# Platinum Capital® Limited

# Quarterly Investment Manager's Report

31 December 2018

Platinum®
CAPITAL LIMITED

ABN 51 063 975 431

# Investment Update

## by Andrew Clifford, Portfolio Manager

### Performance

**(compound pa, to 31 December 2018)**

| | QUARTER | 1 YR | 3 YRS | 5 YRS | SINCE INCEPTION |
|---|---|---|---|---|---|
| Platinum Capital Limited | -8.1% | -7.4% | 6.0% | 6.5% | 11.8% |
| MSCI AC World Index^ | -10.3% | 0.6% | 7.8% | 9.4% | 6.7% |

PMC's returns are calculated using PMC's pre-tax net tangible asset (NTA) backing per share as released to the ASX monthly. PMC's returns are calculated after the deduction of fees and expenses, have been adjusted for taxes paid and any capital flows, and assume the reinvestment of dividends. **PMC's returns are not calculated using PMC's share price.**
Portfolio inception date: 29 June 1994.
^ Index returns are those of the MSCI All Country World Net Index in AUD.
Historical performance is not a reliable indicator of future performance.
Source: Platinum Investment Management Limited for PMC's returns; FactSet for MSCI Index returns. See note 1, back cover.

### Net Tangible Assets

The following net tangible asset backing per share (NTA) figures of Platinum Capital Limited (PMC) are, respectively, before and after provision for tax on both realised and unrealised income and capital gains.

| | PRE-TAX NTA | POST-TAX NTA |
|---|---|---|
| 30 September 2018 | $1.6655 | $1.5801 |
| 31 October 2018 | $1.5692 | $1.5128 |
| 30 November 2018 | $1.5261 | $1.4855 |
| 31 December 2018 | $1.5025 | $1.4857 |

Source: Platinum Investment Management Limited.

PMC's portfolio returned -7.4% over the last year and -8.1% in the final quarter. While our full year return was well below the global index, which returned +0.6%, portfolio performance was slightly ahead in the last quarter as the index fell -10.3%.[1]

Performance across markets was notably different in the final quarter of the year. During the first nine months of 2018, price weakness was concentrated primarily amongst companies that were directly exposed to the concerns surrounding China's economic slowdown, the US-China trade war, and rising US interest rates. In the last quarter, this stock price weakness spread to the high-growth software, e-commerce and biotech companies which had hitherto been holding up the broader market. These highly valued sectors led the US market lower, with the US finishing the quarter in line with or weaker than other major markets. Please refer to the enclosed Macro Overview for a more in-depth discussion of the factors driving markets.

As a result of the sell-off in tech stocks and the US market more broadly, our short positions made a significant positive contribution to performance this quarter. Of particular note was the 55% plunge in the share price of Nvidia (a US maker of graphic processing units or GPUs), one of the portfolio's key short positions, which was closed out for a significant profit. Also making strong contributions were our short positions against the US NASDAQ and Russell 2000 indices as well as a Biotech ETF.

In the broad sell-off, few of our long stock positions made ground. Notable exceptions included China Overseas Land & Investment (Chinese real estate developer, +10%) and ICICI Bank (Indian bank, +18%).

The oil price fell 40% during the quarter as the US decided to effectively defer sanctions on purchases of Iranian oil. As OPEC producers had been increasing production to make up for the potential shortfall, and US onshore producers had also expanded their output in response to higher prices, the result was an unexpected deterioration in the supply-demand balance in the oil market. Not surprisingly, oil-related stocks were impacted and our holdings in TechnipFMC (oil project service provider, -37%), Transocean (drilling service contractor, -50%), and Seven Generations (Canadian oil and gas producer, -8%) were key detractors from performance over the quarter.

In last quarter's report, we noted that "clearly, for the present, we are well and truly out of step with the market in terms of where we believe the attractive investments are in the current environment." While most of the portfolio's positions experienced further price declines this quarter, the significant change is that the expensive stocks and markets that we have been avoiding – or indeed shorting – are now starting to decline at least at similar rates. While the net result is far from satisfactory, the shift does suggest that investors are starting to recognise the differentials in value between the companies in our portfolio and the broader market averages.

1 Global market index referring to MSCI All Country World Next Index (A$).

## Portfolio Review and Commentary

Over the quarter, our cash levels increased from 12.6% to 13.9%, while short positions decreased from 15.8% to 13.5%. The resulting net invested position of the portfolio remained largely unchanged – at a relatively conservative 72.6%, compared with 71.6% as at 30 September.

While one might expect cash to have been put to work with such widespread falls, the increase in cash at quarter-end is merely the net result of ongoing sales and purchases. Underlying this net increase in cash have been ongoing efforts to reposition the portfolio towards more attractively-valued stocks that have emerged as a result of the broad-based sell-off.

