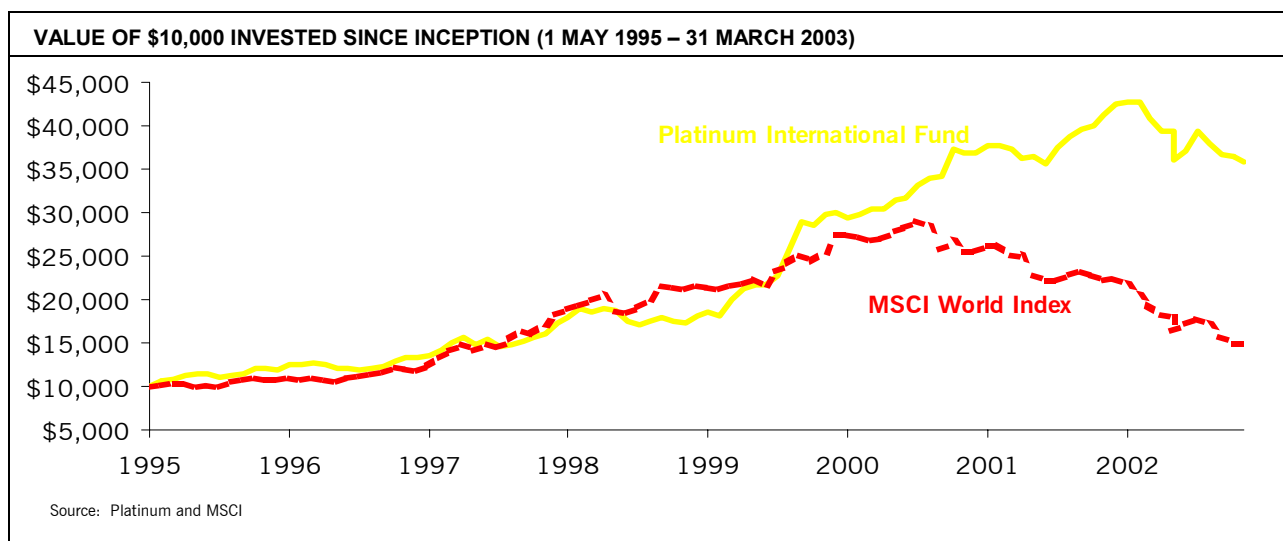


Platinum International Fund

Performance

REDEMPTION PRICE: \$1.4275



All major markets were down for the year, ranging from -13% for Australia to -49% for Germany. The MSCI was off 33%. The same pattern was true for the last three months with Brazil alone in having risen by 2% from very depressed levels. The average was down around 11.5%.

Looking at the MSCI by industry categorisation, it is remarkable that there was nowhere to hide. Each of the ten sectors was down for the year and not one by less than 27% (consumer staples) while information technology had the dubious honour of again being the weakest at -43%. Unfortunately the Fund has not escaped this continuous decline and has fallen by 18% for the year and by 8% for the quarter. All these numbers have been expressed in A\$.

On a quarterly basis the Fund's performance was not much better than the MSCI. This is partly explained by the continuing weakness in Germany even though many of our holdings there have acquitted themselves well. At the same time, our short sales, which are predominantly in the US, have been somewhat more resilient than the broader US market. These shorts are principally among

consumer staples and financials which investors use from time to time as a refuge. They together with the other shorts were established on account of their extravagant valuations or lax credit procedures, and we believe, will gradually lose their investor following as time passes.

MSCI WORLD INDEX – INDUSTRY BREAKDOWN		
Sectors	3 months	1 year
Telecommunications	-14.4%	-34.8%
Materials	-14.2%	-30.0%
Financials	-13.7%	-33.8%
Consumer Staples	-13.6%	-26.9%
Consumer Discretionary	-11.6%	-37.0%
Industrials	-11.6%	-36.9%
Energy	-10.3%	-29.4%
Utilities	-9.6%	-30.8%
Information Technology	-8.2%	-43.3%
Health Care	-7.7%	-28.8%

Source: MSCI

Changes to the Portfolio

DISPOSITION OF ASSETS		
Region	Mar 2003	Dec 2002
Western Europe	32%	34%
Japan	20%	19%
North America	13%	14%
Emerging Markets (incl. Korea)	10%	10%
Australia	2%	2%
Cash	23%	21%
Shorts	29%	24%

