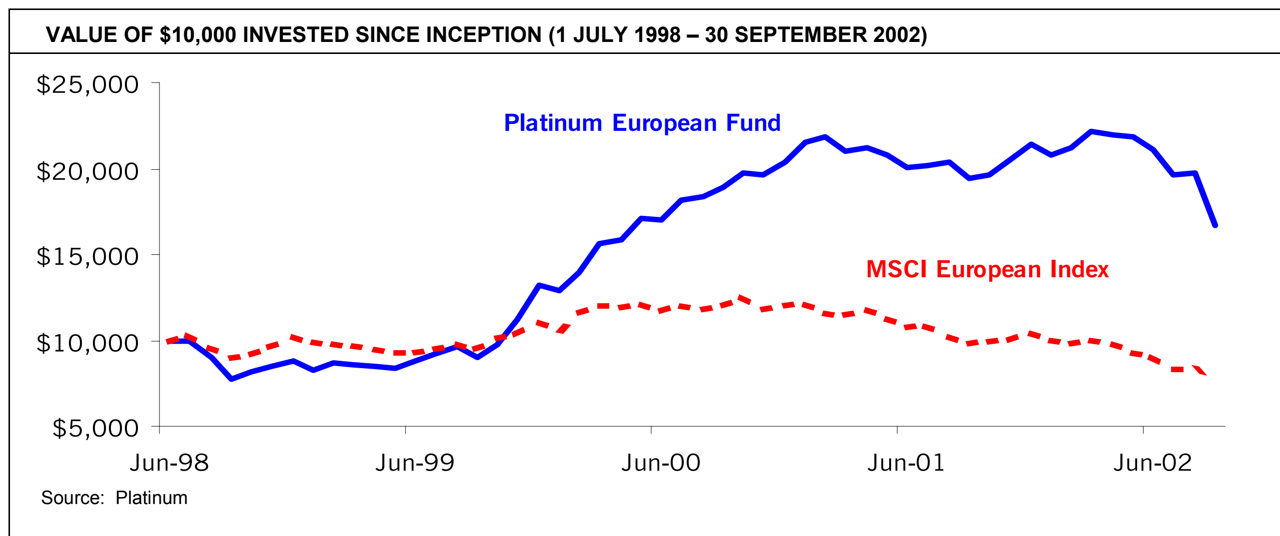
Platinum European Fund

Performance

REDEMPTION PRICE: $1.2782

VALUE OF $10,000 INVESTED SINCE INCEPTION (1 JULY 1998 – 30 SEPTEMBER 2002)



Source: Platinum

Broad bear market in Europe, spectacular declines in Germany

European share prices collapsed in the three months to 30 September 2002; the breadth of the sell-off was the distinguishing feature of the period. Every sector of the market fell, so that although food, beverages and pharmaceuticals (all traditional "safe havens") were only down about 10%, the rotation that has characterised so much of the last five years (ie. money reluctant to leave the market) was replaced by almost indiscriminate selling.

The weakest sectors were computer services (-53%), and software (-45%) reflecting concern over corporate expenditure. Note that these two sectors also fell 40% in the previous quarter. The industrial products (-45%) and manufacturing (-35%) groups fell heavily as markets discounted a generally weak globally industrial economy. And the sell-off in insurance stocks (-45%) was savage for reasons explored below. In a way, however, the 32% sell-off in water utilities and the 26% fall in food retail stocks better illustrate the frenzy of selling seen in the last few months.

The breadth of the bear market can be seen in the individual stocks: of Europe's 500 largest, just 12 shares rose by 5% or more, while 44 companies saw their share prices halve, and 130 lost over a third of their value (in just three months).

The depth of the sell-off varied across the region, with the UK falling the least (-21%) and Germany the most (-37%). In fact the German DAX had its worst quarterly performance since 1959. Some explanations for the capitulation in Germany are offered later in this report. European bond markets, as measured by the German 10 year government bonds, were strong over the three months, with yields falling from about 5% to under 4.3%, reflecting the weak economy and the institutional switch from equities to bonds.

The MSCI European index fell 23% over the three months, and the Euro appreciated 4% against the A$ over the period (the pound Sterling rose 6% against the A$). These currency movements exacerbated the variation among countries, with the German DAX down 35% in A$, while the UK FTSE fell 16%. Overall, the A$ return for the MSCI Europe index was –20%.

The Platinum European Fund fell sharply over the three months, down 21%. This disappointing outcome reflects the 40% or so of the Fund invested in Germany (and only 5-6% in the UK – note that the MSCI index weight of the UK is about four times that of Germany). The damage done in Germany offset protection offered by the modest short positions (and cash held) in the Fund.

Commentary

European insurance companies – the viscous circle for stock markets

The importance of the breadth of the sell-off in stocks is that it helps illustrate the motivation of the sellers. Institutions (pension funds, mutual funds, and insurance companies) were effectively forced sellers. Pension fund trustees have begun to question their 5-10 year infatuation with equities and have, in many cases, decided that a 60-80% weighting in shares is too high. Mandates have been switched or reduced, and the fund managers sell down all the holdings proportionately. Similarly, mutual fund investors have been redeeming their investments, forcing their fund managers to sell down holdings across their portfolios. This is of course part of the "Giffen good" nature of shares which exacerbates bull and bear markets: shares are one of the few things that people wish to buy more of as they become expensive, and to buy less of as they become cheaper (houses in Australia are another good example).

