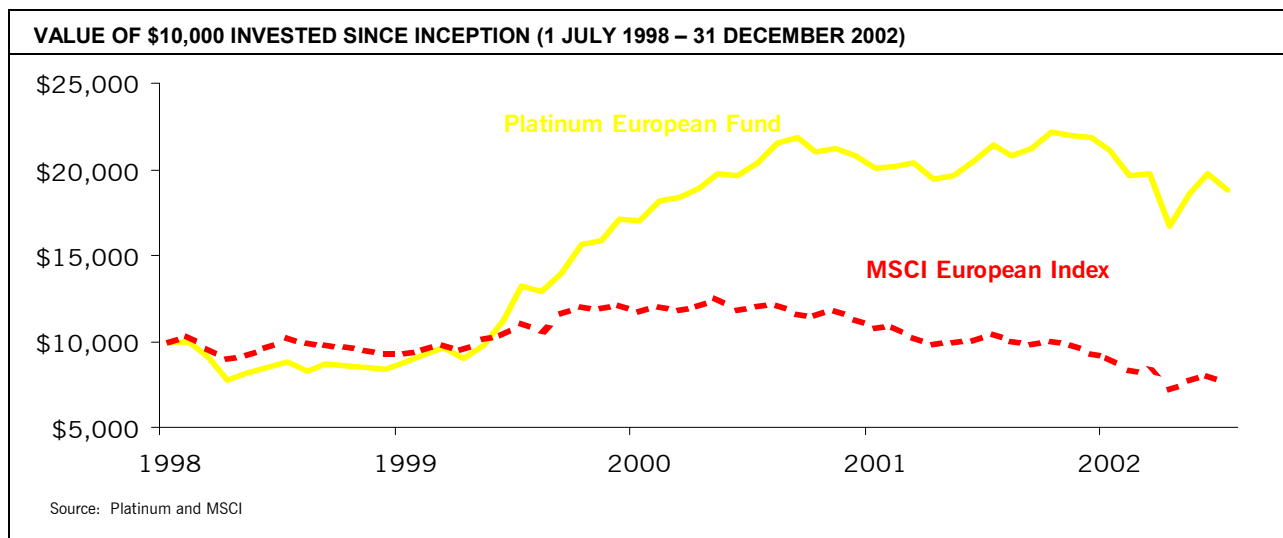


# The Platinum European Fund

## Performance

REDEMPTION PRICE: \$1.4406



### Markets stage muted rebound after September collapse

European stock markets experienced a dull fourth quarter rebound (+4%), to be down 35% for calendar year 2002. The inevitable October rally (after September's sharp falls) petered out quickly in December, as concerns over the German economy, the oil price, and world economic prospects weighed on both earnings forecasts and investors' risk appetites.

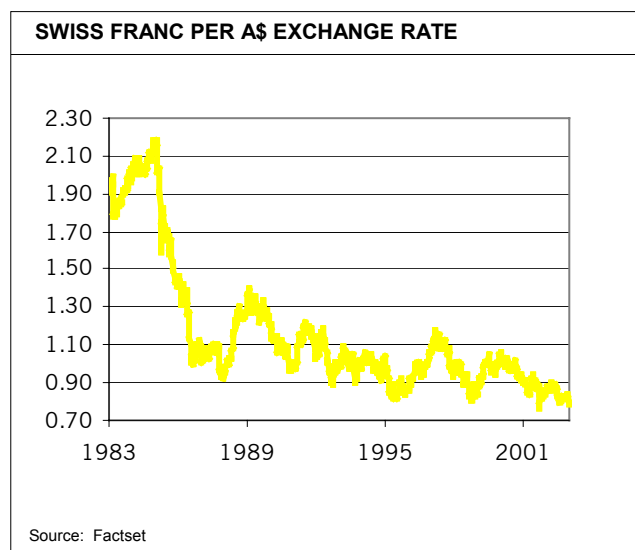
In the fourth quarter, technology (+28%), telecom (+22%) and insurance (+17%) shares rebounded, with "defensive" areas such as pharmaceuticals (-5%), and beverages (-12%) drifting down. These movements are partial reversals of the previous quarter's action. On a country by country basis, Germany rebounded a paltry 4% after the September quarter's 37% decline. The UK FTSE was up 6% and the French CAC +10% for the three months to December.

