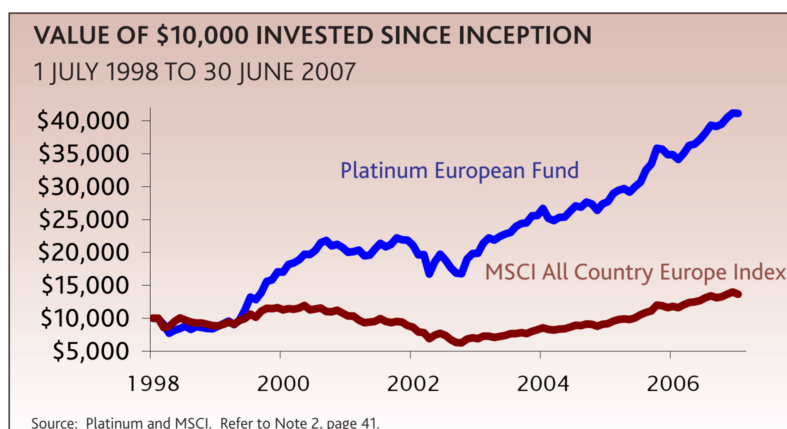
PLATINUM EUROPEAN FUND

Toby Harrop
Portfolio Manager

PERFORMANCE

A year ago we wrote that markets appeared to be correcting in response to rising interest rates. We worried about the strong performance of small and mid sized stocks, and the accompanying takeover activity (both by companies and by the "private equity" buyers). We wrote also that we were still finding some interesting investments, but felt that markets may struggle given the general euphoria and the rising price of money. Today those factors are generally amplified, and markets are higher again! Mid-2007 sees gathering momentum in the domestic German economy, and now real hope that France can join in with a "policy-led" recovery under the new president. Italy has held together better than we expected, and while cracks are becoming obvious in the Spanish ponzi scheme, overall the European economic picture seems fine. The macro-economic offsets to this situation are rising rates and highly priced currencies (Euro and pound Sterling).

In the latest quarter, European markets are up another 5%, with Germany leading the way (+15%), while the Spanish and Italian markets were left behind (roughly unchanged over the 3 months). There was a clear preference for the "cyclical" (i.e. economic growth sensitive) sectors, with manufacturing (+22%), telecom equipment (+16%), steel (+15%), and autos (+15%) leading the way. Solar energy stocks continued to shine, several up 30-60% in three months. "Defensive" areas such as pharmaceuticals (-2%) and food (-3%) told a similar (risk-preference) story, while real estate (-18%) suffered as rising interest rates and troubles in Spain in particular, corrected some of the wild enthusiasm in that area. Overall, the stronger Australian dollar against the Europeans resulted in the MSCI Australian dollar index returning 3% for the quarter, and 15.8% for the 12 months to June 2007.



Source: Platinum and MSCI. Refer to Note 2, page 41.

The Platinum European Fund returned 4% for the quarter, and 18% for the year. Several of the German holdings, especially Siemens, made the main contribution, while the partial hedge into the Australian dollar shielded the Fund a little from its strength. The Fund remained at around 70% net invested through the quarter.

So why do we continue to withhold nearly a third of the portfolio from exposure to our "good ideas"? (The stocks we own have continued to outpace the market, so logically we would do better if we could only bring ourselves to fully expose the Fund to the stocks). The simple answer is that on various measures of greed versus fear, markets are now around the sort of levels which prevailed in 1987, and in early 2000. Those dates will resonate with many – stock markets generally fared poorly for some time after!

We of course risk relying too heavily on these signals (and more generally, of seeing what we want to see). Indeed, the most bearish of the strategists we read report plenty of clients feeling the same way. On its own – i.e. if those investors are positioned as bearishly as their fears dictate – this would simply force the markets to climb the "wall of worry". However, the phenomenon of "fully invested bears" (i.e. fund managers who, intellectually, agree that markets look overstretched, but due to their own definition of "business risk" are running fully invested positions in line with their competitors) may make such protestations irrelevant.

We can identify specific events, **already underway**, which could catalyse a reversal in stocks. For example, there is significant unravelling in the "sub-prime" mortgage loan market in the US: one of the key features of the last few years – perhaps ironically given capitalism's reach – has been the **lack of market pricing for important asset segments**. As we write, a large US bank is "bailing out" one of its hedge funds, presumably as this action outweighs the risk of further damage to their business. For the moment this means that the system is being **saved from price discovery**. That is, temporarily at least, no one has to concede that the "real" prices of the instruments in these, and of course many other hedge funds are lower than stated hitherto. These prices, and thus the performances of the funds, are dependent on complex models, not on market-determined prices. Mainstream commentators contrast "mark to market" with "mark to model"; skeptics propose "mark to myth"!

And to the extent that these funds have a real impact on economic activity – the hedge funds in question hold the debt that has fuelled the "sub-prime" mortgage boom and thus the property and building boom - then clearly such behaviour matters.

