



PLATINUM ASSET MANAGEMENT

# The Platinum Trust Quarterly Report

31 March 2003

Incorporating the:

International Fund

European Fund

Japan Fund

International Technology Fund

International Brands Fund

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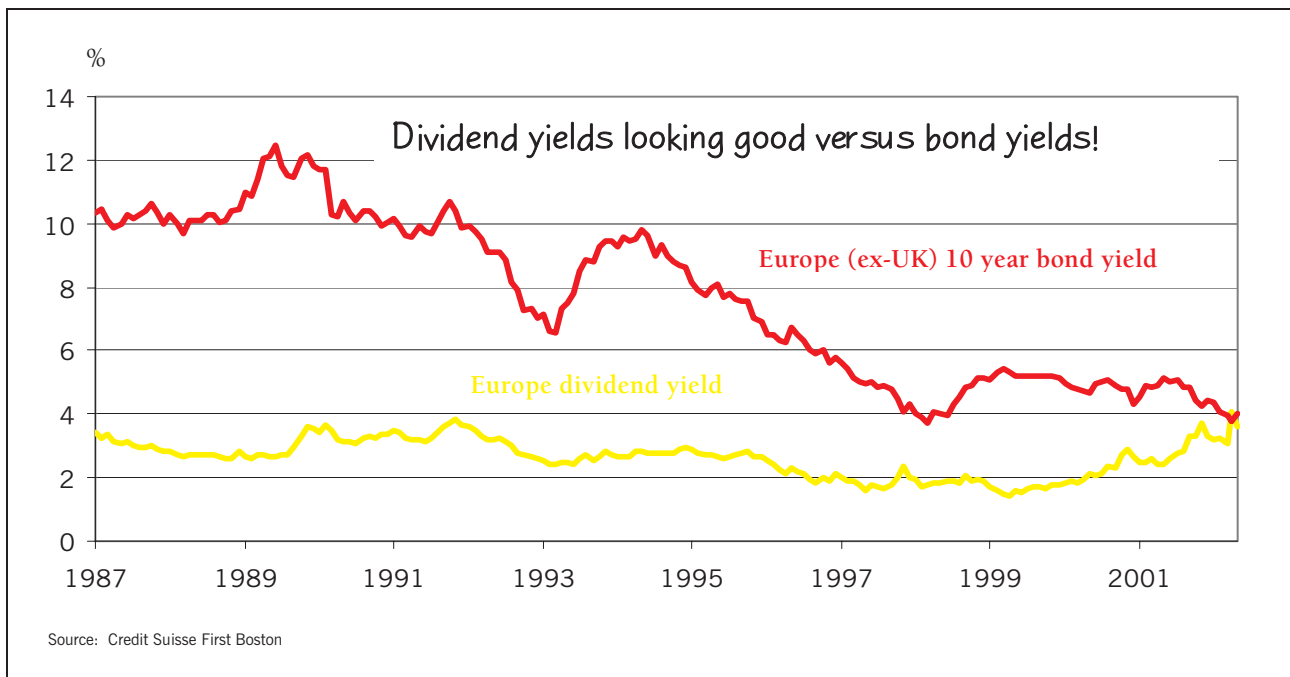
International Brands Fund

## PERFORMANCE RETURNS TO 31 MARCH 2003

Fund	Fund Size	Quarter	1 Year	2 years (compound pa)	3 years (compound pa)	5 years (compound pa)	7 years (compound pa)
<b>International Fund</b>	<b>\$2293mn</b>						
MSCI * World Index		-8.3%	-18.1%	-2.9%	5.1%	15.0%	16.6%
<b>Japan Fund</b>	<b>\$63mn</b>						
MSCI Japan Index		-11.5%	-33.1%	-23.4%	-18.3%	-3.9%	4.9%
<b>European Fund</b>	<b>\$82mn</b>						
MSCI European Index		-7.4%	-15.5%	-7.3%	-6.6%	-	-
<b>International Technology Fund</b>	<b>\$31mn</b>						
MSCI World Technology Index		-14.1%	-28.1%	-28.2%	-25.3%	-	-
<b>International Brands Fund</b>	<b>\$65mn</b>						
MSCI World Index		-11.1%	-24.6%	-10.7%	2.4%	-	-
		-15.4%	-34.5%	-24.7%	-18.3%	-	-
		-5.1%	-27.5%	-10.3%	-	-	-
		-8.7%	-44.5%	-34.1%	-	-	-
		-6.7%	-12.6%	5.1%	-	-	-
		-11.5%	-33.1%	-23.4%	-	-	-
* Morgan Stanley Capital International							
<b>Micropal average int'l fund return (637 Funds surveyed)</b>			<b>-34.7%</b>				

Source: MSCI and Platinum

## EUROPE (EX-UK) 10 YEAR BOND YIELD VERSUS DIVIDEND YIELD



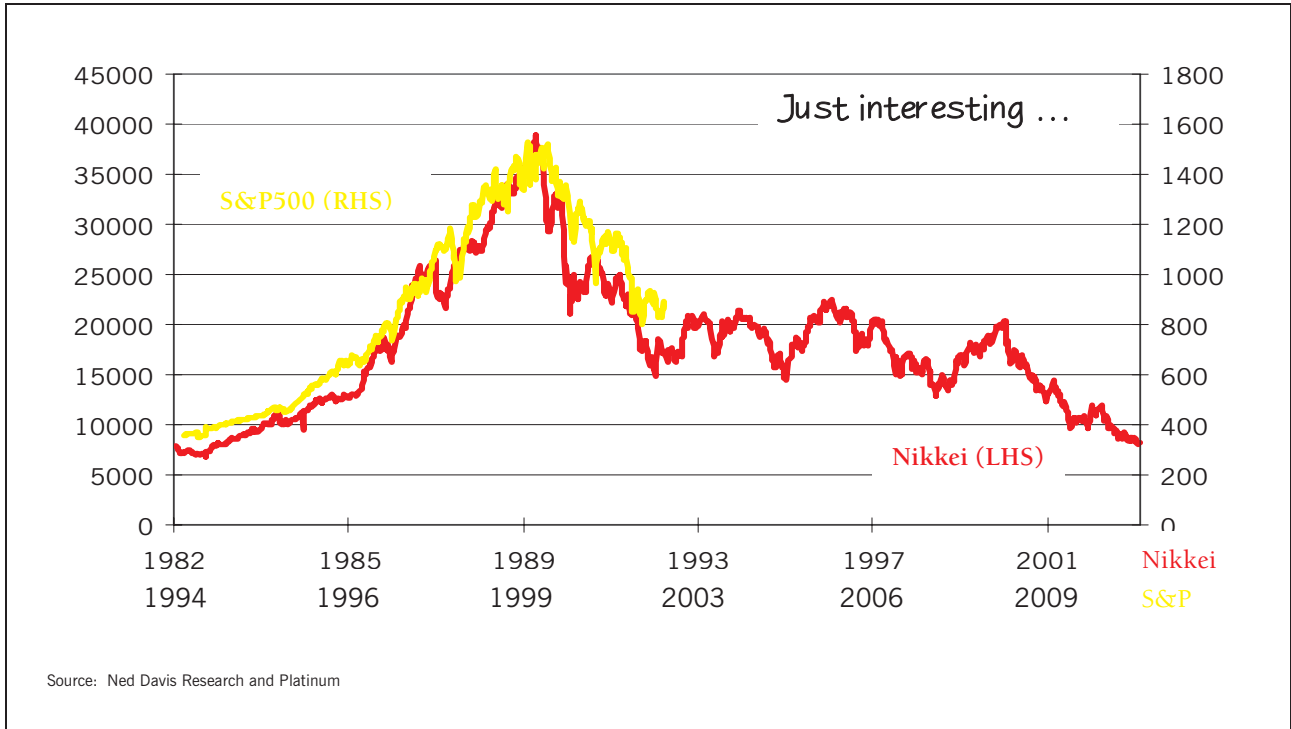
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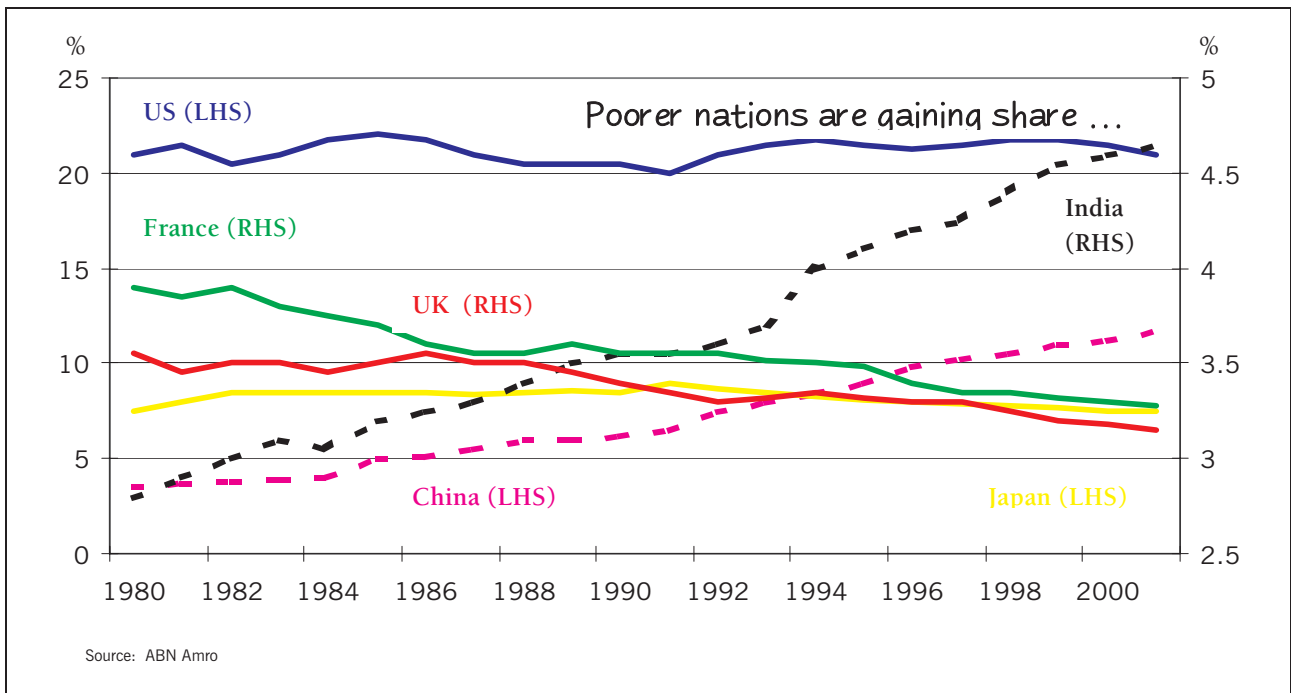
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**S&P500 INDEX (1994-2003) VERSUS NIKKEI INDEX (1982-2003)**



