# Platinum Asia Fund

**Joseph Lai** Portfolio Manager

## Disposition of Assets

| REGION | DEC 2015 | SEP 2015 |
|---|---|---|
| China (Listed Ex PRC) | 31% | 29% |
| China (Listed PRC) | 9% | 5% |
| Hong Kong | 4% | 3% |
| Taiwan | 3% | 2% |
| **Greater China Total** | **47%** | **39%** |
| India | 18% | 19% |
| Korea | 8% | 11% |
| Thailand | 6% | 6% |
| Philippines | 4% | 4% |
| Vietnam | 3% | 2% |
| Singapore | 2% | 2% |
| Malaysia | <1% | 2% |
| Cash | 12% | 15% |

Source: Platinum. Refer to Note 3, page 5.

## Performance

**(compound pa, to 31 December 2015)**

| | QUARTER | 1YR | 3YRS | 5YRS | SINCE INCEPTION |
|---|---|---|---|---|---|
| Platinum Asia Fund | 2% | 2% | 16% | 10% | 16% |
| MSCI AC Asia ex Jp Index | 0% | 2% | 12% | 7% | 10% |

Source: Platinum and MSCI. Refer to Note 1, page 5.

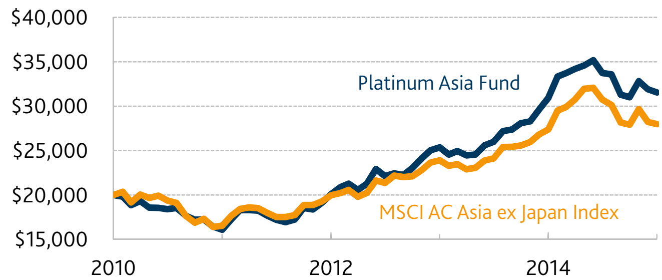
The broad MSCI Asia Ex Japan Index was up 3.8% for the quarter in US dollar terms while the Australian dollar appreciated against the USD by 4%, resulting in a more or less flat overall return for Australian investors. The Fund concluded the quarter with positive returns (+1.7%), bettering the Index (in AUD terms).

Similar to global markets, regional markets have been lacklustre. Slowing economic growth, depreciating currencies and the prospect of a US interest rate rise reduced investors' appetite for risk. The Hong Kong market was up 5%, with H-shares up 3%, Taiwan was up 2%, India was flat, and Thailand was down 5%.

The Chinese A-share market was a good performer, up 16% for the quarter from a low base post the sell-off mid-year. As economic reforms continued and the authorities loosened

**Value of $20,000 Invested Over Five Years**

*31 December 2010 to 31 December 2015*




Source: Platinum and MSCI. Refer to Note 2, page 5.

fiscal and monetary policies to stabilise the economy while simultaneously tightening capital outflow to manage a steady depreciation of the Chinese yuan, capital gravitated towards the stock market, particularly to stocks linked to the new economy.

Contributors to performance were mostly Chinese stocks the Fund had added to early in the quarter: Jiangsu Yanghe, Kweichow Moutai, Gree, JD.com, Tencent and Baidu. Detractors were mainly our Indian holdings – banks (working through legacy bad loans) and Adani Ports (ironically, greater domestic coal production led to a drop in coal imports).

## Changes to the Portfolio

The Fund maintained a 13% short position in the Chinese yuan against the US dollar. This has added to the positive performance this quarter, and we expect the Yuan's depreciation to continue. The Fund has taken profits from certain positions during the recent rally and reduced the overall net invested position while awaiting better opportunities to re-deploy capital into companies with favourable, secular dynamics and attractive valuations.

We reintroduced positions in **Qingdao Haier** and **Gree** (leading household appliance manufacturers in China) as valuation became attractive for these companies which have dominant market positions, significant cash reserves on their balance sheets and tantalising dividend yields.

We also added to our **Indian gas sector** exposure. Indian gas import is rebounding strongly as imported gas price has declined more than 50% in the last 12 months. For an energy-scarce country, weak gas prices are hugely beneficial for its balance of trade and economic activities!

## Commentary

### Transitions and Reforms

Shenzhen (population: 11 million), a vibrant metropolis situated in southern mainland China, a stone-throw away from the Hong Kong SAR (population: 6 million), has ignored the doom and gloom with which foreign investors have often characterised China over the last five years. As the first of China's five Special Economic Zones, Shenzhen was singled out in 1980 to be an experimental ground for the country's economic reforms. The city now hosts the headquarters of quite a number of the corporate titans of modern China – Tencent (the Facebook of China), Ping An Insurance (a dominant life insurer), ZTE and Huawei (globally competitive mobile network equipment providers), China Vanke (the biggest real estate developer in China), and China Merchants Bank – to name just a few.

