



**Platinum  
Capital<sup>®</sup> Limited  
Quarterly Investment  
Manager's Report**

31 March 2016



**Platinum<sup>®</sup>**  
**CAPITAL LIMITED**

ABN 51 063 975 431

## Markets

Fear stalked the markets as this new year began with the major stock indices trending lower through January and February. The fear stemmed from doubts about growth, not helped by questionable signals from China. Even the prospect of further action by central banks was treated with a measure of scepticism as doubt spread as to the efficacy of quantitative easing (QE) in dealing with weak demand and deflation.

The announcement by the Organisation of the Petroleum Exporting Countries (OPEC) of a meeting to discuss production restraint on the 11th of February set a change in tone and commodity prices, led by oil, rebounded with force. Helping the mood also was evidence that China's economy was stabilising and the government was beginning to stem the loss of foreign exchange reserves and hence diminishing the fear of a weak Renminbi. With such negativism well expressed and strongly backed by short positions, commodities, shares and bond yields all fired upwards.

Financials have been among the least responsive to the mood change because higher prudential capital requirements imply lower returns on shareholders' funds and this is exacerbated by negative interest rates that squeeze interest spreads. With investment banks no longer willing to make markets in fixed income instruments, investment funds holding illiquid bonds hedged their positions by shorting broader instruments such as high yield exchange traded funds (ETFs) or credit default swap indices. However, as the quarter closed, financials regained their poise.

By March, Draghi announced yet further QE measures which include the European Central Bank's (ECB) intent to purchase corporate bonds. He also introduced a long-term refinancing operation (LTRO) with an interesting twist to encourage

### MSCI World Index Regional Performance (AUD)

REGION	QUARTER	1 YEAR
<b>Developed Markets</b>	<b>-6%</b>	<b>-4%</b>
<b>Emerging Markets</b>	<b>0%</b>	<b>-13%</b>
<b>United States</b>	<b>-5%</b>	<b>0%</b>
<b>Europe</b>	<b>-7%</b>	<b>-9%</b>
Germany	-8%	-12%
France	-5%	-5%
United Kingdom	-8%	-9%
<b>Japan</b>	<b>-12%</b>	<b>-8%</b>
<b>Asia ex Japan</b>	<b>-4%</b>	<b>-12%</b>
China	-10%	-19%
Hong Kong	-6%	-7%
India	-8%	-14%
Korea	-1%	-7%
Australia	-3%	-11%

Source: MSCI

European banks to increase their lending. In the event of their loan books growing by more than 1% a year, these banks will be able to borrow from the ECB at *minus* four-tenths of one percentage point (-0.4%). This is essentially a fiscal transfer to encourage bank lending.

Within equities, Emerging Markets (EM) had the biggest bounce. The most remarkable was Brazil, up more than 50% in USD, despite being stuck in a recession and enduring inflation, high interest rates, corruption and political scandals of the worst kind. Russia is also up 35% in USD, despite low oil prices, sanctions, recession and being involved in geopolitical conflicts. As we have noted in the December 2015 Quarterly Report, outflows from EM funds and bearish investor sentiment were at historical extremes which suggested total capitulation.

Interestingly, China has lagged the EM bounce substantially. As a quick reminder, the National People's Congress held its annual meeting in early March when China's new 6.5% GDP growth target was set, though few foreigners take this seriously. What is the real number? How will the transition to a consumer economy evolve? How will the non-performing loans be absorbed and will they be greater than 10% of loan books, with regional banks experiencing highest losses? What about shutting down capacity in money-losing industries? These are just a few of the many questions that keep investors away from China.