Amongst the positions that have been sold or reduced are companies which, while still representing reasonable value, have become less attractive relative to the other opportunities as a result of their "comparatively" good recent performance. Stocks sold from the portfolio include **Murata Manufacturing** (Japan, electronic components) and **AstraZeneca** (UK, pharmaceuticals). Reduced holdings include **Asahi Group** (Japan, brewery), **Kasikornbank** (Thailand, bank) and **Ping An Insurance** (China, insurance and banking).

**General Electric (GE)** was added to the portfolio during the quarter. The company has had an extraordinary fall from grace over the last two decades, as a result of poor management and some disastrous acquisitions. Today, it finds itself in a financially compromised position with an over-leveraged balance sheet. However, GE has two core business units that are of very high quality and are growing: aerospace and healthcare. It also has good operations in power generation, oil services, and a range of other businesses, though which currently tend to be cyclically depressed with some also dealing with other issues. The company has experienced significant changes at the board level and has a new CEO in Lawrence Culp, who previously ran the highly successful Danaher Corporation as its CEO and President from 2001 to 2014. GE's stock price has collapsed, now down nearly 80% from its highs in 2016, in the face of concerns that the company may need to raise significant equity to bolster its balance sheet. Even if this is the case, we think GE's current price represents a good entry point and have taken an initial position. One should note that, however, given the magnitude of the issues GE faces in some of its business divisions, we expect the resolution of the company's problems to take some time.

Other new holdings for the portfolio include **Sumco**, a Japanese producer of silicon wafers used in the production of semiconductors. The industry has survived a long period of oversupply of wafers and, in recent years, seen improved pricing and profitability. However, the slowdown in global

### Disposition of Assets

| REGION | 31 DEC 2018 | 30 SEP 2018 |
|---|---|---|
| Asia | 36% | 36% |
| Europe | 21% | 22% |
| North America | 15% | 15% |
| Japan | 12% | 13% |
| Africa | 1% | 1% |
| Australia | 1% | 1% |
| Cash | 14% | 13% |
| Shorts | -14% | -16% |

Numbers have been subject to rounding adjustments.
See note 2, back cover. Source: Platinum Investment Management Limited.

### Net Sector Exposures ^

| SECTOR | 31 DEC 2018 | 30 SEP 2018 |
|---|---|---|
| Communication Services | 16% | 15% |
| Financials | 14% | 15% |
| Materials | 13% | 12% |
| Industrials | 11% | 11% |
| Information Technology | 6% | 5% |
| Energy | 6% | 7% |
| Consumer Discretionary | 5% | 6% |
| Health Care | 4% | 5% |
| Real Estate | 2% | 2% |
| Consumer Staples | 1% | 3% |
| Other* | -6% | -9% |
| TOTAL NET EXPOSURE | 73% | 72% |

^ A major GICS reclassification was implemented during the quarter. The changes affected the Information Technology, Communication Services (previously Telecommunication Services) and Consumer Discretionary sectors. Historical exposures have been updated for continuity.
* Includes index short positions.
Numbers have been subject to rounding adjustments.
See note 3, back cover. Source: Platinum Investment Management Limited.

### Top 10 Holdings

| COMPANY | COUNTRY | INDUSTRY | WEIGHT |
|---|---|---|---|
| Samsung Electronics | Korea | IT | 3.1% |
| Glencore PLC | Switzerland | Materials | 2.9% |
| Ping An Insurance | China | Financials | 2.7% |
| Alphabet Inc | USA | Comm Services | 2.6% |
| China Overseas Land & Invt | China | Real Estate | 2.5% |
| Roche Holding | Switzerland | Health Care | 2.4% |
| Sanofi SA | France | Health Care | 2.2% |
| Jiangsu Yanghe Brewery | China | Consumer Staples | 2.1% |
| PICC Property & Casualty | China | Financials | 2.0% |
| Siemens AG | Germany | Industrials | 2.0% |

As at 31 December 2018. See note 5, back cover.
Source: Platinum Investment Management Limited.

mobile phone sales has created valid concerns around near-term profitability, which have resulted in a sharp stock price fall. Longer term, we are of the view that prospects for this industry remain bright as semiconductor volumes will continue to grow, improving the demand for wafers, which should in turn lead to better pricing power for wafer producers. Also added to the portfolio was **Scout24**, a German online real estate and auto marketplace, which has been a long-term holding of the Platinum European Fund (an unlisted managed fund). In addition to these new positions, we have also added to existing positions where stock prices have fallen to very attractive levels. These included **Intesa Sanpaolo** (Italy, banking) and **Raiffeisen Bank** (Eastern Europe, banking), **Tencent** (China, internet), and **Nitto Denko** (Japan, electronic components).

## Currency

Changes were made to the portfolio's currency positioning on two fronts. 16% of PMC's exposure to the Chinese Yuan was hedged into US Dollars.[2] While we expect the People's Bank of China may take some steps to prevent the Yuan from falling against the US Dollar due to the trade negotiations, China's likely need for further monetary and fiscal policy easing to encourage economic activity will potentially place downward pressure on the exchange rate. The other key move was to add 11% to the portfolio's exposure to the Japanese Yen, which has historically performed strongly in times of market uncertainty. The portfolio continues to maintain a minimal exposure to the Australian Dollar.

