

# Platinum International Fund



**Kerr Neilson** Portfolio Manager

## Disposition of Assets

REGION	DEC 2011	SEP 2011
North America	30%	30%
Europe	26%	24%
Asia and Other	17%	17%
Japan	16%	18%
Australia	1%	1%
Cash	10%	10%
Shorts	20%	21%

Source: Platinum

## MSCI World Index Regional Performance (AUD)

REGION	QUARTER	1 YEAR
India	-19%	-37%
Emerging Markets	-1%	-18%
China	2%	-18%
Germany	-1%	-18%
Asia ex Japan	-2%	-17%
France	-3%	-17%
Hong Kong	1%	-16%
Japan	-9%	-14%
Korea	0%	-12%
Europe	0%	-11%
Australia	2%	-11%
Developed Markets	2%	-6%
United Kingdom	3%	-3%
United States	6%	1%

Source: MSCI

## Performance

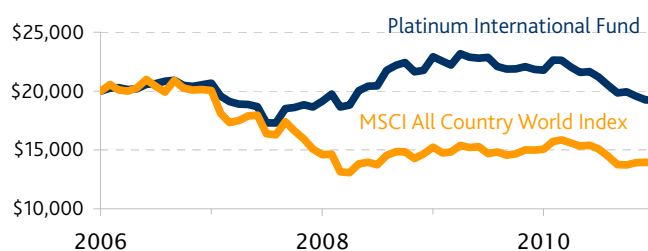
Vacillation was the preferred course of global politicians as problems mounted and stultified decisive action. The barrage of woeful economic news also took its toll on investor confidence. In the second half of the year, the expression of this fear was seen in the flight to cash and bonds. In the US, for example, this amounted to some \$79 billion leaving the equity market, while bonds and cash received inflows of \$103 billion.

Not that the concerns were shared equally. The US market was essentially flat for the year; Europe down by 11%; Asia by about 17% and the emerging markets of the BRICs (Brazil, Russia, India and China) were down by around 18%. When looking at global industries, we find defensives massively outperformed cyclicals. Industries such as healthcare and consumer staples (defensives) were up for the year, while materials and financials (cyclicals) were heavy losers.

For the year as a whole, the MSCI World Index fell by 7.4% and 7.6% for the past six months, and was up 1.6% for the quarter.

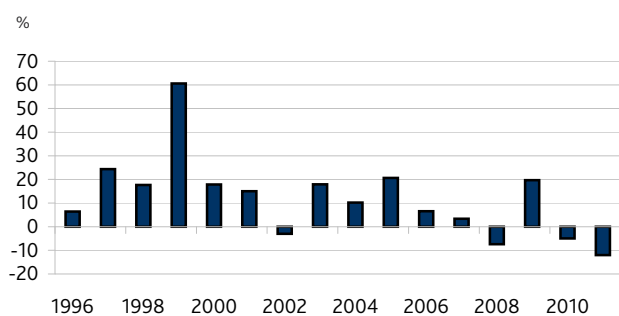
## Value of \$20,000 Invested Over Five Years

31 December 2006 to 31 December 2011



Source: Platinum and MSCI. Refer to Note 2, page 6.

## Platinum Int'l Fund - Yearly Returns to 31 December



Source: Platinum. Refer to Note 1, page 6.

This has been the worst calendar year for performance in the Platinum International Fund's 16 year history.

This has raised questions as to "what has gone wrong?", particularly amongst investors who recall being protected in earlier bloodbaths, where for example in 2008, the Fund fell 'only' 7% when most other global funds were down by over 25%.

There are several components to our current poor performance. In essence it relates to our particular **investment style** of looking for aberrations/neglect.

Firstly, the **composition of the portfolio** is usually very different to that of the MSCI World Index. This was particularly important this year as the US market, comprising some 40% of the Index was relatively flat for the year, while the remainder, principally Europe, Japan and the emerging markets were variously down by 11% to 18%. See the accompanying table on page 6.

Secondly, when we compare the performance of our **long exposure to stocks** during previous periods of market weakness, it is evident that our long positions tend to behave as badly as the market as a whole. The net outcome, however, is considerably better on account of our short selling of certain stocks and/or indices. These tend to make a significant offsetting positive return in market wash-outs. This year, however, our shorts made only a 2% positive contribution. Our performance during the tech wreck of 2000 was aided by the unusually bifurcated market. We followed our normal course of avoiding the heat which was represented by tech stocks on astronomical valuations and clambered into the

'rest' which were cheap. We were then able to progressively short sell different components of tech which resulted in positive returns over varying periods when the Index correspondingly fell.