Some of the interesting, new industry companies that we have recently visited include:

- Han's Laser – the dominant provider of advanced laser equipment for use in the making of iPhones and iPads.
- BYD Auto – China's own up-and-coming electric vehicle manufacturer. Electric vehicles saw a fourfold increase in sales in China in 2015 – around 350,000 units. The performance of the BYD cars is improving at an incredible pace, so much so that the "golf cart" we saw a couple of years ago is now able to accelerate from 0 to 100 km/hr in under five seconds!
- Centre Testing International – the biggest independent testing and certification service provider in China, which is seeing demands rise with increasing regulatory requirements on environmental, safety and authenticity standards across all industries (e.g. food and drugs, toys, building materials, motor vehicles, workplaces).

Shenzhen's economy has been growing robustly. The property market has been a star performer, up more than 30% this year. GDP per capita (productivity per person) is at around US$25,000 a year and is expected to catch up to that of Hong Kong in a few years' time.

Hosting one of the two stock exchanges in China has helped Shenzhen's fortunes, but its success was really a story of reform and free market economics. It is encouraging that after a few years of consolidation of power by senior leaders in China, some reforms are likely to be coming through.

The country's state-owned power grids have over the years been operating without an effective regulatory framework. They have all the monopolistic powers of a regulated public utility, but few of the social obligations, thereby leading to high power prices and a significant proportion of alternative energy generators not having their power purchased by the grid. A more robust regulatory framework has been proposed by the authorities to solve these issues. It is expected to effectively turn the grid operators into a utility that we typically see in developed countries, earning a reasonable return on investment, but mandated to buy power from alternative energy sources. This will significantly improve both air quality and the economics of wind and solar farms.

We met with CT Environment, a company based in Guangdong Province that will continue to benefit as Chinese regulators become more stringent on enforcing restrictions against discharge of industrial effluence. Water tanks the size of football fields are now required in many Chinese cities to treat waste water from industrial users, with the government having real time access to check the quality of water produced. A lot of work is yet to be done. Although output from designated industrial parks is easily monitored, those operating outside these areas are yet to come under effective supervision.

Our recent trips visiting different Chinese cities confirmed our view of a simultaneous rustication of the old and emergence of the new economy (information technologies, environmental initiatives, industrial upgrading, modern services, upgrades in consumption patterns). The older parts of the economy have matured (mainly the construction and infrastructure related sectors) while the new continues to flourish, driven by reforms, urbanisation and growing incomes. Fortunes of cities and associated job markets are linked to this dynamic.

Notwithstanding the cross currents of this gargantuan economic transition, we are still seeing relatively stable consumption and wage growth. While this is particularly apparent in the booming service sectors, manufacturing and low-end labour wages also continue to grow at single digit rates.

Research and development as a percentage of the country's GDP has gone up from 0.5% to greater than 2%. While still below that of a few developed nations on this metric, China is already coming second globally in dollar terms! The jury is still out on whether most of these new investments will bear fruit, but new industries are being developed right in front of our eyes.

China's economic growth most likely will slow in 2016, somewhat offset by the growing new economy; bad debts in the banking system will rise; and job losses will continue which the new economy has evidently been absorbing thus far. Going forward, one can expect further policy loosening to seek to ease the slowdown.

The property market is generally healthy, with significant regional divergence reflecting the varying abilities of the respective local economies to cope with transition. Big coastal cities that are home to the new industries are booming; inland cities that are able to absorb the westward movement of manufacturing capacities are also holding up.

Obvious weakness can be seen in regions dominated by traditional sectors which are suffering from over-supply and starting to see capacity closures (steel mills, etc.). The authorities are working on more aggressive policies to clear inventories in these areas by making health care and other social services more accessible to the hundreds of millions of migrant workers, encouraging them to buy or rent subsidised apartments, and potentially allowing tax deduction on property purchases. We believe these measures are intended to provide a soft landing for the downward cycle in these cities, rather than to ignite another property investment boom.