## Net Currency Exposures

| CURRENCY | 31 DEC 2018 | 30 SEP 2018 |
|---|---|---|
| US dollar (USD) | 34% | 26% |
| Japanese yen (JPY) | 22% | 11% |
| Hong Kong dollar (HKD) | 14% | 14% |
| Euro (EUR) | 14% | 12% |
| Chinese yuan (CNY) | 7% | 8% |
| Indian rupee (INR) | 6% | 5% |
| Korean won (KRW) | 6% | 7% |
| British pound (GBP) | 5% | 7% |
| Norwegian krone (NOK) | 3% | 3% |
| Swiss franc (CHF) | 3% | 2% |
| Canadian dollar (CAD) | 2% | 3% |
| Australian dollar (AUD) | 1% | 1% |
| Thai baht (THB) | <1% | 1% |
| Danish krone (DKK) | <1% | 1% |
| Chinese yuan offshore (CNH) | -16% | 0% |

Numbers have been subject to rounding adjustments.
See note 4, back cover. Source: Platinum Investment Management Limited.

For further details of PMC's invested positions, including country and industry breakdowns and currency exposure, updated monthly, please visit www.platinumcapital.com.au.

## Outlook

The net invested position of PMC's portfolio remains conservative at 72.6%. As we stated last quarter, this low invested position is not quite an expression of any particularly bearish outlook on markets, but rather reflects the significant disparity in valuation between the popular stocks and markets, which we are short, and the out-of-favour stocks in which we are invested.

Indeed, the attractive valuations of our holdings, both on an absolute basis and relative to broader market averages, entail a cautiously optimistic outlook regarding the portfolio's prospective returns, particularly in light of both quantitative and qualitative indicators suggesting that our companies are both more profitable and growing faster than the average.

However, the shorter-term outlook is more problematic. How will global macroeconomic conditions develop in light of China's policy easing and interest rate moves in the US? Will China and the US come to an agreement on trade and, if so, when? As we have discussed in the enclosed Macro Overview, given the complexity and the uncertainty surrounding these issues, the timing of the unfolding of events is far from clear.

2 When we consider currency exposure to the companies we hold, we do not look to the currency in which the stock is priced or purchased, but rather the underlying economic exposure of the company's businesses. This is relevant where a company is listed on an exchange outside of its home market. For example, for a company doing business predominantly in China but is listed on an exchange in the US, we will consider the holding as a Chinese Yuan exposure, even if we buy and sell the stock in US Dollars. This is because, if the Chinese Yuan were to devalue by 5%, all else being equal, we would expect the US Dollar price of the stock to reflect this by falling 5%.

# Macro Overview

## by Andrew Clifford, CIO, Platinum Investment Management Limited

### 2018 – Year in Review

As we entered 2018, the prospects for the global economy were as bright as they had been since the onset of the Global Financial Crisis (GFC) over a decade ago. The US economy was growing from strength to strength, with tax cuts on the way that promised an additional boost. China had recovered well from its investment slump of 2014-15. Economic momentum was building in Europe and Japan.

There were a number of risks on the horizon. Many stemmed from rising US interest rates, especially as there were fears of inflation being fuelled by the tax cuts which added stimulus to what was already a buoyant economy. Another concern was how funding the increased fiscal deficit would impact on the US bond market. Further on the horizon remained the question of how the world's central banks would extricate themselves from their money printing exercises or "quantitative easing" (QE). There was also President Trump's threat of a trade war, along with other politically inspired skirmishes such as Brexit.

Under the radar of most Western media and commentators were the developments of China's financial reform. The reform essentially aimed to bring securitised assets – the so-called shadow banking activities – back onto the balance sheets of banks. The goal of the authorities was to tighten up on the speculative use of credit outside of the regulated banking environment. While to our minds this was good policy, we did highlight in our March 2018 Macro Overview[1] that the reform process gave rise to a risk of tightened credit availability which could potentially impact the economy. Our base case at the time was that, as China's economy was undergoing robust growth, the system should absorb and cope with the impact reasonably well.

This assumption turned out to be overly optimistic. The Chinese economy did progressively slow throughout 2018 in response to tighter credit conditions, with notable credit losses occurring in unregulated peer-to-peer lending networks, impacting consumer spending. The slowdown was further exacerbated by the commencement of President Trump's "trade war" in July. As we have highlighted in past reports, while the impact of the tariffs imposed to date has been relatively minor, they have certainly damaged business confidence and resulted in cut-backs in investment spending in China's manufacturing sector. The slowdown in China has continued throughout the latter months of the year, with passenger vehicle sales down 13% and 16% from a year ago in October and November 2018 respectively, and the first 11 months of the year registering a 2.8% decline from the same period in 2017.[2] Similarly, mobile phone sales volume in China in Jan-Nov 2018 decreased by 8% year-on-year.[3] Other indicators, such as the Purchasing Managers' Index (PMI), also registered declines over the last quarter.