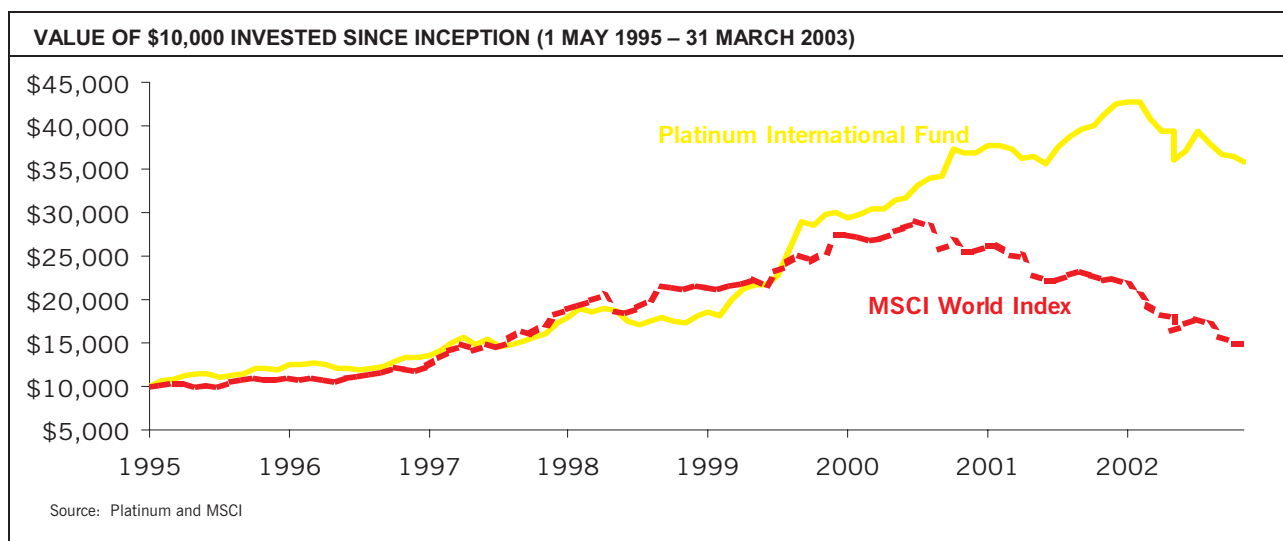
**IMF ESTIMATES OF PURCHASING POWER PARITY SHARE OF WORLD GDP**



# Platinum International Fund

## Performance

REDEMPTION PRICE: \$1.4275



All major markets were down for the year, ranging from -13% for Australia to -49% for Germany. The MSCI was off 33%. The same pattern was true for the last three months with Brazil alone in having risen by 2% from very depressed levels. The average was down around 11.5%.

Looking at the MSCI by industry categorisation, it is remarkable that there was nowhere to hide. Each of the ten sectors was down for the year and not one by less than 27% (consumer staples) while information technology had the dubious honour of again being the weakest at -43%. Unfortunately the Fund has not escaped this continuous decline and has fallen by 18% for the year and by 8% for the quarter. All these numbers have been expressed in A\$.

On a quarterly basis the Fund's performance was not much better than the MSCI. This is partly explained by the continuing weakness in Germany even though many of our holdings there have acquitted themselves well. At the same time, our short sales, which are predominantly in the US, have been somewhat more resilient than the broader US market. These shorts are principally among

consumer staples and financials which investors use from time to time as a refuge. They together with the other shorts were established on account of their extravagant valuations or lax credit procedures, and we believe, will gradually lose their investor following as time passes.

MSCI WORLD INDEX – INDUSTRY BREAKDOWN		
Sectors	3 months	1 year
Telecommunications	-14.4%	-34.8%
Materials	-14.2%	-30.0%
Financials	-13.7%	-33.8%
Consumer Staples	-13.6%	-26.9%
Consumer Discretionary	-11.6%	-37.0%
Industrials	-11.6%	-36.9%
Energy	-10.3%	-29.4%
Utilities	-9.6%	-30.8%
Information Technology	-8.2%	-43.3%
Health Care	-7.7%	-28.8%

Source: MSCI

## Changes to the Portfolio

DISPOSITION OF ASSETS		
Region	Mar 2003	Dec 2002
Western Europe	32%	34%
Japan	20%	19%
North America	13%	14%
Emerging Markets (incl. Korea)	10%	10%
Australia	2%	2%
Cash	23%	21%
Shorts	30%	24%

Source: Platinum

With share prices moving in a range of as much as 30% in a quarter, there is opportunity to either add to positions that have sold off fiercely or to trim those that bounce on very short term considerations. This was our pattern in this period where companies like Assicurazioni Generali rose by a third as a result of a fight for control and Allianz sold off 50% on solvency concerns. Having satisfied ourselves as to the fundamentals of each, we reduced our position in Generali and progressively added to Allianz. As noted later in this report, we bought this share far too early in the cycle but now that it is addressing its solvency margin via a rights issue, it is not the time to be conjuring up creative imaginings about the fate of the world's largest insurer! Potential buyers are likely to be holding back in anticipation of a stock over-hang from the rights issue but our work suggests this makes for a good buying opportunity.

BREAKDOWN BY INDUSTRY			
Categories	Examples of Stocks	Mar 2003	Dec 2002
Cyclicals/Manufacturing	Schindler, Siemens, RMC, Bayer, Linde, Océ	21%	21%
Medical	Yamanouchi, Takeda, Draegerwerk, Novartis, Merck KGaA	9%	8%
Financials	Assicurazioni Generali, Allianz, Alleanza	9%	7%
Gold and Other	Barrick Gold, Newmont Mining, Gold Fields	8%	8%
Technology/Hardware	Agere Systems, National Semiconductor, Samsung, AMD	8%	10%
Telecoms	Hellenic Telecom, Ericsson, NTT	7%	8%
Retail/Services/Logistics	Metro, Hornbach, Fraport	7%	8%
Consumer Brands	Citizen Watch, Adidas Salomon, Lotte Confectionary	5%	5%
Software/Media	Sky Perfect Communications, Seoul Broadcasting	3%	4%

Source: Platinum

## Currency

The US\$ was weak for the quarter and saw the Euro rise from around \$1.00 to \$1.09. Similarly, the A\$ gained ground and rose from 56 cents to 60 cents versus the US\$. Our hedging strategy is working favourably and even though the US\$ could find some

vitality in the short term, we are reluctant to fine tune our position. We remain principally hedged into A\$ at 70% and own Euros, Swiss Francs and some Korean Won.

## Commentary

Armchair Generals may be disappointed at our lack of commentary about the invasion of Iraq. There are plenty more knowledgeable sources than ourselves, and besides, we believe this war is coincident with the bear market rather than causal. That the war adds to uncertainty via geopolitical risk is indisputable.

We have just celebrated the **third anniversary of the Nasdaq bear market** and arguably approximately the fourth year of the broader US indices decline.

In case there is need to emphasise the madness of the crowds, in mid-March of 2000, the Nasdaq index ostensibly represented 4% of US corporate earnings and 40% of total US listed equity values. Today this index represents some 25% of available US market capitalisation. Other signs of the deflation of the bubble lie in the collapse in merger and acquisition (M&A) activity and the rapid decline in cross-border capital flows. World M&A activity amounted to US\$12.4 trillion between 1995 and 2002. The peak year was 2000 which accounted for 26% of this total. Characterising the excitement for instant gratification was the amount devoted to pure "body businesses"; support services, media, and software. These in aggregate accounted for 34% of all activity. (The point being that in the heat of the moment good investment bankers can convince clients and the market of the apparent necessity to acquire entire blocks of people rather than hiring the individual talent that embody these asset-poor enterprises. Often, the expensive goodwill purchased fails to meet expectations but it is only as the bubble deflates and the urgency subsides that the logic of acquiring other people's problems is questioned).

**Cross border capital flows** are showing a similar pattern. Having peaked in 2000 at around 14% of world GDP, they have evaporated. The diminished desire to invest in distant markets is reflected in the de-rating of emerging markets. From the frothy highs of 1994 when emerging markets had price earning ratios higher than the developed markets, they are now valued at just over half (PE relatives are about 55%).

The extravagances of the bubble can start to be measured by the spectacular level of **corporate busts**. The magnitude of these is well worth recording and all the more when viewed alongside those company's peak capitalisations (see accompanying table).

Fortunately we have avoided these disasters and in fact benefited from some through our shorting activity. It also incidentally serves to underline the benefit of following our seemingly perverse disdain for popular stocks.

**TOP BANKRUPTCIES IN THE US IN 2001/02 BY ASSET SIZE**

Company	Bankruptcy Date	Peak Market Capitalisations (US\$ mn)
WorldCom	July 2002	162,980
Enron	December 2001	62,698
Global Crossing	January 2002	39,438
Pacific Gas & Electric	April 2001	15,527
NTL	May 2002	13,328
UAL	December 2002	12,328
Kmart	January 2002	11,198
Conseco	December 2002	10,570
Adelphia Communications	June 2002	7,410
Federal-Mogul	October 2001	4,000
Finova Group	March 2001	3,412
Reliance Group Holdings	June 2001	2,182

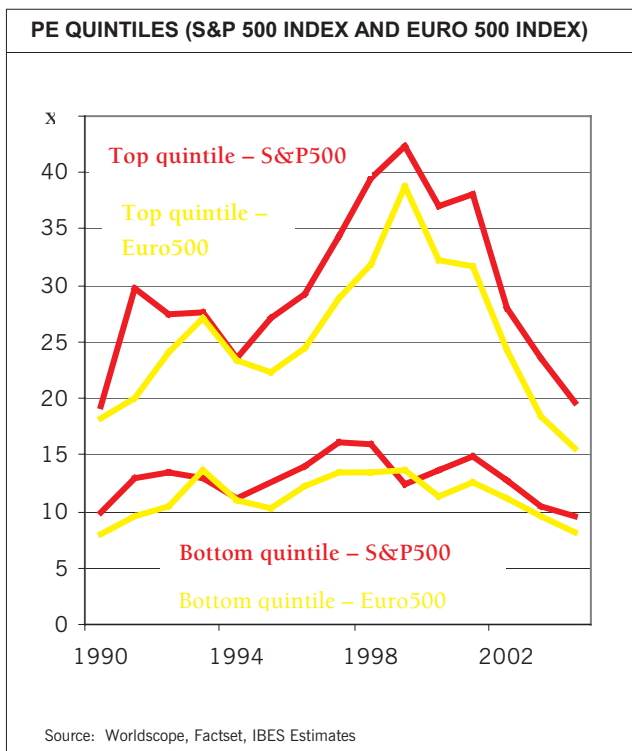
Source: BankruptcyData.co, Worldscope, Factset

In the place of ultra-large mergers and corporate hubris there are now spectacularly **large rights issues**. The scramble for liquidity is clear. Led by yesterday's heroes, money is being extracted from unwilling pension funds and insurance companies who are in any case reviewing the wisdom of such large exposure to shares. We have managed to avoid most of the bother except that we unwisely bought into the world's largest insurer Allianz. The cardinal error was to be influenced by the share's price collapse. This was foolish particularly when set against the backdrop of general under-reserving by the insurance industry and the cavalier behaviour of the finance industry in general. Further we had recognised the bear market and understood the effect of falling share prices on solvency ratios. (For more on the stresses within the financial system, please read John Hempton's piece on page 11).

This leads us to the problem of assessing where we are in this bear market. Investor psychology suggests that Europe and NE Asia are already well into the second phase of the negative appraisal of shares. The general talk is about **geopolitical risk, balance sheet rebuilding and corporate malfeasance**.

Often phrases are chosen to match the music of the moment. We have written before on the valuations found in Japan where the share prices barely match the value of cash in companies' bank accounts, without regard to the business value. In Europe, share values have declined to a level where dividend yields exceed the interest payment on Government guaranteed bonds (see chart page 2).

