

# Pengana Emerging Companies Fund December 2011 Quarterly Review



Australian Equities - Small Caps

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## Fund Performance

Net performance for periods ending 31 December 2011 <sup>1</sup>

	3 months	1 year	3 years p.a.	5 years p.a.	7 years p.a. <sup>4</sup>	Since inception p.a. <sup>2</sup>
<b>Pengana Emerging Companies Fund</b>	-2.6%	-14.6%	19.0%	1.0%	10.2%	11.3%
<b>S&amp;P/ASX Small Industrials Acc Index <sup>3</sup></b>	0.0%	-12.8%	8.9%	-8.0%	-0.5%	0.0%
<b>Outperformance</b>	<b>-2.6%</b>	<b>-1.9%</b>	<b>10.1%</b>	<b>9.0%</b>	<b>10.7%</b>	<b>11.3%</b>
<b>S&amp;P/ASX Small Ordinaries Acc Index</b>	-0.6%	-21.4%	11.8%	-5.2%	3.0%	3.3%
<b>Outperformance</b>	<b>-2.0%</b>	<b>6.8%</b>	<b>7.1%</b>	<b>6.1%</b>	<b>7.2%</b>	<b>8.0%</b>

## Fund Commentary

The Fund fell 2.6%<sup>1</sup> over the December quarter, versus a 0.6%<sup>1</sup> fall in the Small Ordinaries Index and a flat Small Industrials Index. For the 12 months to December, the Fund has declined 14.6%<sup>1</sup>, outperforming the Small Ordinaries Index by 6.8%<sup>1</sup> but slightly underperforming the Small Industrials Index by 1.9%<sup>1</sup>.

The December quarter saw a recovery in the US market with the Dow Jones up 12%, following a dismal September quarter. The Australia market did not enjoy this recovery, with the All Ordinaries only rising 2%, led by defensive sectors. The smallcap sector underperformed mildly, falling 0.6%, primarily due to a fall in the mining stocks versus a flat industrial sector.

Australia's poor performance versus the US market reflects two factors. Australia's fortunes are highly exposed to global economic growth with concerns that a protracted European downturn may impact on China's growth. Conversely, recent data in the US shows a mild recovery in sentiment and retail activity which has buoyed the US market despite the Europe driven volatility.

The European situation remains key to global markets in the short term. With valuations near record lows, and cash weightings very high, many investors have abandoned shares in favour of the lower risk asset classes. This reminds us of early 2009 where macro uncertainty was very high, however this was more than reflected in valuations, which set the scene for a 60% rise in the All Ordinaries once the US situation stabilised. Hence any sense of optimism that the rate of decline in Europe is abating could result in a rise in shares as uncertainty takes a back seat to value. Timing such a potential rally is impossible, hence longer term investors are advised to step back from the volatility and remember the important role shares play in long term wealth creation.

Our Fund had a mildly disappointing quarter driven by a few stock specific announcements. We had avoided discretionary retailers for some time, however the current retail recession has more recently impacted even the most defensive of retailers (such as Collins Foods' KFC operations). Further we had sold half of our holding in CSG Group following a qualified takeover offer, however the share price declined quickly following a withdrawal of the bid, impacting our remaining position. On the flipside our high weighting in mining services continues to reward unitholders, with profit upgrades continuing to feed confidence in the outlook for the sector.

Our strategy remains consistent. We retain a high weighting to stocks which are not tied to the economic cycle, and a high weighting to mining services. We believe the market will revert back to a rewarding environment for stock pickers as the European situation becomes clearer and investors return to focus on long term value rather than short term volatility.

<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.

<sup>4</sup> The Fund only existed for eight months in the 2005 financial year

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### Recent portfolio activity

We added one new stock to the portfolio over the quarter which was **Alliance Aviation** via an IPO. The company operates "fly-in, fly out" services for staff in remote mining locations. Unlike a traditional airline which is at the mercy of short term bookings, Alliance signs long term contracts with the mine owner which creates a high level of earnings predictability. We sold down or out of **Resources Equipment**, **Cardno**, **Wellcom**, **G8 Education**, and **IOOF**.

### Key stock moves during the quarter

Key successes in the portfolio during the period included **Ausdrill** (+13%), **Campbell Bros** (+20%), **Domino's Pizza** (+19%), **REA Group** (+7%), and **Mineral Resources** (+8%). Detractors included **CSG Group** (-44%), **Collins Foods** (-39%), **Talent 2** (-57%) and **Kathmandu** (-22%).

