

# PLATINUM JAPAN FUND



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Portfolio Manager

## PORTFOLIO POSITION

Some of the themes/large positions contained in the current portfolio include (position prior quarter):

Domestic related 47% (49%), including:

- 13% (13%) Defensive (transport, food, telecommunications, services).
- 13% (12%) Financials.
- 11% (12%) Real estate, retail.
- 8% (7%) Construction.

Export related 36% (37%), including:

- 10% (12%) Technology (including specialty materials) and machine tools.
- 9% (7%) Autos.
- 7% (7%) Global energy and infrastructure capital equipment.
- 6% (6%) Commodity producers.
- 4% (5%) Chemical/process.

Net exposure to stocks 68% (73%).

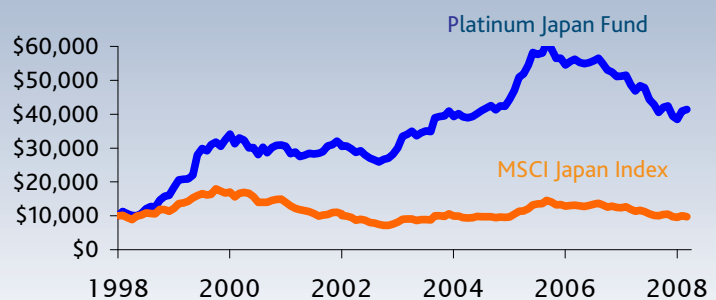
### DISPOSITION OF ASSETS

REGION	SEP 2008	JUN 2008
JAPAN	78%	83%
KOREA	5%	4%
CASH	17%	13%
SHORTS	15%	13%

The Fund also has an 11.8% short position in Japanese Gov't Bonds.

Source: Platinum

### VALUE OF \$10,000 INVESTED SINCE INCEPTION 1 JULY 1998 TO 30 SEPTEMBER 2008



Source: Platinum and MSCI. Refer to Note 2, page 36.

## PERFORMANCE AND CHANGES TO THE PORTFOLIO

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Over the past 12 months the Fund fell 15%, outperforming the MSCI Japan Index (AUD) benchmark by 3% and over the past quarter the Fund rose 5%, outperforming the benchmark by 5%. Over the quarter the benchmark fell 18% in JPY terms and was flat in AUD terms.

The three major investments/ideas that made money this quarter were attributed to:

1. Remaining heavily exposed to JPY, with little exposure to the AUD. Over the quarter the AUD depreciated 17.4% against the YEN; as the sell-off intensified we bought AUD, ending the quarter with 18.5% in AUD (having started the quarter with zero exposure).
2. Shorts on South Korean and Japanese cyclicals – explained in more detail below.
3. Our holdings in Japanese construction stocks gained on nascent indications of renewed pricing power – explained in more detail below.

The two major investments/ideas that cost money this quarter were attributed to:

1. Holding onto some of our commodity stocks (Inpex and Mitsui) for too long as we believed their cheap value relative to global peers provided downside protection – this proved wishful thinking. We recently added to our Mitsui position as we think the valuation is extremely compelling, even with a large fall in commodity prices factored in. Based on our work, the Japanese commodity stocks are roughly 30% cheaper than their global peers.
2. The prices of our small stocks have been hit hard as liquidity shrank – we are finding extremely compelling valuations in this area.

Our short exposure over the quarter roughly averaged 16%; with a long exposure of 84% resulting in an average net exposure of 68%. The 5% quarterly gain for the Fund comprised a:

- Long cost of 1.7%
- Short gain of 4.9%
- Cash and other, gain of 1.8%

Another way of expressing the attribution is that in AUD terms, our average long fell 2%, whilst our average short fell in excess of 31%, that is, we shorted the right stocks.