Source: Platinum

With share prices moving in a range of as much as 30% in a quarter, there is opportunity to either add to positions that have sold off fiercely or to trim those that bounce on very short term considerations. This was our pattern in this period where companies like Assicurazioni Generali rose by a third as a result of a fight for control and Allianz sold off 50% on solvency concerns. Having satisfied ourselves as to the fundamentals of each, we reduced our position in Generali and progressively added to Allianz. As noted later in this report, we bought this share far too early in the cycle but now that it is addressing its solvency margin via a rights issue, it is not the time to be conjuring up creative imaginings about the fate of the world's largest insurer! Potential buyers are likely to be holding back in anticipation of a stock over-hang from the rights issue but our work suggests this makes for a good buying opportunity.

BREAKDOWN BY INDUSTRY			
Categories	Examples of Stocks	Mar 2003	Dec 2002
Cyclicals/Manufacturing	Schindler, Siemens, RMC, Bayer, Linde, Océ	21%	21%
Medical	Yamanouchi, Takeda, Draegerwerk, Novartis, Merck KGaA	9%	8%
Financials	Assicurazioni Generali, Allianz, Alleanza	9%	7%
Gold and Other	Barrick Gold, Newmont Mining, Gold Fields	8%	8%
Technology/Hardware	Agere Systems, National Semiconductor, Samsung, AMD	8%	10%
Telecoms	Hellenic Telecom, Ericsson, NTT	7%	8%
Retail/Services/Logistics	Metro, Hornbach, Fraport	7%	8%
Consumer Brands	Citizen Watch, Adidas Salomon, Lotte Confectionary	5%	5%
Software/Media	Sky Perfect Communications, Seoul Broadcasting	3%	4%

Source: Platinum

Currency

The US\$ was weak for the quarter and saw the Euro rise from around \$1.00 to \$1.09. Similarly, the A\$ gained ground and rose from 56 cents to 60 cents versus the US\$. Our hedging strategy is working favourably and even though the US\$ could find some

vitality in the short term, we are reluctant to fine tune our position. We remain principally hedged into A\$ at 70% and own Euros, Swiss Francs and some Korean Won.

Commentary

Armchair Generals may be disappointed at our lack of commentary about the invasion of Iraq. There are plenty more knowledgeable sources than ourselves, and besides, we believe this war is coincident with the bear market rather than causal. That the war adds to uncertainty via geopolitical risk is indisputable.

We have just celebrated the **third anniversary of the Nasdaq bear market** and arguably approximately the fourth year of the broader US indices decline.

In case there is need to emphasise the madness of the crowds, in mid-March of 2000, the Nasdaq index ostensibly represented 4% of US corporate earnings and 40% of total US listed equity values. Today this index represents some 25% of available US market capitalisation. Other signs of the deflation of the bubble lie in the collapse in merger and acquisition (M&A) activity and the rapid decline in cross-border capital flows. World M&A activity amounted to US\$12.4 trillion between 1995 and 2002. The peak year was 2000 which accounted for 26% of this total. Characterising the excitement for instant gratification was the amount devoted to pure "body businesses"; support services, media, and software. These in aggregate accounted for 34% of all activity. (The point being that in the heat of the moment good investment bankers can convince clients and the market of the apparent necessity to acquire entire blocks of people rather than hiring the individual talent that embody these asset-poor enterprises. Often, the expensive goodwill purchased fails to meet expectations but it is only as the bubble deflates and the urgency subsides that the logic of acquiring other people's problems is questioned).

Cross border capital flows are showing a similar pattern. Having peaked in 2000 at around 14% of world GDP, they have evaporated. The diminished desire to invest in distant markets is reflected in the de-rating of emerging markets. From the frothy highs of 1994 when emerging markets had price earning ratios higher than the developed markets, they are now valued at just over half (PE relatives are about 55%).

The extravagances of the bubble can start to be measured by the spectacular level of **corporate busts**. The magnitude of these is well worth recording and all the more when viewed alongside those company's peak capitalisations (see accompanying table).

Fortunately we have avoided these disasters and in fact benefited from some through our shorting

activity. It also incidentally serves to underline the benefit of following our seemingly perverse disdain for popular stocks.