The other forced sellers of note are insurance companies, who have prudential regulators compelling them to reduce their investments in shares as share prices fall. This European insurance company selling became very much a self-fulfilling prophecy in recent months as the "thin" markets intensified the share price declines. In addition, financial stocks are the largest single sector of the European stock markets, and the insurers – Allianz and Munich Re in Germany, Generali in Italy, AXA in France, Swiss Re in Switzerland – are (or at least were) among the largest stocks in Europe. As the value of some of the assets (ie. shares) on their balance sheets collapsed, so these companies' own share prices fell too.

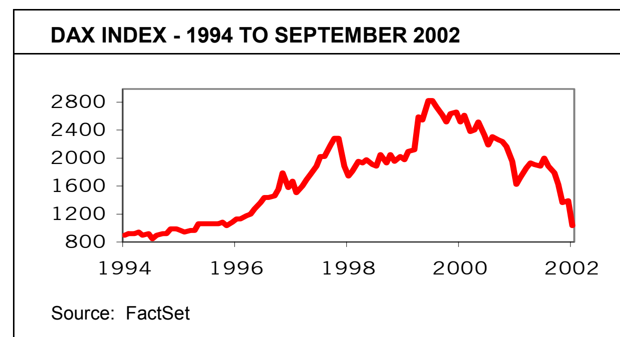
The perversity of all this is that insurance is one of the few businesses which has "pricing power" at the moment. Demand for general insurance (home, car, professional indemnity, earthquake etc) is fairly stable through time, but the supply or capacity to insure is a function of the capital made available to and by the insurance industry. The profitability of insurers (investment returns aside for the moment) is largely a function of the premiums they can charge and the payouts they must make, so clearly this capacity is key to the so-called *insurance cycle*. Insurance payouts have grown, partly due to the insidious effects of American-style litigiousness, and this has caused capacity to leave the industry. Specific events such as the collapse of the buildings in New York a year ago have also weighed on the industry. And the weak share markets have meant that the poorly capitalised insurers have withdrawn capacity still further. The outcome is that insurance premiums have generally been increasing, and with this scenario in mind we have made some investments in the industry over the last 6-12 months.

These investments – in Allianz in Germany and in Generali and Alleanza in Italy (all strong, well capitalised companies) - have been costly, however, partly because of the share price effects referred to above. And in recent weeks the weak insurers (some of the Swiss, Dutch and British in particular) have been forced to raise fresh equity capital. This hurts the whole industry because even though the low share prices of those weaklings means the capital raising is very damaging to their existing shareholders, once the capital is raised, it is available to write insurance. This is an offset to the reduction of insurance capacity described above. In a sector share price sense, it has also damaged our holdings because of the supply of insurance company shares flooding the stockmarket.

Share prices, European economics & capitalism, and the German election.

The above discussion may give some sense of the "flows" of money out of shares in recent months. But what is the underlying fundamental message the market is sending? Was the 1990s strength of European share markets a mistaken capitalist fantasy that is being extinguished? Or is this just a correction (from a "bubble") that has few serious implications for the general direction of the economies? And why did the German voters just re-elect the same government that has presided over the last few years of economic stagnation?

DAX INDEX - 1994 TO SEPTEMBER 2002



Source: FactSet

Excluding the instances where sharemarkets closed due to world wars, there have been, in the last century or so, only three other instances of developed country share markets suffering bear markets as violent as that which currently afflicts Europe (ie. down more than 50%). These instances were 1929-1932 (US), 1973-74 (US, UK, France), and 1990-1992 (Japan). In each of these cases, the stocks markets were signalling fundamental change in the economic environments of the afflicted countries. With this in mind many commentators are starting to wonder what the coming years hold in a macro-economic sense. The general blueprint is Japan, though the conceit of policy makers (and the faith of most professional economists in the efficacy of monetary policy intervention, especially that of the US Federal Reserve) means that few think the US is headed in this direction. As an aside, it is worth considering the importance of a healthy financial sector to monetary policy as practiced in the last 25 years – in many ways the trouble in Japan is probably the lack of an effective private sector credit creation mechanism. Very high corporate and personal debt levels in the US financial system are, therefore, not just dangerous to the holders of bank equity, but to the economy generally.

Macroeconomic commentators and international strategists are almost uniformly negative about Europe's prospects. While we have observed for a long time that the European stock markets behave as derivatives of Wall St, (tending to exaggerate its movements up or down), it is quite another thing for serious commentators to write of Europe's economic and political status as "a dependency of America".

Growth in Germany is very poor. Inflation is not a risk; deflation probably is. Germany has, these last few months, often been labelled "the next Japan", and its anaemic economic growth means this claim is difficult to refute for the moment. But even assuming that such an analogy proves appropriate in coming years, there can still be many interesting investment opportunities, just as there has been in Japan in the last decade.

