

# Pengana Emerging Companies Fund September 2011 Quarterly Review



Australian Equities - Small Caps

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## Fund Performance

### Net performance for periods ending 30 September 2011 <sup>1</sup>

	3 months	6 months	1 year	3 years p.a.	5 years p.a.	Since inception p.a. <sup>2</sup>
<b>Pengana Emerging Companies Fund</b>	-9.4%	-15.8%	-5.0%	6.7%	5.3%	12.2%
<b>S&amp;P/ASX Small Industrials Acc Index <sup>3</sup></b>	-10.5%	-14.7%	-8.0%	-2.2%	-5.7%	0.1%
<b>Outperformance</b>	<b>1.1%</b>	<b>-1.1%</b>	<b>3.0%</b>	<b>8.9%</b>	<b>11.0%</b>	<b>12.1%</b>
<b>S&amp;P/ASX Small Ordinaries Acc Index</b>	-11.8%	-20.0%	-12.1%	-0.1%	-2.3%	3.5%
<b>Outperformance</b>	<b>2.4%</b>	<b>4.2%</b>	<b>7.1%</b>	<b>6.8%</b>	<b>7.6%</b>	<b>8.7%</b>

## Fund Commentary

The Fund fell 9.4%<sup>1</sup> over the September quarter, outperforming the Small Ordinaries Index by 2.4%<sup>1</sup> and the Small Industrials Index by 1.1%<sup>1</sup>. For the 12 months to September, the Fund has declined 5.0%<sup>1</sup>, outperforming the Small Ordinaries Index by 7.1%<sup>1</sup> and the Small Industrials Index by 3.0%<sup>1</sup>.

The September quarter saw markets fall globally, driven by despair over the European sovereign debt crisis and the faltering US economy. Commodity stocks were worst hit, continuing the trend established earlier this year. This sector is the most leveraged to global economic activity, therefore currently the riskiest. The domestic share market was not spared, with the All Ords falling 12.7%. Smallcaps underperformed, driven primarily by resources stocks, which fell 13.5%.

Markets are currently heavily driven by emotion and short term fear. The European situation seems to change daily, however France and Germany have taken a leadership role, and it appears likely that a definitive rescue package will be announced in the coming days if not weeks. Markets have recovered strongly in early October to reflect this growing optimism.

While the current concerns about Europe are very real, we would highlight that most observers do not expect the fallout to be anywhere near as severe as the GFC, which saw a near collapse of the banking system. Credit markets are still highly liquid hence the shocks we witnessed three years ago are unlikely to be repeated.

Volatility distracts many investors from the medium term goals, which is to invest in quality stocks at the right price. Our fund has a seven year track record of negotiating a wide variety of economic conditions and outperforming the market in each scenario.<sup>1</sup>

The current situation reminds us of the markets in early 2009 where all the fundamental news was bad, investor time horizons very short, volatility high, but valuations were cheap. Markets recovered strongly as government action averted the worst case scenarios. A definitive policy in Europe has the potential to provide such a catalyst in the current market.

Valuations are appealing, and our portfolio remains heavily invested in stable businesses which do not rely on a strong economy to grow.

## Recent portfolio activity

New stocks added to the portfolio over the quarter included **Collins Foods** (IPO), **Mermaid Marine**, and **Coffey International**. **Collins Foods** listed during the volatility in July which allowed us to increase our holding below the issue price soon after. The company owns KFC and Sizzler restaurants which is a relatively stable business. The float saw the company restructure its balance sheet in order to fund a store refurbishment program to drive longer term growth. We sold down or out of **Bradken**, **BT Investment Mgmt**, **Cardno**, **Corporate Travel**, **GNG Engineering**, and **Transfield Services**.

<sup>1</sup> All performance figures are calculated net of fees and assume reinvestment of income distributions. Past performance is not a reliable indicator of future performance.

<sup>2</sup> Since November 2004

<sup>3</sup> 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 **Reckon** (+12%), **CSG Group** (+11%), **Domino's Pizza** (+11%), **Flexigroup** (+9%), and **Ramsay Healthcare** (+6%). Detractors included **Slater & Gordon** (-19%), **Transfield Services** (-28%) and **Boart Longyear** (-33%).

**Reckon** posted a solid result and announced a deal to customise its software for Australian accounting firms for the US market. **CSG Group** has received a takeover approach at \$1.20 and has also fielded calls from other interested parties. **Domino's Pizza** posted a very good result with Australian sales up 13% in what has been regarded a mature market. **Flexigroup** also showed strong results for the FY11 period and has confidently forecast 12-15% EPS growth into FY12. **Ramsay Healthcare** posted EPS growth of 20% with further growth expected. **Slater & Gordon** has drifted lower following a reasonable profit result but with a shorter term cash flow disappointment. **Transfield Services** warned of an earnings gap following two asset sales – we immediately sold our position which protected the Fund from a further 15% fall. **Boart Longyear** fell heavily in line with the mining stocks, as its earnings can prove volatile should exploration activity decline, a scenario we do not currently expect, however we do not have a large position in this stock given the risk of volatile earnings.