With the cost of money likely to remain low for some while, mergers and acquisitions (M&A) and share buybacks are two of the obvious uses of excess money. Bank of America Merrill Lynch estimates that this year between 5% and 8% of the US float will disappear as a result of buybacks, M&A and the absence of meaningful IPO supply. Most notable is the activity of the Chinese in bidding for significant Western companies such as Starwood, Terex and Syngenta. They have not been shy to use Western banks to fund these acquisitions which provide an ironic twist to the intent of central banks – **their low interest plan is predicated on new investment, rather than the recycling of existing assets!**

### MSCI World Index Sector Performance (AUD)

SECTOR	QUARTER	1 YEAR
Utilities	3%	4%
Telecommunication Services	1%	2%
Energy	1%	-15%
Materials	0%	-13%
Consumer Staples	-1%	7%
Industrials	-2%	-3%
Information Technology	-4%	1%
Consumer Discretionary	-6%	-3%
Financials	-10%	-12%
Health Care	-12%	-9%

Source: MSCI

## Performance

(compound pa, to 31 March 2016)

	QUARTER	1YR	3YRS	5YRS	SINCE INCEPTION
Platinum Capital Ltd	-5%	-6%	15%	10%	12%
MSCI AC* World Index	-5%	-5%	17%	12%	6%

\* Morgan Stanley Capital International All Country

Source: Platinum and MSCI. Refer to note 1.

## Net Asset Value

The following Platinum Capital Limited (ASX: PMC) net asset value per share figures are before and after provision for tax on both realised and unrealised income and gains. The February and March figures have been adjusted for the \$0.03 fully-franked interim dividend declared on 9 February 2016 and paid on 4 March 2016.

	PRE-TAX NAV	POST-TAX NAV
31 December 2015	\$1.5846	\$1.5453
31 January 2016	\$1.5105	\$1.5019
29 February 2016	\$1.4456	\$1.4504
31 March 2016	\$1.4556	\$1.4580

Source: Platinum

## Currency

Our US dollar position was reduced to 31%, with 9% added to the Euro and 5% to the Australian dollar. In the short-term, the prospect of delayed interest rate rises by the US Federal Reserve and a rebound in commodity prices has shifted market perceptions. For the present, the attractive yields offered in Australia give support to the Australian currency.

CURRENCY	MAR 2016	DEC 2015
US dollar (USD)	31%	50%
Euro (EUR)	17%	8%
Australian dollar (AUD)	14%	9%
Hong Kong dollar (HKD)	12%	12%
Japanese yen (JPY)	10%	10%
Indian rupee (INR)	6%	6%
Chinese yuan offshore (CNH)	-7%	-6%

Source: Platinum

## Shorting

As the markets sold off in January and February, we reduced our short positions by over a third and exited the Biotech ETF to good account. With the crescendo of negative sentiment we began to use cash, in some cases a little prematurely, but by early March had increased our exposure to companies we already own or to new positions. We re-established shorts on the Russell 2000 and S&P 500 indices through March to get back to a total short position of 14%.

## Disposition of PMC's Portfolio

REGION	MAR 2016	DEC 2015
Asia	34%	35%
Europe	23%	22%
North America	22%	21%
Japan	11%	9%
Russia	1%	1%
Africa	1%	1%
Cash	8%	11%
Shorts	-14%	-14%

Source: Platinum. Refer to note 2.

## Changes to the Portfolio

In keeping with our concerns about pricing power in this deflationary environment, we have used the market recovery to trim cyclicals like **KBR** and **Allegheny Technologies** which are finding conditions extremely difficult. We exited **Corning** which plans to borrow for a significant share buyback, which is out of character for this good, technology-driven company. We also sold out of **Korea Electric Power Corporation** which met our profit turn-around expectations. A takeover bid for **Youku Tudou** also gave us an excellent outcome.

Lower prices persuaded us to add to **Sanofi** and **Qiagen** (drug companies), **Rakuten** and **Tencent** (e-commerce), **Intesa Sanpaolo**, **Mediobanca**, **Lloyds** and **PICC** (financials), **ENI** (oil) and **JSR** (manufacturing). New positions were established in **Inpex**, **Gilead Sciences** and a **gold miner ETF**.