Thirdly, even though we have avoided exposure to resources and machinery shares, to reflect our concern about weaker demand and the coming of new supply, the **cyclical companies** that we added, have mostly performed poorly. In the past, our new holdings tended to follow a pattern of moving sideways after purchase and then gradually appreciated in the subsequent three years. This year it was very different. On account of risk aversion and the much shortened investor time horizons, because of uncertainty, these stocks have tended to sell-off further, from historically low valuations, to ultra-low valuations. We believe this is an **error of timing** rather than having bought poor companies. There will shortly follow an investment précis for each in the 'Commentary' section. Clearly not all of the top 12 new acquisitions, accounting for about 18% of the Fund, were poor performers, but the distinguishing feature among them was principally cyclicity. The lesson has been to retard one's purchases to ensure a greater margin for error being priced into the share. Please refer to the article titled 'Why Valuation Matters'.

### Shorting

We have progressively shifted our shorts to individual companies rather than composites of industries. These companies tend to be extravagantly priced stocks involving favoured concepts like cloud computing or seemingly predictable growth. Netflix, Salesforce.com and Green Mountain Coffee Roasters are among our winners and there are others that await their Quarterly Reports to reveal whether we are on the right track. Importantly, these individual shorts are in markets across the globe.

The remaining aggregated shorts in the form of Exchange Traded Funds (ETFs) are US retail and US machinery stocks. The latter seems to be working and the former is proving hard work to date. Recall that 10% of US GDP is funded by government deficit.

## Currency

We have been relatively inactive on currencies during the quarter. We added some Yen but reduced the Euro and Australian dollar. At year's end, we were long the US dollar (plus the Hong Kong dollar) 51%, other Asian currencies 16%, Euro 10% and Australian dollar 8%.

As a matter of interest, the Australian dollar is virtually unchanged from December 2010. The Euro is down from 134 to 130 to the US dollar, the Yen has risen about 5% from 81 to 77 to the US dollar, the British pound is off 1.2% against the US dollar, and the Renminbi has appreciated by 1.3% to 6.29.

## Commentary

Let us now look at the 12 largest holdings we added to the portfolio in 2011, sequentially by invested funds.

### Nexen Inc (1.9% holding as at 31 December 2011)

This purchase is predicated on a firm-to-rising oil price. When we wrote about it in June we emphasised the increasing oil and gas production profile, politically stable resource base and huge reserves. On the basis of proven and probable reserves, Nexen is one of the cheapest oil and gas producers we are aware of, being capitalised at \$8 per barrel and half that if we include its huge tar sands resource! Subsequent to our entry, the British government introduced an additional levy on North Sea production and the hoped-for improvement in output from its Long Lake tar sands has been tardy.

We spent a day on site with the company in Alberta and believe they are gradually mastering the tar sands geology and the *sagd* (steam assisted gravity drainage) process. Some money has been lost to experience, but in the scheme of the company's resources, the cost lies more in the present value calculation than a huge squandering of our funds. Our calculations put the shares on a P/E of seven times in 2013, with a steady increase of output through to 2015 as the \$8 billion invested to date in new projects progressively comes on stream; at Usan off the Nigerian coast, shale gas production in NE British Columbia (BC) and the ramp-up at Long Lake. The recent sale of part of its Horn River shale gas to PetroChina validates the value of this resource and highlights the prospect of exporting liquefied natural gas from BC.

By way of contrast, Royal Dutch Shell (a 2.2% position in the Fund) which has been one of the best major oil plays this year, sells on 10 times earnings. It, however, does not have the same growth profile or inherent valuation attraction, but benefits from being ahead of the other oil majors in its reserve accretion and capital spending cycle.

### Deutsche Börse (1.6%)

This exchange company is a cheap, highly cash flow generative business, which with the likely merger with the New York Stock Exchange creates a highly entrenched franchise with modest growth prospects. There are issues that detract from growth in the short-term such as low interest rates, which affects both the revenue from the float on margin accounts, and lower trading volumes of interest rate derivatives. In addition, there is heightened regulatory noise in the form of financial transaction taxes and the opening to competitors of DB's derivatives trading and clearing platform. Given the 5% dividend yield and the share buybacks with the residual earnings, one is paying very little for this oligopoly.