Among individual stocks, about 80 of Europe's largest 500 stocks rose 20% or more for the quarter, many of these from very distressed levels. Just 17 stocks fell 20% or more over the period, most of these in the UK.

The Australian dollar depreciated a further 3% against the euro. On 31 December the A\$ had its lowest monthly close against the euro since that

currency's inception four years ago; against the Swiss franc (to take a currency with a longer history), the A\$ printed its lowest monthly closing price since being floated in 1983.

Flattered by the weaker A\$, the MSCI Europe index (measured in A\$) returned 7% for the December quarter; and it fell 26% for the calendar year 2002. The Platinum European Fund gained 13% for the quarter, despite its heavy weighting in German shares, and despite also suffering the drag of its 60% hedge into A\$. For the year 2002, the Fund was down 12%.



## Commentary

### **The French government centre stage as usual; GE makes waves in medical equipment market**

Several large companies listed on the Paris stock exchange saw surging share prices in the last three months; the involvement of the French government was the common factor. France Telecom (+140%) led the charge, as it recovered from a share price which reflected the difficulties it would have in repaying the E15bn debt due in 2003 (the company has over E70bn debt in total, and was financially vulnerable without new funds from shareholders). In the event, the government pledged E9bn in a complicated arrangement designed to trick Brussels (ie. as opposed to agreeing to European Union laws) – in this case France is once again breaking the EU ban on states bailing out private companies. France Telecom formally announced its plan to cut debt by E30bn over the next three years, by raising E15bn (!) in new equity (of which the E9bn mentioned above is the government's share) and by cutting investment, costs, jobs and dividends (!!).

Telecom equipment companies' shares have been declining since mid-2000 on the twin ideas of excess installed telecom capacity in most countries, and the near or actual bankruptcy of many erstwhile customers. Thus the government bail-out of France Telecom far outweighed the announcement of lower planned capital expenditures. Alcatel (for whom the custom of France Telecom is of crucial importance), was up 78% in the December quarter.

The last great French government bail-out was the Ffr125bn (A\$40bn!!!) "rescue" of Credit Lyonnais in the mid 1990s, after the bank's adventures in real estate, Hollywood, golf courses etc. Thus December's final solution for Credit Lyonnais ends a sorry chapter in French banking. The chairman of the bank has made the finance ministry's task very difficult, as he has played off the need to keep the bank afloat from depositors' perspective against the desire of the government in Paris to have it acquired (including the state's 11% stake). Exasperated, the ministry decided to auction its stake on 23 November 2002. You may notice that this was a Saturday, and apologists may explain this by imagining the hard working public servants (!) of Paris. Such apologists will blush to learn that only three French financial institutions were told of this auction (the French have a uniquely opportunistic take on "one Europe"!), and thus it effectively became a closed bid battle between the two giants

BNP and Credit Agricole. BNP paid E58 per share, a 49% premium to the previous day's share price to buy the 11% stake, and was suddenly regarded as the front-runner to buy the whole bank. However BNP was thwarted in mid-December when Credit Agricole bid for the whole of Credit Lyonnais at E56. Credit Agricole, only listed on the stock market for one year (though formed in 1894 to provide services to French farmers), paid nearly E20bn, of which two-thirds was in cash, to buy Credit Lyonnais. The new Cr. Agricole group, with E700bn in assets, will have around a third of the consumer banking market in France.

