



PLATINUM CAPITAL LIMITED

ABN 51 063 975 431

Half Yearly Report

3 1 D E C E M B E R 2 0 0 0

FOR MORE TIMELY COVERAGE OF INVESTMENT MARKETS, WE HAVE SEPARATED THE INVESTMENT MANAGER'S REPORT FROM THE HALF YEARLY FINANCIAL STATEMENTS. THESE SHOULD FOLLOW SHORTLY.

Performance

It has been a gruelling quarter for investors. Initially some thought the market was simply accommodating a convergence of valuations between the highly valued tech stocks and the rest. Subsequently, the massive erosion of Nasdaq (down 33% for the quarter) and the other *Neuer Markets* of the world had a knock-on effect as concerns emerged about the broader implications of such value destruction. These included margin calls, credit delinquencies and other factors associated with a slowing world economy. Investors are now starting to come to terms with the reality that shares are not a non-stop express to wealth accretion. The Company has been relatively well positioned for this change in sentiment. Apart from allowing cash to rise we have been actively shorting individual shares for which the valuations made no sense – companies such as EMC, Sun Microsystems, i2 Technologies, Oracle and so on.

As the quarter progressed we rotated into shorting other so-called defensive issues. These include banks/brokers and consumer branded goods – notably Bank of New York, Schwab, Budweiser and Colgate. While it is true that these companies can either benefit from lower interest rates and have more predictable profits, investors have, we believe, put too much store in these qualities and here at the end of the bull market are using them as hiding places rather than liquidating positions and building cash balances. Further we have maintained our shorts on the S&P index, which from here may give more protection than the Nasdaq index shorts.

The consequence of this activity is that the Company has managed to rise by 28.2% for the year, after a fourth quarter advance of 13.5%

(pre-tax). By way of contrast the MSCI returned 2.2% for the year, having had a miserable last three months when it declined by 8.6%.

The table below highlights the extremes of sector movements over the year within the MSCI.

INTERNATIONAL SECTOR EXTREMES	
SECTOR	1 YEAR CHANGE
Health Services	+90%
Healthcare	+57%
Industrial Services	+32%
Consumer Non-durables	+18%
Finance	+15%
Technical Services	-44%
Communication	-41%
Retail	-9%

The Net Asset Value figures in the table below are after provision for tax on both realised and unrealised income and gains. ☺

31 OCTOBER 2000 *	30 NOVEMBER 2000	31 DECEMBER 2000
159.62	164.73	165.07
* This is after making provision for the 8 cent final dividend paid 14.11.00.		

Changes to the Portfolio

Apart from sound stock picking and short selling, our relatively strong performances can be attributed to the changes in emphasis of the portfolio throughout the year. By March we had exited most of the over-priced tech and telecom stocks and began to move to low priced “old economy” companies which were very out of favour. This also happened to lead to greater exposure in Europe where we reasoned companies would be least affected by a retrenchment by the consumer in

the USA. These simultaneous movements built-up our holdings in Europe and reduced them significantly in Japan. The following table quantifies these changes.

Note that companies with cyclical earnings patterns, together with those companies sensitive to interest rates, now constitute 31% of the portfolio versus 18% a year ago. Technology, telecoms, and software are still well represented at 29% but well down from 47% last year. Moreover, within this category the valuations of our

holdings are a fraction of those typically found in Nasdaq – specifically an average PE of 16.7x 2000 earnings versus an estimate of 115x for the NDQ 100 index. ☺

DISPOSITION OF ASSETS %		
REGION	DEC 2000	JUN 2000
Western Europe	35.0	26.3
Japan	21.5	31.3
North America	20.2	19.2
Emerging Markets (incl. Korea)	6.0	7.5
CASH	17.3	15.6

BREAKDOWN BY INDUSTRY %

CATEGORIES	EXAMPLES OF STOCKS	DEC 2000	JUN 2000	DEC 1999
Cyclicals	RMC, Akzo, Bayer, Stinnes, Linde	19	17	12
Financials	Lippo, Nordea, Japanese Brokers, Halifax	12	9	6
Technology Hardware	Toshiba, Samsung, AMD, Fujitsu	11	11	12
Telecoms	NTT, DDI, SK Telecom, Lucent	11	11	16
Software & Media	Novell, Peoplesoft, Nippon Broadcasting	7	9	19
Medical	Draegerwerk, Merck KgaA, Novartis	6	5	5
Consumer Brands	Adidas-Salomon, Japanese Coke Bottlers, Wella	6	6	5
Retail/Services/Other	Hornbach, Raytheon	5	3	3
Consumer Durables	MEI, Sony	4	4	7

The company's short position is 15% against the S&P500 and 20% against individual US companies.

