# Platinum European Fund

**Clay Smolinski** Portfolio Manager

**Nik Dvornak** Portfolio Manager

## Disposition of Assets

| REGION | JUN 2014 | MAR 2014 |
|---|---|---|
| Germany | 23% | 24% |
| UK | 21% | 23% |
| France | 8% | 8% |
| Italy | 6% | 7% |
| Russia | 5% | 4% |
| US * | 4% | 1% |
| Spain | 3% | 3% |
| Austria | 3% | 3% |
| Switzerland | 2% | 2% |
| Sweden | 1% | 1% |
| Netherlands | 1% | 1% |
| Turkey | 1% | 1% |
| Belgium | 1% | 1% |
| Cash | 21% | 21% |
| Shorts | 2% | 2% |

*Stocks listed in the US but predominent business is conducted in Europe

Source: Platinum. Refer to Note 3, page 4.

## Performance and Changes to the Portfolio

**(compound pa, to 30 June 2014)**

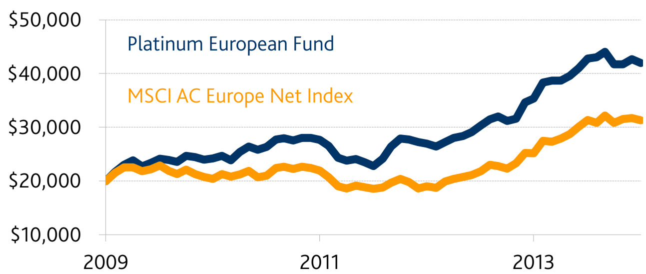
| | QUARTER | 1YR | 3YRS | 5YRS | SINCE INCEPTION |
|---|---|---|---|---|---|
| Platinum European Fund | 1% | 19% | 15% | 16% | 12% |
| MSCI AC Europe Index | 2% | 24% | 13% | 9% | 2% |

Source: Platinum and MSCI. Refer to Note 1, page 4.

The Western European markets moved modestly higher over the quarter. The standout was Spain +8%, followed by Germany +4%, while the French, UK and Italian markets all rose less than 2%. The Russian market bounced 14% as the standoff between Russia, Ukraine and Europe did not continue to escalate.

**Value of $20,000 Invested Over Five Years**

*30 June 2009 to 30 June 2014*




Source: Platinum and MSCI. Refer to Note 2, page 4.

In terms of position changes, we added to our holding of Russian search engine leader, **Yandex**. We took advantage of the sharp sell-off triggered by President Putin's comments around greater state control of the Internet (which would incidentally cause greater harm to its main competitor Google). Elsewhere we participated by the IPO of **Markit**, with Nik outlining the rationale in the commentary below.

For the quarter, the Platinum European Fund returned 0.5% versus 1.6% for the MSCI Europe Index.

## Commentary

Bank regulation doesn't excite most people. Subjects like capital adequacy, liquidity coverage ratios and counterparty valuation adjustments are dry, even downright boring. Most in the investment community share these sentiments, which is precisely what attracts us to the subject.

Regulatory constraints on banks have been progressively loosened since the 1970s. This was partly a response to political pressure fuelled by bank lobbying and partly driven by a genuine belief in the free market doctrine, which held that market discipline could moderate banks' irrational tendencies. Whatever the reason, the trend was undeniably one of deregulation. This came to an abrupt halt following the 2008 financial crisis. Political winds changed as former political allies rushed to disassociate themselves from the banks. Regulators, once brought to heel, were now unleashed and have been reapplying the shackles with zeal.

Banks are reeling under the waves of new rules, sanctions, scrutiny and some truly eye-popping fines. Their position is a treacherous one. In their eagerness to appease the public, lawmakers rushed through legislation without much thought given to implementation. Regulators are scrambling to interpret the new rules and figure out how to implement them. Ultimately, this is an evolutionary process that necessitates 'learning by doing' which makes life hard for banks who find the goal posts keep shifting. Yet they get little sympathy, with compliance failures likely to attract severe punishment from regulators and capital markets alike. For once, it is not just shareholders who suffer, with senior management necks on the block too; CEOs included.

Predictably, investors see regulation in a negative light; regulation makes banking safer but less profitable. That's bad for business, right? Well, for banks, perhaps. But it should be great for business, if your business is helping banks navigate this treacherous environment. Nothing loosens a bank's purse strings quite like a risk that could get the CEO fired.

Hunting for beneficiaries of tighter regulation has yielded a mere handful of candidates, typically US-based. Europe proved fallow ground until the recent IPO of UK-based **Markit** in which we participated.

Markit is just over a decade old, founded by derivatives traders from Toronto Dominion (TD) Bank. They recognised the difficulty TD's risk managers had valuing the positions of its traders. Often risk professionals were forced to rely on the very traders they were overseeing for essential information – basically the traders were auditing themselves! This group left TD to provide i**ndependent, third-party valuations** to risk managers across Wall Street.

The core product here is a **contributory database**. Banks submit information to Markit which combines it, cleans it and then sells it back to those same banks, as well as asset managers, hedge funds and regulators the world over. A business that gets something for free only to sell it back to its providers, and many others, is an appealing investment proposition.

Originally, the business addressed a small niche within the securities market. To create a truly valuable company, they needed to expand to cover as many financial instruments and markets as possible. To this end, the founders sold 70% of the company to their largest client banks. This not only gave them the money needed to build out their business but also ensured the participation of those banks. That participation was critical in the early days because more contributors mean more accurate and reliable data which, in turn, attracted new users and contributors.