### Stillwater Mining Co (1.3%)

This company is predicated on the turning fortunes of palladium now that Soviet-era stockpiles are exhausted. Producing some 500,000 ounces a year from a huge deposit in Montana, with a 28 mile strike, grading 15 grams per tonne, this is truly a unique property. By 2015, a second operation will begin production in Ontario, Canada.

We see this company as providing a natural hedge against the likely further reductions in output from the South African platinum mines because of labour problems and a diminishing resource. These workings are now operating at depths approaching three kilometres meaning huge haulage distances and intolerably hot working faces. Alternative supplies will in time need to come from Zimbabwe and Russia.

The share has been a terrible performer after the company announced a takeover of a copper explorer in the Argentine Andes with some interesting gold possibilities. Though the argument goes that palladium is an industrial metal, structurally tighter supply should ensure a higher trend price. Moreover, rising production costs in the Bushveld complex, suggest that the platinum should resume its premium pricing to gold over time.

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### **Foster Wheeler AG (1.3%) together with Jacobs Engineering Group Inc (1.3%)**

These companies are seen as longer term plays on the essential need to bolster investment in the downstream petrochemical refining chain. As we have highlighted before, levels of investment activity are at 60 year lows in the US and the needs of the developing world will ensure good workloads in the years ahead. Jacobs Engineering has a strong US focus and has been a moderately good performer while Foster Wheeler has been very weak. This is because of management's cautious approach to bidding for new work which has led to an absence of growth in its engineering and construction backlog. We are comfortable with the company's broad geographic reach, its very strong proprietary technology in coal gasification, refinery coking and circulating fluidised bed boilers. The cautious approach by management should payoff in time. Compared to its backlog and historic valuation, the company is very attractive.

### **Pepsico Inc (1.5%)**

Pepsi is an interesting multi-national that is developing some radical ideas in healthy foods and dairy. It is unusually cheap versus its historic rival Coke and is performing well.

### **Marvell Technology Group (1.5%)**

Marvell is performing relatively well as it attempts to develop a mobile chip set for the Chinese TD-SCDMA protocol and leads in the supply of solid state drive controllers that are at the heart of tablets and other mobile devices. This family-driven company has an enviable record of profitable growth and a history of succeeding in technology transformation having started in controllers, before diversifying into networking and Wi-fi chipsets. The share price will be driven by the company's success with its Trojan horse strategy in low-cost smartphone chipsets and the growth in solid state memory devices.

### **Guess? Inc (0.8%)**

This clothing and accessories company has been very disappointing as an investment to provide stable growth. Ironically its North American business has done much better than we had expected, but its European and Asian expansions have been a drag on profitability. It is now priced for very modest success as it refreshes its offer in Europe along the lines adopted in the US. It is a highly profitable business earning over 30% on capital employed, with a strong growth record and rated at under 10 times 2011 earnings.

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### **Bank of America Corp (1.8%)**

We have cautiously added to this holding as it has progressively weakened and it has been one of our poorest performers. Currently capitalised at \$54 billion, BAC is America's largest bank with 50 million customer accounts, deposits of \$1 trillion, and leading positions in business banking, credit cards and financial planning via the old Merrill's business with its 18,000 advisors.

We are very conscious of the changed operating environment regarding capital ratios, litigation, pressure on fees and yet believe that it can generate a steady state pre-tax profit of at least \$25 billion pa. There are huge cost-cutting initiatives being adopted and other costs will fall away when the foreclosure pipeline and documentation failures are finally settled (an army of 30,000 is temporarily employed on this task).

There remain risks regarding capital adequacy even though on paper the bank has set aside \$50 billion for bad debts and legal claims, and has tangible equity of \$130 billion. There is probably one more year of earnings losses to pay for earlier errors and then it is a matter of time for equity to rebuild.

The market is pricing BAC for further dilution of its equity base in an economy which is seeing recovering loan growth, still attractive loan spreads and evidence of job growth, driven by the private sector. Risks remain but the bank should add the equivalent of 30% of its market capitalisation to equity in 2012 and this should accelerate subsequently.

### **Gilead Sciences Inc (1.1%)**

Gilead is a biopharmaceutical company that pioneered the single-tablet regimen for the treatment of HIV infection, dominating the field with market shares of 75% and above. Its position in virology has been cemented with the acquisition of Pharmasset for an admittedly high price. With the growth in the HIV franchise now slowing, the opportunity lies in the development of its Hepatitis C franchise. It is estimated that some 7.3 million people are infected with Hepatitis C in Europe, the US and Japan, yet only 130,000 patients are treated each year. The problem in some developing markets is more acute. The share price will be influenced by the launch of the Quad HIV tablet and progress with its now enlarged HCV franchise.

