



**Platinum
Capital[®] Limited**
**Quarterly Investment
Manager's Report**

30 June 2016

 **Platinum[®]**
CAPITAL LIMITED

ABN 51 063 975 431

Markets

The quarter was characterised by a further recovery in confidence following the growth scares that climaxed in February. The MSCI World Index progressively rose for most of the three months with a change of tone as cyclicals (energy and materials) played catch-up with defensives (consumer staples, health care and utilities). At least that was the case until the Brexit vote was announced on the morning of the 24th of June. By the measures of earlier shocks, it proved a short affair, though powerful, with the MSCI World Index cracking by 7% in three days. By month end, the discussions seem to have settled back to the practical remedies available and a belief that there was only a modest threat of a contagion as Euro leaders considered measures that addressed issues like the funding of the Italian banks.

News out of China has been more reassuring, though the Renminbi has weakened through the quarter. At the same time investors also became more comfortable with the idea that the US Federal Reserve will proceed with greater caution in raising rates even as wages creep higher and consumer spending looks to be growing by over 4%. The market's view has changed from expecting two hikes earlier in the year to one hike after a weak May payroll number, to no hike just after the Brexit vote.

Prospects of easier money in the face of concerns of Brexit spurred interest in gold. When tracing the international movement of gold bullion it is perhaps surprising that despite negative interest rates in Europe, movements are principally from the West to Asia. However, record positions in the futures market and a further rise in the ownership of gold exchange-traded funds (ETFs), where physical holdings of gold have risen from 47 million ounces last December to 63 million ounces at the end of June, tell of concerns regarding central bank intervention.

Oil prices bottomed in mid-February and rose steadily throughout the quarter which emboldened investors to return to energy related assets. Energy stocks were not the only winners. The price of high-yield bonds also rebounded strongly as concerns of an increase in defaults by highly indebted oil companies subsided. Energy-reliant regions or countries such as the Middle East, Russia and Indonesia saw their equity markets bounce strongly throughout the quarter. There has also been encouraging price action in non-ferrous metals even though stockpiles are at record highs, reminding us perhaps that markets anticipate!

Despite questions about the effectiveness of Quantitative Easing (QE) and passing references to the effects of tightening in 1936, which is blamed for the subsequent stagnation pre-war, the European Central Bank (ECB) and the Bank of Japan (BOJ) are pumping huge sums into the banks by buying a wide array of mostly fixed income instruments. In the case of the BOJ, this also includes equities and equity ETFs.

The obvious consequence of slow growth and massive price-insensitive buying has been the growing (and unprecedented) list of sovereign bonds that are trading at negative yields. The total amount trading in negative territory now exceeds US\$11.7 trillion. The Swiss lead the field with 100% of their government issued bonds now offering negative yields, followed by Japan at 85% of outstanding issuance. The northern Europeans range from 77% to the low 60s while even Italy and Spain have one-fifth of their government bonds giving a small running yield that will be offset by capital loss if held to redemption. Among the large Western economies only the US and the UK have a range of maturities giving positive yields.

In Japan, 'Abenomics' has run out of steam and the 2% inflation target looks increasingly distant. In response, the Yen moved from 112 to 106 before Brexit and is now sitting just above 100 while the Nikkei touched the lows of February before recovering marginally.

MSCI World Index Regional Performance (AUD)

REGION	QUARTER	1 YEAR
Developed Markets	4%	0%
Emerging Markets	4%	-9%
United States	6%	6%
Europe	0%	-8%
Germany	-2%	-9%
France	-1%	-6%
United Kingdom	3%	-9%
Japan	4%	-6%
Asia ex Japan	4%	-9%
China	3%	-21%
Hong Kong	4%	-8%
India	7%	-4%
Korea	2%	0%
Australia	4%	-1%

Source: MSCI

MSCI World Index Sector Performance (AUD)

SECTOR	QUARTER	1 YEAR
Energy	13%	-3%
Health Care	9%	-2%
Utilities	8%	16%
Consumer Staples	7%	16%
Materials	7%	-6%
Telecommunication Services	6%	6%
Industrials	4%	3%
Financials	2%	-11%
Information Technology	2%	4%
Consumer Discretionary	-1%	-3%

Source: MSCI

The overall returns from geographic markets are shown in the accompanying tables, as are the returns from the industry subsets. As you can see, it has been a dull year for global equities with small losses recorded in Australian dollars.