### An out-of-favour market and an over-supplied commodity give us an interesting opportunity

to take a position on the eventual recovery in the oil price. **Inpex** is a quasi-state owned Japanese company and its share price has been weak in the face of delays of its 62% owned Ichthys liquids-rich natural gas project. This is exacerbated by the view that hydrocarbon prices will stay low for a long time. Traditionally, this type of unambiguous negativism has led to great returns.

You might feel this is being too contrary, but not when one realises that Inpex is about to raise its **core** annual production from some 400,000 barrels of oil equivalent (BoE) per day to over 600,000 BoE, which brings a large gain of free cash flow, conservatively put at over US\$2.5 billion per year with an oil price of US\$50 a barrel. At US\$70, which is not beyond reality over the life of a 20+ year operation, the **attributable** cash flow should exceed US\$4 billion per annum.

So what are the negatives? Firstly, the cost over-runs and delays at Ichthys. From an initial estimate of US\$34 billion, we are now looking at approximately US\$37.5 billion and a nine to 12 month delay, but offset partially by an 8% rise in annual throughput. The company will also be losing a lucrative profit sharing arrangement in Indonesia (the Mahakam Block) where the concession faces renegotiation in 2017. For our calculations, we have assumed a virtual loss of

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this concession and removed it from core output. Lastly, the company has an important gas field north of Darwin in Indonesian waters, the Abadi field, where the government is requiring the gas to be taken ashore in Indonesia. This raises the cost of the project and, together with sales likely being directed to the domestic market, reduces the longer-term viability of the concession.

Even when we load the dice for these handicaps, the magnitude of Ichthys' production, 11 million tonnes of hydrocarbons per year, makes the current capitalisation of US\$2.50 per BoE or enterprise value of US\$5.75 per BoE look remarkably cheap, particularly when one takes into account the optionality derived from Ichthys' 889 km, 42 inch pipeline from the north of Broome to Darwin to possibly convey additional gas from neighbouring fields (owned separately by Inpex) or from other gas/liquid finds in the Browse Basin.

The company's gas-to-oil ratio is close to the industry average and will rise to about 55% when Ichthys reaches attributable peak capacity of 225,000 BoE in 2020. Its reserves are more than double the industry average, at around 26 years, and its reserve decline rate, about 3% per year, is much lower than the industry average. The company's cost of production is around the industry average and, despite having funded its share of a US\$37.5 billion project and added further capacity by buying 17.5% of Shell's **Prelude Project** which will add 40,000 barrels to its daily output from 2017 onwards, net debt will be US\$13 billion versus equity of US\$28 billion. (The equity base was enlarged by an expensive, if ill-timed, rights issue in August 2010.) Clearly there are many other variables we have discovered and assessed, but our judgment is that this is a perfect storm of uncertainties which make a really interesting risk-adjusted investment.

**Pricing in the drug sector is under a cloud** and **Gilead**, with its expensive cure for **Hepatitis C**, is among those affected. It has a very powerful position in the treatment of **HIV**, though faces doubts about patents and their follow-on combinations. Notwithstanding, the pipeline is promising in both HIV and other areas. Trading on a single digit P/E, it is conspicuously cheap and, even when adjusted for likely margin erosion, the cash flow generation in the next few years is spectacular – at around US\$18 billion per annum. Having followed the company and owned it at much lower levels before its qualities were recognised, we are not pessimistic about its HIV or Hep C franchises and are prepared to back its ability to deploy these surpluses to our benefit.

The **gold miners ETF** allows us to lay off the risk of central bank error in managing the weak demand environment that prevails. It ironically allows us much greater liquidity and an interesting spread of 37 producers, which is more attractive than building our own gold miners portfolio. All-in production costs for this basket of producers is around US\$910 per ounce, with gross debt at 23% of EV. This is a defensive investment predicated on the futility of QE and complements our other precious metal producers.