Another measure of values is the compression of PEs where there is relatively little difference in valuations between the best and worst companies (see below).



By contrast, shares in the US are still relatively highly valued. Here PEs are still above their long term average, balance sheets are more indebted and no case can be made that the book keeping is superior. Possibly the economy is showing greater responsiveness to cheap money but given the greater use of debt and the low savings rate, we are puzzled and unconvinced. The US remains our principal shorting arena.

Rather than hacking around in that undergrowth let's move to where we have been active. In the last three months we have visited Asia twice. We strongly

subscribe to the view that the Eastern hemisphere will be the **strongest area of world growth** over the next few years.

With the opening up of the American west and for that matter, Australia and Argentina, together with improved transport, agricultural land and commodity prices in Europe collapsed in the latter part of the 19th Century. As we have noted previously, the removal of trade barriers and rapid transfer of technology and capital to emerging economies is having similar consequences for labour employment in the developed world while flooding it with goods at low prices. Russell Napier of brokers CLSA has written an excellent study comparing the emergence of China with that of the US in the latter part of the 1800s and Japan in the 1950s. The parallels he draws suggests that the opening of China will tend to depress labour and land costs in the developed world. Simultaneously the improvement of Chinese living standards will tighten the supply of various raw materials and raise urban land values in China. Russell sees China as being at a similar level of per capita commodity consumption as the US in 1910 and Japan in the 1950s. He argues that in a fiat money system, the emergence of a relatively resource poor nation is likely to produce commodity price inflation.

We have no argument with Russell's view.

Interestingly, the economic take-off of Japan in the 1950s coincided with very high levels of mining exploration and development. This is not apparent today! Studies by the auto majors corroborate the view about commodity usage and show how once incomes per head exceed US\$2,500 to \$3,000, automobile consumption grows at an accelerating rate. Several of China's coastal provinces are now in this position and vehicle production is accelerating past three million per annum. In general, Australia seems particularly well placed on account of the prospects for its exports and most importantly the relative weak prices of its imports ie. improving terms of trade. The big surprise will be the explosive rise of mainland Chinese travelling abroad.

Yes, China is the favourite for the moment but we cannot find much that will get in the way of this juggernaut. Our recent visit avoided the normal rounds of Beijing and Shanghai as we sought out multinationals, local officials and emerging entrepreneurs in other locations.

To distil our observations to a few sentences is awkward. The sheer size of China and its population makes the comparison with other emerging markets



misleading. Secondly, we are witnessing the **transformation of over one fifth of the world's population from a communist regime with the complicity of capitalism.** The desire and ability to leapfrog patterns established by other emerging economies is breathtaking. Increasingly the old brigade are tolerated rather than revered or even feared. Regional governments are vying amongst themselves to attract new foreign investment secure in the knowledge that this will bring them popularity and wealth. This is helping to expedite approvals and the breadth of regional competition is tending to reduce opacity.

For good ideas money always seems available; be it from the State banks trying to grow their way out of non-performing loans to State Owned Enterprises or other sources. These include the State and municipal governments, and informal mobilisation of savings. It is striking, and perhaps worrying, that long term funding is available at a floating rate of only 4.5% pa.

It is seldom clear who is the true beneficial owner in many of the recent success stories. The share register is kept a mystery as various front-men masquerade as owners. Interests seem to be shuffled among the participants in an endless choreography but invariably there are politicians at local or regional level who share some of the action. For this and other reasons one sensed that we were visiting *chaebols* in the making.

**Competition is extremely fierce.** As soon as a new idea or product takes off, imitators pop up, showing little regard for trademarks or intellectual property. We were constantly surprised at the relatively small labour forces we encountered at many of the sites visited. Far from relying on low labour costs alone, we found many examples of highly sophisticated industrial solutions that one would normally have expected in the West. Assembly line workers (making say TVs, cars, motorcycles or heavy earthmoving tractors) typically earn around Rmb 1,000 to 1,400 per month (US\$120 to \$170) - depending on whether housing is supplied. It is standard practice for a free canteen lunch to be given.

The **theft of intellectual property** is a major problem for foreign firms. Lucent was a stark example of this.

Having initially come to China to supply telecommunications equipment, they soon found local imitators who both undercut prices and responded far faster in developing new applications. They now find themselves in the invidious position of having to go deeper into the lion's den and have established some of their leading R&D labs in three mainland cities. Far from being a market to be sold to, China is now being seen as an integral part of Lucent's global research and procurement network. The fact that China is fast developing into the biggest market for many products puts many foreign firms in a similar dilemma: how to participate in one of the few large and growing markets and yet not lose one's know how. Speed of response, low manufacturing costs and market opportunity all contribute to the leapfrogging process noted earlier. The rule of thumb is that capital costs of setting up in China are about 50% of western costs!

For all the positive aspects of change taking place on the mainland, one should not underestimate the immense problems the country faces. These include a growing income differential between the coastal areas and the interior, problems with education, health, water supply, influence-peddling and so on. Our assessment is that these are all the ingredients for major booms and spectacular busts as unbridled optimism takes its toll. The energy that this transformation has unleashed, accompanied by nearly two decades of strong growth will lead to periodic over-estimation of demand. This could further exacerbate the pressure on profitability outside China.

Will we be able to make money out of China? The answer is far from clear. However it does give us some keen insights of what to avoid and who may be well placed to supply this burgeoning market or produce products they themselves cannot provide. Imports of sophisticated equipment is clearly on the rise as local sources have still not mastered the technology. This is helping to balance out the trade account with developed countries and indeed is opening a new export market for advanced capital equipment makers.

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## Conclusion

It would be surprising if “positive” news on the Iraq front does not lift some of the gloom in equity markets. However, a weak investment cycle and over-stretched consumers in the Anglo Saxon countries is likely to suppress a strong economic rebound. Companies may continue to face pressure

on prices even as their costs keep rising. However, valuations in Asia and Europe seem to reflect a scenario that is even more grim than appears plausible. We suspect the worst of the declines are behind us and so expect share prices to move up in a jagged fashion.

Kerr Neilson  
Managing Director



Old housing in Lijiang



New housing in Tianjin

Aerial view of SW China



Motorcycle Factory



Three Gorges Dam

## Bad Money

At Platinum we have become increasingly concerned that lower income American consumers (and possibly American consumers in general) have too much debt. We think this situation will end in a blaze of credit defaults and a substantial slowing of consumer spending. This will have a large impact on businesses that rely on buoyant consumer finance (such as the automobile manufacturers and their suppliers) and also on the holders of consumer debt and the debt of companies that lend to consumers (such as some life insurance companies).

In the 1990s any business in a fashionable sector with a “growth plan” was able to find funding in the US. The extreme manifestation of this was dot.com. Such excesses were not limited to dot.coms. It also appeared in businesses that lent money. In keeping with the spirit of the times, companies with new and high tech methods of lending money (and assessing the credit worthiness of borrowers) were funded by the debt and equity markets. There were for instance several companies which specialised in giving credit cards to people with poor credit records (people who had previously defaulted or defrauded lenders) backed by complex models of individual credit behaviour. There were also companies that specialised in giving credit out on the internet. Some companies combined mathematical scoring models with dot.com distribution.

These companies were revered for their growth. Higher growth (which means lending to more people) was rewarded by a higher share price and greater access to (debt market) funding to lend more money to more people. It was a virtuous circle.

The problem was that where it might be possible for a single company to find “underserved” markets where otherwise good borrowers are denied access to loans (for example amongst recent Hispanic immigrants), it is improbable for a dozen companies to successfully identify such borrowers without cut-throat competition. Moreover when the companies are rewarded for growth they will tend to find it *even when it is not profitable*. Cut-throat competition meant previously “underserved” markets were now served by a plethora of lenders operating on ultra-thin margins with increasing “competitive” interest rates.

In normal circumstances this would be quickly self-correcting. The companies that were lending too

much to the wrong people at low interest margins would report poor profits and poor credit data. Hence these companies would find it difficult to raise additional funds and the “over-lending” would cease. However, for the management of the new-age finance companies this would be catastrophic, probably putting them out of business. Instead the companies went to extreme measures to ensure that they did not need to report bad credit data to capital markets.

The most common solution to underlying deterioration was for lenders to mask the problem by lending even faster. On account of the “denominator effect” the percentage of the loans deemed problematic looked small. Growth rates over 50 per cent per annum were common amongst aggressive participants.

Eventually fast growth was not enough (and besides it was too easy to assess by looking at this year’s credit losses against last year’s loans). Amongst the worst companies it became commonplace to fake credit data through collection methods or by changing the definition of things as simple as “is the customer late in making their payments”. This sounds extreme, but it was widespread.

It may have started innocently enough. The management thinking being “the model is not working, so let’s tweak it; manipulate the data so the investors are none-the-wiser, and get it working for new loans (of which we are making many)”. However what started innocently became mass fraud.

The fraud hid and exacerbated some very bad lending. For instance we know of a car finance company that reported lending losses of less than four percent of outstanding loans. However the loans were so bad that eventually about 35 loans in every hundred will eventually either skip (ie. disappear without making payments) or be repossessed. Very bad lending was disguised as good lending through a deliberate process of:

- extending the repayment terms on loans from which no payment had been received so the loan would appear to be current under the new extended timetable,
- poor or non-recording of skips,
- where the car had been repossessed, only accounting for a loss when the car was sold – the

company stored tens of thousands of repossessed cars,

- not reporting (or under-reporting or reporting with a lag) losses on loans to customers where the customer had declared bankrupt,
- increasing the size of the loan portfolio at massive rates to hide losses with the “denominator effect.”

The car lender in question had financed the purchase of approximately three quarters of a million cars. It was the biggest independent car lender in the United States.

The fact that this car lender is likely to need to repossess over a quarter of a million cars is staggering – but it is the logical conclusion of the rush for growth in consumer lending. Finding and lending to customers who have the intention and the ability to repay you is hard (just as finding customers for any business is usually difficult). However lending to people who have no intention of repaying is easy. Stand in a poor neighbourhood and shout “anyone want to borrow \$5,000” and generally you won’t be disappointed.

Semantic definition changes were a key part of the (non) reporting of bad credit data. For example two of the companies we know will not report a credit loss on a card which is issued, drawn to its limit and on which no payment has ever been received. They classify this as a fraud loss so as to bury it in their selling and administrative expense (which is not much watched by Wall Street).

We also know of companies which provide in-store credit at electronics shops. They have extended credit at zero interest rates and with no obligation for a repayment for up to fourteen months. These loans can not be delinquent because there is no legal obligation to make a payment until the fourteenth month. Making large numbers of nothing-to-pay loans will make very poor credit data look good through denominator effects. (There is of course a problem brewing in fourteen months’ time.)

In case you believe we are overstating the degree of manipulation, see how the SEC interpreted Household International’s accounts. At its peak,

Household was more “profitable” and more highly valued than National Australia Bank (viz US\$20 billion).

*[The SEC found that] Household's disclosures regarding its restructure policies fail to present an accurate description of the minimum payment requirements applicable under the various policies or to disclose Household's policy of automatically restructuring numerous loans and are therefore false and misleading. The SEC also found misleading Household's failure to disclose its policy of excluding forbearance arrangements in certain of its businesses from its 60+ days contractual delinquency statistics. The SEC noted that the 60+ days contractual delinquency rate and restructuring statistics are key measures of Household's Financial performance because they positively correlate to charge-off rates and loan loss reserves.*

It turns out that Household would lend to customers who did not pay. Household would then (say after 70 days of non-payment) reschedule the loan payments without consulting the customer (giving forbearance and/or waivers of interest and fees). The loan could then be classified as current according to the rescheduled payment requirements. They therefore did not need to provide for possible losses on these loans, and by so doing depress their published profits.

