't think the generalized answer can be either meaningful or accurate.

Using different ratios (such as Price to Earnings or Price to book ratios) can provide some insights particularly when measured against long term historic means. However relying on this method to assess value reminds me of the following analogy. It's like driving a car by looking in the rear view mirror, great for the long and straight roads but sharp turns can be very tricky.

Our preferred answer to the above question relies on our proprietary experience. Based on the criteria we use for assessing attractive investments are there many or few investable opportunities currently on offer? If we are finding a host of great investment opportunities then there is a good chance the market is



offering value, if not then either we are not working hard enough (and the whip needs to come out) or the opportunities are not there to be found (the market may be expensive).

How do we find and assess investment opportunities?

My father said if you want to get hit by a truck make sure you stand in the middle of a highway (as opposed to a small dead end lane). Our daily activities are geared towards placing ourselves in the middle of high traffic idea flow - company visits, regular dialogue with industry experts, access to high quality analysts and their research reports. This, in addition to a team with experience, common sense and a high work rate, has been fundamental to generating our strong investment returns.

The assessment process is simple in concept yet complex in application. Basically we look to invest in companies with good businesses, competent management and at the right price.

Perhaps the best way to provide some insight into the application of this assessment is to use an investment from our portfolio as a case study.

NIB Holdings - NIB is the only listed health insurer in Australia.

Is it a good business?

Several important factors have convinced us that this company has a resilient business model. First and foremost the profit drivers are identifiable, i.e. we can understand how the company makes money.

NIB acquires and retains customers who pay it a monthly insurance premium to cover a defined portion of their potential medical expenses. We analyse NIB by splitting it into three businesses, each with its own risk and cash flow characteristics.



A) The risk business, i.e. the business of paying out less in attracting, retaining and covering customers than it collects from customers. (Worth approximately \$1.06 per share or 62% of our \$1.70 per share valuation)

B) The float business, i.e. how well the company invests the money it collects before it pays it out. Typically a cash or fixed interest business based on the assets of the float. (Worth about 10c per share)

C) The shareholders' funds, usually two pools of capital. One is the regulated capital i.e. the amount of capital the regulator requires the business to hold to support its license and the other is the shareholders' capital surplus to this need. (Worth about \$0.56 per share or 33% of our \$1.70 per share valuation)

Secondly this is not a cyclical business. Most healthcare companies have defensive, non discretionary and therefore resilient cash flows. Accordingly we don't need to predict the economic cycle to be able to predict the future sales of the business.

Thirdly the business model produces working capital rather than consuming it, i.e. shareholders benefit from the "float" or pool of funds as customers pay in advance while most costs are paid in arrears. This is one of our favourite "good business" characteristics.

Competent management is another important characteristic.

As full time investors we spend a significant portion of our time on assessing management. This process involves regular meetings with the management of the companies we are investing in as well as their competitors, suppliers and customers. Our focus is on whether the incumbent management team has the core competencies required to maximize future cash flows from the business.

Our interviews with the management of NIB, their competitors, suppliers, site visits, the Federal Health Minister's office and customer surveys have given us comfort that: a) management has



created the culture and processes to ensure that medium term customer acquisition remains strong and cost efficient, b) management will continue to negotiate favourable regulatory outcomes and c) management is capable of achieving commercially pragmatic outcomes with suppliers (predominantly hospitals and medical practitioners).

An important addendum is that both the board and management are focused on optimizing the capital structure of the company for the benefit of shareholders.

Can we make money if we buy shares at this price?

Discipline is required to ensure that, no matter how resilient the business model or competent (and usually charismatic) the management team, we should never confuse a great business with a good investment opportunity.

When we consider buying shares in a company we rely on the following fundamentals:

- The after tax cash earnings yield of every business has to be enough for it to pay its way in the portfolio. We find it difficult to make money by anticipating that someone else will arrive with a more optimistic valuation than ours and therefore buy us out at a profit. So, rather than relying on the kindness or ignorance of others to make money we look to "live off" the surplus cash flows produced by the businesses we own.
- Our definition of after tax cash earnings is the surplus the business would generate for a 100% owner. This is different to dividend yield or reported earnings. While both are at times good proxies for our favored metric, they can be misleading. Large adjustments are often required for the working capital absorbed by the business and for stay-in-business capital expenditure instead of the accounting



entries of depreciation and amortization. Both these adjustments are positive for NIB cash earnings.

- The implied price of these earnings (or company market capitalization) is not always as straight forward as multiplying the number of shares by the current share price. In some cases the additional "pieces of paper" - options, convertible notes, etc etc... need to be included. NIB has a clean capital structure.

Our expected range of after tax cash earnings yields is between 6% and 8% with good growth over the next 5 years. The goal is to build a portfolio of assets that generate after tax cash earnings yields in 4-5 years of 15% plus.

Importantly our experience has been that finding these opportunities are significantly easier when sentiment is negative. (Our analogy is that it's a lot easier to find low hanging fruit when there is no one else in the orchard)

Our Investments

While we have covered the underlying reasons for making individual investments, other important factors come into play when constructing our portfolio. Diversification is considered important, hence our self imposed limit of not more than 10% in any single investment. Importantly we feel the balance between diversification and diluting our conviction calls means we are comfortable with holding 20 to 25 equity investments at any one time.

In addition, we are cognisant of not wanting to be vulnerable to one single macro event. Accordingly we generally have exposure to a range of industries with a mix of profit drivers.

Defensives (or non-economically sensitive investments)

This constitutes the largest grouping of our investments and typically includes healthcare, utility, grocery and telco sectors. Interestingly, a strong argument for inclusion could be made for many other companies within the portfolio given the resilience of their business models.