The composition of the long side of our portfolio did not change greatly over the quarter. Most of the action in terms of new positions was on the short side. As stated in the last quarterly report, whilst we think Japanese equities are very cheap, it continues to be hard to achieve absolute gains whilst the world financial system remains in such a fragile state. This was the reason for seeking short opportunities. We entered the quarter with most of our short position concentrated in the South Korean market index and capital equipment stocks as we thought these were vulnerable to declining global growth expectations. Over the quarter we added shorts in Japanese capital equipment and commodity related stocks that had similar vulnerabilities (eg. Kurita Water Industries, Japan Steel Works). As can be seen from the quarterly attribution, this was a profitable strategy. Our only regret is that we did not short more as we managed to talk ourselves out of some prime opportunities. As the sell-off in the global cyclicals (capital equipment, chemicals, commodities) intensified, we closed out some of these positions and replaced them with shorts on highly rated, so-called defensive names (eg. retail, cosmetics), where we believed many domestic investors and index funds had been hiding. We continue to find some interesting opportunities in this area. We think that as global credit remains tight and much of the global economy enters recession, very few areas will prove truly “defensive”.

Also, as stated in the last quarterly report, if the world entered a deflationary debt spiral, we would re-initiate our short on the Japanese Government Bonds (JGBs) as yields collapsed. This has happened.

## COMMENTARY

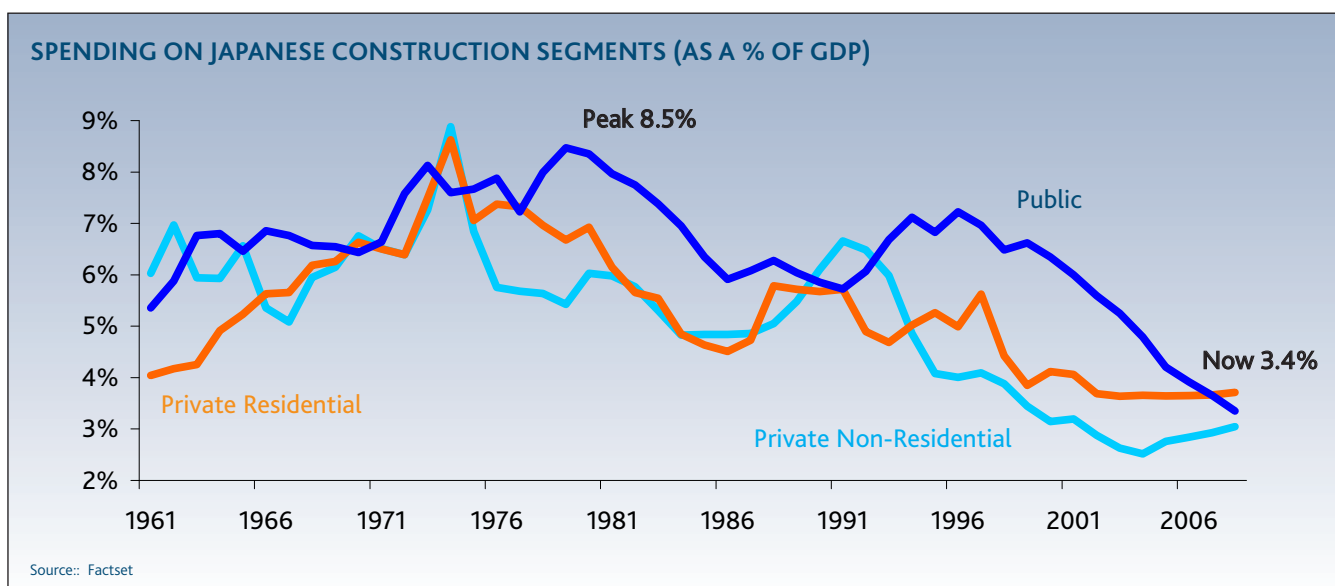
The irony won't be lost on some, that Japan, not often referred to as a bastion of free markets, is yet to ban shorting in any form. Another interesting fact is that ongoing Japanese M&A activity picked-up dramatically during the quarter (TDK-Epcos, Kirin-Dairy Farmers, Tokyo Marine-Philadelphia Consolidated). It would seem that some of those so-called "lazy" balance sheets are being put to work. Whilst not every deal will be satisfactorily executed and the environment is likely to worsen and valuations become cheaper, prices have corrected significantly, as have the number of competing buyers ie. private equity has gone missing in action and only well-capitalised corporates can access debt markets.