Household is one of the biggest consumer lenders in the world with loans outstanding of US\$120 billion. This is the disclosure of very poor practice in mainstream American consumer lending. Household however noted that most of their competitors have credit management procedures similar to itself. Paraphrased: “our competitors faked their data and if we did not do so we would be disadvantaged in capital markets”. The point of course is that bad lending and manipulated credit data – once a preserve of the new-age lenders had become a mainstream activity. This is not sustainable – and when it is no longer sustained there are serious implications for the willingness of consumers (particularly credit constrained consumers) to spend. It follows that there are problems brewing in industries (such as car manufacturing) dependent on those consumers spending and having continued access to finance.

**CONSUMER LENDING COMPANIES - MARKET CAPITALISATION (PEAK AND CURRENT) AND SIZE OF THEIR LOAN PORTFOLIOS**

Company	Approximate peak valuation (US\$ bn)	Current valuation (US\$ bn)	Total outstanding loans (US\$ bn)	Loan type
<u>Conseco</u>	21	0.01	44	Manufactured home loans, sub-prime mortgages, credit cards
<u>Oakwood Homes</u>	1.9	0.002	4.8	Manufactured home loans
<u>NextCard</u>	2.7	0.00037	2.5	Credit card lending
Providian	18	1.9	25	Credit card lending
Metris	2.5	0.14	11	Credit card lending
Capital One Financial	15	6.8	60	Credit cards, car loans
MBNA	32	19.2	107	Credit card lending
Compucredit	2.8	0.29	1.5	Credit card lending
Sears Roebuck	19	7.5	31	Credit cards, store cards and a large retail chain
Household International	31	13.4	110	Subprime mortgages, credit cards, retail store credit and car loans
Americredit	<u>6</u>	<u>0.5</u>	<u>12</u>	Car loans
<b>TOTAL</b>	<b>151.9</b>	<b>49.7</b>	<b>408.8</b>	

Source: 10K company reports

Household International has been purchased (in distress) by HSBC at the price given above. Sears has announced that it is selling its credit card business. The companies underlined have filed bankruptcy.

The total outstanding loans of these companies are more than twice the Australian mortgage market.

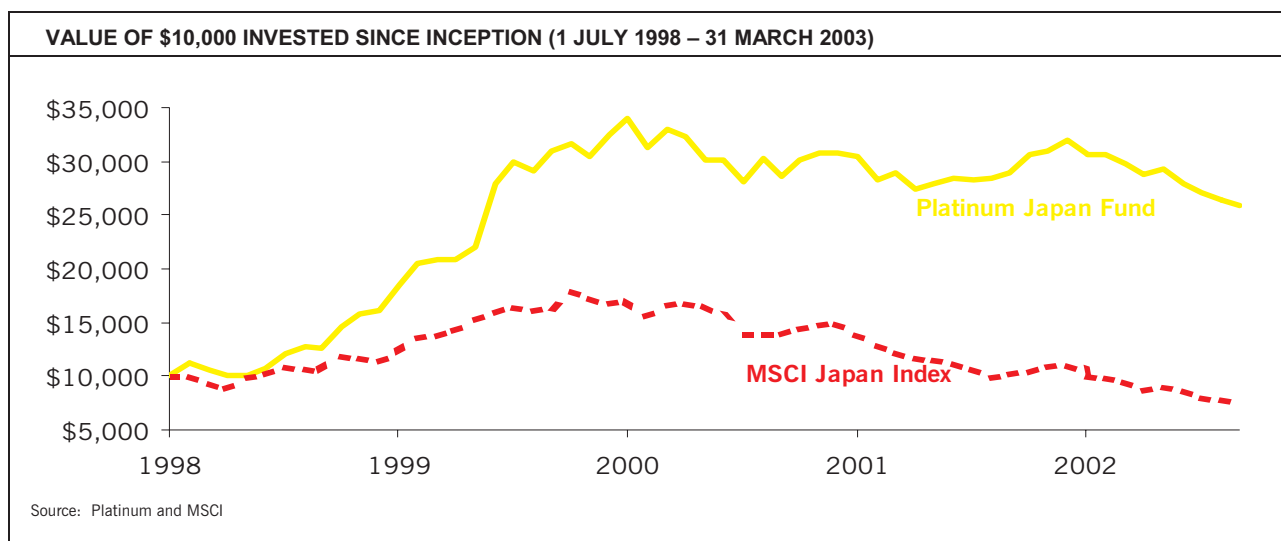
We have had short positions in most of the companies on this list.

John Hempton  
Investment Analyst

# Platinum Japan Fund

## Performance

REDEMPTION PRICE: \$1.4709



The Japanese market continued its decline this quarter with the benchmark Topix index down 6.6% in local currency terms. Investors were disappointed that the choice of the new Bank of Japan (BOJ) Governor Fukui seemed likely to lead to the current monetary policy settings being maintained. In addition, very large preferred share issues by the banks in an attempt to stave off nationalisation weighed down the finance sector. Declines in financial stocks were balanced somewhat by broad gains in the industrial sectors of the market such as shipping and steel which are perceived beneficiaries of Chinese growth. In Korea, the market was considerably weaker, declining by 14.6% in local currency terms with the Won weakening by 5.8% against an already weak US\$. Apart from the obvious concerns surrounding North Korea there were

numerous domestic factors which drove the market down (see commentary).

The Fund was down by 7.4% over the quarter in A\$ terms as compared with a decline of 14.1% in the MSCI Japan index. The main differentiating factor was the hedge into A\$ (now at 72% of the Fund) which benefited as the A\$ rose by 6.7% against the yen during the period. In terms of stocks, strong performers were Citizen Watch (strong LED sales for use in handsets), Komatsu and Canon Sales. On the negative side our Korean stocks including Korea Telecom and Lotte Confectionary had sizeable falls as did Aiful and Ushio in Japan. For the year to 31 March 2003, the Fund fell by 15.5% in A\$ terms but substantially outperformed the MSCI Japan index which declined by 28.1%.

## Changes to the Portfolio

We added new positions in NTT Docomo, Yamato Transport, Daiwa House and Mitsubishi Corporation. These purchases were financed by sales of holdings in Fujirebio, Sky Perfect, Sohgo Security, Sony and Kookmin Bank as well as partial sales of NTT and Matsushita Electric.

The Fund sold its entire long position in Nikkei Index futures as it appeared the market would break to lower ground as relative values elsewhere, especially in Europe, adjusted sharply lower over the quarter. This proved to be the case.

DISPOSITION OF ASSETS		
Region	Mar 2003	Dec 2002
Japan	72%	75%
Korea	11%	16%
Cash	17%	9%
Short Derivatives	-6%	-9%
Long Derivatives	7%	11%
Net Derivatives	1%	3%
Net Invested	84%	94%

Source: Platinum

Currency exposures were further weighted toward the A\$ with 10% of the Korean Won exposure being hedged into A\$ before the sharp deterioration of the Won. We continue to believe that the A\$ is a relatively attractive currency due to Australia's weighting to commodities and the Asian region in general.

## Commentary

As we commented in our last report, there was an opportunity for the Japanese government to embrace a more activist stance in the economy by appointing an aggressive BOJ governor. As it transpired this was not the case and the leading consensus candidate Mr Fukui was appointed. So far it appears his policies will be an incremental continuation of those of his predecessor Mr Hayami and in that sense it is a disappointment. For his part, Prime Minister Koizumi now seems increasingly incapable of bold action and appears isolated even within his own party. This may mean that he suffers a serious challenge to his leadership at the next LDP leadership election due later this year. This is not positive news for the market in the short run.

The most interesting development in Korea this quarter was uncovering by government investigators of fraudulent accounting at the SK Chaebol company, SK Global. This fraud involved the company systematically overstating profits and understating debt (around US\$1 billion) in an attempt to hide its weak financial position subsequent to the purchase of SK Telecom shares off the government many years ago. The impact of this revelation on financial market psychology was very direct:

- It served as a reminder of the bad old days of the Asian crisis and such corporate failures as Daewoo where fraud was widespread.
- Bond fund investors withdrew money on fears that the insolvency of the SK group would lead to defaults. This effectively froze the bond market for a period, triggering problems for the credit card companies who were trying to refinance.

- A fear of whom is next amongst the big chaebols?

The SK scandal serves as a stark reminder of the risks inherent in all equity markets, not just in Korea, with similar (fraudulent) activities being reported in the US in recent times. In regards to Korea we would continue to avoid the highly indebted mid-sized chaebol companies, of which SK was one, for fear that similar practices may have occurred. The reality is that high levels of debt give a group little room for movement when hit by shocks. The same negative view applies to the banks which despite some positive reforms are still party to many of the bad aspects of the Korean system.

On the positive side these events are generally helpful in improving investor confidence over the medium term. We note that from the Korean perspective and especially relative to history, the authorities have moved especially swiftly in this case. The top 20 executives from the SK group face charges and the major shareholder has had to relinquish his shares in group companies. The banks have moved very quickly towards an orderly workout. We would also point out that from a macro perspective Korea has reduced debt significantly in recent years and these events are really hangovers from a murky past. For reference, the Daewoo fraud ended with total debts of around \$80 billion of which probably \$5-10 billion was recovered. SK group has every chance of being able to meet all of its commitments.

### Debt and the Japanese Economy

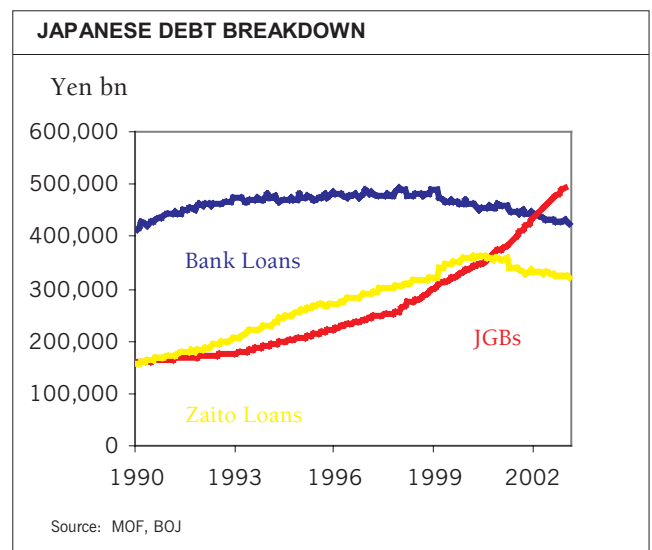
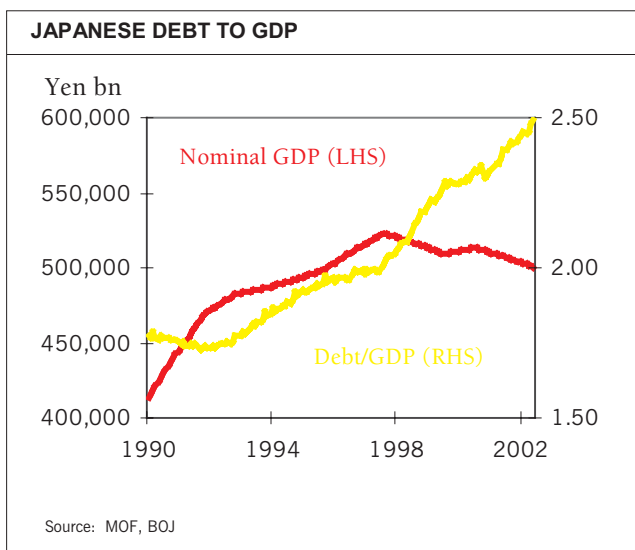
Recently we reviewed the Japanese Banking sector and the level and composition of total debt in the



wider economy. What immediately stood out from a macroeconomic perspective is that the fundamentals of the Japanese economy continue to steadily deteriorate. Japan's Debt/GDP ratio (a kind of debt service ratio) continues to rise sharply with both rising debt levels and falling nominal GDP (see chart). The ratio itself remains at a level well above those of the western economies and indicates that despite 10 years of recession the economy remains dangerously leveraged. This is clearly an unsustainable situation and the financial markets are at some stage, perhaps in the relatively near future, likely to force a resolution. This is likely to be some form of rejection by the financial markets of the endless accumulation of government debt (see chart). This could be triggered by credit rating agency downgrades or in an extreme scenario, bank runs. Should this happen, the government would then have to make a choice between further retrenchment in the economy (as debt was reduced) or the more palatable solution of inflation (raising

nominal GDP) through a weakening currency and a relative reduction in standard of living for Japanese. Under this second scenario we see short positions on the yen and JGB's and long positions in select exporting stocks as the best positioning.