The impacts of China's slowdown have been felt far beyond its borders. While China today is the world's second largest economy (US$12 trillion versus the US at US$19 trillion), it is for many goods the world's largest market. Not only is this the case for commodities and raw materials, such as iron ore and copper, it is also the case for many manufactured goods, from cars to smartphones to running shoes. Indeed, it would be difficult to think of a physical good for which China is not the biggest consumer in volume terms. As a result, China's slowdown has been felt globally and has been a significant factor in the loss of economic momentum in Europe, Japan and many of the emerging economies. The one country that has so far appeared immune to China's slowdown is the US, which was growing faster in the first instance, but also had the benefit of a fortuitously timed fiscal stimulus in the form of tax cuts.

### Prospects for 2019

What does the year ahead hold in store?

Reasons for Caution

The loss of momentum in China, together with the trade war, will continue to cause a significant deal of uncertainty. Many companies entered 2018 with strong order books. As is typical in times of boom, customers were likely double-ordering components or items which they thought might be in short supply. When business slowed, these customers would have found themselves cutting back on new orders aggressively. In addition, the trade war also led some

1 www.platinum.com.au/Insights-Tools/The-Journal/Macro-Overview-March-2018

2 www.marklines.com/en/statistics/flash_sales/salesfig_china_2018, based on data compiled by the China Association of Automobile Manufacturers.

3 www.counterpointresearch.com/china-smartphone-share/

companies to bring forward orders to avoid the added cost of tariffs. All of this has created a significant amount of noise in sales outcomes for many businesses and it may well be some time into the new year before one has a clear sense of where demand has settled for many goods. And, of course, we are yet to see whether the US and China can negotiate a compromise on trade prior to the 1 March deadline – when, absent an agreement, US tariffs on a further US$200 billion of Chinese imports will take effect.

More importantly, the greatest risk facing the global economy is that the last driver of growth, the US, is now poised to slow. Housing and auto sales have fallen in response to higher interest rates. The benefits of the tax cuts have for the main part been expressed. The impact of tariffs on business is now being felt. While their direct impact on the US economy is perhaps not significant, the tariffs and the broader trade tension likely have begun to affect both consumer and business confidence, particularly as we await the outcome of the US-China negotiations.

Furthermore, the political environment in the US post the mid-term elections is also likely to be a drain on confidence, and the partial shutdown of the US government over funding debates may well be a prelude for what is to come. While similar shutdowns have occurred in the past with relatively minor disruptions, they certainly add to the distractions faced by both businesses and consumers. President Trump's infrastructure program could potentially be the next boost to growth, though it is unlikely to have much impact within the next 12 months even if it were to eventuate. As for interest rates, while the Federal Reserve has signalled that it will slow the pace of rate hikes, rate cuts appear a distant prospect. Many commentators have been focusing on the likelihood of a US recession, but it is beside the point. The conditions are in place for a progressively slower environment in the US throughout the course of 2019.

An important lesson from the last four years is that a maturing Chinese economy has become more responsive to domestic interest rate movements and credit condition. As the financial reform started to take hold in 2017, interest rates did rise and the Chinese Yuan appreciated, which subsequently saw economic activity slow in 2018. This is not dissimilar to what happened in 2015 when a recovery in activity from the prior investment slowdown was building momentum, only to be extinguished as capital outflows under the country's managed exchange rate mechanism led to tightened monetary conditions. Absent a more flexible exchange rate mechanism, China will likely remain susceptible to these mini booms and busts.

Another lesson from 2018 was how important China had become to the global economy. For the last 30 years or more, the US economy and financial markets have been at the centre of every analysis of global markets. It has long become a cliché to say that "when the US sneezes, the rest of the world catches a cold". In 2018, the US economy was in great shape, and yet the rest of the world slowed, because of China.

Reasons for Optimism

Applying these lessons to the year ahead, we would make the following observations. In order to alleviate the stress the financial reform has placed on the system, China has pushed out the deadlines for banks to comply with the requirement to bring their shadow banking assets back onto the balance sheet. Banks' capital reserve ratios have been cut to free up lending capacity, and funding has been assured for approved infrastructure projects. By October 2018, the 1-month Shanghai Interbank Offered Rate (SHIBOR) had fallen to 2.7% from 4.7% at the start of the year, and anecdotally the availability of credit for companies with strong balance sheets has improved dramatically. Tax cuts are on the way for households and businesses, which are estimated to be in the order of 1% of GDP.