Platinum Capital Limited (ASX: PMC) has performed poorly, suffering from its underweighting of the US and commensurate overweighting in China, Japan and Europe. As you can see, in AUD terms there was only one significant plus over the year and that was the US market, up close to 6%, with many countries experiencing losses of double that.

Performance (compound pa, to 30 June 2016)

	QUARTER	1YR	3YRS	5YRS	SINCE INCEPTION
Platinum Capital Ltd	-1%	-7%	9%	11%	12%
MSCI AC* World Index	4%	-1%	14%	13%	6%

* Morgan Stanley Capital International All Country

Source: Platinum and MSCI. Refer to note 1.

Net Asset Value

The following PMC net asset value per share (NAV) figures are before and after provision for tax on both realised and unrealised income and gains.

	PRE-TAX NAV	POST-TAX NAV
31 March 2016	\$1.4556	\$1.4580
30 April 2016	\$1.4737	\$1.4715
31 May 2016	\$1.5180	\$1.5032
30 June 2016	\$1.4444	\$1.4519

Source: Platinum

Currency

The principal changes were to be fully hedged out of the Chinese currency, to reduce exposure to the Yen as it rose sharply, and to add slightly to the Australian dollar.

CURRENCY	JUN 2016	MAR 2016
US dollar (USD)	43%	31%
Australian dollar (AUD)	17%	14%
Euro (EUR)	16%	17%
Hong Kong dollar (HKD)	12%	12%
Indian rupee (INR)	6%	6%
British pound (GBP)	4%	4%
Japanese yen (JPY)	<1%	10%
Chinese yuan (CNY)	-3%	0%
Chinese yuan offshore (CNH)	-8%	-7%

Source: Platinum

Shorting

We traded around the short positions but with no meaningful return as markets whipsawed between positives and negatives in the days around Brexit. Overall, the position was raised with a blend of indices and stock specific positions.

For an in-depth review of how the recent market turmoil impacted on some of our holdings (particularly our European banks such as Lloyds, Intesa and Mediobanca, as well as Japanese company Lixil) and where we believe they stand, we would encourage you to read the Platinum Unhedged Fund 30 June 2016 Quarterly Report available at www.platinum.com.au/documents/funds/puf/quarterly_reports/pufqtr_0616.pdf.

Disposition of PMC's Portfolio

REGION	JUN 2016	MAR 2016
Asia	32%	34%
Europe	23%	23%
North America	21%	22%
Japan	11%	11%
Australia	1%	<1%
Russia	1%	1%
Africa	1%	1%
Cash	10%	8%
Shorts	-17%	-14%

Source: Platinum. Refer to note 2.

Changes to the Portfolio

We pursued our barbell strategy of looking for established growth companies that are temporarily out-of-favour as well as others which had been unduly punished for having businesses that are dependent on general market conditions, like the energy sector. The latter, **oil and gas**, remains highly prospective in our view on account of **record low levels of spare capacity** in the face of possible disruptions and a commonly held view that increases in the production of shale oil and gas will prevent these commodity prices from rising much above current levels. There have already been some fierce moves and drilling activity is starting to revive.