Looking at the Japanese banks it is hard to see them as being able to operate effectively outside the realities of the above described situation. It is true that they have been making progress in writing off bad loans with operating earnings and appear at least on paper much closer to being appropriately capitalised. However when the government is forced to start addressing the size of its debt, it is hard to see how the banks avoid being hurt. If the government chooses to cut spending, the resulting debt deflation scenario will see further bad debts surface and delay recapitalisation. On the other hand a sharp inflation caused by printing of money would also destroy their trading profits (inverted yield curve) and create losses in the large government bond holdings they have amassed in recent years.



## Outlook

We continue to see good profit results from most of our Japanese holdings, which in the current difficult demand environment is mostly attributable to large cost reductions. However this profit growth is unlikely to continue unless the global economy can provide some decent demand growth and this seems problematic because of the lack of leadership being

shown by the US economy. Korea remains uninteresting at this stage until the domestic scene settles down although the market is quite volatile and events in the North could change quite rapidly which would require a quick adjustment. Both markets essentially remain very cheap but lack the catalyst of global growth.

Jim Simpson  
Portfolio Manager

## A trip to North Korea – February 2003

Nick Harbinson is the Managing Director of Merrill Lynch's Asia desk. Nick has been living and working in Asia for over 20 years now and this article reflects his personal views and observations.

20km north of the factories where You Eal turns out seventh generation keypads for the global cellular market, the peasants in the fields around Kaesong lack running water, heat and fuel. It is -12C, and under a dusting of snow the ground is solid. Apart from some sickles, hoes and the odd bullock cart, there is no agricultural machinery. On the trip south from Pyongyang, 160km away, the only animals to be seen are a few goats and hens. The contrast in the countryside either side of the 38<sup>th</sup> parallel is striking. The north is treeless, arid and devoid of vegetation, anything larger than a shrub being gleaned as fuel by the peasants who roam the hillsides tearing off anything they can find and transporting it on rudimentary cradles to their huts. Trench systems are a consistent feature on barren hillsides, and the return journey up the deserted 4-lane Reunification Highway (completed in 1989) provides a clearer view of rows of gun emplacements and pillboxes facing south. The military presence is omniscient.

In the countryside a few miles east of Kaesong we stopped to view the only original surviving burial mounds of one of the Korean dynasties. I opted to walk a portion of the way. Passed by stooped old women carrying bundles of twigs and leaves 10 feet tall on their backs, I avoided a pile of human excrement. It was largely composed of what appeared to be straw.

In the Yangkakdo Hotel, the assortment of international guests (mainly east German steam engine fans) left the breakfast and dinner buffets embarrassingly untouched, and jostled each other at the fried egg stand. There is no milk, and bread made an appearance twice in five days. Hot water was supplied 4 hours daily, although we had heat, and some light. Our Korean minders, in another wing, had neither. In the basement Stanley Ho runs Casino Pyongyang, which sports a massage parlour and karaoke lounge, staffed by Chinese and off limits to the Koreans. Unfortunately, similarities with Macau were few, but here I could defrost my feet and eat immoderately expensive fried rice, priced in euros. In the city itself, crumbling concrete

tenements with broken glass and plastic sheeting showed minimal light, and the chimney stacks were lifeless. The shops were predictably bare (no bread, fresh meat or vegetables), with tinned goods and biscuits being the staple items. They were again unheated and poorly lit. In the many cavernous public buildings, we filed past huge murals of the Great Leader, hosted by whey-faced women in overcoats and gloves, and froze politely as we listened to the latest tale of American perfidy or of extraordinary sacrifice in the building of the nation.

The city itself is attractive, with wide, tree-lined boulevards, riverside walks and parks, leading inexorably to yet another war memorial or outsize statue of the Generalissimo. The main public buildings are imposing, more so than those in the southern capital. There is no traffic other than trams and buses, and the occasional bicycle. Most walk. Attractive young women in sky-blue uniforms and jackboots, perform pirouettes as human traffic lights for the intermittent motorist. I wonder what they wear in summer. On the morning of my final day, sirens sounded at 10am and within minutes buses stopped, streets and houses emptied, and the entire population disappeared into subway tunnels and bunkers to freeze for an hour in an air-raid drill. Driving through an abandoned city, attracting the hostile scowls of the few police and soldiers enforcing the curfew, was a surreal experience. One group stopped us and informed me through my translator that, as bombs didn't distinguish between foreigners and Koreans, I should be in a basement too.

Conditions are as bad, or worse, as anything I recall seeing in Eastern Europe, Russia or Albania. But what I found significant was the stoical, almost jovial acceptance of this lifestyle. In contrast to the apathy and cynicism of the eastern bloc, the DPRK gives an impression of bustle, purpose and self-belief that is very striking. I was particularly impressed with the absence of any form of public drunkenness.

This was not an encouraging trip. I came away with the strong conviction that if the most of the Korean bulls (amongst whom I count myself) had any idea of what the world looks like the other side of the DMZ they would be noticeably more cautious in their asset allocation. Granted: the bellicosity of the DPRK regime is long-standing, and the likelihood is that a

visitor to this place would have come away dismayed by any visit in the last 20 years. What differs this time is the level of the stakes, the virulence of the rhetoric sparked by the “axis of evil” designation and the palpable anger in the streets.

The DPRK’s entire mythology is built around its history of defiance, struggle and victory over the imperialist and capitalist powers, Japanese and American. They date a conspiracy to ensure their economic subservience to 1844, and a motion in Congress authorising the opening of trade. The first attempt at commerce was made a few years later in 1866 when the USS Sherman, a Confederate blockade-runner with a cargo of cotton and tin, reached Pyongyang. A decade earlier on a similar mission Perry had met with Japanese hospitality and Pinkerton his Cho-cho san. The Koreans were less receptive. The Sherman was burnt and its crew massacred thus setting a door policy that many Seoul nightclubs continue to this day.

The DPRK see themselves as the heirs to the patriots of 1866, which is as vivid a part of their national consciousness as the Pueblo incident in 1968, or the shooting down of a US helicopter over the DMZ in 1994. The Pueblo, bullet and shrapnel holes

emphasised in red paint, floats on the Taedong River on the site of the Sherman’s destruction, with the Woodward “apology” prominently displayed. School groups are led through this, and museums of the Korean War that emphasise a history of US hostility and atrocities, including germ warfare and the first airborne delivery of napalm. These exhibits are essential props to a regime that defines itself in relation to a long-running aggression from the US and the west. A year ago it looked as if tentative attempts at a market economy were being introduced, but this remains at heart a marxist-leninist state, which rallies back to its roots when threatened.

In an aging Tupolev on the flight out to Shenyang, I brightened when an attractive young hostess engaged me in conversation. When would I be back, and how many of my friends would I bring with me? She was familiar with Moscow, Bangkok, Beijing, and Khabarovsk, but she said, Pyongyang was far nicer. She was determined to work hard for the Fatherland. Did I understand the basis of the “juche” idea? She was eager to enlighten me. I smiled, realising Dostoyevsky would be easier going, and opened my book.

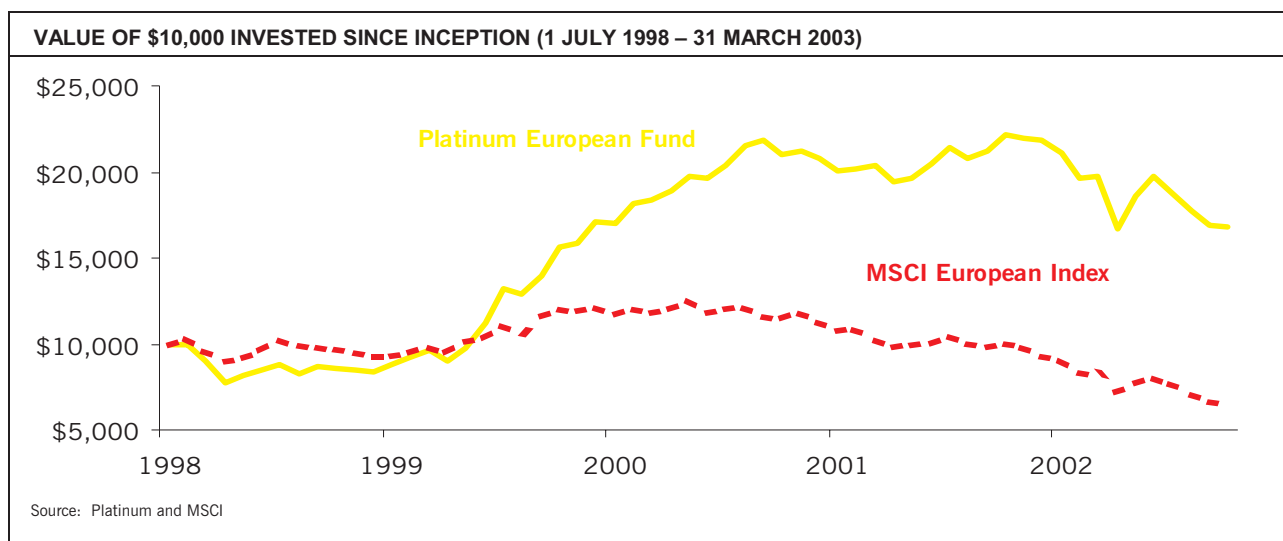
Nick Harbinson

Editor’s comment: Doesn’t look too promising from the point of view of unification and the likely cost thereof ...