### Amadeus IT Holding SA (1.1%)

Serving as a central clearing facility for regional and international air traffic bookings, Amadeus is *the* dominant platform. The internet has eroded some of the fee base of the global distribution system (GDS), as passengers go direct to carriers circumventing the central booking system. However, this has not been so for the more complex international and corporate travel bookings.

The real strength of this company stems from airlines outsourcing virtually all their IT functions (flight inventory, flight scheduling, ticketless travel, online sales function including frequent flyers points). This opportunity has come from the complexity introduced by the airline alliances, the move away from legacy in-house mainframes and the desire of the airlines to unbundle the sale of their services (i.e. the proliferation of ancillary services such as frequent flyer miles, baggage fees, meals etc). Growth will be driven by passenger numbers and Amadeus is particularly strong in the fast growing emerging market air routes. Selling at about nine times earnings with rapidly diminishing debt, the dividend is about to take-off.

### TNT Express NV (1.5%)

TNT is the leading end-to-end express parcel operator in Europe (including central Europe and Russia) with 18% market share. TNT's parcel flow largely stems from business-to-business deliveries, while the increasingly interesting business of internet commerce (business to consumer deliveries) is still dominated by the traditional postal suppliers. As such, TNT's business is economically sensitive, yet volumes have grown by 7% pa over the last decade and remained highly profitable. Short-term negatives for the stock include losses caused by errors in Brazil where it has the largest express system, and

development costs associated with the building of its Chinese express network. The drivers for the stock price are the likely improvement of losses in Brazil (via turnaround or divestment), the continuing growth and overhead absorption in China and the possibility of a takeover bid from either UPS or Fedex who are both still insignificant in Europe and know the extraordinary costs of building market share. There is concern about economic risk in Europe, but the company has little financial risk (i.e. it is debt free and is producing good profits).

## Conclusion

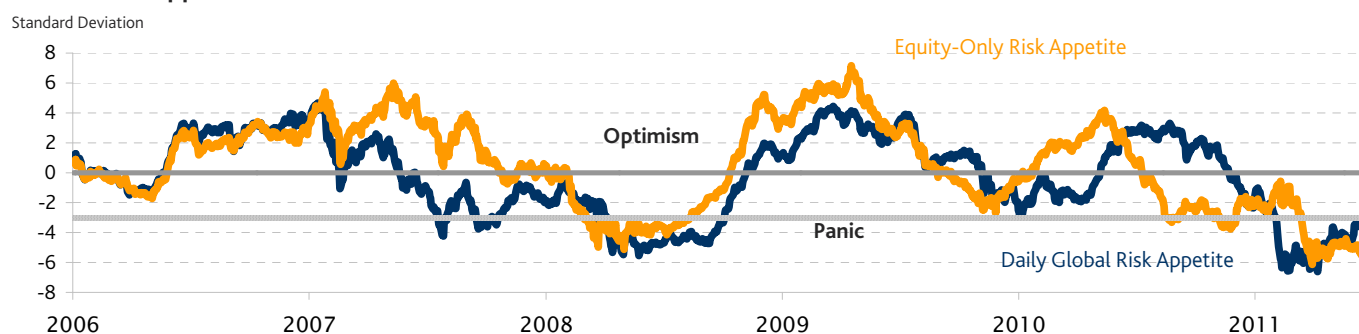
When one looks at this assemblage of companies, together with smaller purchases, some of which are cyclical and some defensive, we cannot identify any that have management, product, profitability or longer term growth issues. This traditionally has been a formula for making money.

We have written in the past of the serious problems facing most economies. Europe is the media's favourite today, but the wallpapering of the cracks in other economies is hardly encouraging. The US and the UK are relying on currency debasement to reignite activity while lower food costs are allowing the emerging countries to start improving the availability of affordable credit. To the surprise of some, this may not be an instant on-switch but at least they still have strong control of the levers for growth.

Companies that achieve earnings improvements will be most elusive but we believe the portfolio has its fair share of steady growers and others, like some of those described above, that have additional share price drivers.

The principal measures of investor sentiment indicate high degrees of fear generally associated with over-sold markets (see chart below).

## Global Risk Appetite



## 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 31 December 2006 to 31 December 2011 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.

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