General Electric (US) made one of the larger cash bids of recent times when GE Medical announced just before Christmas its E2bn bid for anaesthesia monitoring specialist Instrumentarium of Finland. Instrumentarium has been a successful company for some time, being another one of the Finnish "multi-trading" groups (a la Nokia, Kone, Huhtamaki etc) which has successfully pared its activities down to a central core over the last 10-15 years, and then flourished. Instrumentarium had been working in the area of anaesthesia machines since the 1970s and was the first company to come up with the innovation of a combined dosing and monitoring machine in the early 1990s. Since then, and helped by buying distribution companies in the US, Instrumentarium has grown quickly thanks to its strong product range. GE, under pressure in the medical area from small companies like this, and also from the relentless product innovations from Siemens (GE had until recently been reducing R&D expenditures, presumably in the interest of propping up reported profits) admitted defeat and paid a big premium for its tormentor.

Siemens recently combined its patient monitoring equipment with machinery powerhouse Draegerwerk AG of Lubeck, Germany (in which the Fund is invested). Several commentators attribute GE's acquisition of Instrumentarium to this Siemens/Draegerwerk deal; either way the market is becoming considerably more concentrated (GE and Instrumentarium between them having bought several of the other players in the 1990s – particularly in the US). One interesting aspect of the GE acquisition is that Instrumentarium has secured GE's agreement to make Helsinki the centre for its medical IT systems effort in Europe. Software to link patient data from such devices (eg. such as

anaesthesia monitors) into hospital databases for efficient management and storage of patient records is an important growth area for the big medical equipment companies, and GE's concession perhaps suggests how enthusiastic it was to buy Instrumentarium.

### **European Union, the common currency, and addressing structural flaws**

In May 1950 the French proposed creating a common market in coal and steel, primarily to secure the peace by bringing countries together within an institutional structure that would allow them to co-operate as equals. (It is interesting to note that coal and steel were still the starting point: in 1919 the core of the French strategy for the "peace" treaty of Versailles was to destroy Germany's coal and steel supply lines in order to impose economic constraints on that country – the post-WWII strategy was a little more constructive).

In 1950, six countries (Germany, France, Italy, Netherlands, Belgium, Luxembourg) subscribed to the idea. In 1957 the arrangement was expanded through the creation of the European Economic Community (EEC) in the "Treaty of Rome". This was to allow the free movement of workers, goods and services between member countries, and abolished duties on manufactured goods. It is also from this period around 1960 that the (infamous) Common Agricultural Policy (CAP) dates.

Over subsequent decades the membership of the EEC expanded with UK, Denmark, Ireland joining in the 1970s, Greece, Spain and Portugal in the 1980s, and Austria, Sweden and Finland in the 1990s. Norwegians have twice rejected joining, in referenda in 1973 and again in 1994; Switzerland has never applied. And also over the decades, the role of the EEC (and subsequently the EU) expanded to include social, regional and environmental matters, and then progressed toward economic and monetary union (1970s onwards). "Europe" has slowly evolved toward political union; the debates about how much and how fast are as vigorous as those about federalism versus functionalism. Direct elections to the European Parliament have been made since the 1970s, additionally the European Council, composed of individual country leaders, meets regularly.

Since January 1999, European countries sharing the euro as their currency, have had, as a corollary, common monetary policy, and are all signatories to the so-called Maastricht treaty which includes the optimistically named "stability pact" provisions. Thoughtful critics of this arrangement note that a comparable (by population and economic diversity)

area such as the USA has a strong federal government and a population with unsurpassed propensity to migrate when economic prospects demand it. Europe has neither. (Brussels has more than enough institutions, but they lack the legal clout – not to mention the moral authority – of a national parliament).