But that's in America, you might protest! This is true, but the debt markets ignore borders with European financial institutions holding unknown, but substantial, amounts of the resulting paper. (Banque de France officials were confounded on a recent trip to the US investigating the *extent* of French banks' exposures to repackaged credit). Troubles in this part of the US market had swift impacts on other borrowers; late June/early July has seen several private equity deals held up or cancelled due to lack of funding, as well as general corporate debt issuance delays in Asia and Europe. In an asset bubble, credit is the key, and while money is still widely available at unusually low prices, signs of strain are showing in the system.

The trouble with worrying about the markets too early is of course that we risk becoming de-sensitised to the dangers at the wrong moment. Trying to balance these conflicting pressures we press on, steadily favouring safer large stocks over smaller more volatile issues (even though that volatility is of course mainly upwards at present – therein lies the dangerous temptation!)

"Emperor" Sarkozy's France

The Fifth Republic (established around the time of the Algerian crisis half a century ago by de Gaulle) gives considerable power to the French president – quite unusually so for a European parliamentary democracy. Hence the press focus on the presidential election in France (Sarkozy's prospects have dominated the last 6-9 months of French politics), with comparatively limited attention given to the subsequent parliamentary election. And so it is that Mitterand, Chirac and now Sarkozy are household names around the world, while Prime Ministers Balladur, Juppe, Jospin, Raffarin, de Villepin, and now Fillon are lower profile – the latest perhaps the least known! This itself may reflect Sarkozy's stated intent to be an especially "hands-on" president, indeed, his latest book, his election campaign and the last five years of his utterances promise an energetic approach. Much more importantly, they promise a dose of "American style" medicine for the "ailing" French economy. Sarkozy is against France's 35 hour week, high minimum wage and generous dole payments. He talks aggressively about creating (rather than merely redistributing) wealth, celebrates individual initiative and entrepreneurship, and makes broad statements about improving education, the civil service, immigration policy etc.

Some readers may recall our doubts in 2002 and 2003 when great hope was invested in (ex)-chancellor Schroder's prospects of reforming the German economy. We pointed out that (a) the German federal government is merely one of several players – arguably less able to affect reform than unions, employer federations and the states; (b) his trivial lower house majority (and opposition in the upper house) meant he couldn't do much, and (c) that "the market" – in that case the low wage countries to the east – with Germany's companies as the agent, would be more likely to reform the system. This has been the case to such an extraordinary extent that we keep underestimating the profits of corporate Deutschland, and now companies are paying bonuses to employees who successfully recruit engineers!

So should we expect that France can be fixed by the politicians? Perhaps so given the centralisation of power in France, notably in the Élysée Palace. Perhaps more so given the strong "mandate" of this president – his UMP party also gained a majority in the parliament. And perhaps especially so given Sarkozy's character and stated policies. The French were finally faced with a clear choice this year to either keep the overbearing state intervention in the economy, or to elect someone promising to add some market vim to the mix. Sarkozy is not Thatcher; nor does France face the problems of late 1970s Britain. France is a disappointment to itself – for its lack of influence on the world stage and its inability to dominate Europe – but it is hardly a moribund economy or society. A dose of optimism would be among the most useful contributions the new government could make, a rejuvenated France and growth in Germany could be just the thing to offset difficulties in Spain and Italy.

Siemens – the giant stirs…

If the unresponsive Chinese stock market (despite the economic boom) was the surprise of 2003/04, then the dull performance of Siemens' share price was perhaps the equivalent surprise of 2005/06. We have written at length on the topic of the German export-of-capital-goods-led renaissance, and of the internal reform of German companies leading to great profitability. Siemens, as the uber-capital goods export machine, with the "perfect" strengths of electrical power (generation & distribution) as well as factory automation and drives, matched with wild overmanning should have been the best play on the core theme in Europe. Yet the stock was a disappointment. Sales have been great, and the company was clearly one of the leaders in reforming the German labour market.

Perhaps the best explanation for the slow stock price before this year was the perception that profitability was only a minor detail for the company, while technical innovation, career prospects and political significance were the real drivers. Our view was that a great deal of work took place under Heinrich von Pierer in the 1990s, and continued under Klaus Kleinfeld more recently, to convince the company that good profitability was a core part of the company's future security, not a side issue for the accountants.

As 2006 unfolded and markets around the world celebrated the realisation that China's growth seemed broad-based and ongoing, Siemens went through an agonising "bribery scandal" and the stock was left out again! This exercise in self-flagellation showed the strengths and weaknesses of this 400,000 person organisation: the discipline to accept error, and self-impose the unreasonable penalty of firing both chairman von Pierer and CEO Kleinfeld (neither of whom, so far as can be determined were involved). With ongoing investigations by authorities, and frankly the risk of hindered participation in many markets for capital goods, this issue is not yet behind us, and the company may pay a substantial fine.

However the core strengths of Siemens, especially in the current environment which is so favourable to its business, cannot be denied. The company is making headway in focusing on a few key divisions (3 or 4 out of 10 or so main areas), it is likely selling (at handsome prices) some distractions, and more importantly it is undertaking serious internal change by addressing the excessive layers of management within and above the main divisions. A bit like Germany itself, the momentum has taken a long time to build up within the Siemens organisation, but we expect it to be irresistible once underway. At 5%, Siemens was the single largest position in the Platinum European Fund as at 30 June 2007.