PLATINUM ASSET MANAGEMENT

The Platinum European Fund

Quarterly Report

31 March 1999

Performance – the market helped by the UK, battered by Germany

European stock markets returned a small gain in local currency, but a weak Euro and strong A$ cut that to -5% measured in A$ for the three months to 31 March 1999. The quarter was characterised by a large bounce in the battered cyclical or commodity stocks (pulp/paper and steel were the strongest having been the weakest last year) as hopes for economic revival pushed investors to look at economy sensitive areas. The safe haven of domestic retailers was shunned as the "emerging markets crisis" lost its immediacy, Brazil's real devaluation notwithstanding. Later in the quarter, as doubts over European economic revival began to surface, the "reliable growth" (high p/e ratio) stocks - telecom service and equipment, pharmaceuticals, IT services - began to run again.

Country by country differences were important with Germany performing very poorly (-14% in A$) due to investor fears over the political direction of the country and attendant implications for business. The UK was strong (in local currency, flat in A$) as the bond market (stronger) and sterling (weaker) began to anticipate membership of EMU. Italian domestics generally struggled due to the weak economy, although this was largely masked by extensive takeover activity in banks and telecoms (Milan MIB30 Index -7% in A$ for the quarter).

The Platinum European Fund returned -2.4% in A$.

Politics – Lafontaine gone, EU commission a different issue, Balkans war

Politics in Europe has moved back to its familiar centre-stage position in recent months. War in the Balkans and difficulties in the relationship between NATO and Russia have received the most press; from a business perspective the spectacular resignation of German Finance Minister Oskar Lafontaine and the removal of the European Commission are vital indications of the general trend in Europe.

The battle between the European parliament (elected by the people of the European Union) and the unelected bureaucrats of the European Commission is an indication of the transition of power from other sources (the Commission, but also sovereign governments) to the European Parliament. A greater level of political union in Europe is a necessary co-condition for an effective monetary union. It is therefore encouraging to see the weakening of the Commission because in a reasonably direct way it signals that this power hand-over is continuing.

The story behind Oskar Lafontaine's resignation is well worth a moment's consideration. A career politician who has worked for two decades to get to the position of party chief and then Finance Minister resigns after five months in the job. Why? The short answer is that the German model relies on general consensus between government, business and unions, and that Lafontaine dared to attack that model. Recall that Schroeder never expected to have the problem of Lafontaine being so powerful. The real surprise was the devastating election loss of chancellor Helmut Kohl in September 1998. Instead of the expected "Grand Coaltion" between left and right, Schroeder found that he could govern on his own (with a little help from his "friends", including the Greens). This left party chief Lafontaine in a position of far greater power than had been anticipated, and so suddenly Germany's political direction took a more radical turn. Lafontaine proposed penal tax and legislative policies against business and the press was full of stories of German icons like insurer Allianz and utility RWE threatening to remove their business from Germany. Note the rapid effect of EMU – the non-existent border between Germany and Spain means German industry cannot afford its traditional generosity. Equally, EMU has given far greater credibility to the threats of big business. For weeks on end the press and comedy shows were full of satire about Lafontaine's position. Criticism that may have been considered normal (if overdone) in an anglo country was an indication that the German system was being severely shaken by Lafontaine's attempts to ignore the reality of the region and the world. In this context the apparently unimaginable decision of such a powerful politician to resign makes sense. More importantly it illustrates the irresistibility of Europe-wide trends even for the largest member-state. The spectre of politicians as "brokers of globalisation" is becoming rapidly real.

Economics – weakening, but rate cuts coming and emerging markets turning

Contrary to widespread expectations a few months ago that Europe would take up the baton from the US as the world's economic engine in 1999, the quarter's economic data from Euroland generally and Germany and Italy in particular has been discouraging. Apart from a very harsh winter, and general discomfort from the politics discussed above, the engineering export machines of Germany and Italy are hit disproportionately hard by struggling Asian and Latin American economies. Perplexingly, even in France, where the consumer had been boldly holding the economy together, indicators turned down.

The time has come for the fiscal and monetary authorities to react, and for the remainder of the year we would anticipate the combined effect of (hopefully imminent) European Central Bank interest rate cuts, a better political tone in Germany post Lafontaine, and more stability from the emerging markets to lead to a recovery in European economic growth. Risks to this forecast are a weak US$ (excessively strong Euro) and perhaps difficulties in China leading to further emerging markets weakness.

