

# Pengana Emerging Companies Fund



## June 2006 Quarterly Review

The Pengana Emerging Companies Fund posted a return of 3.8% (after mgmt fees) over the June quarter, compared with the benchmark performance of -1.9%. Since inception in November 2004, the fund has returned 57.8% outperforming the smallcap benchmark by 22.5%. The fund does not invest in resources stocks, which have rallied 67% since formation of the fund. The outperformance in that environment is particularly pleasing, with the fund beating the *industrial* benchmark by 30%.

The fund was recently rated **"A"** by **van Eyk \*\*\***, adding to existing ratings of "Highly Recommended" by **Lonsec**, "Strong Buy" by **InvestorWeb**, and "Recommended" from **Morningstar and Zenith**. The fund is approved for **BT and Macquarie Wrap, Symetry, Asteron, Austchoice and Beacon platforms**, and various margin lending providers, and now has over \$82m invested.

### Total return performance for periods ending 30 June, 2006

	3 months	6 months	1 Year	Since inception*
Pengana Emerging Companies Fund	3.9%	18.2%	38.6%	57.8%
S&P/ASX Small Ordinaries Acc Index	-1.9%	10.5%	25.5%	35.3%
Outperformance of benchmark	<b>5.8%</b>	<b>7.7%</b>	<b>13.1%</b>	<b>22.5%</b>
Pengana Emerging Companies Fund	3.9%	18.2%	38.6%	57.8%
S&P/ASX Small Industrials Acc Index**	-2.5%	6.1%	20.1%	27.6%
Outperformance of benchmark	<b>6.4%</b>	<b>12.1%</b>	<b>18.5%</b>	<b>30.2%</b>

\* Since Nov 1, 2004

\*\* The fund does not invest in resource stocks

Total return performance figures are derived from Manager's records and are shown after management fees, but before performance fees, and assumes reinvestment of income.

## Market backdrop

The June quarter was volatile, with the All Ords reaching record highs in May, only to fall 9% in four weeks driven primarily by weakness in the resources and banking sectors. The small cap market moved in a similar fashion, with resources stocks a feature in the weakness during May and June. From peak to trough, the Small Resources index fell 22% (in four weeks) as base metals prices corrected sharply on fear of rising inflation exacerbated by speculative investment in direct commodities. A rally late in June saw the small resource stocks recover much of their lost ground and outperform the Small Industrials over the quarter.

## Review of quarterly performance

Key successes for the fund during the period included **Integrated Group, Peet & Co, Reject Shop, Reverse Corp, Transfield Services** and **Web Central**.

The 31% rally in **Integrated Group** was driven by underlying strength in the labour hire operations, plus the sale of two lower quality divisions in vessel charter and training. **Peet & Co** continues to re-rate (up 25%) as the market appreciates its high quality land bank, efficient capital structure, and its shorter term exposure to the booming WA housing market. Shares in **The Reject Shop** rose 15% with its low price points attractive in a struggling retail environment. **Reverse Corp** provided an upgrade to earnings forecasts, generating a 44% rally in the share price. **Transfield Services** moved 12% following two acquisitions and a proposal to sell down its infrastructure assets, potentially releasing hidden value. **Web Central** rose 26% following a proposal to merge with Melbourne IT.

## Portfolio activity

During the period, we reduced exposure to some stocks which had reached our valuation objectives such as **Adelaide Brighton**, **Mortgage Choice**, **SAI Global** and **Skilled Engineering**.

New additions to the portfolio include recent floats such as **Ausenco**, **Bravura**, **Retail Food Group**, and other stocks such as **Energy Developments**, **Reverse Corporation**, **S8**, and **Saferoads**.

The weighted average PER of our portfolio for the FY07 year is estimated at 13.6 times, compared with the overall smallcap industrial average of 15.5 times. The dividend yield on our portfolio is an estimated 4.8% which suggests a slightly defensive stance in the portfolio. Our top five positions are listed below.

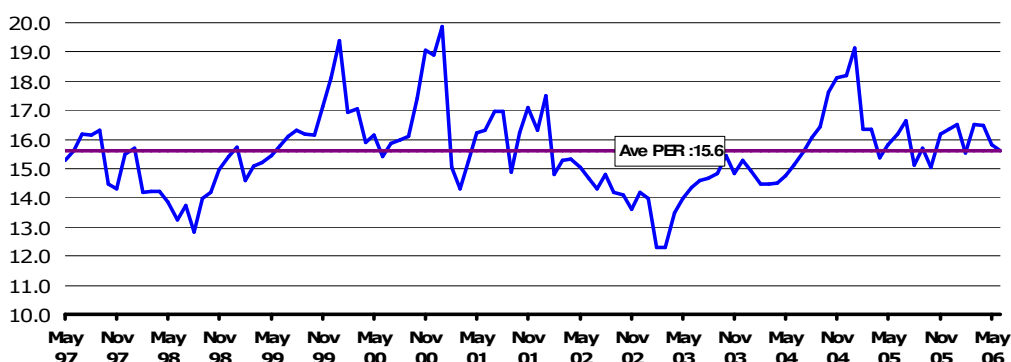
Top 5 positions in the fund
Candle Australia
Oakton
Primary Healthcare
WHK Group
Reverse Corp

## Outlook

The short term volatility in markets is not surprising given the very positive momentum of previous quarters. Overall, we do not see valuations as overly stretched (refer chart below), and with healthy corporate balance sheets and a strong underlying economy, investing risk remains neutral on the whole. Many companies have raised their dividend payouts in recent times, with high dividend yields providing support to share prices.