These are important developments that are worth paying attention to. **If China's economy slowed in response to a tightening of credit conditions, one should also expect to see activity gradually pick up as policy loosening takes effect.** As it happens in any economic downturn, there will be debates around whether enough has been done and how long before the economy responds. Nevertheless, policy is clearly moving in a direction to, at least, gently encourage growth. Certainly, the broader economic data is yet to show any obvious signs that a bottom has been found, though some "green shoots" can be observed in improving construction equipment sales and a pick-up in infrastructure investment.

Besides the potential for a recovery in China, the other positive that may unfold is a resolution, at least in part, to the trade conflict between the US and China. In our last quarterly report we discussed in some detail the reasons that we believed there were significant incentives for both sides to find a compromise. Subsequently, the 1 January increase in US tariffs from 10% to 25% on US$200 billion of Chinese imports has been deferred while the two sides look to negotiate a deal. In our view, the need for both countries to find a middle ground is compelling, and it also appears that post the mid-term elections in the US, there is now an imperative for President Trump to win a domestic political victory. However, given the innumerable unknowns around the incentives on both sides of the negotiating table, it is difficult to have a strong level of conviction in this view. Presumably, we will be entertained by a "made for TV" style drama as the 1 March deadline approaches.

## Market Outlook

As we observed in last quarter's Macro Overview, the slowdown in China, the uncertainty around trade, and rising interest rates in the US, had resulted in falling stock prices across the sectors that are sensitive to economic growth or exposed to trade issues. On the other hand, companies that were perceived to be immune to these concerns had performed strongly. These good performers were found primarily amongst high-growth companies in sectors such as software, e-commerce and biotech. Again, as we noted, these high-growth stocks were either at or approaching valuations that were exceedingly high by historical standards. Through the first nine months of 2018, the performance of these sectors accounted for much of the performance differential between the US market, which had continued to reach new highs, and the world's other major markets, which had been in steady declines since February. In the last quarter, in response to higher interest rates and tightening liquidity, this pattern changed with the US selling off in line with or even more fiercely than other major markets, led by the highly valued tech and biotech names.

Recently Bloomberg recorded an interview with Stan Druckenmiller, one of the most successful hedge fund managers of all time. The hour-long interview covered a wide range of topics, but of particular interest is Druckenmiller's observation that the signals he has relied on over the last 40 odd years to make calls on markets are no longer working. Druckenmiller noted that interest rate moves during a period of quantitative easing and very low rates, as well as stocks' price movements in response to news, could no longer be reliably reverse-engineered to give readings on what is happening in the economy. The result has been a higher degree of difficulty in extracting returns from markets. His comments echo those we have read from other experienced fund managers, and indeed in recent years many managers with strong long-term records have performed poorly with quite a number of them choosing to close shop and cease managing money. It is part of the phenomenon of active managers struggling to outperform the market and what some have referred to as the "death of value investing".

Various reasons have been offered for this idea that markets aren't behaving quite as one expects. At the top of this list of

### MSCI Regional Index Net Returns to 31.12.2018 (USD)

| REGION | QUARTER | 1 YEAR |
|---|---|---|
| **All Country World** | **-12.8%** | **-9.4%** |
| **Developed Markets** | **-13.4%** | **-8.7%** |
| **Emerging Markets** | **-7.5%** | **-14.6%** |
| **United States** | **-13.8%** | **-5.0%** |
| Australia | -10.0% | -12.0% |
| **Europe** | **-12.5%** | **-14.8%** |
| Germany | -15.5% | -22.2% |
| France | -15.0% | -12.8% |
| United Kingdom | -11.8% | -14.2% |
| Italy | -11.8% | -17.8% |
| Spain | -8.7% | -16.2% |
| Russia | -9.0% | -0.7% |
| **Japan** | **-14.2%** | **-12.9%** |
| **Asia ex-Japan** | **-8.7%** | **-14.4%** |
| China | -10.7% | -18.9% |
| Hong Kong | -4.5% | -7.8% |
| Korea | -13.1% | -20.9% |
| India | 2.5% | -7.3% |
| Brazil | 13.4% | -0.5% |

Source: FactSet.
Total returns over time period, with net official dividends in USD.
Historical performance is not a reliable indicator of future performance.

### MSCI All Country World Sector Index Net Returns to 31.12.2018 (USD)

| SECTOR | QUARTER | 1 YEAR |
|---|---|---|
| Utilities | 0.8% | 1.4% |
| Communication Services | -6.2% | -10.9% |
| Consumer Staples | -6.6% | -10.5% |
| Health Care | -9.6% | 1.7% |
| Financials | -11.9% | -15.7% |
| Materials | -13.4% | -16.0% |
| Consumer Discretionary | -14.4% | -8.3% |
| Industrials | -15.6% | -14.4% |
| Information Technology | -17.1% | -5.8% |
| Energy | -20.2% | -13.3% |

Source: FactSet.
Total returns over time period, with net official dividends in USD.
Historical performance is not a reliable indicator of future performance.

reasons is the impact of QE and low interest rates. Especially topical at the moment is the question of how the reversal of QE, with the Federal Reserve reducing its holding of US Treasuries, particularly at a time of rising fiscal deficits, is impacting on markets. Another oft-cited reason for recent market "anomalies" is the "rise of the machines" – be they high-frequency algorithmic trading or quant-based investment strategies. Furthermore, with the rise of populist governments across the world, political risk, at face value, is much greater than it has been. Accumulation of high levels of debt in certain sectors of the global economy may also be playing a role, though this is hardly a new phenomenon. It may simply be that China is having a much greater influence on the global economy and on markets than ever before.