The continuing economic slump in Germany has brought the euro (and EU) setup under renewed scrutiny. The "stability pact" which insists that governments keep inflation, budget deficits etc within narrow limits to avoid putting strain on the monetary union, in fact has the opposite of its intended effect during recessions. In Germany today, as tax collections decline and welfare payments rise, the government is forced into contractionary fiscal tactics (ie. raising taxes and cutting discretionary spending) to meet the treaty obligations of Maastricht. This of course exacerbates the recession, and is roughly the exact opposite of what Keynes prescribed for such an economic circumstance. The unavailability of other tools (like lower German interest rates or a cheaper Deutsche mark) highlights the unbalanced nature of the current arrangements. In theory, it would be helpful if one or two million unemployed Germans could move to faster growing parts of Spain, the Netherlands, Ireland, etc (ie. the sort of arrivals California experienced last century and Texas is experiencing more recently). This is unlikely.

In practice, the crisis will (hopefully) prompt improvements to the institutional arrangements – it looks as though there is a flurry of action in Brussels with, for example, the plans for the proposed constitution of Europe being taken seriously (signalled by the active involvement by heavyweight politicians from Germany and France). Additionally, Chancellor Schroeder's announcement of half a dozen new taxes in a fortnight shows how unworkable things have become, and it looks as if he is ready to make some more fundamental changes both within Germany and in its relations with Brussels.

At the December European Council in Copenhagen, it was announced that negotiations had successfully concluded for ten countries (Estonia, Latvia, Lithuania, Poland, Hungary, Czech Republic, Slovak Republic, Slovenia, Malta and Cyprus) to become new member states of the EU from May 2004. It is generally accepted that many of these countries are working toward entering the EMU also (ie. taking on the euro currency and common monetary policy etc). In the light of the problems described above why do these countries wish to join the Union? And the post-reunification economic performance of eastern

Germany compares poorly with that of the Czech Republic (but is that due to Germany or EU/euro?). Some combination of peace and prosperity seems to be the answer – the desire to engage deeply with “the west”, rather than with the confusion available to their east and south; but also it looks as though the EU is kind to its poorer members. The money which has flowed from northern to southern Europe over the years beggars belief; plenty will flow from west to east too. The growing geographical, not to mention internal and external political complexity of the EU, as well as the economic problems of existing

members, all argues for urgent reform and improvement.

In general we err on the side of presuming Europe will remain hampered by “too much” government, and the investment strategy thus concentrates in the main on companies which can prosper despite, rather than because of, their operating environment. However analysts which describe “Europe” as nothing more than the plaything of the political classes are too cynical, and the crisis centered in Germany should lead to more useful reforms (and sooner) than such cynics currently expect.

BREAKDOWN BY INDUSTRY		
Categories	Examples of Stocks	Dec 2002
Pharmaceutical/Biotechnology	Novozymes, Novartis, Sereno	16%
Miscellaneous Services	Fraport, Hagemeyer	14%
Consumer	Adidas, Henkel, Michelin	14%
Retail	Hornbach, Metro, Kingfisher	14%
Capital Goods	Océ, Schindler, Siemens, Draegerwerk	12%
Chemicals/Materials	Linde, Merck KGaA	10%
Financials	Alleanza, Allianz, Assicurazioni Generali	7%
Tech/Media	Ericsson, Great Nordic	7%

Source: Platinum

## Outlook

Stocks in Europe are in general modestly rated given the expected dull economic outlook. Earnings growth and/or catalysts for the re-rating of companies are in short supply. We are still avoiding those companies with too much debt, and medium sized companies are more attractively priced, in most cases, than the very large. We continue to find French stocks more expensive than other continental European markets; in the UK we find few interesting companies at all. Over half the portfolio is invested in Germany and Switzerland; we also have several holdings in each of Denmark and the Netherlands.

The portfolio is hedged over 60% into A\$; the current consensus is that the euro is the “best of a bad bunch” (ie. compared with US\$ and yen), and the A\$ “will suffer on the crosses” (ie. strengthen against the US\$ but not against the yen and certainly not against the euro). We are concerned that this widespread view exists primarily because it has worked in recent years, so while we concur that the euro is preferable to the US\$, maintaining a considerable A\$ hedge looks sensible at 54 euro cents.

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Portfolio Manager