While **NIB Holdings** has already been extensively covered in the report we include the following short synopsis. The management of this well capitalised domestic health insurer has demonstrated an ability to price risk appropriately, generate above industry customer growth and focus successfully on improving operating efficiencies. Furthermore NIB's large surplus capital position distorts the traditional valuation methodologies. This company provides an attractively priced exposure to a rapidly growing healthcare sector, via a large, process driven, business model.

CSL is the second largest plasma fractionator globally. The conservative management team has been astute in positioning the business as the lowest cost producer of plasma derived medical products across its major markets. Recent market consolidation has confirmed our view that the combination of stable earnings, cash rich balance sheet and improving profit margins will continue to generate strong after tax cash earnings for shareholders.

ResMed is the dominant manufacturer and distributor of medical devices for sleep apnea. The company has been growing volumes and revenues at 15% plus levels for over 10 years. The long term outlook for the top line remains attractive as its penetration of the addressable market remains low. Its expertise and global scale allows for a robust and resilient business model that is not economically sensitive. In addition the structural change to the industry of home sleep testing is expected to bypass the bottleneck of sleep labs and accelerate market growth. Both management and the board have adopted a conservative



approach to the balance sheet resulting in a large (and growing) cash balance which should provide additional returns to shareholders.

Duet Group, a diversified portfolio of gas and electricity distribution assets, was acquired on a healthy (and sustainable) pre-tax earnings yield of 13%. The new management team has taken several significant steps to improve both the overall quality of the portfolio as well as the balance sheet. The new managing director has demonstrated his focus on simplifying the group structure while remaining disciplined with regard to investor returns. The main value constituent of the group (and our preferred asset) is its majority share in the Dampier to Bunbury natural gas pipeline. It is not often that regulated asset bases are available for purchase at close to net asset value hence we were aggressive in building a large position.

Metcash Ltd represents an exposure to an attractively priced, well managed, non discretionary wholesaler to the independent supermarket industry. The group's sound cost control and ongoing ability to find significant pockets of new business that enhance the existing high levels of profitability have delivered excellent shareholder returns. The resilient business model relies on its non-economically sensitive revenues and low working capital intensity nature.

Telstra as a long term investment is probably one of the more controversial companies on the ASX. We recently acquired this holding. Our investment thesis incorporates the fact that management has been able to convert their structurally challenged fixed line business into a long dated government bond yielding in excess of 10%. In addition there are finally signs of the company being able to monetise their superior mobile network in a meaningful manner. Finally, the current level of the sustainable cash earnings yield is at a level high enough not to require too much in growth to make it an attractive investment.

Financials (interest rate sensitive)

The Fund's large holding in **McMillan Shakespeare** is an example of a company that benefits from its business as a supplier to the healthcare industry as well as making an interest margin on motor vehicle finance. As the largest independent salary packaging services (predominantly to the health care employees) the business model incorporates a large pool of upfront cash payments for disbursement, negating the need for any working capital (no stock or debtors). The recent acquisition of a significant leasing business (at a very attractive price) represents a sensible addition on many levels including broadening the group's product offering, increasing the customer base and diversifying the earnings streams. On two recent occasions, an overly pessimistic assessment of the impact from regulatory rulings has created very attractive entry points for accumulating a substantial holding.

Commonwealth Bank provides 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 lack luster credit growth, the company's strong national franchise is attractively priced at a high single digit after tax cash earnings yield.

In a similar vein **NAB** position as the largest business bank offers further exposure to the domestic banking oligopoly. In addition the bold marketing initiatives recently adopted by management in differentiating its retail offering appears to be generating profitable incremental market share.



Credit Corp Ltd is a receivables management company that specialises in the purchase of distressed debt books and the subsequent collection of the underlying individual debts. The competent management team has demonstrated an ability to price these books appropriately. In addition to significant scale, the company's sustainable competitive advantage appears to be their internally developed proprietary systems and processes that optimise collection efficiencies.

Consumer based (potentially economically sensitive)

Our **News Corporation** holding provides a well diversified (both by media type and geographical exposure) collection of earnings streams from high quality media assets. The valuable content based business of Cable (includes Fox News, Fox Sports and the Discovery Channels) and the 20th Century Fox studios dominate our valuation for the company. In addition the group owns the distribution Pay TV companies - BSkyB, Sky Italia and Sky Deutschland. The robust cash flows from these businesses provide a solid underpin to the attractive valuation particularly given the combination of a strong balance sheet and competent management teams. Importantly, after building a robust and resilient media group from the retained cash flows of his original Newspaper and TV businesses, the true value of the company now resides in the non-cyclical content based business.

Mining Services (commodity volume demand sensitive)

Rather than attempting to predict future commodity prices (something not many analysts have consistently achieved) we prefer to invest in those companies which provide the goods and services that make it possible for the large commodity houses to mine and transport the commodities to our rapidly industrializing neighbors. We have two large high quality "pick and shovel" companies.



Seven Group Holdings is a diversified (both by business model and geographical exposure) company whose largest business are owning and operating exclusive Caterpillar franchises assets in Western Australia, NSW and China. The working capital intensive nature of these operations is offset by the strong cash flow generation from the other business which include the free-to-air broadcaster Seven Network, Western Australian newspapers and domestic PayTV. Importantly management has proven itself to be an astute manager of these businesses with a solid reputation for producing sustainable and rapidly growing after tax returns for shareholders.

Mermaid Marine is an integrated provider of chartered vessels and services to the offshore gas industry on the North West Shelf of Australia. Management has used a favourable regulatory regime to establish and enhance its significant barriers to entry by developing a suite of essential operational assets. These include a fleet of customized union compliant vessels, crews and the slipway and supply base to keep them operational.

July 26, 2011

Rhett Kessler
Fund Manager

A handwritten signature in black ink, appearing to read "Rhett Kessler", written over a horizontal line.