Commentary

To counter the problem of myopia - caused by doing daily battle with markets - it is helpful to review the key points that were made about the US in our last three quarterly reports. Starting in March, we referred to Mr Soros' concept of reflexivity and how once the tide changed the trend becomes mutually reinforcing. In June we alluded to the risk of deteriorating consumer confidence in the face of falling stock market values. By September we were pointing to the Euro and oil price as damaging the "priced-for-perfection" mentality and introduced the prospect of a soft landing. Intertwined throughout were references to the over-leveraging of US consumers and companies, the poor pricing environment facing companies, the distortions within the system (tracking stocks, excessive option grants, deteriorating credit) and other evidence of a mania which was most starkly revealed by eccentric valuations of tech stocks relative to the so-called "old economy companies".

As we enter the new year, the tone of the market has changed considerably. There is consternation about the speed of the slowing in the US economy as witnessed by the recent decision by the Fed to cut the

discount rate by 0.5%. In time, one can envisage the discussion moving as to the next rate cut and to the debate on tax cuts as the evidence of economic slowing intensifies.

At this stage we are largely agnostic about the degree of softening that the US economy may experience. From our work on credit we get no comfort.

As you know, our underlying fear in the US has been the growth in debt and the impact of stock market weakness on consumer confidence. In the last five years the debt/equity ratio of US corporations has risen from 74% to 82.6% despite an extraordinary rise in company profitability. This is reflected by the decline in labour's share of the cake when expressed as labour costs to companies revenues; towards the base of the normal band of 62-68%. By contrast, earnings per share has accelerated from the normal trend of 7% pa to around 12% pa since 1995. This latter growth rate is partly attributable to massive share buy-backs - amounting to \$416bn (partly funded by greater borrowing) but underlying margins have also widened as a consequence of robust demand and well contained costs.

As some share prices collapse, the wisdom of buy-backs will come

under scrutiny. More importantly though, the concerns about the burden of debt - which was in earlier years expressed in terms of optimising a firms balance sheet - is being reflected in a significant blow-out in lending spreads. BAA companies, the average of the S&P500 index, must now pay 2.6% more than US treasuries (versus 1.2% in January 2000) and even top AAAs credits are required to pay 1.8% over treasuries. (The treasuries themselves have continued to strengthen - perhaps warning of a more difficult environment as well as the fact that the budget surplus is curtailing supply of government bonds).

The banks are already experiencing a rise in non-performing loans (NPLs) but in very specific areas where it became fashionable to borrow against supposedly secure income streams - notably funeral homes, cinema chains and at the extreme, competitive local exchanges (CLXs).

There is not much evidence yet of rising consumer delinquencies.

We remain highly vigilant because of the still large balance of outstanding share margin accounts at \$219 billion in November. Further, we believe that households applied some of the benefits of mortgage refinancing to play the market. Lurking in our

subconscious is the belief that the credit induced mania just witnessed must have cultivated some extraordinary expectations, the folly of which will only be revealed gradually, if starkly.

One should not, however, paint too gloomy a picture for the US. As noted earlier, the government's finances are in the best position for years – which will allow for massive tax cuts. Even so, we are somewhat circumspect about the US\$1.2 trillion touted in view of the balance of power in Washington – any deal is likely to be protracted. Further, the Fed can drop rates significantly to prop-up confidence. We believe the inflation implications are very low even with the US\$ weakening, principally against the Euro, because of the deflationary bias around the world. However, these steps will only partially ameliorate the likelihood of labour's share reverting to the mean.

By way of example, Microsoft has already indicated that it will bolster wages in the face of the loss of value of its staff option schemes.

We are somewhat more sanguine about Europe. While the EU is also slowing, there are several factors that should provide a growth buffer. Firstly, the big economies of Europe have been lagging behind North America and consequently they are at a different phase of the cycle. Europe has only recently begun to issue stock options and the public's ownership of shares is relatively small. Further, European predilection towards shares is notoriously lower than in the Anglo Saxon countries so the adverse affect on consumer sentiment will be correspondingly lower. After five years of belt-tightening by governments, 2001 will be the first year of fiscal expansion, led by Germany, with tax cuts equivalent to 1.2% of GNP. France and Italy have

smaller cuts but the move to tax reform is well established.