### SMALL INDUSTRIALS - Absolute PER Chart

source: GSJBW Research



While the retail sector remains patchy, we retain a selective exposure through three high quality growth stories at reasonable prices, **Clive Peeters** (a new position), **The Reject Shop**, and **Nick Scali**. The latter is suffering short term pressure due to weak furniture sales, however valuations remain modest, and the store roll out path is very strong. There are other potential opportunities in the sector we are working on, given the poor sentiment (hence modest valuations), and potential for tax cuts to re-ignite sales momentum through 2006.

Our exposure to companies benefiting from the strength in business/government spending remains high, reflecting our confidence in the theme. Key sectors here include IT services, mining services, and non-residential construction. Reported earnings, and outlook sentiment from most companies in the IT services remains very strong given the ongoing recovery in spending since the Y2K "hangover". The mining services sector appears even more bullish, with mine construction and expansion based on rising base metals and iron ore prices. We prefer companies selling consumable products to this sector, rather than contractors which rely on less predictable project related revenue. Non-residential construction is primarily driven by catch up expenditure by state governments in the transport, power and water sectors, which looks like remaining strong into 2008.

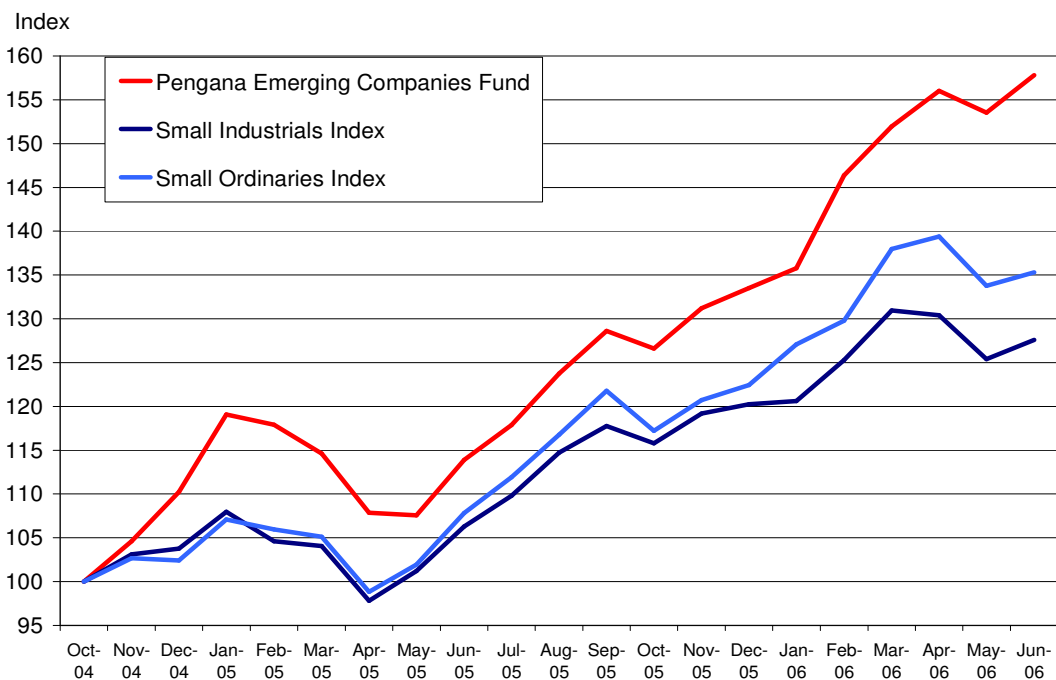
Financial services remains fertile, especially companies which derive income from the superannuation sector which has government mandated growth. Our favoured stocks are **Australian Wealth Management**, **DKN Group**, **MacMillan Shakespeare**, **Timbercorp**, and **WHK Group** (formerly Investor Group).

## 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 face-to-face contact with 68 companies and unlisted competitors of listed stocks. The table below shows the listed companies with which we had direct contact during the period.

ARB Ltd	Emeco	McArthur Cook	S8 Ltd
Ausenco	Environmental Group	McPhersons	Saferoads
Austral Waste	Espreon	Melbourne IT	Sedgeman
AV Jennings	Finbar	MFS Leisure	Select TV
AVFM Ltd	Fisher & Paykell Health	Mineral Resources	Servcorp
Babcock and Brown Infra.	FKP	Nufarm	SMS Mgmt
Brainz Instruments	Fletcher Building	Oakton	Snowball
Bravura	GPS Online	Pacific Brands	STW Communications
Cabcharge	HFA Ltd	PCH Group	Ten Network
Campbell Bros	Housewares	Pipe Networks	Toxfree Systems
Centrebet	IBA Ltd	Praemium	Traffic Technologies
Centrepoint Alliance	Imdex	Primary Healthcare	Tutt Bryant
CPT Global	Incitec Pivot	Prime TV	VDM Group
David Jones	Incitec Pivot	Programmed Maint.	Wellcom
DKN Group	Integrated Group	Record Investments	
DWS Ltd	Iress Technologies	Resmed	
Ellex Lasers	K&S Corp	Retail Food Group	
E*Trade	Legends Corp	Reverse Corp	

## Performance chart since fund inception



For more information on the fund visit our web site on <http://www.pengana.com.au/>

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