Local punters in China have voted with their feet, exhibiting a distinct preference for the new sectors while leaving behind the old. Companies engaged in the new economy have been enjoying vastly superior price performance and valuations (40-60x P/E), compared to the old economy companies (banks and property developers on single digit P/E). Whether the market is cheap or in a bubble depends entirely on the segment of the market one is focused on. While expensive stocks may not be prospective for the contrarian stock picker, the market serves as a source of cheap capital to the new industries, many of which have taken advantage.

The Fund's current positioning – being heavily exposed to the consumer and new service sectors – reflects our belief that many of the old economy stocks are an unlikely source of long-term growth, but our stock-centric approach shields us against indiscriminately chasing the new economy opportunities. We have chosen to participate in stocks in the Hong Kong and Chinese markets that have strong market positions, are seeing secular growth *and* are trading on attractive valuations.

**A Depreciating but Freer Currency**

The new currency regime in China to have the Yuan loosely referenced to a basket of currencies was a profound policy change. The move suggests a greater willingness by the People's Bank of China to allow the Yuan to drift away from the US dollar and conform more to market forces. There is pressure over the medium-term for the Yuan to depreciate, especially if the US dollar strengthens further, going forward.

Over the quarter, the Chinese yuan depreciated by 2% against both the US dollar and the Japanese yen and was down 1% against the Euro. The Yuan has in fact been the strongest major currency in the world over the last five years, having appreciated 2% against the US dollar, 25% against the Euro, and more than 50% against the Yen! However, depreciation is likely to be gradual, but relatively persistent.

China still runs a big current account surplus and the inclusion of the Yuan into the IMF Special Drawing Rights basket will help maintain stability, but depreciation of the Yuan is a key element of the policy relaxation needed to maintain some economic stability in a time of weakening growth.

**The Inevitable Has Begun**

Signals given by the Chinese government appear to suggest that more closures in industries with excessive capacity will take place in 2016. The reality is that with 20-50% of the commodity and energy related sectors running at losses, demand side stimulus is not the solution, especially when considering that China has peaked in its construction super-cycle and the focus has shifted to tackling its critical pollution problems (see recent smog alerts out of Beijing).

Artificially supporting these typically unprofitable companies run by provincial and local governments imposes a cost on the economy. The uncompetitive, excess capacities should be allowed to close down as a natural consequence of low commodity prices, rather than burdening the banks with ever increasing credit risk by extending more money to these loss-making industries.

The crux of this issue is the relationship between state-owned banks and local governments. Typically, credit is extended to these "zombie" companies in the name of job preservation or social stability. As new industries have developed to offset some of the slack, this process of cutting the cord to zombie companies is starting to occur. In fact, some closures have already taken place. Around 45 megatonnes of steel capacities are estimated to have been closed down.

**India**

In India, the issues that have plagued the country's dysfunctional power sector appear to be getting resolved. One of the major problems is the loss-making power distributors. Distribution companies have been running big losses, with aggregate technical and commercial (AT&C) losses ranging from 25% to more than 50%! The impact is that power prices have to be kept high to subsidise these losses. But many distribution companies fail to do so, instead, resorting to debt from State banks to buy power. This situation is obviously unsustainable. Some distribution companies are indebted to such an extent that they could not afford power, leading to blackouts, which obviously looks bad for the State's politicians.

The Central government has put forward a proposal to reform the power distribution network. Financial incentives are provided to the States to cut distribution losses by reducing power theft, improving billing and collection efficiency, and/or raising prices. The State governments, having taken over the debt from their distribution companies, will be more dependent on the Central government's disbursements to balance their books. The onus will be on the States to run their power distribution companies more profitably.

Eleven out of the 28 States have already onboarded with the scheme, and it is expected that most of the other States will also participate. Based on the progress of negotiations currently taking place between the Central and State governments and the banks, most of the 28 States will have signed up before the second quarter of 2016. We would expect to see some improvements in power demand with improved distribution financing. It remains to be seen whether AT&C losses will be reduced over the longer-term.

Economic activities are earnestly improving in India with government projects ramping up, truck sales going strong, power generation increasing (at 10% or so – although there was 0% growth in November compared to October last year, due to the timing of Diwali), railway freight volume growing (ex-coal was up 10% while coal volumes have been weak as power plants now have too much coal), gasoline usage rising (up 10-15%), and steel demand surging (up 10%+). There are anecdotal reports that the country is short on excavators as a result of demands from the raft of road, rail, river and mining projects. Private capex by all accounts remains weak.

## Outlook

The valuations of the Fund's holdings continue to provide the best guide to our future returns, and on this front we remain optimistic over the medium-term.