TOP BANKRUPTCIES IN THE US IN 2001/02 BY ASSET SIZE

Company	Bankruptcy Date	Peak Market Capitalisations (US\$ mn)
WorldCom	July 2002	162,980
Enron	December 2001	62,698
Global Crossing	January 2002	39,438
Pacific Gas & Electric	April 2001	15,527
NTL	May 2002	13,328
United Airlines	December 2002	12,328
Kmart	January 2002	11,198
Conseco	December 2002	10,570
Adelphia Communications	June 2002	7,410
Federal-Mogul	October 2001	4,000
Finova	March 2001	3,412
Reliance	June 2001	2,182

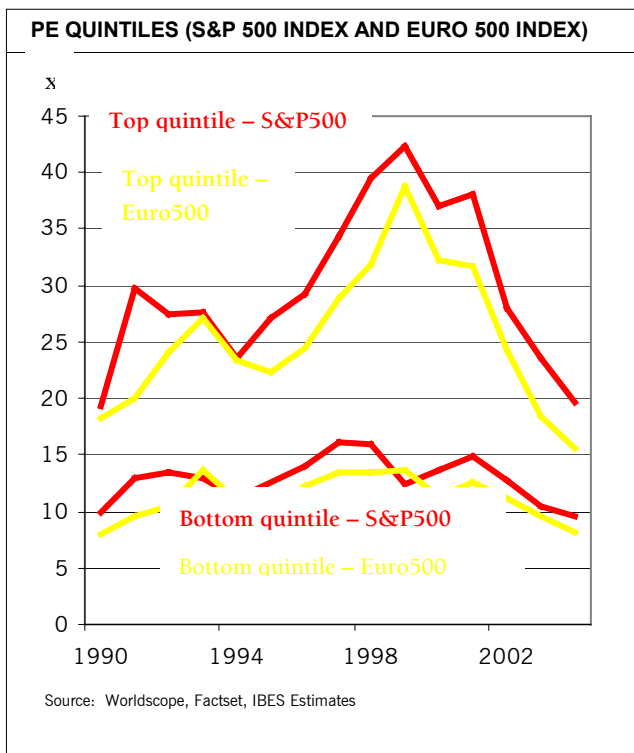
Source: BankruptcyData.co, Worldscope, Factset

In the place of ultra-large mergers and corporate hubris there are now spectacularly **large rights issues**. The scramble for liquidity is clear. Led by yesterday's heroes, money is being extracted from unwilling pension funds and insurance companies who are in any case reviewing the wisdom of such large exposure to shares. We have managed to avoid most of the bother except that we unwisely bought into the world's largest insurer Allianz. The cardinal error was to be influenced by the share's price collapse. This was foolish particularly when set against the backdrop of general under-reserving by the insurance industry and the cavalier behaviour of the finance industry in general. Further we had recognised the bear market and understood the effect of falling share prices on solvency ratios. (For more on the stresses within the financial system, please read John Hempton's piece on page 10).

This leads us to the problem of assessing where we are in this bear market. Investor psychology suggests that Europe and NE Asia are already well into the second phase of the negative appraisal of shares. The general talk is about **geopolitical risk, balance sheet rebuilding and corporate malfeasance**.

Often phrases are chosen to match the music of the moment. We have written before on the valuations found in Japan where the share prices barely match the value of cash in companies' bank accounts, without regard to the business value. In Europe, share values have declined to a level where dividend yields exceed the interest payment on Government guaranteed bonds (see chart page 2).

Another measure of values is the compression of PEs where there is relatively little difference in valuations between the best and worst companies (see below).



By contrast, shares in the USA are still relatively highly valued. Here PEs are still above their long term average, balance sheets are more indebted and no case can be made that the book keeping is superior. Possibly the economy is showing greater responsiveness to cheap money but given the greater use of debt and the low savings rate, we are puzzled and unconvinced. The USA remains our principal shorting arena.

Rather than hacking around in that undergrowth let's move to where we have been active. In the last three months we have visited Asia twice. We strongly subscribe to the view that the Eastern hemisphere

will be the **strongest area of world growth** over the next few years.