We would broadly agree with the claim that markets are not behaving quite as one expects. However, the reality of markets is that they often don't behave in line with investors' expectations, and the patterns that investors think they see are only temporary. So, as investors, how should we navigate our way through this environment? There are two core principles which underpin Platinum's investment approach. First is the belief that **the best opportunities are often found by looking in the out-of-favour areas** and avoiding the popular ones. Secondly, **the price we pay for a company is the single most crucial determinant of the return** that we will earn on the investment.

Guided by these core principles, we would make the following observations about the current state of the markets. Investor sentiment has deteriorated significantly over the last quarter. Sentiment is difficult to gauge with precision, but a number of the quantitative indicators that we use to objectively measure sentiment are certainly pointing to a bearish stance by equity investors. Our more qualitative assessment is that across the markets the level of bearishness varies dramatically by region and by sector. For example, North Asian domestic investors are generally very negatively disposed towards their own markets, and investors are quite fearful of certain sectors, such as autos, semiconductors and commodities, as they are perceived to be more prone to the cyclicality of economic activity. Such observations lack precision and certainty. Of course, if the US economy deteriorates significantly or if the trade talks fall over, it is readily conceivable that markets will fall further. Nevertheless, it is in these periods of great uncertainty that one should be looking for opportunities to buy markets. Our sense is that markets may not have quite bottomed just yet.

At turbulent times like this, we will fall back to an assessment of the potential returns implied by the valuations of our holdings. Simply put, we will consider the earnings or cash flow yields that our companies will provide investors with over the next five years and beyond. While there is no certainty regarding these future earnings, and the prospects of some of our holdings over the next one to two years may have diminished from what might have otherwise been expected, the valuations across these out-of-favour sectors are highly attractive today.

Attractive valuations (i.e. low prices relative to prospective earnings) are not a guarantee that stock prices will not fall further, especially over the short-term. However, the expected returns from an investment are not some ethereal concept – returns will flow to investors' pockets where companies pass their earnings onto shareholders in the form of dividends and/or stock buy-backs. Alternatively, at the right price, knowledgeable buyers may appear and buy out the company from shareholders. In short, based on our assessment of the current valuations across the companies we own, we believe that our portfolio offers good prospects of favourable returns. What we feel less certain about, however, is the time frame over which these returns will be realised, which is difficult to assess given the numerous challenges facing the market today.

# Eastern Europe – New Markets in the Old Continent

## by Nik Dvornak, Portfolio Manager, Platinum Investment Management Limited

Europe comprises around 50 countries, 750 million people and an economy similar in size to those of North America and East Asia. When discussing the region, most investors focus on a handful of large developed economies and multinational companies listed on the stock exchanges of London, Paris or Frankfurt. Since the region is so fragmented and multifaceted, this desire to focus on the familiar is understandable. But doing so risks overlooking some of the best opportunities Europe has to offer.

While it is tempting to think of Europe as an economically developed region, much of the east and south-east comprises emerging markets. Members of Platinum's investment team have a long history of investing in emerging markets. During the 1980s, the firm's founding members were very active in Latin America and Asia. Since the 1990s we have focused particularly intensely on Asia, devoting significant effort, resources and time to this region. Yet, we had not invested in Eastern Europe until 2014. This begs the questions: why not and what has changed?

### 1990 – 2008

Following the end of the Cold War, the so-called Eastern Bloc countries worked to adopt Western systems of government and economic management. This was no simple matter. Industrialisation and economic organisation under Communism did not evolve organically. Industrial development was an artificial construct directed by bureaucrats, which was piecemeal in nature and poorly integrated with the local economy, never mind with global markets. Much of the labour and capital engaged in these uncompetitive endeavours needed to be redeployed.

Such transitions entailed considerable confusion, economic turmoil and social upheaval. There was a high risk that the process would derail in any given country. For investors, this is no bad thing. High uncertainty, combined with the potential for rapid growth, often leads to an abundance of attractive investment opportunities. However, in Eastern Europe, two factors made such opportunities scarce.

Western European investors and companies saw these newly opened-up economies as their backyard. They were familiar with the region, closely tracked the transition processes and scoured them for opportunities. Instances of true neglect, the likes of which we found in South-East Asia following the 1997-98 Asian Financial Crisis or periodically in India, Korea and China, were rare and short-lived. There was tremendous political will to achieve a successful transition on the part of both Western European governments and the ordinary citizens of Eastern Europe. Investors never really lost sight of this and the mood of long-term optimism was rarely shaken.