Japan and Korea give us little room for comfort at the macro-economic level. The leadership under the LDP will go down in history as some of the most inadequate in modern Japan. Fortunately, companies are very aware of the threats and opportunities of globalisation and rather like in Italy, our investment faith resides in the calibre of the people, their education and commitment to leading-edge technologies. Our recent visit highlighted the breadth of know-how in the digital world and optics (the backbone of modern telephony). Our investments in North East Asia are highly selective and tend to have a technology bias. Built in to our stock selection is the view that both Japan and Korea will lose growth impetus as a consequence of a slowdown in the US. ☺

Conclusion

While global headlines may initially carry a prognosis about interest rate and tax cuts, and budgetary stimulus, the key will be the performance of company profits. When we examine the underlying arithmetic of global markets we find that earnings in the last five years have risen about 10% pa which together with rising PE's (multiple expansion) from around mid-teens to 26x has lifted share returns to above twice the historic average of around 9%. While bond rates are likely to remain subdued, which helps valuations, the higher risks associated with slower growth and poor pricing power is likely to cause some multiple contraction –

thereby reducing returns. We therefore see further mileage in the theme of the convergence of valuations. At the same time, companies producing volume sensitive items (mostly commodities) are in many instances investing at less than their depreciation rates. This theme of capital starvation, which should logically lead to a period of higher profitability, should throw up some good opportunities – particularly when it is reinforced by plant closures and mergers. In the case of pulp and paper, for example, International Paper, following its acquisition of Champion International, cut a full 825,000 tons of annual capacity – 5.5% of all US production.

Our third theme relates to productivity take-off. Just as the US experienced a productivity surge from the mid-90s, we believe companies in continental Europe and Japan can experience the same benefits attributable to changes in information technology and ways of doing business. Now that the Europeans have bedded down their "systems" in a single market of 350 million consumers, it is quite plausible to expect the growth in labour productivity to outstrip that of real labour costs. Japanese companies will have less help from their domestic economy, which we expect to remain flacid, but the indications to date have exceeded our expectations. ☺

Currency

Over the quarters we have written about the effect of the US economy growing faster than the rest of the world, as well as M&A and investment demand causing an over-valuation of the US currency. We believe this

tendency reversed decisively in the fourth quarter as the US economy slowed and inward flows diminished.

This greatly helped the hedging position we had taken (albeit far too early) as we saw the Euro climb 7%

versus the US\$ and 13% versus the Yen. At year-end the Company's main exposure was A\$ at 44% and Euro/European currencies at 43%. 🏠

The Digital Revolution

Not so long ago, a mobile phone felt like a brick, music was recorded on black vinyl records, VCRs were guaranteed to rip the cassette tapes to shreds, and a leading personal computer ran at 133Mhz. This year's Christmas shopping lists would alert one to how much things have changed. Not only are mobile phones smaller, they also have longer battery life and include features such as radios and computer games. One can compile and download one's favourite music into MP3 players with just a few clicks of a button. DVD offers amazing audio and visual quality, TV screens have refresh rates of 100Mhz and a powerful PC can now process millions of instructions in a second. And yet, we are still merely at the dawn of the digital age. From here on, nearly all communications will be first converted from the physical world of analog; that of sight and sound, into the digital world of zeros and ones, transmitted at the speed of light via optic fibre cable or wireless and then converted back into the analog world on the other side.

This has enormous implications for us as investors. We cannot vaguely refer to these developments as new fangled ideas but must understand their workings intimately to maximise the opportunity available.

Let's start with the semiconductor chip. These rectangular shaped objects, which are normally housed in protective black plastic casings, are typically less than half a millimetre thick and usually two to ten millimetres in length and width. In its purest form, a semiconductor chip is a collection of transistors. A transistor functions as an electronic switch which allows current to flow or prevents it from flowing. Strange as it may sound, a collection of these simple ON and OFF switches/transistors allows all instructions and data to be converted into a binary language of ones and zeros. The Pentium III logic chip, which may be at the heart of one's PC for example, is made up of 28 million microscopic transistors. Yet, it is only 106mm² in size (smaller than a finger nail). The process of computing involves the pulsing of electrons through the chip at very high frequency (over a billion pulses per second) which regulates like a metronome the reading of codes, the fetching of data, the processing thereof and the final storage of the result.