With the opening up of the American west and for that matter, Australia and Argentina, together with improved transport, agricultural land and commodity prices in Europe collapsed in the latter part of the 19th Century. As we have noted previously, the removal of trade barriers and rapid transfer of technology and capital to emerging economies is having similar consequences for labour employment in the developed world while flooding it with goods at low prices. Russell Napier of brokers CLSA has written an excellent study comparing the emergence of China with that of the USA in the latter part of the 1800s and Japan in the 1950s. The parallels he draws suggests that the opening of China will tend to depress labour and land costs in the developed world. Simultaneously the improvement of Chinese living standards will tighten the supply of various raw materials and raise urban land values in China. Russell sees China as being at a similar level of per capita commodity consumption as the US in 1910 and Japan in the 1950s. He argues that in a fiat money system, the emergence of a relatively resource poor nation is likely to produce commodity price inflation.

We have no argument with Russell's view. Interestingly, the economic take-off of Japan in the 1950s coincided with very high levels of mining exploration and development. This is not apparent today! Studies by the auto majors corroborate the view about commodity usage and show how once incomes per head exceed US\$2,500 to \$3,000, automobile consumption grows at an accelerating rate. Several of China's coastal provinces are now in this position and vehicle production is accelerating past three million per annum. In general, Australia seems particularly well placed on account of the prospects for its exports and most importantly the relative weak prices of its imports ie. improving terms of trade. The big surprise will be the explosive rise of mainland Chinese travelling abroad.

Yes, China is the favourite for the moment but we cannot find much that will get in the way of this juggernaut. Our recent visit avoided the normal rounds of Beijing and Shanghai as we sought out multinationals, local officials and emerging entrepreneurs in other locations.

To distil our observations to a few sentences is awkward. The sheer size of China and its population makes the comparison with other emerging markets

misleading. Secondly, we are witnessing the **transformation of over one fifth of the world's population from a communist regime with the complicity of capitalism.** The desire and ability to leapfrog patterns established by other emerging economies is breathtaking. Increasingly the old brigade are tolerated rather than revered or even feared. Regional governments are vying amongst themselves to attract new foreign investment secure in the knowledge that this will bring them popularity and wealth. This is helping to expedite approvals and the breadth of regional competition is tending to reduce opacity.

For good ideas money always seems available; be it from the State banks trying to grow their way out of non-performing loans to State Owned Enterprises or other sources. These include the State and municipal governments, and informal mobilisation of savings. It is striking, and perhaps worrying, that long term funding is available at a floating rate of only 4.5% pa.

It is seldom clear who is the true beneficial owner in many of the recent success stories. The share register is kept a mystery as various front-men masquerade as owners. Interests seem to be shuffled among the participants in an endless choreography but invariably there are politicians at local or regional level who share some of the action. For this and other reasons one sensed that we were visiting *chaebols* in the making.

Competition is extremely fierce. As soon as a new idea or product takes off, imitators pop up, showing little regard for trademarks or intellectual property. We were constantly surprised at the relatively small labour forces we encountered at many of the sites visited. Far from relying on low labour costs alone, we found many examples of highly sophisticated industrial solutions that one would normally have expected in the West. Assembly line workers (making say TVs, cars, motorcycles or heavy earthmoving tractors) typically earn around Rmb 1,000 to 1,400 per month (US\$120 to \$170) - depending on whether housing is supplied. It is standard practice for a free canteen lunch to be given.

The **theft of intellectual property** is a major problem for foreign firms. Lucent was a stark example of this.

Having initially come to China to supply telecommunications equipment, they soon found local imitators who both undercut prices and responded far faster in developing new applications. They now find themselves in the invidious position of having to go deeper into the lion's den and have established some of their leading R&D labs in three mainland cities. Far from being a market to be sold to, China is now being seen as an integral part of Lucent's global research and procurement network. The fact that China is fast developing into the biggest market for many products puts many foreign firms in a similar dilemma: how to participate in one of the few large and growing markets and yet not lose one's know how. Speed of response, low manufacturing costs and market opportunity all contribute to the leapfrogging process noted earlier. The rule of thumb is that capital costs of setting up in China are about 50% of western costs!

For all the positive aspects of change taking place on the mainland, one should not underestimate the immense problems the country faces. These include a growing income differential between the coastal areas and the interior, problems with education, health, water supply, influence-peddling and so on. Our assessment is that these are all the ingredients for major booms and spectacular busts as unbridled optimism takes its toll. The energy that this transformation has unleashed, accompanied by nearly two decades of strong growth will lead to periodic over-estimation of demand. This could further exacerbate the pressure on profitability outside China.