The other complication was that as a successful transition began looking increasingly likely, domestic economic actors became ever more optimistic. Consumers began to extrapolate their income growth, expecting their incomes to soon converge with those of Western Europeans. Household spending began to increasingly reflect this aspirational level of income, rather than actual earnings. Households were borrowing to live beyond their means with Western European banks only too happy to provide the funds. These imbalances would ultimately result in significant indebtedness and an erosion of competitiveness, similar to what we observed in Asia in the lead-up to the 1997-98 crisis.

### What changed post-2008?

In Eastern Europe, these vulnerabilities were laid bare by the 2008-09 Global Financial Crisis and the 2012-13 European Sovereign Debt Crisis. These episodes severely restricted credit availability, forcing households to adjust spending to match their income. Businesses had to adjust to lower levels of activity by cutting staff, cutting hours and cutting wages. The public sector also had to resort to pay and pension cuts. Competitiveness was restored and imbalances righted the old-fashioned way, via the market mechanism. The imbalances were large and hence the recessions were typically severe.

Hungary is one of the more extreme cases. Hungarian domestic demand contracted by 9% in 2009 while Gross Domestic Product (GDP) contracted by 7.5%. Unemployment reached 11%. Property prices fell 25%. The current account deficit fell from 7% to 1% of GDP in 2009 alone.

Allowing markets to adjust is painful but undeniably effective. Admittedly, Hungary is an extreme example, but it is illustrative of what happened in the region more broadly. Today, Hungary is a fiercely competitive economy, as evidenced by the following (recall that 2008 was the previous peak year for economic performance):

1. Hungary's current account swung from a 7% of GDP deficit in 2008 to a surplus of 6% of GDP in 2017, driven by strength in exports.

2. Direct foreign investment rose from EUR 4 billion in 2008 to EUR 8 billion in 2017, indicative of the appetite among Western European businesses to relocate productive capacity to Hungary.
3. The proportion of working age people participating in the labour force improved from 54% in 2008 to 62% in 2017. Despite this 11% increase in labour supply, unemployment fell from 8% in 2008 to 4% in 2017. Amazingly, participation among 60-74 year-olds has tripled over this period and they now account for nearly 10% of the workforce. This illustrates just how strong demand for Hungarian workers is in the global economy.

The other big change during 2008-13 was a dramatic reduction in indebtedness across the region. Again, using Hungary as an example, bank loans owed by Hungarian households and businesses were 20% lower in 2017 compared to 2008, yet nominal GDP had grown by 40% over this period. As a share of GDP, private sector indebtedness had just about halved between 2008 and 2017.

Being highly competitive with minimal indebtedness makes Eastern European economies very resilient to economic shocks. Yet, perversely, investor interest in the region has greatly reduced. Before 2008, investors tended to see the region as emerging markets in terms of growth, but as developed markets when it came to risk. The 2008-13 experience unveiled the flaw in this thinking and cured many of their exuberance. At the same time, rising support for populist politicians, push-back against perceived European Union (EU) encroachment, and some steps to undermine the rule of law, freedom of the press and civil institutions have caused scepticism to replace long-term optimism.

Meanwhile, the long-term structural appeal of these emerging economies has not diminished. Like most emerging markets, Eastern Europe offers relatively cheap labour and an abundance of unexploited opportunities to deploy capital. Moreover, they are endowed with other favourable structural characteristics that most emerging markets lack:

- The population is highly educated, allowing them to compete in high valued-added sectors.
- The European Union Structural and Investment Funds provide an unwavering stream of capital to pay for infrastructure and other development projects.
- As EU members or as participants in the accession process, these countries must respect EU principles, treaties and laws. They must also submit to external oversight by EU institutions, including the EU judicial system. Essentially they are 'importing' strong, independent institutions which uphold the rule of law, rather than having to develop their own.

The last point is particularly important. The primary reason that most emerging markets fail to 'emerge' is that their political, judicial and civic institutions are too weak to prevent elites in business and government from subverting the rule of law in pursuit of personal interests.

So what has changed about Eastern Europe since 2008? Firstly, our concerns around the erosion in competitiveness and rising indebtedness have been comprehensively addressed. Secondly, investor optimism has been replaced with scepticism even though the favourable structural characteristics of these markets remain very much intact. This has piqued our interest in the region.

With this backdrop in mind, we travelled to the region last month, visiting a broad range of companies and government institutions in Vienna, Bucharest, Warsaw and Budapest. Being relatively new to these markets, we adopted a cautious approach and focused on learning and discovery. In what follows, our aim is to give the reader a taste of the kinds of investment themes we were exploring on our trip and what the region has to offer.

## Eastern European Consumers

We found abundant evidence that Eastern European households are in excellent financial shape.