Three of our five better performing stocks operate in the mining services sector (**Ausdrill**, **Campbell Bros**, and **Mineral Resources**). This sector continues to be the highest exposure in our fund, as mining expenditure continues to grow. **Domino's Pizza** posted 10% like-for-like sales growth in the four months to the end of October 2011 showing that not all retailers are suffering from the current retail recession, while **REA Group** gained further favour from its high levels of recurring income.

The common thread in the detractors is the retailers, where even relatively defensive categories are now under pressure. Feedback from most retailers is that current trading conditions are worse than the GFC. We have avoided discretionary retailers for some time however even defensive retailers such as **Collins Foods** and **Kathmandu** recently disappointed with poor trading announcements in the lead up to Christmas. We remain wary of discretionary retailers, especially those which face rising costs and market share pressure from on-line alternatives. We had sold half of our position in **CSG** as it rose strongly after a recent takeover offer. The offer did not eventuate hence a sharp correction in the share price affecting our (small) remaining position.

### Outlook

The European debt situation continues to dominate global markets, with many investors simply too afraid to hold equities in times of such volatility and uncertainty. Valuations are near record lows especially compared with fixed interest, which shows the premium investors are currently prepared to pay for low risk investments (bonds, bills and cash). Cash holdings are at record levels, again indicating a complete aversion to risk. Anecdotal feedback from listed financial services companies, and our investor base of financial advisors reflect this by virtue of most new money flowing into superannuation accounts being allocated to cash.

The current environment reminds us strongly of late 2008 and early 2009 where the continued flow of bad news caused many investors to abandon shares despite highly attractive valuations. At that point in time the US financial system was under extreme stress and the catalyst for a substantial rally in the stock market was a sense that the situation would not get worse (not necessarily that it would improve dramatically). It was the TARP program whereby the US Federal Reserve allocated hundreds of billions of dollars to buy underperforming loans which saw global markets rise very quickly during 2009 (the All Ordinaries rose over 60%).

Such a fix is not as easy to orchestrate in Europe given that it requires the agreement of a range of nations, each of which have their own domestic political and cultural issues to overcome. Many have suggested that the European Central Bank will, at some point, step in as the lender of last resort, thus providing a "floor" in credit markets and paving the way for a recovery in equities.

The only certainty in a recovery in equity markets is that the time of "maximum pain" is usually the best time to buy (or at least hold) shares. When the future feels uncertain, shareprices have typically already factored in this and more. Fear is the dominant driver of price, with greed a distant memory. This was the case in 2009, and at some point is likely to repeat once the European situation starts to clarify.

Our Fund remains highly exposed to companies with recurring income and high barriers to entry. The current market malaise sees many of these stock trade at highly attractive prices. We also retain a high weighting to the mining services sector which has seen many profit upgrades of late, and remains the strongest performing sector in the domestic economy.

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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 45 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).

Alliance Aviation	Dulux	Photon
Amalgamated Holdings	Fantastic	Primary Healthcare
APN Media	Forge Group	Prime TV
Aust'n Power and Gas	G8 Education	Programmed Maint
BT Investment	Gale Asia Pac	Pro-pac
Cabcharge	IRESS	RCG Group
Campbell Bros	Lifestyle Comms	Retail Food Group
Carbon Consious	M2 Comms	Slater & Gordon
Chandler MacLeod	Mainfreight	STW Holdings
CO 2 Ltd	Michael Hill	Sunland
Coffey	Mortgage Choice	Thinksmart
Collins Foods	Norfolk	Thorn Group
Delta SBD	NZ Telecom	Watpac
Downer	Oroton	WDS Ltd
DUET	Peet & Co	Restaurant Brands

## 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 <sup>4</sup></b>	1.3325%
<b>Benchmark</b>	S&P/ASX Small Ordinaries Accumulation Index	<b>Performance Fees <sup>4</sup></b>	20.5% of the performance above the Benchmark
<b>Investors</b>	Open to all investors	<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>	\$400m
<b>Inception Date</b>	1 November 2004	<b>Application Price at Month End</b>	A\$ 1.7187
<b>Identification Code(s)</b>	APIR PER0270AU ARSN 111 894 510	<b>Redemption Price at Month End</b>	A\$ 1.7084

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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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