As you will have read in our earlier quarterly reports, we have found well-known names that are going through business make-overs and these have proved resilient and profitable investments. We have recently added to this list with the acquisition of **Johnson and Johnson (JNJ)**. Like several in this category, the company's pre-eminent position allowed standards to slip and several years ago JNJ found itself in an unusual position of fighting forest fires in both its orthopaedic/devices division and consumer businesses. These account for some 60% of the company's sales and the problems caused reputational damage. Legal disputes and a loss of market share in over-the-counter medicine ensued from orders by the authorities to withdraw stock from retailers' shelves.

Throughout this time JNJ's pharmaceutical business has sailed through a 'patent cliff' and grown well for 14 consecutive quarters. More interesting still is that we see its areas of specialisation deepening as it has cleverly nurtured

relationships with research boutiques and is well positioned to reap further benefits in the future. Unlike many of its peers, JNJ never reports on its early stage pipeline (phases 1 & 2) and hence it has tended to be covered by analysts who concentrate on the orthopaedic/devices sector, with relatively light coverage among drug specialists.

The company's investor day in October last year spelled out its change in priorities and that head office had realised that the historic emphasis on devolution of power had denied the group the potency of developing truly global brands in consumer products. Now that their products are back on retail shelves and there is a realisation of the latent power in its brand, we can see good reason to believe their claims that their consumer division can earn similar margins as its peers: 20% versus 14% at present. At the same time, the orthopaedic/devices division is being refocused with an emphasis on sales channels, which have changed with the growing influence of the buying groups, and on taking advantage of e-commerce in areas like eye care and contact lenses where JNJ is clearly the world leader.

This is a truly remarkable company with 54 years of consecutive dividend increases, well above-average profitability, and although it is an average grower, the cash generation through very disciplined use of funds has allowed it to periodically reshape itself and to remain **one of the only two US-listed companies with an 'AAA' credit rating**. We bought it on a P/E of 17 times which is slightly cheaper than the average of the S&P500 index for what we consider to be a well above-average quality company. Some may point to possible pressure on drug company pricing as a threat, and this cannot be ignored except that the cost of drugs is only part of the problem and accounts for 12% of US medical expenditure. Moreover, within the industry there has been a tendency of scaling where increasingly the big global players develop strong disease franchises and use these as platforms for other drug originators to gain access to increasingly complex markets. JNJ has been exemplary in such manoeuvres (for a more detailed account, please refer to the Platinum International Health Care Fund 30 June 2016 Quarterly Report available at www.platinum.com.au/documents/funds/pihf/quarterly_reports/pihfqtr_0616.pdf).

Commentary

Please bear with us as we take you on a circuitous journey through the behaviour in the world's bond markets as a way of trying to illustrate the disruptions that are affecting the world of equities. Strange things are happening. To the casual observer they seem absurd. At the end of June, the 30-year Swiss government bond traded at a price of CHF235 against a face value of CHF100. If held to maturity, this asset, admittedly denominated in a historically strong currency,¹ will generate a guaranteed (and deferred) capital loss of some 57% for the privilege of receiving a biannual payment of

¹ The Swiss franc has appreciated by about 1% p.a. over the last 30 years.

CHF2. In the parlance of the bond traders, this bond, with 30 years to repayment is **giving a negative yield of 0.07% (i.e. -0.07% per annum)**.

Strangely, what seems crazy to individual investors makes sense to life insurers, pension funds, and central bankers. It comes down principally to the regulatory environment imposed on these institutions. In particular, the intention is to **protect policy holders and consumers from these institutions mismatching their assets and liabilities**.² Remember, when these institutions write new life insurance policies or pension funds commit to long-term retirement funding obligations, these promises can be for 10 to 30 years, while many of the investment options open to these institutions tend to have shorter durations. Under circumstances where interest rates have progressively fallen to well below historically-formed expectations, as has been the case in Japan, some institutions failed and promises had to be 'renegotiated'! In an environment of negative rates, however, it becomes all the more probable that these promises shan't be kept as these institutions keep to the rule book required of them. Importantly, falling yields have seen *retail investors* in the Euro zone reduce their holdings of debt instruments by some €200 billion on average each quarter for the last five quarters and progressively increase their allocation to equity, which is seeing an incremental rising trend to approximately match the former.