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## Commentary

In markets where there is great uncertainty and a sense that the central banks are changing the rules with negative interest rates and subsidies to borrowers, how does one know that one is on the right path? For those strategies that closely track the underlying index, deviation of performance from that of the index would give a hint of a need for modification to their approach. The same question is more challenging for a **portfolio manager who pays no heed to index weighting, as is the case with Platinum**. The performance difference can be amplified in rising markets when, as a matter of policy, the portfolio manager attempts to **reduce volatility by holding cash, augmented by short selling**. This has indeed been our position and it has been to the cost of performance to the extent of 0.7% p.a. relative to the MSCI AC World Index for the last four years. In absolute performance terms, the appreciation is fine at 14% p.a. (pre-tax).

While disappointed that our strategy has fallen short of our strong longer-term record, we can explain it in terms of unusual **market trending** and a prolonged period of relatively **small dispersions of market returns** (i.e. the gap between the strongest performing shares and the weakest). You might then challenge and ask "**how can you know** whether the approach that has been so successful over many cycles still works". We ask this question internally and have written extensively about underlying changes in markets and there being "too much of everything, in particular debt". Among other things, this observation leads us to question the efficacy of QE in an inherently deflationary environment and certainly **steers us away from buying so-called "cigar butt" value stocks** (fundamentally poor or structurally challenged businesses where the only virtue is that they are cheap) in the hope that these companies will revert to a higher valuation in due course. However, what has clearly not changed is the tendency for investors to over-react to short-term factors and to crowd around what seem to be the most exciting ideas of the day, and as a consequence over-pay for the privilege. These characteristics are evident to all, as highlighted in the opening section of this report and from measures of volatility over time (if anything, high volatility suggests undue skittishness in recent times).

Starting from first principles, most would agree that **if one can assemble a portfolio comprising superior companies** that are not priced to perfection, one should be able to outperform over time.

So how do we define "superior" companies? To subjectively rely on general impressions about the management, brand awareness or public profile and the like runs many risks. We would prefer to measure a set of variables that give evidence of a history of above average performance and the characteristics we favour are **superior growth, superior profitability and below average use of financial leverage**. Using these criteria we conducted a review of the portfolio of the unlisted Platinum International Fund (PIF), which the

portfolio of Platinum Capital Limited (PMC) closely resembles, and ranked each of our holdings in PIF's portfolio against our investment universe. (For those wishing to know exactly how we build this ranking, please refer to the Appendix at the end of this report.)

A good outcome for us would be for our actual weighted portfolio **to rank better than the average opportunity of the global universe** (i.e. to fall within 0-50<sup>th</sup> percentile of the universe). As it happens, PIF's portfolio is a lot more attractive than the average and represents the **best value over the last 17 years!**

As you will notice from the accompanying chart, there have been two occasions when the value of PIF's portfolio has become poor, 1999/2000 and 2006/7. This was when the portfolio **was massively outperforming** on account of the holdings being recognised for their qualities and rising faster than the market and faster than we were selling. Right now, it is possible that the exposure to Emerging Markets is partially responsible for such strong readings of superior growth, profitability and value. However, even when we **strip out our exposure to China**, representing some 20% of PIF's portfolio (and about 19% of PMC's portfolio), it reduces the growth to average and profitability falls marginally, but the quality and value of the portfolio as a whole is still well above average.

Remember, the 100 or so companies comprising our portfolio are the result of specific work undertaken by our analyst team. The graph represents how these companies score versus the global equities universe. For this measure to mislead, it would require two things, neither of which we find probable. Firstly, it would mean that the superior historical returns of the constituent companies in the portfolio do not accurately characterise the companies nor help in assessing their prospects, and should therefore be ignored or downplayed. The second possibility is that our stock specific research is completely off-track and the *portfolio* is about to face a future that is far worse than its past and, moreover, worse than the prospects of the general investment universe. We can find no basis to believe either is the case.