Companies and Industries – teleco m&a, Italian banks, consolidation generally

At the time of writing, over half the Italian stock market (by market capitalisation) is involved in corporate activity. Olivetti (the ex-computer company which controls the second mobile phone operator in the lucrative Italian market) made an audacious – indeed scarcely imaginable – bid for its much larger rival Telecom Italia (imagine Optus bidding for Telstra for context). While it seems that the senior management of T.I. will fend off the bid, it should at least have the medium term effect of ensuring that management pursues strategies to make the (cheap) T.I. stock price reflect the potential value of the company. In addition, our long term holding and favourite European bank, San Paolo-IMI, has bid for the many-branched but under-capitalised Banca di Roma, while rivals Unicredito have bid for Banca Commerciale Italia. Both bids are more hostile than friendly, but in reality mark the next stage of a rapidly consolidating banking industry.

Elsewhere the Astra-Zeneca pharmaceuticals merger has been successfully completed, Vodafone and Airtouch have formed a vast international mobile phone operation, Hoechst and Rhone-Poulenc have studied the practicalities of their merger and decided to complete this year rather than in 2002, French luxury goods powerhouse LVMH (Louis-Vuitton Moet-Hennesey) and French billionaire Francois Pinault (owner of retail giant Pinault-Printemps) are fighting over the purchase of Gucci, Banque National de Paris has proposed buying both its rivals Societe Generale and Banque Paribas, and Volvo seems to have sold its car division to Ford and be in the throws of trying to position the truck business.

Holdings

Overall we have tended to favour larger companies in line with our view that the large in general are better able to cope with the global environment. We have maintained and even increased our exposure to Germany as that market has suffered and we have continued to add to/subtract from our core holdings as stock prices move too low or too high respectively.

We bought *Veba* (German electricity utility/telecoms conglomerate where market too negative on anti-nuclear power politics of Green part of government, also a nice play on telecomms), *Hornbach* (a German DIY retailer we have liked for a while whose stock price discounts excessively bearish economic growth), *Akzo* (nice pharma business masked by chemicals division),

Sartorius (high tech weighing and measuring equipment at fire-sale price), *Douglas* (German perfume retailer), *Sainsbury* (UK food retailer suffering from underperforming core supermarket chain with evidence of management change and still the best underlying position among majors), *ICI* (stock suffered as market lost faith in company's ability to sell bulk chemical assets to focus on specialties), and *Alcatel* (play on data driven requirement for more bandwidth generally in the wired world).

We sold *Astra* (reached its target price), *Draegerwerk* (reducing exposure to small stocks), *Albright & Wilson* (taken over), *Duerr*, (a trade in the cyclicals which had rallied), and *RMC* (good bounce, dull results, small stock).

Outlook – some improvement in the economy, more consolidation

As mentioned above we anticipate some improvement in the prospects for the Euroland economies. The portfolio, while not totally dependant on this outcome, is positioned to benefit from such a turn of events. Generally we cannot see why the consolidation trend does not continue in many industries, and start in several others. Certainly in banks, telecomms, pharmaceuticals, where it has already been widespread; and perhaps more in insurance, food retail, chemicals and utilities.

We are enthusiastic about the prospects for European telecom equipment stocks. We observe the lowly ratings of Alcatel, Ericsson, and Siemens, the spending needs of incumbent telecos and upstart data or voice competitors, and the data technology acquisitions which all three companies have made in recent months. These factors together with the clear leadership these companies still have in voice telephony over market favourite Cisco give us confidence in their ability to take advantage of the telecoms/internet boom.

We foresee generally modest earnings growth for the European stock markets, though stock prices should continue to be supported by bond yields. We have tried to position the portfolio in companies where earnings growth looks fairly secure; and also where earnings pre-conditions are met, in companies for whom the consolidation trend looks advantageous.

Breakdown of Portfolio – Fund Size $1.4mn

Industry Categorisation	**Holding**	**Growth Categorisation**	**Holding**
Financials	15%	Growth/High Growth	27%
Retail/Consumer	23%	Cyclical Growth	14%
Telecom/Media/Software	26%	Steady Growth	21%
Engineering	17%	Cyclical	6%
Pharma/Chemicals	15%	Restructuring	28%