The fund management industry has different regulations to those of life insurers and pension funds, but firms have in fact been acting in a similar herd-like way when offering products that are, explicitly or covertly, classified as 'index aware'. This causes so-called 'index hugging' where, to a large extent, the portfolio will mimic the constituents of the index against which the fund is measured. Individual portfolio managers may in addition be given a 'risk allowance' or 'tracking error budget' to achieve performance that varies by a small degree from the index. By having these tight parameters, it certainly reduces the anguish of managing money and tempers the business risk of relative underperformance, but it is **at the sacrifice of participating in very crowded trades** which can result in greater exposure to market shocks; that is to say, **as a component of the index becomes ever more popular and higher priced, the fund is obliged to own more of it**.

By contrast, Platinum is index agnostic. This will cause our performance to vary markedly from the index from time to time as we seek out neglected companies.

² Holdings of government bonds are classified as *risk free*. This for financial institutions means that new business and promises (i.e. liabilities) matched by the purchase of very long term bonds need little or no matching equity capital. As rates of interest have fallen, the duration of their portfolios has risen (these institutions have become more sensitive to interest rate changes), and this forces them to rematch their books by often selling more of their share portfolios and adding to their long term bond holdings. The regulator sets the rate at which liabilities are valued, usually by the long term bond rate or the swap rate, and this then determines the process of rematching assets as rates move about. There are also other arcane technicalities at work which go beyond the scope of this note.

At its core, superior long-term returns are derived from allocating savings to companies that can demonstrate an ability to generate surpluses over and above their long-term cost of capital. To simply follow the crowd often leads to mispricing of shares. We have all experienced these great extremes like the tech bubble or, more recently, the mining boom, where shares became too highly favoured on the basis of misplaced extrapolation and momentum investing. At the same time, other areas become remarkably neglected and offer fertile hunting grounds for the hardy.

The parallel to long duration and the search for certainty in equity markets is exemplified by **consumer staple companies** around the world. For example, the 'consumer staples' subset of the S&P500 index has outperformed the broader market by 35% since 2010. This is so, even though over the same period their combined sales have grown by 3% p.a., net income by 1.4% p.a. and earnings per share (EPS), with the help of buybacks, by 5% p.a. The main thrust of their outperformance has come from a re-rating of earnings. The sting lies in the fact that, against the market as a whole, the EPS of this subset have trailed the average by 18% (that is, 3% p.a.).

Readers may correctly observe that such a crowding strategy has worked in the past six years and may ask why it shouldn't continue to work for a little longer. The counter call is that **the odds do not favour renewing bets on the same colour when there has been a significant de-rating of all markets vis-à-vis Wall Street** over these six years and that, indeed, a good part of the superior earnings growth in the US has been attributed to a single company, Apple, which accounted for some one-third of the profit rise of the index! The gap in valuation is all the more intriguing given that around half of the S&P500 companies' earnings come from international markets.

The difficulty lies in selecting companies that will verily grow in the next few years and where the fear suppressing the share prices of out-of-favour companies fully reflects these concerns. This assessment is being made more difficult by negative interest rates. However, it is our view that the case for more intervention by central banks is weakening and that **governments will progressively turn to fiscal stimulus as they discard the mantra of fiscal rectitude that is a hangover from times when demand exceeded supply.**

To assess PMC's prospects, let's examine its current portfolio, using the observed record of holdings, characterised as strong earnings growers, slower but probable growers, high payout/buyback companies, and lastly, cheap companies (see accompanying table). These categorisations are by their nature somewhat elastic with few being mutually exclusive. For example, within the high payout group there are several drug companies that should grow quite quickly over the next three years.