Will we be able to make money out of China? The answer is far from clear. However it does give us some keen insights of what to avoid and who may be well placed to supply this burgeoning market or produce products they themselves cannot provide. Imports of sophisticated equipment is clearly on the rise as local sources have still not mastered the technology. This is helping to balance out the trade account with developed countries and indeed is opening a new export market for advanced capital equipment makers.

Conclusion

It would be surprising if “positive” news on the Iraq front does not lift some of the gloom in equity markets. However, a weak investment cycle and over-stretched consumers in the Anglo Saxon countries is likely to suppress a strong economic rebound. Companies may continue to face pressure

on prices even as their costs keep rising. However, valuations in Asia and Europe seem to reflect a scenario that is even more grim than appears plausible. We suspect the worst of the declines are behind us and so expect share prices to move up in a jagged fashion.

Kerr Neilson
Managing Director

Bad Money

At Platinum we have become increasingly concerned that lower income American consumers (and possibly American consumers in general) have too much debt. We think this situation will end in a blaze of credit defaults and a substantial slowing of consumer spending. This will have a large impact on businesses that rely on buoyant consumer finance (such as the automobile manufacturers and their suppliers) and also on the holders of consumer debt and the debt of companies that lend to consumers (such as some life insurance companies).

In the 1990s any business in a fashionable sector with a “growth plan” was able to find funding in the US. The extreme manifestation of this was dot.com. Such excesses were not limited to dot.coms. It also appeared in businesses that lent money. In keeping with the spirit of the times, companies with new and high tech methods of lending money (and assessing the credit worthiness of borrowers) were funded by the debt and equity markets. There were for instance several companies which specialised in giving credit cards to people with poor credit records (people who had previously defaulted or defrauded lenders) backed by complex models of individual credit behaviour. There were also companies that specialised in giving credit out on the internet. Some companies combined mathematical scoring models with dot.com distribution.

These companies were revered for their growth. Higher growth (which means lending to more people) was rewarded by a higher share price and greater access to (debt market) funding to lend more money to more people. It was a virtuous circle.

The problem was that where it might be possible for a single company to find “underserved” markets where otherwise good borrowers are denied access to loans (for example amongst recent Hispanic immigrants), it is improbable for a dozen companies to successfully identify such borrowers without cut-throat competition. Moreover when the companies are rewarded for growth they will tend to find it *even when it is not profitable*. Cut-throat competition meant previously “underserved” markets were now served by a plethora of lenders operating on ultra-thin margins with increasing “competitive” interest rates.

In normal circumstances this would be quickly self-correcting. The companies that were lending too

much to the wrong people at low interest margins would report poor profits and poor credit data. Hence these companies would find it difficult to raise additional funds and the “over-lending” would cease. However, for the management of the new-age finance companies this would be catastrophic, probably putting them out of business. Instead the companies went to extreme measures to ensure that they did not need to report bad credit data to capital markets.

The most common solution to underlying deterioration was for lenders to mask the problem by lending even faster. On an account of the “denominator effect” the percentage of the loans deemed problematic looked small. Growth rates over 50 per cent per annum were common amongst aggressive participants.

Eventually fast growth was not enough (and besides it was too easy to assess by looking at this year’s credit losses against last year’s loans). Amongst the worst companies it became commonplace to fake credit data through collection methods or by changing the definition of things as simple as “is the customer late in making their payments”. This sounds extreme, but it was widespread.

It may have started innocently enough. The management thinking being “the model is not working, so let’s tweak it; manipulate the data so the investors are none-the-wiser, and get it working for new loans (of which we are making many)”. However what started innocently became mass fraud.

The fraud hid and exacerbated some very bad lending. For instance we know of a car finance company that reported lending losses of less than four percent of outstanding loans. However the loans were so bad that eventually about 35 loans in every hundred will eventually either skip (ie. disappear without making payments) or be repossessed. Very bad lending was disguised as good lending through a deliberate process of:

- extending the repayment terms on loans from which no payment had been received so the loan would appear to be current under the new extended timetable,
- poor or non-recording of skips,
- where the car had been repossessed only accounting for a loss when the car was sold – the company stored tens of thousands of repossessed cars,

The Platinum International Fund

- not reporting (or under-reporting or reporting with a lag) losses on loans to customers where the customer had declared bankrupt,
- increasing the size of the loan portfolio at massive rates to hide losses with the “denominator effect.”