## Outlook

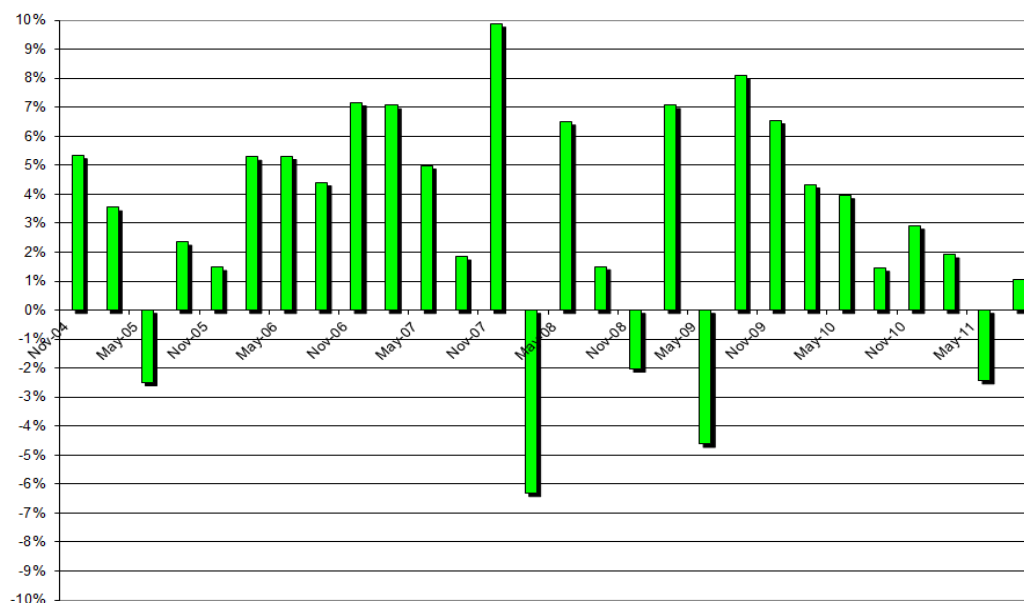
Global markets are spooked by the poor outlook in Europe, a sagging US recovery, and signs that the Chinese economy is growing at a slower rate. While we would not dismiss the challenges and risks, there are signs that panic has become the overriding emotion, with valuations very cheap. Volatility has spiked, and the press attention given to this only serves to heighten most investors' sense of fear.

This volatility may well continue, however it is important for investors to maintain a disciplined medium term focus. Often the best time to invest in an asset class is exactly when everyone else is losing their nerve. There is no clearer example of this than the market recovery in 2009. In early 2009 the headlines were full of bad news about the global economy, and stock valuations were cheap. At the time fear was extreme and most investors assumed they were taking an enormous risk by owning shares. Over the following 12 months the All Ords rose by up to 60% as the fear unwound and the value was recognised.

Our Fund has a very clear objective of investing in high quality stocks at attractive prices. We are wary of the risk to earnings of many sectors such as retail, media, housing as the domestic economy slows, however the majority of our portfolio is invested in stocks whose earnings are not heavily influenced by the economy.

Our Fund has a seven year track record of stock picking which has negotiated extreme market conditions and outperformed the market over the medium term.<sup>1</sup>

## Quarterly performance versus Small Industrial Index (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 over 86 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).

Allmine	Emerson Stewart	Mermaid Marine	Slater & Gordon
Ammcom	Fantastic	Michael Hill	Southern Cross Electrical
ARB Corp	Finbar	Mineral Resources	Sumerset
Auckland Airport	Fletcher Building	Monadelphus	Sunland
Audio pixels	Flexigroup	Nomad Building	Supercheap Auto
Ausdrill	Flight Centre	Oroton	Swick Mining
Ausenco	G8 Education	Premier Investments	Talent 2
Austbrokers	HFA Holdings	Qube Logistics	Thinksmart
Australian Power and Gas	Humanis	Ramsay Healthcare	Thorn Group
Bega	ii net	RCG Group	Transfield Services
Big Air Group	IOOF Ltd	RCR Tomlinson	Transpacific
Breville Group	Life Healthcare	REA Group	Treasury Group
BT Financial	Little World Beverages	Reckon	Vita Group
Cardno	Lycopodium	Redflex	Vocus
Carsales	M2 Communications	Reject Shop	Warrnambool Cheese
Cedar Woods Property	MACA Group	Resources Equipment	WDS Group
Challenger Financial	MacMahon Holdings	RFG Group	Webjet
Clearview	MacMillan Shakespeare	Royal Wolf	Wellcom
Coffey International	Magellan Financial	SAI Global	WHK Group
Collins Foods	Mainfreight	Sedgman	XRF Scientific
CSG Group	Mastermyne	Sigma Pharmaceuticals	
Domino's Pizza	Kathmandu	Skilled Group	

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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

<b>Style</b>	Bottom up stock picker	<b>Management Fees</b> <sup>4</sup>	1.3325%
<b>Benchmark</b>	S&P/ASX Small Ordinaries Accumulation Index	<b>Performance Fees</b> <sup>4</sup>	20.5% of the performance above the Benchmark
<b>Investors</b>	Open	<b>Fund raising</b>	Maximum of 0.5% of the Benchmark capitalisation
<b>Minimum Initial Investment Amount</b>	A\$25,000 (direct)	<b>FUM at Month End</b>	\$423m
<b>Inception Date</b>	1 November 2004	<b>Application Price at Month End</b>	A\$ 1.7642
<b>Identification Code(s)</b>	APIR PER0270AU ARSN 111 894 510	<b>Redemption Price at Month End</b>	A\$ 1.7536

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<sup>4</sup> 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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