You can observe that the portfolio is predominantly composed of growing companies and those that are paying

back decent amounts of income to shareholders and, by our calculations, likely to also grow, though in the main, slowly. **We strongly favour this portfolio over the alternatives of long-dated negative-yielding bonds or very highly priced consumer staples.**

With equanimity, let us survey the general economic climate further. Now that the direction has been decided and Britain is looking at its options regarding its long-term relationship with the European Union (EU), it strikes us that the heaviest burden will be carried by the British pound and a deferral of both investment and consumption decisions in the UK. Europe is growing and pointers like property prices, consumer spending, etc. are trending upwards. The alarm in Britain regarding the negative repercussions of leaving the EU leads one to doubt that this will result in an immediate contagion among other EU member countries.

CATEGORY & % OF PORTFOLIO *	DESCRIPTION	STOCK EXAMPLES (RANKED BY SIZE OF HOLDING *)
High growth 24%	18x average P/E; 21% average growth over the last 5 years; 23.5% average return on equity	Tencent 3.1% Alphabet (formerly Google) 2.7% Rakuten 2.0% PayPal 2.0% Sina 1.8% Vietnam Dairy 1.8% Kweichow Moutai 1.7% China Pacific Insurance 1.6% PICC Property & Casualty 1.3% Baidu 1.2%
Slower growers 27%	15x average P/E; growing at 3%; paying 2% dividend	Samsung Electronics 3.2% Qiagen 1.9% Level 3 Communications 1.6% Kering 1.4% China Mobile 1.3% NTPC 1.3% Intel 1.3% ICICI Bank 1.2%
High payout/buyback 21%	5.4% average payout yield	Sanofi 2.6% AstraZeneca 2.3% Cisco 2.1% Ericsson 2.0% Carnival 1.7% Intesa Sanpaolo 1.7%
Low valuation companies 8%	0.62 average P/B ratio	KB Financial Group 1.4% Toyota Industries 1.3% Ushio 0.7% Allegheny Technologies 0.6%
'Safety net' 10%	Precious metals; oil and gas producers	Eni 2.5% Inpex 2.0% A large gold miners ETF 1.5% Newcrest Mining 1.0% Stillwater 0.8%
Cash 10%	-	-

* As at the time of writing in early July 2016.

Source: Platinum; Factset.

Looking further afield and contrary to general commentary in the press, there is evidence that the Chinese government is indeed changing its investment priorities towards social and infrastructural work. In addition, among the state-owned enterprises (SOEs), investment has slowed and indeed the government is pressing for and achieving the closure of redundant capacity. The consumer is responding with greater willingness to use credit and, with the country's high savings rates, this can be readily accommodated, unlike in many developed countries.

India continues to grow, and the problems of the banking system are on the wane.

The US economy trundles upwards with a tightening labour market and solid consumer spending. Investment and weak productivity growth remain a drag, but Brexit has likely deferred further tightening by the Federal Reserve by several months.

Outlook

There are mixed signals about the general state of world growth. When assessing our portfolio, we assume relatively slow growth and, for the present, little threat of an inflation uplift notwithstanding the improving price trend of various commodities. Profits will remain hard to grow, but when companies with strong market positions are on offer at P/E multiples of 12 to 14 times this year's earnings, a degree of risk has already been accounted for. Our weak performance to date is due to a very different allocation to the average global fund, and we see little virtue in joining the crowds. As the foregoing table shows, there is no shortage of growth companies in PMC's portfolio.

Kerr Neilson
Managing Director
Platinum Asset Management

Level 8, 7 Macquarie Place
Sydney NSW 2000

GPO Box 2724
Sydney NSW 2001

EMAIL
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



Notes

1. The investment returns are calculated using PMC's 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 PMC's share price.

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 in the underlying assets of PMC and other risk factors associated with investing, investment returns can be negative (particularly in the short-term).

The portfolio inception date for PMC is 29 June 1994.

It should be noted that Platinum does not invest by reference to the weightings of the MSCI All Country World Net Index (AS) (the "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.

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

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

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