## Outlook

For now, the belief is that the US Federal Reserve will be very slow to raise interest rates as it is seemingly taking account of global growth rather than focusing on domestic growth and inflation alone. Activity levels, while low in parts of the world, are still generally positive, but profits remain in doubt. Downgrades are becoming more common and the difference between reported profits and inherent profits are at record levels of exaggeration. According to Bernstein, "the S&P 500 P/E ratio is currently 32% higher on a GAAP earnings basis

### Platinum International Fund – Portfolio Characteristics\*

Percentile (Relative to Global Opportunity Set)



\* Long positions, ex-financials, market capitalisation >US\$500 million

Source: Bloomberg; Factset; company reports; Platinum.

than the pro-forma multiple (21.3x versus 16.1x), a spread that has expanded in recent years”.

When we examine PMC’s portfolio, we like the prospects of what we own and, to the extent that profits could disappoint, they nonetheless seem priced with great circumspection. Apart from the US, most market indices are well off their highs and we are finding companies we want to buy.

### Kerr Neilson

Managing Director  
Platinum Asset Management

## Appendix

The universe against which we **rank** our holdings comprises stocks with a market capitalisation of above US\$500 million. This gives a base universe of some 11,000 companies worldwide. By comparing each of the holdings in PIF’s portfolio, we can rank the quality of the portfolio against that of the host of 11,000 companies. In each case, PIF’s portfolio is weighted by the actual size of our holding while the denominator, the global opportunity set, is likewise weighted by the collective market capitalisation of the constituent companies.

Looking at each of the three key factor rankings:

- **Growth** is equally weighted in terms of sales per share, earnings per share and book value per share both over the

long-term and in more recent years, with an emphasis on recent performance. By having three measures of growth and adjusting them for the number of shares outstanding, we eliminate the more obvious distortions.

- For **profitability**, we look at the return on capital employed, including goodwill, going back 15 years, 7 years and 3 years respectively. Each is given an equal weighting which serves to doubly weight the most recent periods. The incorporation of goodwill in the asset base serves to account for “bought” growth achieved through M&A activity.
- For **leverage**, we are ranking the net debt-to-book value ratio. This is an important variable as enhancing growth through raising financial leverage adds risk and has an end point. Moreover, if share buybacks are funded through debt, it will be captured by this measure.

The last piece of the puzzle is to compare the **value or price** that we are paying for our pool of companies and to rank this versus that of the universe. Here we use a weighted composite ranking based on five components, namely, enterprise value versus capital employed (**EV/CE**), how this value compares with the **trend of the previous 10 years**, the **forward price-to-earnings ratio (P/E)**, the cash generated before tax, interest and amortisation in relation to the market cost of the company (**EBITDA/EV**), and, lastly, the **yield to shareholders** from dividends and buybacks, less employee stock option issued (a cause of great dilution in some companies).

Level 8, 7 Macquarie Place  
Sydney NSW 2000

GPO Box 2724  
Sydney NSW 2001

**EMAIL**  
[invest@platinum.com.au](mailto:invest@platinum.com.au)

**TELEPHONE**  
1300 726 700 or 02 9255 7500  
0800 700 726 (New Zealand only)

**FACSIMILE**  
02 9254 5555

**WEBSITE**  
[www.platinumcapital.com.au](http://www.platinumcapital.com.au)



## Notes

1. Performance results have been calculated using the pre-tax net asset value (as released to the ASX) and represent the combined income and capital return of the investments for the specified period. Please note that the results are not calculated from the share price of Platinum Capital Limited (PMC). You should also be aware that performance results are calculated using historic points of reference. PMC cannot guarantee that such results will be replicated in the future; therefore, this information should not be used to make future investment decisions.

It should be noted that Platinum does not invest by reference to the weightings of the MSCI All Country World Net Index (A\$) (Index) or any other indices or benchmarks. 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. Index information is provided as a reference only.

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

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