In this vein, one of our largest holdings MUFG took a 21% stake in Morgan Stanley at less than book value almost on the same day that Warren Buffet took a stake in Goldman Sachs. Whilst it's fashionable to describe Buffet as an investor of genius, the tag is less likely to be applied to Japan's largest bank. The danger is that both deals prove premature.

In analysing the performance of the longs, we finally witnessed one of our major ideas gain some currency, namely the Japanese construction sector, which many believe to be in terminal decline. Whilst it's early days, it would appear our thesis outlined below is gaining attention:

- After a 19 year declining trend of construction, spending as a proportion of GDP (see chart below), has shrunk below its long-term sustainable level and is now rising as vital projects can no longer be delayed. In fact, private non-residential construction spending has been growing at an average rate of 5% pa since 2003. Most people have forgotten that Japan was once referred to as "The Kingdom of Construction".

- The workforces of the smaller construction companies are shrinking rapidly as the baby-boomer generation on whom they are so heavily dependent retires. In many instances, in excess of half the workforce is over fifty years old. Also, many of the larger companies that we have invested in, have better working conditions and are attracting a younger workforce. They are consequently winning market share, on reasonable margins, from their shrinking rivals.



- The period of rising raw material costs and falling margins has started to reverse as steel prices, et al, are now falling.

In fact, the construction industry data that we track suggests that contract prices (measured on an area basis) are increasing significantly faster than input prices ie. that pricing power is returning to the industry and that margins are set to expand after fifteen years of decline.

## OUTLOOK

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Clearly, the Western world is going through a major consumer recession and this will impact Japan, even if Japan itself exhibits few Western blights within its domestic economy. The feedback loop is clearly the export sector. The question, as always, is how much is in the price? With the retro-spectroscope firmly implanted, Japan probably led the world into the bear market simply because two of the largest sectors in the market, autos and consumer electronics, are highly exposed to the Western world consumer. We have purposely been underweight these sectors, though we would have done better by having absolutely no exposure. Our biggest exposure is Denso, a Toyota affiliate, and the world's largest auto components company. Denso is discussed further in the Platinum International Fund report.

Despite the fear of sounding repetitive or hopelessly naive, our basic case for investing in Japanese equities hasn't changed:

- Japanese household and corporates are under-leveraged; Japanese housing remains affordable and the large banks have a surfeit of deposits.
- Japanese households are significantly underweight risk assets like stocks and bonds relative to their Western counterparts.

- Cash flows to shareholders from dividends and net buyback of shares are greater in Japan than any other country and the buybacks are occurring at very attractive levels. Whilst we would prefer higher payout ratios over buybacks, we're not going to quibble about cash funded buybacks, and we take comfort in many dividend yields being twice that of the JGBs.

- Valuation. On average, Japanese equities are roughly 20% cheaper than developed world equities on a price-to-book basis. The sceptics will state that this discount is warranted due to lower profitability but our work has found that the profitability gap has narrowed considerably in recent times to around a 10% discount. However, we believe there is a major offset. On average, Japanese equities are roughly 33% less geared than the developed world average. Given the current global credit crisis, this should make a significant difference to the risk profile of holding Japanese equities. To date, it hasn't. We are hopeful that at some point this low level of debt, reflected in an ability to maintain dividends and buybacks in the face of a major global recession, will one day result in outperformance, if not absolute returns.

Nonetheless, we lack a clear catalyst for reigniting investor interest. We had thought that domestic investor interest would return if inflation persisted but the worsening credit crunch has put inflationary concerns on hold, though longer-term, there is a chance that inflationary concerns may reignite on the back of coordinated global rate cuts and fiscal pump priming. The ride will remain rocky, but when an entire stock market approaches book value (and as we write, the Nikkei 225 Index as a whole is trading below book value), opportunities abound.