The car lender in question had financed the purchase of approximately three quarters of a million cars. It was the biggest independent car lender in the United States.

The fact that this car lender is likely to need to repossess over a quarter of a million cars is staggering – but it is the logical conclusion of the rush for growth in consumer lending. Finding and lending to customers who have the intention and the ability to repay you is hard (just as finding customers for any business is usually difficult). However lending to people who have no intention of repaying is easy. Stand in a poor neighbourhood and shout “anyone want to borrow \$5,000” and generally you won’t be disappointed.

Semantic definition changes were a key part of the (non) reporting of bad credit data. For example two of the companies we know will not report a credit loss on a card which is issued, drawn to its limit and on which no payment has ever been received. They classify this as a fraud loss so as to bury it in their selling and administrative expense (which is not much watched by Wall Street).

We also know of companies which provide in-store credit at electronics shops. They have extended credit at zero interest rates and with no obligation for a repayment for up to fourteen months. These loans can not be delinquent because there is no legal obligation to make a payment until the fourteenth month. Making large numbers of nothing-to-pay loans will make very poor credit data look good through denominator effects. (There is of course a problem brewing in fourteen months’ time.)

In case you believe we are overstating the degree of manipulation, see how the SEC interpreted Household International’s accounts. At its peak, Household was more “profitable” and more highly

valued than National Australia Bank (viz US\$20 billion).

[The SEC found that] Household's disclosures regarding its restructure policies fail to present an accurate description of the minimum payment requirements applicable under the various policies or to disclose Household's policy of automatically restructuring numerous loans and are therefore false and misleading. The SEC also found misleading Household's failure to disclose its policy of excluding forbearance arrangements in certain of its businesses from its 60+ days contractual delinquency statistics. The SEC noted that the 60+ days contractual delinquency rate and restructuring statistics are key measures of Household's Financial performance because they positively correlate to charge-off rates and loan loss reserves.

It turns out that Household would lend to customers who did not pay. Household would then (say after 70 days of non-payment) reschedule the loan payments without consulting the customer (giving forbearance and/or waivers of interest and fees). The loan could then be classified as current according to the rescheduled payment requirements. They therefore did not need to provide for possible losses on these loans, and by so doing depress their published profits.

Household is one of the biggest consumer lenders in the world with loans outstanding of US\$120 billion. This is the disclosure of very poor practice in mainstream American consumer lending. Household however noted that most of their competitors have credit management procedures similar to itself. Paraphrased: “our competitors faked their data and if we did not do so we would be disadvantaged in capital markets”. The point of course is that bad lending and manipulated credit data – once a preserve of the new-age lenders had become a mainstream activity. This is not sustainable – and when it is no longer sustained there are serious implications for the willingness of consumers (particularly credit constrained consumers) to spend. It follows that there are problems brewing in industries (such as car manufacturing) dependent on those consumers spending and having continued access to finance.

CONSUMER LENDING COMPANIES - MARKET CAPITALISATION (PEAK AND CURRENT) AND SIZE OF THEIR LOAN PORTFOLIOS

Company	Approximate peak valuation (US\$ bn)	Current valuation (US\$ bn)	Total outstanding loans (US\$ bn)	Loan type
<u>Conseco</u>	21	0.01	44	Manufactured home loans, sub-prime mortgages, credit cards
<u>Oakwood Homes</u>	1.9	0.002	4.8	Manufactured home loans
<u>NextCard</u>	2.7	0.00037	2.5	Credit card lending
Providian	18	1.9	25	Credit card lending
Metris	2.5	0.14	11	Credit card lending
Capital One Financial	15	6.8	60	Credit cards, car loans
MBNA	32	19.2	107	Credit card lending
Compucredit	2.8	0.29	1.5	Credit card lending
Sears Roebuck	19	7.5	31	Credit cards, store cards and a large retail chain
Household International	31	13.4	110	Subprime mortgages, credit cards, retail store credit and car loans
<u>Americredit</u>	<u>6</u>	<u>0.5</u>	<u>12</u>	Car loans
TOTAL	151.9	49.7	408.8	

Source: 10K company reports

Household International has been purchased (in distress) by HSBC at the price given above. Sears has announced that it is selling its credit card business. The companies underlined have filed bankruptcy.

The total outstanding loans of these companies are more than twice the Australian mortgage market.

We have had short positions in most of the companies on this list.

John Hempton
Investment Analyst