# Platinum European Fund

## Performance

REDEMPTION PRICE: \$1.2810



### Stock prices fall – financials distressed and strong Euro exacerbates cyclicals' woes

European stocks fell 13% in the March quarter, with cyclicals (steel, auto parts, chemical companies etc) and financials (insurers mostly but banks also) leading the declines. One slightly surprising sector to suffer was the water utility area (-25%), driven down primarily by the two French giants (Vivendi Environnement and Suez-Lyonnaise). Country differences were significant with Germany (-16%) again being thrashed, France (-15%) suffering, while Italy (-10%), UK (-7%) and Sweden (-7%) were steadier. After the Ahold revelations, the Dutch market (-19%) received some especially vigorous selling attention. Stock prices in Europe have fallen in eight of the last 12 quarters, and the market overall is down 56% from its March 2000 high.

Once proud UK companies such as ICI and Invensys (both of which are now minnows due to years of mismanagement) fell 60-80% in the last three months, and the American division of Dutch retailer Ahold assured virtual oblivion for the company with its US-style accounting trickery uncovered in February. Among serious businesses the insurance companies – life, general and reinsurance – continued their remarkable share price declines: Swiss Life -54%, Munich Re -54%, Allianz -50%, Aegon -44%, Baloise -43%, Royal&Sun Alliance -43% etc. Banks also featured heavily among the casualties: Hypovereinsbank -55%, Egg PLC -42%, Banco Comercial Portugues -39%, Abbey National

-36%, BHW Holding -34%. In addition, many cyclicals suffered, such as chemical companies Clariant (-44%), Akzo Nobel (-40%), and Bayer (-39%).

Strongly performing shares over the period featured several technology and telecom stocks which bounced off near-bankruptcy levels (Alcatel +64%, Cable&Wireless +62%, France Telecom +31%) – which does not necessarily stop those companies being near bankruptcy still. Wella was up nearly 60% for the quarter after Procter & Gamble of the US bid a rich price for the business. Many of the other top gainers, Centrepulse (ex Sulzer Medica) +21%, Safeway PLC +21% and Six Continents +21% were also the targets of bids. Overall 25 companies among Europe's 500 large stocks had share prices up 10% or more; over 100 were down 20% or more in the quarter.

The Australian dollar recovered marginally from its 31 December record lows against major European currencies so that the MSCI measured in A\$ declined 15% for the quarter. The Platinum European Fund declined 11% over the period, as resilience in large holdings such as Novozymes, Adidas and SGS Surveillance was offset by the considerable cyclical exposure in the portfolio (Schindler -26%, Michelin -23%) and the exact halving of our holding in Allianz. The Fund's hedge into A\$ was a small benefit.

## Commentary

### **Circular argument continues for insurers; German banks – misery, some relief in 2005**

As noted in recent quarterly reports, not only have insurance stocks been some of the largest decliners in the market, they have simultaneously been some of the largest sellers of the market. This frustrating circularity relates to the solvency position of insurance companies which is undermined by the declining value of shares they hold against their equity capital, and against part of their float (or technical reserve). To reduce the exposure of their capital/float to (declining) shares, they are forced to sell more as stock prices fall.

In addition, the market is discounting the grim reality of insurance, namely that in bull markets, insurers write weaker and weaker combined ratios (ie. accept a lower premium for a given risk) on the assumption that higher stock market returns will improve the yield on their float to at least compensate. These tactics are of course unsustainable and a lower value is now placed on the operating businesses too.

One point which is worth making relates to the consequences of continued forced and/or irrational investment decisions by insurers: they have, in the last 1-2 years, greatly increased their allocation of funds to bonds - at what may well be the top of a massive bull market in bonds! That is, it is possible that when central banks are forced to make the decision to monetise US debt (ie. inflate) then as bond markets around the world collapse, insurance companies will be forced into the next round of asset impairments and threats to their solvency. Having said that, share prices of insurance companies are reflecting today's (miserable) profitability, and in the case of behemoths such as Allianz or Munich Re, the valuations look extremely modest given the "footprint" of these insurers in what is, after all, a favourable premium environment.

Profitability of private sector banks (Deutsche, Dresdner, HypoVereinsbank etc) in Germany is non-existent today, having been anaemic at best through the last decade. The basic explanation is that interest spreads are pressured by state-owned banks who enjoy their parents' very strong credit rating and hence low funding cost. State and mutually owned savings banks (who provide "retail" banking services) ensure that there is little in the way of "free" deposit funding. With deep corporate bond

markets meeting the needs of the big companies, the private banks' business is by necessity with small and medium sized businesses in Germany. This is the part of the economy that has been damaged by unrestrained global competition; and its dependence on domestic German growth (which has been almost zero for much of the past decade) has hurt. Finally, the German economy lost much of its shock-absorption capability with the introduction of monetary union – this means that adjustments in relative competitiveness come the hard way: deflation, unemployment and bankruptcy.

Relief for the listed banks is almost at hand in the form of an agreement between Brussels and Germany that the use by the so-called "Landesbanken" of their parents' quasi-sovereign credit ratings is tantamount to a government subsidy and thus must cease forthwith (well *fifthwith*, at least, in 2005). Two years, however, currently feels like a long time in German banking as liquidity crises jostle with solvency crises (HypoVereinsbank has this week abandoned plans for a capital raising and instead announced it will sell part of its prized Bank Austria business to meet immediate capital needs). And of course once relief arrives – credit rating agencies have already indicated the big cuts they will make to the various state banks' ratings effective 2005 – the better spreads will take time to improve the profitability of the private sector bank loan books.

In the meantime, the German economy continues to struggle, and banks are nothing if not geared to their local economies. What should be said is that Germany, and Europe more generally, is in the grip of a full blown financial crisis in the insurance sector; the risk that this spreads to the banking sector is real. The ability and decisiveness with which the European Central Bank forestalls and/or copes with such a scenario may well be the main issue for at least the next 12 months in Europe (not to mention a stern test of whether the ECB is an adequate replacement for the individual country central banks).

### **"Bear market" mergers and acquisitions**

During the excitement of the 1999/2000 segment of the bull market, we often commented upon the dramatic mergers and acquisitions which companies made, cheered on by drunken investment banks and short-sighted fund managers. (We often used to be amazed that stock prices would go up - not straight

down - in the day following announcements of the utmost absurdity!). In recent months in Europe the “M&A” has resumed – but it is (in the main) the far more interesting bear market variety. This variety involves cash-rich opportunists – be they family shareholders, patient corporates, or buyout funds – generally buying companies at sensible (sometimes fire-sale) prices.

It has been particularly interesting to see some of the mid-sized Swiss-listed companies (with strong track records in a particular business) being taken private by their controlling family shareholders. Zellweger Luwa, a company specialising in gas detection and “air engineering” systems, was taken private by its majority shareholder in February at half book value, which was a price of less than 30% of sales. Toolmaking business Hilti AG ends its 17-year stock exchange listing as the family takes it private once again. Hilti has earned CHF100-150 per share in recent years and the family bid CHF900 per share (a generous premium to the prevailing price) to buy the listed portion of the company. And CHF1.4 billion

sales fruit preserver Hero AG, owned by the German Oetker family, is being delisted at 14 times last year’s earnings.

One of the Fund’s significant holdings, elevator business Schindler AG of Germany, is widely regarded in Switzerland as facing the same future: the families controlling the company are shocked at the share price and institutional shareholders are being relieved of large blocks of stock each week in the market. We suspect that delisting may not in fact be the ultimate solution for Schindler, if only because of the number of second and third generation family shareholders (for whom a stock market valuation and the potential to sell was the initial attraction of listing). However, the vigorous action by informed buyers illustrates the sort of sensible valuations we have among the Fund’s investments.

Elsewhere we get regular reports of cash-rich companies (who avoided the peculiar “temptations” of share buy backs and investment banker-inspired “strategic acquisitions” in the bubble era) looking at the considerable opportunities now being presented.

#### BREAKDOWN BY INDUSTRY

Categories	Examples of Stocks	Mar 2003	Dec 2002
Pharmaceutical/Biotechnology	Novozymes, Novartis, Serono	17%	16%
Miscellaneous Services	Fraport, Hagemeyer	14%	14%
Retail	Hornbach, Metro, Kingfisher	13%	14%
Consumer	Adidas, Henkel, Michelin	11%	14%
Capital Goods	Océ, Schindler, Siemens	11%	12%
Chemicals/Materials	Linde, Merck KGaA	10%	10%
Tech/Media	Ericsson, Great Nordic	6%	7%
Financials	Alleanza, Allianz, Assicurazioni Generali	4%	7%

Source: Platinum

## Outlook

All of which perhaps at least reminds one that modestly priced, well-run companies in the large economic area of Europe are not without merit as investments. In recent months we have generally been adding to existing positions when we have judged price declines to be reaching crescendos. In one or two cases where stocks have had a sharp move upwards we have reduced the position (the most

notable example being Italian insurer Generali, as various banks bought stock to intervene in the latest Machiavellian plot – we sold most of our holding in the excitement). Six Continents (UK based hotelier) was also sold as it moved up strongly with various (some dubious) parties bidding for pieces of the company. This is the sort of action that we will be continuing, as well as the addition of one or two new ideas.

## The Platinum European Fund

Valuations, notwithstanding the financial strains discussed earlier, are appealing across a broad range of stocks in Europe (and Germany especially). Among obvious caveats such as the trouble being made in the Middle East, struggling economies, and continuing forced institutional selling of stocks, the issue of supply should not be forgotten. As we foreshadowed last quarter, a colossal (Eu15 billion – around half of which the French government has

supplied) rights issue is underway from France Telecom, Allianz is raising Eu4 billion, and many other insurers may be forced to replenish their coffers.

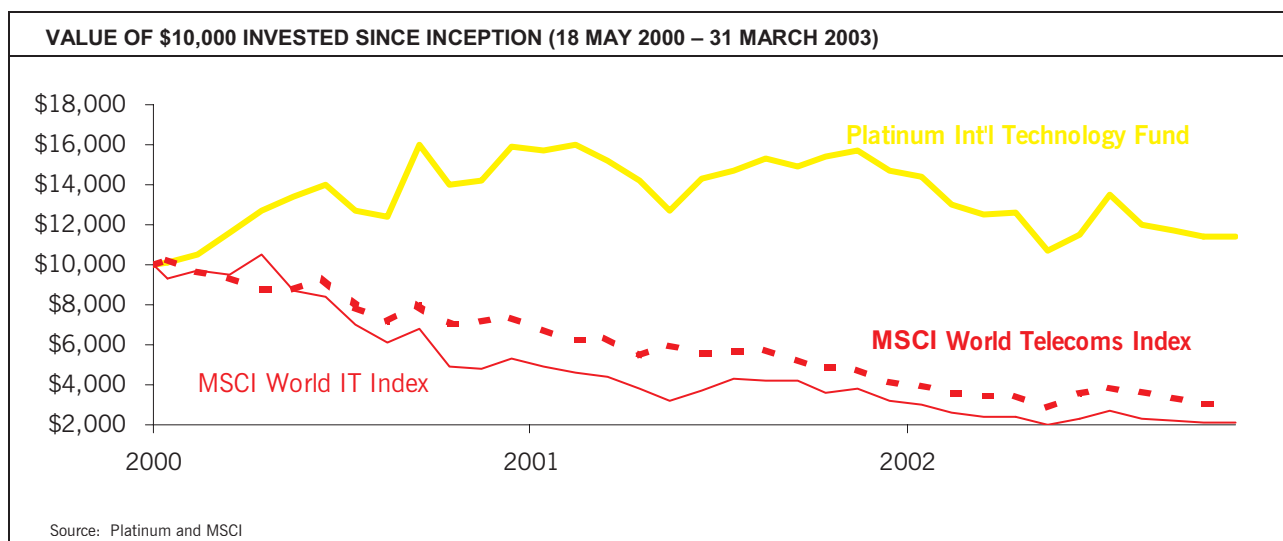
At quarter-end the Fund is 86% long, with 4% of short positions for a net exposure of 82% to stocks in Europe. Currency exposure is around 63% A\$, 14% Euro and 23% other European currencies (of which zero in British pounds).