While China's way forward is not going to be straightforward, the country is gradually delivering reforms and policies are being loosened to maintain economic stability, allowing new industries and companies to prosper. As economic growth slows, the Chinese market may continue to experience a relatively high level of volatility. However, we believe that the Fund's portfolio is well positioned with companies with strong fundamentals and that the current elevated cash level allows us to take advantage of volatilities opportunistically.

A simmering economic recovery is evident in India, and key reforms of the power sector, if successful, can unleash significant productivity improvements in this vast, developing country.

We continue to find opportunities with favourable growth dynamics and will deploy capital in their direction.

## Notes

1. The investment returns are calculated using the relevant Fund's unit price and represent the combined income and capital return for the specific period. They are net of fees and costs (excluding the buy-sell spread and any investment performance fee payable), are pre-tax, and assume the reinvestment of distributions. The investment returns shown are historical and no warranty can be given for future performance. You should be aware that historical performance is not a reliable indicator of future performance. Due to the volatility of underlying assets of the Funds and other risk factors associated with investing, investment returns can be negative (particularly in the short-term).

   The inception dates for each Fund are as follows:
   Platinum International Fund: 30 April 1995
   Platinum Unhedged Fund: 28 January 2005
   Platinum Asia Fund: 4 March 2003
   Platinum European Fund: 30 June 1998
   Platinum Japan Fund: 30 June 1998
   Platinum International Brands Fund: 18 May 2000
   Platinum International Health Care Fund: 10 November 2003
   Platinum International Technology Fund: 18 May 2000

   (NB: The gross MSCI Index was used prior to 31 December 1998 as the net MSCI Index did not exist.)

2. The investment returns depicted in this graph are cumulative on A$20,000 invested in the relevant Fund over five years from 31 December 2010 to 31 December 2015 relative to its benchmark index (in A$) as per below:

   Platinum International Fund - MSCI All Country World Net Index
   Platinum Unhedged Fund - MSCI All Country World Net Index
   Platinum Asia Fund - MSCI All Country Asia ex Japan Net Index
   Platinum European Fund - MSCI All Country Europe Net Index
   Platinum Japan Fund - MSCI Japan Net Index
   Platinum International Brands Fund - MSCI All Country World Net Index
   Platinum International Health Care Fund - MSCI All Country World Health Care Net Index
   Platinum International Technology Fund - MSCI All Country World Information Technology Net Index

   The investment returns are calculated using the relevant Fund's unit price. They are net of fees and costs (excluding the buy-sell spread and any investment performance fee payable), pre-tax and assume the reinvestment of distributions. It should be noted that Platinum does not invest by reference to the weightings of the benchmark index. Underlying assets are chosen through Platinum's individual stock selection process and as a result holdings will vary considerably to the make-up of the Index. The Index is provided as a reference only.

3. Invested position represents the exposure of physical holdings and long stock derivatives.

## Disclaimer

This publication has been prepared by Platinum Investment Management Limited ABN 25 063 565 006 AFSL 221935 trading as Platinum Asset Management (Platinum®). It contains general information only and is not intended to provide any person with financial advice or take into account any person's (or class of persons') investment objectives, financial situation or needs. Before making any investment decision you need to consider (with your financial adviser) whether the information is suitable in the circumstances.

Platinum is the responsible entity and issuer of units in the Platinum Trust Funds® (the Funds). You should consider the Product Disclosure Statement in deciding whether to acquire, or continue to hold, units in the Funds. You can obtain a copy from Platinum's website, www.platinum.com.au or by phoning 1300 726 700 (within Australia), 02 9255 7500 or 0800 700 726 (within New Zealand), or by emailing to invest@platinum.com.au.

No company in the Platinum Group® guarantees the performance of any of the Funds, the repayment of capital, or the payment of income. The Platinum Group means Platinum Asset Management Limited ABN 13 050 064 287 and all of its subsidiaries and associated entities (including Platinum).



## MSCI Inc Disclaimer

Neither MSCI Inc nor any other party involved in or related to compiling, computing or creating the Index data (contained in this Quarterly Report) makes any express or implied warranties or representations with respect to such data (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any of such data. Without limiting any of the foregoing, in no event shall MSCI Inc, any of its affiliates or any third party involved in or related to compiling, computing or creating the data have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages. No further distribution or dissemination of the Index data is permitted without express written consent of MSCI Inc.