PLATINUM ASSET MANAGEMENT

The Platinum European Fund

Quarterly Report

30 June 1999

Performance – the market helped by hopes for economic recovery, battered by the bond market

European stock markets returned a small gain in local currency, but a weak Euro and strong A$ cut that to minus 5% measured in A$ for the three months to 30 June 1999. The strong sectors - heavy industrial groups, chemicals, building materials – reflected gradually growing conviction of European economic revival, as well as a rapid lift in confidence in the recovery of emerging markets, especially Asia. Consumer related products were mixed, though luxury goods were very strong following the stunning Q1 GDP report from Japan (the most important consumer of such goods). The strength of telecom equipment suppliers may seem at odds with the weakness in the bond market (given the high rating of the equipment stocks), but this reflects strong earnings upgrades in the sector over-riding the negative effect of the higher discount rate.

Interest rates, as measured by the bond markets, went up across Europe in the June quarter – due mainly to the trends in the US treasury market. While German growth is nowhere near as robust as the US economy, it is clear that the European bond markets have trouble "disconnecting" from their US counterpart. German 10 year government bond yields rose from 4% to 4.5% over the quarter and this discount rate effect made things very difficult for the "earnings certainty" stocks (pharmaceuticals –7%) and also for natural bond market "proxies" such as the insurance sector (-6%). Computer services stocks, a strong area in recent years, was also a few percent down as the bond market took its toll.

Among the major stock movements, mergers and acquisitions continued to play an important role – UK hypermarket retailer Asda was up 44% for the quarter after WalMart of the US outbid general UK retailer Kingfisher. Speculation around mergers in the industrial gases business was rife with BOC (British Oxygen Company) seemingly involved in all potential combinations and that stock was the main winner also up 44%. German department store retailer Karstadt merged with the catalogue-based operation of Quelle and hopes that this may revive the woeful profitability of Karstadt drove the stock up 41%. Heidelberger Cement of Germany was up over 40% also as the market applauded its move in buying Scancem (Scandinavia Cement as it was). Other major movers among large stocks included Ericsson (+36%) as telecom equipment stocks boomed, luxury group LVMH (+36%) on the Japan/Asia recovery, and the unstoppable Swedish clothing retailer, Hennes & Mauritz (+35%) as the market celebrated the planned expansion into the US market, and as the company's results continued to surge ahead of the wildest expectations.

At the wrong end of the performance tables there were many bank and insurance stocks (bond market) and also some specific stories such as the previously lauded Rentokil (-35%) as it became clear that the mathematics of 20% per annum earnings growth must provide its own constraint (in fact the company admitted the target was too high). Another poor performer was media business Reed International (-23%) as the (seemingly endless) search for a CEO continued to strike a blank, and as the underlying businesses drifted into another profit warning. Lastly, as mentioned above (and with a few stock-specific issues), the very large drug companies Roche, Glaxo and AstraZeneca were all among stocks down 10-20% for the quarter.

The Platinum European Fund returned 2% over the period in A$, 7% better than the market. This was due principally to the bias toward economically-sensitive stocks in the portfolio. In addition the Platinum European fund has a small hedge into A$ which defended 35% of the portfolio from the weak Euro.

Economics –mixed, but rate cut beginning to show and emerging markets will benefit Germany, Italy

After a difficult first quarter, the European Central Bank cut interest rates early in April and together with a rebound in Asia and Latin America (and Eastern Europe) this should help German and Italy (the real laggards over recent quarters) to industrial and then consumer recovery. The ongoing drift weaker of the Euro means that the export machines of the large Euroland economies have a very favourable environment to enjoy profitable recovery in their markets.

The economic indicators have continued to be mixed in recent months but there is a sense from the numbers, and more particularly from the companies, that there is more good news than bad now and we would consider it more likely that the world can experience a period of coincident growth rather than the opposite in the coming two years.

Industries - data revolution and deregulation driving teleco capex, ongoing consolidation generally

Regulatory and technological change are conspiring with the buoyant investment and business climate to produce a surge in expenditures by telecommunications companies. Deregulation means that this involves multiple carriers and resellers in each market segment rather than just the old monopolies. The reality of competing for customers through a wider product offering, as well as the need to provide more capacity for greater (eg. mobile) usage means that the expenditure is large and urgent. The technological change has meant that, for example, the apparently far-fetched idea of data (eg. internet) over mobile is effectively with us now. Clearly whether for survival or to tap new revenue streams, the result is the same – telecommunications service providers must spend a lot of money, and the marketing demands it be spent as soon as possible. It is perhaps telling that in some cases we are hearing reports that companies are proceeding even as equipment vendors warn that product is not yet ready for installation....