With ever greater oversight high on the agenda, bank boards, risk managers and regulators are finding Markit's data indispensable. It is **emerging as the de facto standard** for valuing a broad range of financial instruments. This not only underwrites the strong demand for this product but creates a powerful lock on customers. If the regulator and every other bank use this data, no risk manager is going to go out on a limb and start using something else. Today this business generates half a billion dollars of revenue per year and growing, albeit modestly. Not bad for a company just entering its second decade.

Yet management haven't been idle. Being a trusted provider to, and majority-owned by the banks puts Markit in a unique position to identify new problems that they can help solve. In 2007, they established a **second leg** to their business: an electronic **platform that processes so-called 'over-the-counter' derivatives transactions** which account for the bulk of derivatives trades. Today, this segment brings in a further quarter of a billion dollars per year, serving those same bank customers, helping them reduce operational risk and stay on the right side of regulators.

The third and **final leg** to this company is a 'solutions' business, the most interesting facet of which is a database Markit is building to **help banks comply with onerous 'Know Your Customer' rules**. This issue is especially pressing because US prosecutors are now applying a much tougher standard than the rest of the world. As *The Economist* recently put it, it's no longer enough to merely know your own clients. You're now expected to know your clients' clients! The cost of doing so is hefty. The ten largest banks, between them, spend over a billion dollars a year on this effort. Yet failure is more costly still, with French bank BNP reportedly facing a staggering $10 billion fine.

There is **undeniable commercial logic** to having a third-party build and maintain this sort of database, with banks paying to access this data, **rather than each building its own**. Banks are desperately looking for someone to fill that role and Markit is endeavouring to assume it. Should it emerge as the provider of choice, the rewards will be significant. The 'solutions' business already brings in a quarter of a billion in annual revenue and grows 20% pa. This new venture could underwrite that sort of growth for years to come.

IPOs are typically not our cup of tea. They usually constitute sales by well-informed insiders looking to get out. This one was different because the sellers were the banks, probably motivated by regulatory concerns around conflicts of interest. <u>The founders and senior management chose not to sell their shares</u>. They will stay and grow this business with the bulk of their capital invested alongside shareholders.

At 18.5 times earnings, this company is not a steal although it is cheaper than similar businesses which trade at P/E multiples well over 20 times. The lower multiple reflects **investor concern** over a regulatory **push to have derivatives trades centrally cleared**, which will hurt Markit's business to a degree. This concerns us too, especially since we aren't exactly buying this company on the cheap. Yet the time frame and extent to which this happens will give this entrepreneurial management team plenty of time to nurture its new ventures to fruition and use its unique relationship with banks to discover new avenues for growth. With the theme of re-regulation in full swing there is unlikely to be any shortage of such opportunities. Rather the shortage is of listed companies that are well-positioned to capitalise on these opportunities and management teams that can develop them.

## Outlook

We are relatively sanguine about the outlook for Europe.

While the market is trading at roughly fair value, asset prices will continue to be supported by very low interest rates and the European Central Bank gradually increasing its efforts to stimulate the economy. This can be seen in the recent ramp up in merger and acquisition activity in Europe as corporates, aided by very cheap money, increasingly realise it is cheaper to buy rather than build.

We will continue to use our cash balance to take advantage of any periodic set-backs in stock prices.

Nik Dvornak has joined Clay Smolinski as co-manager of the Platinum European Fund. Nik has covered financials over the past seven years at Platinum.

## Notes

1. The investment returns are calculated using the Fund's unit price and represent the combined income and capital return for the specific period. They are net of fees and costs (excluding the buy-sell spread and any investment performance fee payable), are pre-tax, and assume the reinvestment of distributions. The investment returns shown are historical and no warranty can be given for future performance. you should be aware that historical performance is not a reliable indicator of future performance. Due to the volatility of underlying assets of the Funds and other risk factors associated with investing, investment returns can be negative (particularly in the short-term).

   The inception dates for each Fund are as follows:
   Platinum International Fund: 30 April 1995
   Platinum Unhedged Fund: 31 January 2005
   Platinum Asia Fund: 4 March 2003
   Platinum European Fund: 30 June 1998
   Platinum Japan Fund: 30 June 1998
   Platinum International Brands Fund: 18 May 2000
   Platinum International Health Care Fund: 10 November 2003
   Platinum International Technology Fund: 18 May 2000

2. The investment returns depicted in this graph are cumulative on A$20,000 invested in the relevant Fund over five years from 30 June 2009 to 30 June 2014 relative to their Index (in A$) as per below:
   Platinum International Fund - MSCI All Country World Net Index
   Platinum Unhedged Fund - MSCI All Country World Net Index
   Platinum Asia Fund - MSCI All Country Asia ex Japan Net Index
   Platinum European Fund - MSCI All Country Europe Net Index
   Platinum Japan Fund - MSCI Japan Net Index
   Platinum International Brands Fund - MSCI All Country World Net Index
   Platinum International Health Care Fund - MSCI All Country World Health Care Net Index
   Platinum International Technology Fund - MSCI All Country World Information Technology Net Index
   (nb. the gross MSCI Index was used prior to 31 December 1998 as the net MSCI Index did not exist).

   The investment returns are calculated using the Fund's unit price. They are net of fees and costs (excluding the buy-sell spread and any investment performance fee payable), pre-tax and assume the reinvestment of distributions. It should be noted that Platinum does not invest by reference to the weightings of the Index. Underlying assets are chosen through Platinum's individual stock selection process and as a result holdings will vary considerably to the make-up of the Index. The Index is provided as a reference only.

3. Invested position represents the exposure of physical holdings and long stock derivatives.

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