To achieve this level of speed and compactness, chip makers, together with their equipment suppliers, have devised some extraordinarily complex manufacturing processes. An integrated circuit, better known as a semiconductor chip, is comprised

of 6-8 layers of material in total. The base is a thin sliver of silicon crystal, hence wafer, upon which sequential layers are systematically deposited. Circuits are imprinted by shining a fiercely bright light through a stencil (mask) onto the photo-sensitive treated wafer. That part of the surface which is struck by light is softened while that which is in the shadow remains hard, thus in the subsequent washing and etching process the exposed part is removed thereby creating maze-like patterns. The process then proceeds to the next layering and so on. A typical wafer takes two to three months to manufacture having been through several hundred steps. There follows the dicing of the wafer into discreet chips (possibly three hundred). This is followed by the mounting of the chip on a leadframe, the spider like leads that allow the minute circuits of the chip to communicate with the printed circuit board (PCB) upon which it is mounted. Once attached to the leadframe, the chip is encased in a protective casing (that black cube), though new mounting techniques are evolving.

A modern chip factory, so called fab, costs US\$2-3 billion. The expense lies principally in the ultra clean conditions required and the intricate equipment. Do remember, these chips comprise circuits of 0.18µm in

THE DIGITAL REVOLUTION PROVIDES A STRONG GROWTH OPPORTUNITY ALBEIT CYCLICAL

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000F	CAGR*
Sales (US\$bn)	55.0	60.0	77.3	101.9	144.4	132.0	137.2	125.6	149.0	209.0	14%

* Compound Annual Growth Rate

width, which is around 1/600th the width of a strand of human hair. Putting it another way, it is equivalent to the amount one's hair may grow in a single minute. A good example of the sophistication of the tools employed is that of the stepper. This is the photolithography device that allows the pattern to be laid down on the chip. It comprises a laser, which was first envisaged in the US Department of Defence Star War project, and a platform (stage) that moves the wafer imperceptively under the gaze of the light source. Such a tool can cost over US\$10 million even though its footprint is only 6.5m². The multiple faceted lens alone takes nine months to produce.

As one might imagine from the above, the semiconductor industry has spawned a multitude of disciplines and industries that barely existed 20 years ago. This is fertile ground for us to look for opportunities for investment in a similar way to that which existed during the glory days of machine tools. The beauty of this industry is that unit demand is still growing very strongly which not even an economic slowdown will damage. A good example of this is the car industry. Additional functions such as air bags, ABS braking, global positioning systems all entail greater electronic content within a car: 60 – 70 chips are used in the current BMW 7 series and this is expected to double in the soon to be released

model. Mobile phones and personal digital assistants (PDAs) are new areas that will require more and more semiconductor chips: mobile handset shipments quadrupled in a little under four years, from 108 million units in 1997 to approximately 420 million units this year. More importantly, semiconductor content per mobile phone is expected to rise as we move to the next generation wireless protocol.

There also have been tremendous strides in fixed line communication. The backbone of the system is now largely comprised of optic fibre and with ingenious engineering a single strand of fibre can carry 64 channels by using multiple light wavelengths. This adds impetus to the semiconductor industry in that the analog signals (electrical pulses) must be first converted into light pulses, amplified and shot down the optic fibre. At the other end, the reverse has to take place. In this case, there are a host of semiconductors used to translate electrical pulses into light for amplification and for transmission.

Despite the favourable long term trend to worldwide semiconductor consumption, one cannot lose sight of the fact that it is a cyclical growth industry. Like many industries that benefit from economies of scale, incremental additions to capacity tend to be chunky and often come on stream just after demand has peaked. Further, this industry has

been characterised by broadening geographical participation with the Taiwanese and Koreans playing catch-up and challenging the likes of Japan and America. One factor that may smooth the amplitude of the cycle is the development of the super fab companies who take in works from the design specialists. This is also an important development for the equipment suppliers who face a greater concentration of buyers. The outcome of this may be more mergers and acquisitions amongst the equipment suppliers who in any case see benefits from consolidating R&D budgets. Furthermore, over the next three years, the equipment suppliers will find themselves better insulated from the vagaries of the cycle as their customers, the semiconductor makers, are at the start of two major technology upgrades. For all that, the industry stands out for its persistent profitability: even at the bottom of the cycle the quality companies remain profitable.

We believe the recent sell off in the Nasdaq where fabless chip designers have seen their share prices collapse to a third of their peaks and those of the semiconductor equipment suppliers (SPE) by 70%, sets an interesting environment for investors with sensible time horizons. 🏠

Kerr Neilson
Managing Director

PLATINUM CAPITAL LIMITED
LEVEL 21, GOLD FIELDS HOUSE, 1 ALFRED STREET, SYDNEY NSW 2000
TELEPHONE: 61 2 9255 7500 or 1300 726 700 (Aust. only) FACSIMILE: 61 2 9254 5555
EMAIL: invest@platinum.com.au WEB: http://www.platinum.com.au

Platinum Asset Management does not guarantee the repayment of capital or the performance of the Company.