Toby Harrop  
Portfolio Manager

# Platinum International Technology Fund

## Performance

REDEMPTION PRICE: \$0.7445



The Fund performance during the quarter was -5.1%, as telecoms and technology stocks retraced from the rally of late 2002. The MSCI Information Technology (A\$) Index fell 8% and the MSCI Telecommunication (A\$) Index fell 14% during the same period.

We reduced our net invested position to 45% and increased our cash position to 38%. While some of

our US investments performed nicely during the period, the overall performance was mostly penalised by the price decline of our Korean and Japanese holdings. We continue to hold a 17% short position in some selected stocks which we consider excessively valued.

## Changes to the Portfolio

DISPOSITION OF ASSETS		
Region	Mar 2003	Dec 2002
US	32%	42%
Other Asia (incl. Korea)	11%	14%
Japan	10%	10%
Europe	9%	6%
Cash and Other	38%	28%
Shorts	17%	16%
Net Invested	45%	56%

Source: Platinum

BREAKDOWN BY INDUSTRY		
Region	Mar 2003	Dec 2002
Semiconductor	20%	23%
Telecom Equipment and Suppliers	19%	17%
Software	11%	6%
Electronic Components	7%	6%
Other	5%	20%

Source: Platinum

During the quarter, we made a few changes to our portfolio.

We added two new positions in Europe: Siemens and Infineon Technology.

Siemens is a global electrical engineering group, with strong positions in power generations, medical solutions, transportation systems, automation, mobile telephony and network infrastructure. With a strong balance sheet and a lower dependency on



Germany than generally thought (only 22% of sales are from Germany), Siemens is in much better shape than many of its competitors. The stock price was marked down on the back of the general weakness of the German stock market and technology stocks and we were able to buy it at 0.35x sales and a PE of 14x.

Infineon Technology, formerly the semiconductor division of Siemens, is the third largest supplier of Dynamic Random Access Memory (DRAM), memory chips that are most commonly used in PCs. Between 2000 and 2002, despite an extremely competitive market environment for the semiconductor industry worldwide, Infineon improved its industry ranking from number nine to number six globally. Despite DRAMs being a highly competitive market, Infineon has some key competitive advantages: Infineon is the first company in the DRAM industry to produce chips on 300mm wafers technology (leading to a 2.2 times improvement in the number of chips per wafer produced compared to 200mm technology). This will give them cost savings of as much as 30% over existing technology and what we believe is a one year lead time against its competitors. (Infineon began pilot production on 300mm wafers in 1999, two years ahead of its number one DRAM competitor Samsung).

While the general perception is that DRAM is tied to the slow growing PC market, new alternative

applications for high end mobile handsets (as much as 64MB DRAM each) can represent a promising area of growth. Infineon is also the number one supplier in smart cards (cards with embedded microchips to store information), is the second largest semiconductor supplier to the automotive industry and is amongst the top three in the wireless semiconductor market. Infineon is valued at 0.9x sales, a substantial discount to most of its competitors.

We sold out of our position in Numerical Technologies after the company became the target of a tender offer by Synopsys. We sold our entire position in Furukawa Electric considering chances of a recovery in the global fibre optics industry in the medium term as remote, and that the company's restructuring efforts will not be enough to restore profitability. We sold LSI Logic because the company is seeing greater than expected pricing pressure in the consumer electronic business.

We closed our short positions in Dell, TSMC and Electronic Arts after those stocks reached their target levels. We introduced new short positions with Juniper Networks and France Telecom, which are priced by the market at levels already discounting a return to strong profit growth which we consider highly unlikely, given the difficulties of their respective industries.

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## Commentary

This quarter coincided with a series of Industry Conferences attended by Telecom analysts in exotic locations such as Cannes (GSM Annual Conference), New Orleans (CTIA Wireless 2003) or less exotic locations such as Hannover (CeBIT 2003). Although we did not personally enjoy the sunny "promenade" of the French Riviera we have tried to gather intelligence from those who were there, to understand how we can make money out of the ongoing developments in the mobile telephony industry.

While we are convinced that mobile phones will become an even more essential part of our daily life, with applications like video, music, messaging etc reaching levels we cannot even imagine now, the



evidence is mounting that handset producers face a future of commoditisation (ie. available handsets will eventually be fairly similar in terms of features/price and profit margins will be shrinking due to the increased supply of products by an increasing number of competing producers). More specifically we will likely see a transfer of market share from US-European manufacturers to Asian producers.

Nevertheless, as we mentioned in our previous reports, the ageing of the current "fleet" of phones coupled with the availability of more functionality should help the replacement cycle and push the global handset market up 10% in 2003 to a total of 440 million phones.

The adoption of new phones that can transmit live-video, receive streams of digital data and can be used for new applications, is going to introduce an area of conflict between handset manufacturers and telecom operators. New generation handsets generally require complex software to run the handset's

Operating System (OS). To understand the importance of this issue, think how important was the dominance of Microsoft Windows OS to eventually lead the PC industry.

Until last year the two major operating systems were Symbian (backed by Nokia, supported by almost every handset manufacturer and widely adopted in Europe) and BREW (Binary Run-time Environment for Wireless) backed by Qualcomm, and widely adopted by CDMA operators and suppliers in Asia.

Microsoft had obviously spotted the potential market opportunity of the growing wireless industry and they started developing a slimmed-down version of their Windows software to be installed on mobile phones. In a revolutionary move for the industry Microsoft has now offered to seven telecom carriers (including Orange and Deutsche Telekom) a software platform to run on a custom-made Smartphone manufactured by the Taiwanese company High Tech Computer. The phone will ultimately carry the brand of the Telecom Operator. You can imagine that Nokia, Motorola and friends were not very happy about that ...

A few weeks ago, in a similar move, Motorola (a founding member of the Symbian's consortium) announced its intention to use Linux (an open source code freely developed by software developers communities) as its operating system for handsets sold in Asia. The decision may be interpreted as a way to please authorities in China (where Motorola has 30% market share) who often suggested their preference for royalty-free software.



As if the war for the Operating System wasn't tough enough, last week another surprise announcement came from Vodafone and Orange. They became shareholders of a small American company called SavaJe, which is offering a self-sufficient (no other

operating system required) Java-based operating platform (Java is a programming language licensed from Sun Microsystems, an investment of the Fund). This software will soon be offered to several mobile

operators around the world and deployed in a number of handsets.

All these trends are increasingly pushing the industry towards more fragmentation. We are not sure if and when one standard will eventually prevail, but in the short term we would expect some shake-outs to take place.

**The battlefield for the mobile phone industry is also moving East.**

China is increasingly a very significant buyer of mobile handsets (approximately 60 million or 15% of global demand in 2002), and an increasing portion of handsets is being assembled in China itself.

While Motorola and Nokia still command an aggregate 40-45% market share of the Chinese market, the number of local manufacturers are growing by the day. According to Deutsche Bank, in January 2003 there were more than thirty domestic suppliers accounting for nearly 37% of all handsets sold in China (up from 14% a year ago but still short of the government's goal of 80% in 2005).

Many semiconductor companies like Intel or Texas Instruments are keen to expand their potential market by offering Reference Platforms to entrepreneurial companies in China, where the assembly task can take place at a fraction of Western countries costs. Moreover, the number of local manufacturing facilities is mushrooming (Deutsche Bank estimates that in the last 6-9 months China has added enough manufacturing capacity to support between one third and two thirds of its domestic annual demand). As domestic demand is not expected to grow at such torrid pace - more like 10-12% over the next few years - sooner rather than later Chinese manufacturers will start looking outside of the country to fill their capacity.

Obviously we are not expecting all these manufacturers to survive, but, given the success enjoyed by other Asian manufacturers like Samsung or LG in the USA, we believe the emergence of at least some new low-cost manufacturers is going to create pressure on margins of existing market leaders (at least for the low price-mass market models).

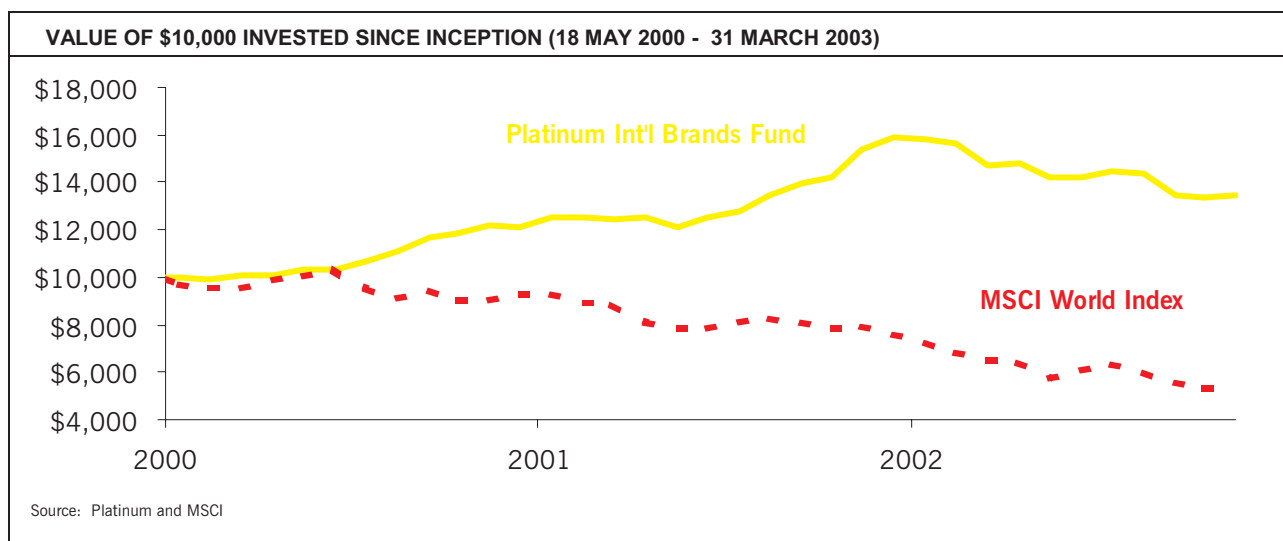
We are looking at this industry to find investment opportunities and the Fund already has positions in semiconductor companies like National Semiconductor, AMD and Samsung Electronics, which we believe should be beneficiaries of these trends.

Alex Barbi  
Portfolio Manager

# Platinum International Brands Fund

## Performance

REDEMPTION PRICE: \$1.2246



The International Brands Fund fell in value by 6.7% in the quarter against a backdrop of falling markets. The MSCI World Index fell by 11.5% in the quarter, whilst our proprietary index of branded goods fell by 12.6%.

As illustrated by our proprietary index, the fall in value was widespread across the consumer stocks. Our proprietary index of branded goods stocks tracks nearly 100 companies, of these only eight showed a positive return on the quarter, whilst nearly 40% of the stocks showed a decline of more than 20%.