The pro-business parties lost what many considered an "unloseable" federal election in Germany a few weeks ago. The incumbent "socialist" coalition (very centralist, but heavily dependent upon German labour unions) retained a slim majority mostly because of the performance of the Greens, who campaigned vigorously *against* Germany supporting an American invasion of Iraq, among other things. But the main point is that there was not a strong vote for change – the pro-business parties were seen as most likely to implement reforms for the labour market etc, and they polled very poorly.

And late in September Deutsche Boerse (the German stock exchange) announced the closure of the German Neuer Markt ("new market" – which we described in 2000 as the "supercharged NASDAQ of Europe"). The whimper rather than bang that marked this occasion perhaps makes it a valid signal for the complete removal of optimism in Germany for shares generally.

The point of all this is that, in the context of the stock market collapse, European share prices have corrected most if not all of their excesses, and there is little "irrational exuberance" remaining in the prices. While we wrote a quarter ago that poorly positioned (and heavily indebted) companies were apparently cheap, now it must be said that many strongly positioned (and securely financed) companies have been sold down to very low levels as well.

Industrial survivors

Several German machinery companies with decent size businesses (sales of up to A$10 billion) and strong market positions in their areas are now trading at a fraction of sales, under 10 times earnings (even in a meagre year like this) and yielding 5% or more (dividend). Where such companies have solid balance sheets, and do not face medium term devastation from Korean or Chinese competitors, they do not even need to grow much to make worthwhile investments (ie. at current ratings). We wrote at length in the mid-1990s how many such German companies had faced despair (union imposed wage and working conditions, threat from cheaper countries, seeming inability to charge a sufficient price for the superiority of their product etc) – and at that point of despair had in fact set about change. Pragmatism has dictated that they outsource some of the basic components and sub-assemblies while reinforcing the core offering of the product and emphasising design, marketing, maintenance, replacements, and upgrades.

Although the stock market is suggesting failure, failure is far from certain. These companies had a solid base to build from, and the extent to which, for example, the heavy industrial product businesses can successfully generate profitable service revenue streams out of their equipment position (and whether this is sensible as a strategy or merely an appealing fashion) is a matter which we are currently considering.

BREAKDOWN BY INDUSTRY

Categories	Examples of Stocks	Sep 2002
Miscellaneous Services	Fraport, Hagemeyer, Draegerwerk	17%
Consumer	Adidas, Michelin, Henkel	14%
Retail	Hornbach, WH Smith, Rinascente	13%
Capital Goods	Océ, Schindler, Siemens	11%
Chemicals/Materials	Linde, Merck	10%
Pharmaceuticals/Biotechnology	Novozymes	9%
Financials	Alleanza, Allianz, Assicurazioni Generali	7%
Health Care	Novartis	6%
Tech/Media	Ericsson, Deutsche Telekom	6%

Source: Platinum

Portfolio Activity and Outlook

In keeping with the view that the price declines had made many stocks more attractive, the principal portfolio activity was steady additions to our existing holdings. Allianz was, as mentioned, a new investment; and earlier in the quarter we took a small position in Deutsche Telekom at E10 per share (this stock has been from E28 to E105 since we last owned it!). And as prices fell, we reduced the short positions in the Fund (halving some, closing others) over the quarter so that by 30 September short positions were down to 7%.

During the quarter we sold the position in German transport/logistics giant Stinnes (which for most of the last year or two has been the largest holding in the Fund) which was taken over – at a very favourable price for us – by Deutsche Bahn (German Rail). Additionally we sold out the remainder of Deutsche Boerse (the German stock exchange), which, considering the collapse in share trading activity by traditional investors, had held up well and has been a good investment for the Fund. And Givaudan, the Swiss flavours and fragrances leader, has had a solid business performance rewarded by a share price going in the opposite direction to the rest of the market. We still like this business, but fear that the stock has been used as a place of refuge for many and that it may reverse in the coming (?) stock market recovery. Overall the net invested position of the Fund has increased over the period from under 70% to 86% as of 30 September 2002.

To the extent that it is possible to feel enthusiastic about stocks after such a dreadful six months, valuations mean that while underlying economic conditions provide a solid headwind for almost all businesses, as investors we have the best offering that has been available for some years. It is disturbing that the so-called “stability pact” criteria (governments may not run deficit above 3% of GDP) mean that European fiscal policy is effectively tightening into the recession. Given underlying deflationary tendencies, real interest rates look far too high in Europe also, so there should be some monetary policy relief from the ECB imminently.

The history of bear markets, and the destruction of enthusiasm for shares means that sustained uptrends for stock markets are unlikely to come soon. However as the general selling abates, a portfolio of well chosen stocks can make some headway even while the overall market trades sideways. In the absence of indications of a sharply greater macroeconomic downturn in Europe, we will most likely be moving to a highly net-invested portfolio in the coming weeks and months.

Toby Harrop
Portfolio Manager