Job security is very high and employment prospects are excellent. Unemployment is at record lows throughout the region. More importantly, demand for labour is underpinned by competitiveness in the global labour market, not a temporary overheating of the domestic economy.

Wages are rising 5-10% per year, depending on the country. Hungary is resorting to enticing 60-74 year-olds back into employment. Poland is keeping wage growth relatively low at 4-5%, but had to import 1.3 million Ukrainians on short-term visas to achieve this. Local firms are locked in a struggle to stop workers from migrating west. For example, the entire region is grappling with a drain of doctors and nurses as aging populations in Western Europe compete for their skills.

With minimal inflation and low taxes, this wage growth flows through to hip pockets. Most households also own their homes outright, having received title when Communism ended. This means most people's monthly expenses do not include any mortgage repayments, interest payments or rent. Without mortgages, most households have very little debt. Finally, many households have significant savings set aside. For example, 45% of property transactions in Hungary do not involve borrowing.

These consumers are confident, have significant under-utilised spending power, and are resilient to economic shocks. Higher interest rates are of little concern to households with little debt. As for a slowing economy, firms typically fire their least cost effective workers first, meaning that the highly competitive workers of Eastern Europe should be more insulated than most. Contrast these consumers to their counterparts in the United States, the United Kingdom and Australia who are tapped out and heavily indebted. Their circumstances could not be more different.

As households in this part of the world enjoy rising incomes and wealth, their demand for financial services, travel and consumer goods will grow. Markets for these goods and services in Eastern Europe remain small and fragmented, and carrying on business there entails significant operational risk. Many large global firms have bigger fish to fry, leaving these markets for local or regional providers.

Lufthansa is not rushing to connect Debrecen, in Eastern Hungary, to the world. ASOS is not going to build distribution centres that enable same-day delivery in the Balkans when it has Western Europe and the United States to fight over. This allows regional firms like low-cost airline, Wizz Air, and fashion-retailer, LPP, to tap these increasingly wealthy yet neglected consumers, largely unchallenged.

## Oil Refineries

Eastern Europe's energy infrastructure was built during the Communist era and designed to process oil imported from Russia. The region has complex oil refineries designed to process the heavy, sour crudes from the Ural and Volga regions. These refineries have considerable flexibility over the feedstock they can process and the mix of outputs they produce.

Such flexibility would be irrelevant if all feedstock types are readily available and demand growth is similar for all outputs. But this is not the case. Demand for mid-distillates (diesel, kerosene) is growing more rapidly than demand for light fractions (gasoline) and heavy products. Complex refineries have greater capacity to increase their mid-distillate yield than simple refineries. Eastern European refiners also have pipeline access to Russian heavy crude which is well suited to producing mid-distillate yields, but can process a range of different crudes if price disparities develop. This will prove advantageous if supply growth continues to be dominated by light crude (US shale), condensate and natural gas liquids.

The other interesting attribute of Eastern European refiners is that they have extensive distribution networks in the region. This is something of a barrier to competition from seaborne imports, with the hinterland being landlocked.

As incomes grow, people will drive more, fly more and buy more goods that need to be trucked around. They will also consume more plastics. These local refiners have a decent lock on these markets, tremendous flexibility in terms of inputs and outputs as well as the capacity to direct less valuable light products to petrochemical manufacturing.

## Hydroelectric Power Generators

The Danube River flows through many countries in the region and is an important source of hydroelectric power. Hydroelectric power plants are capital intensive, requiring extensive civil works. However, once built, they produce power from a free input – water. The design life of the turbines is typically 40 years, but with proper maintenance they can last 90 years (and counting). These are fantastic fixed cost assets that are tremendously profitable when power prices rise.

Eastern European electricity markets are connected to the Synchronous Grid of Continental Europe. Pricing is deregulated and domestic power is often priced off German wholesale prices. Power prices in Europe have appreciated markedly in recent years, driven by rising coal and gas prices, a big rebound in carbon prices, and slightly higher demand. Many countries in Europe are moving to phase out coal power plants, which will put pressure on gas prices and increase power price volatility as a source of inflexible production is removed.

Eastern Europe and Austria have some great hydroelectric power assets. There is also some potential for pumped storage to help manage the intermittency problem that will only grow as the share of renewables in the generation mix increases.

## Summary

Eastern Europe has changed markedly since 2008. Investor sentiment has waned while the problems of high indebtedness and eroding competitiveness have been comprehensively addressed. At the same time, the favourable structural characteristics that differentiate these countries from most emerging markets remain in place. The region's prospects look quite promising though it is by no means without its challenges.

We spent a week travelling in Eastern Europe in November. This was our first trip to a region we had not followed closely in the past. We met a range of companies and found some interesting potential investments, particularly among businesses serving local consumers, such as banks, airlines and retailers as well as oil refiners and hydroelectric power producers. As we are relative newcomers, our approach is cautious and our positions will initially be small as we take time to build our understanding of this part of the world.

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