At the bottom of the performance table tended to be the retailers with Royal Ahold losing over 70% of their value as accounting frauds surfaced and highlighted the desperate debt position of this company. The Brands Fund did not hold this stock

albeit we do hold some retailers such as Metro of Germany and WH Smith (UK newsagent) which declined over the quarter.

On a positive note our position in Wella performed well as speculation mounted that both Henkel and Procter & Gamble (P&G) were vying for ownership of this business. Our Clarins investment has also benefited, as it becomes clear that the major multinationals, Unilever, P&G and L'Oreal will continue to focus on improving their competitive positions in the cosmetics sector through acquiring leading brands. We held short positions in L'Oreal and P&G, which added a little to performance.

With the exception of Citizen Watch our positions in Japan also lost value over the quarter.

## Changes to the Portfolio

We have been active in our short positions however the overall level of short positions has fallen over the quarter. We would note that whilst this has assisted in the Fund's performance it is insufficient to offset the overall decline in investment performance.

We have only added two new names to the portfolio this quarter, Samsung Electronics (Korea) and Sony Corporation (Japan). In Europe, we added to our

Nestlé position whilst reducing our Michelin investment and selling our Six Continents holdings.

We have no US stocks in the portfolio and continue to see opportunities to sell short the major US branded goods companies. Although valuations have been falling we believe they still do not reflect the deteriorating economics of their businesses. More on this follows.

DISPOSITION OF ASSETS		
Region	Mar 2003	Dec 2002
Europe	47%	55%
Japan	23%	20%
Other Asia (incl. Korea)	9%	7%
Cash and Other	22%	18%
Shorts	15%	23%
Net Invested	63%	59%

Source: Platinum



## Commentary

We have mentioned before, our concerns that the final customers for our Branded Consumer companies are facing more difficult times. Driven by the high levels of consumer indebtedness (mortgages, car loans and credit card debt), the rise in unemployment levels and the loss of job prospects as companies defer investment in new facilities. We have also previously explored and commented that consumers have reacted to the changing environment with changing patterns of expenditure, such as substituting for cheaper products, shopping at discount retailers or redirecting spend from international holidays to things closer to home. Companies have reacted with discounting, promotional activity and expanding product ranges tagged with “new” or “improved” in an attempt to keep the consumer moving along.

Recently we have heard a wide range of excuses from the companies, especially retailers. The winter weather has been harsh, petrol prices are at record levels impacting on trips to the Mall, Easter is on a different weekend and so forth. We are also beginning to hear comment that consumers are staying home to keep up with world events on the TV. No doubt over the next few quarters we will hear some more imaginative excuses to do with the events in the Middle East or the impact on tourism of the latest flu virus. Nonetheless, behind the excuses we are also seeing corporate management reassess their prospects with a growing trend in avoiding forecasts and earnings guidance and perhaps some realism creeping into the outlook and comments.

Selective representation still persists though.

At a recent US industry conference of branded consumer companies, analysts were disappointed with the lack of excitement and enthusiasm from corporate management. No doubt the promotional and marketing “fizz” has been toned down but there is still precious little honesty or completeness to the information presented. Highlighted were companies such as Kellogg where the CEO commented that they were a simple and dependable business, which is perhaps an improvement on past hype. We’re not sure that the business is either simple or dependable and wonder where the commentary is on flat demand, increasing competition and the complexities of the acquired Keebler biscuit business. We’re not particularly singling out Kellogg as unusual perpetrators of this style of communication other than as an example.

As corporate management reassesses the prospects of maintaining the corporate growth rate and rising costs of competing, they once again look to acquisitions. During the quarter we have seen a number of acquisitions, such as Procter & Gamble buying Wella (of Germany) and Energizer acquiring the Schick business to compete with Gillette in razors as well as batteries.

P&G assessed their capacity to compete in Europe, their need to drive growth in their hair care business and determined that they should buy their way into Europe. Recall also that they paid a significant price for the Clairol business in 2001 and have yet to meet

the promises on growth used to justify that price. The Wella business is attractive to P&G for much the same reasons that attracted us. Over a century of investment in research and development that had yielded superior products (particularly in colouring and styling) and a professional salon distribution business, second only to L’Oreal. But wait, there’s more. P&G can also see opportunities to “fix” some other issues, such as gaining distribution in the professional hair care market for Clairol, assuming of course that the professional salon workers and their clients accept the decision to use Clairol. Meanwhile, L’Oreal has also highlighted their ambitions in the US retail hair care market and the Wella styling and colouring products allow P&G to expand their core shampoo and conditioner range to better line up against L’Oreal. If we add up the market share ambitions for the US market of P&G, Unilever and L’Oreal we see the opportunity for some exceptional competitive dynamics. Our

suspicion is that the consumer will be the winner in the short term.

There are always bright spots to be found. We are currently reviewing the luxury goods companies, particularly the accessories and watch companies, many of which have fallen in valuation as the international tourism industry has suffered. It is interesting to note that in the rankings of the Swiss watch industry exports of two years ago, China didn’t rate a mention in the top thirty countries. Last November, China ranked eighteenth and last month ninth, clearly a combination of strong growth from that region and falling demand elsewhere in the world. These rankings also fail to capture the growth that companies like Swatch are enjoying by having manufacturing facilities located within China. We will continue to develop our understanding of these opportunities whilst also looking for interesting valuation opportunities as these stocks are impacted by the negative headlines.

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## Outlook

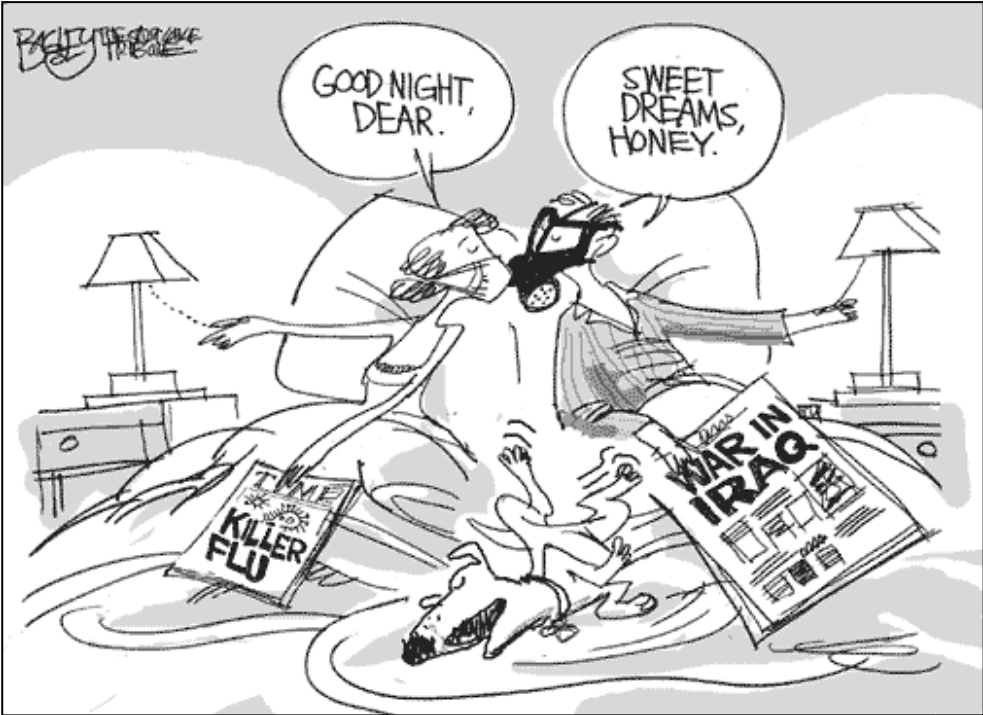
We don’t believe that the prospects for branded consumer companies are going to show any meaningful improvement in the near term. Over the past few quarters we have built on a growing list of concerns that impact on the willingness and capacity of the consumer to continue to spend at levels that might support the wishful thinking of many corporate managers. We have also found in the majority of cases that valuations are still too high for us to consider them compelling investments. Accordingly, we take the view that company management are still adjusting to the harsh realities of difficult conditions and will continue to lower expectations for earnings growth. It’s not about

managing expectations though we are more interested in understanding that the resource allocation decisions being made by management make some sense.

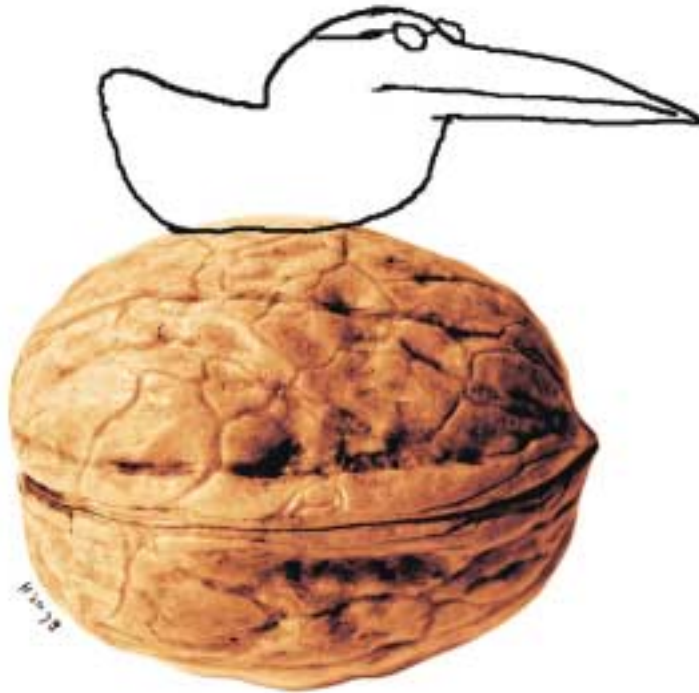
Perhaps we will see some interesting opportunities as investors question the perceived reliability of earnings and the price they are willing to pay for companies operating in increasingly competitive markets.

We find valuations are more attractive in Europe and Japan than the United States, however we are acutely aware of the need to be opportunistic and nimble in all the markets.

Simon Trevett  
Portfolio Manager







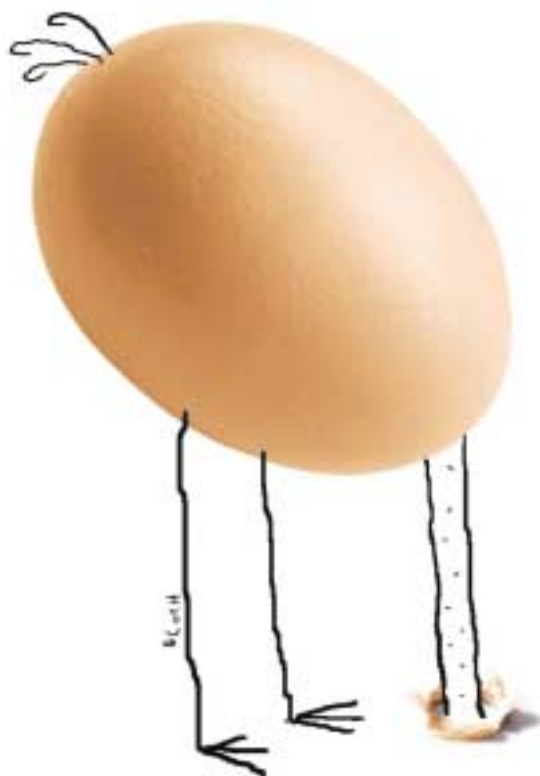
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