Given the above it is not surprising that the European equipment companies have been prospering this last few months. The specific catalysts are probably three in number: (1) Ericsson (ie. Europe) came to a deal with Qualcomm (ie. America) over standards for the so-called third generation ("3G") mobile communications. This has meant that development can go ahead apace and without the worries of conflicting standards as in the past (with the attendant problems for "roaming" etc); (2) marketing initiatives by US mobile operators in mid-1998 are taking effect so that the laggardly US mobile market is finally exploding in size; and (3) an appreciation that the vast Japanese mobile networks have hit capacity constraints and are ready to move to 3G. The focus on mobile here reflects the dominating scale of Nokia and Ericsson. These respectively Finnish and Swedish companies are spectacularly successful in this business, with Nokia focused on handsets and Ericsson the runaway leader in base station and other infrastructure for mobile telephony. While still too dependent on traditional switching technologies (and importantly, struggling to move their focus from the traditional state-owned incumbent monopoly to more demanding corporate, new telco, and ISP customers) Alcatel and Siemens have made considerable strides in the so-called data-comms and mobile businesses and so they too participated in the strong sector performance. For the three months Ericsson (+36%), Alcatel (+28%), and Siemens (+22%) were important contributors to the Platinum European Fund performance. Together these three stocks represent around 18% of the fund as at 30 June 1999.

Elsewhere in the markets the consolidation frenzy reported last quarter has continued briskly in recent months. The Olivetti-Telecom Italia deal was a "success" in that Olivetti won; it remains to be seen whether the new management of TI can balance the "streamlining" of the business (a lot of Olivetti debt needs funding) with the need to keep the company at the forefront of Italian telecommunications (ie. spending generously as described above). Kingfisher, the UK general retailer who merged last year with French home improvement retailer Castorama to create the first real force in the so-called DIY (do-it-yourself) retail market in Europe, extended its ambition in the proposed merger with UK food retail giant Asda. Just as the stockmarket was really convincing itself that the transaction made sense, a superior strategy (and a deep-pocketed one at that) arrived from across the Atlantic as WalMart outbid Kingfisher and bought Asda outright (and for cash not stock). What was a German strategy at WalMart, is rapidly becoming more than that and we are hearing of their presence in France – either talking to the big operators, or participating in the research and sometimes bidding process when small retail chains change hands. As mentioned above there has been a lot of talk in the industrial gases businesses; rumours continue to swirl around the Swedish truckmakers (reports that the Germans are interested in one or both of Volvo trucks and Scania); building materials deals are being done around the continent and in the financial sector the pace-setting Lloyds-TSB bank in the UK bought the mutual life insurance business of Scottish Widows. This is widely anticipated to mark the beginning of another wave of consolidation in the UK savings market.

A final word on mergers is that we are still of the view that they are not unambiguously good news. For a start many are prevented (the Bank of Italy and an apparently resurgent Mediobanca have scuttled both the SanPaoloIMI/Banca di Roma and the Unicredito/Credito Italiano deals since our last report), and of those that succeed there are logistical issues of a vast scale on which to squander management time. Europe has been and continues to cry out for consolidation in many industries, but when it happens, the work (certainly for the management and probably for the stock price) is just beginning.

Holdings

Through the quarter we have added companies better placed to benefit from economic growth, and have sold some financial and utility businesses. Apart from adding to *Hornbach* and *Havas Advertising*, we bought *Ericsson* (refer above), the Greek telephone operator Hellenic Telecom (as the Balkan conflict drew to a close) and genomic research specialist *Genset*. In the so-called cyclicals category, we bought Swedish holding company *Investor*, German machinery conglomerate *Linde,* paper/pulp machinery leader *Valmet*, a small German engineering business called *Elexis*, and the elevator/escalator company *Schindler* in Switzerland. On the other side we sold our holding in SanPaolo-IMI bank, we sold Telecom Italia and we sold SIG in Switzerland (in favour of Schindler).

Outlook – some improvement in the economy, more consolidation

As mentioned above we anticipate some improvement in the prospects for the Euroland economies; if this is matched by a continuing rebound in emerging markets and even perhaps Japan, then well managed economy-sensitive stocks will perform well. The portfolio should now be regarded as strongly 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, telecoms, pharmaceuticals, insurance and food retail, where it has already been widespread; and perhaps soon in general retail, chemicals and utilities.

As in most countries, the individual European saver must and is confronting the reality that demographics and government spending profiles make state pensions less reliable in the future. The consequent need to invest as well as ever-lower bank deposit rates conspire to push traditionally conservative savers toward stocks. So notwithstanding considerable supply (eg. Deutsche Telekom raised around E11bn near the end of June), the so-called "liquidity" factor should continue to provide support to stock markets in Europe.

Breakdown of Portfolio – Fund Size $1.4mn

Industry Categorisation	Holding	Growth Categorisation	Holding
Financials	10%	Growth/High Growth	30%
Retail/Consumer	20%	Cyclical Growth	22%
Telecom/Media/Software	24%	Steady Growth	13%
Engineering	32%	Cyclical	6%
Pharma/Chemicals	11%	Restructuring	27%

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