



PLATINUM
ASSET MANAGEMENT

investor
REVIEW
MAY 2004

MLC – Platinum Global Fund

QUARTERLY REPORT

Performance (as at 30 April 2004)

Fund Size: \$3.67bn	Last Quarter	Last 12 months	% pa Compound Return over 5 years	% pa Compound Return Since Inception
MLC-Platinum Global Fund [†]	7.7%	41.7%	14.9%	15.5%*
Morgan Stanley Capital International All Country World Index (A\$)	4.3%	13.4%	-3.3%	7.6% [#]

* The inception date for the MLC-Platinum Global Fund was 23/06/1994

MSCI All Country World Index (A\$) performance since the inception of the MLC-Platinum Global Fund

† SOURCE: MLC INVESTMENTS LIMITED

Almost every share market in the world has risen in the last twelve months (with the exception of Finland). Looking at them in their local currencies, we find the wildest being the Caracas exchange which is up 252%, while the tamest is the UK, up only 19%. The pattern which we noted last quarter of the emerging markets tending to outpace the traditional markets, continued over the quarter but there was some hesitation as China, India and Thailand retraced some ground over the last month. Converting everything back into the relatively strong A\$ (which has risen 15% versus the US\$ in the last 12 months), we find the MSCI All Country World Index 13% higher than a year ago and 5% higher than at the beginning of 2004. (In US\$ these figures are 30% and 1% respectively).

By industry categorisation, IT, which had been very strong, lost momentum against defensives like utilities and consumer staples.

It has been an interesting time for fund managers as volatility in shares as well as currencies provided great opportunities as well as hazards. Fortunately we made more good choices than bad and outperformed the markets by over 3%. Stock selection was the main differentiator but it was important to recognise the effect China would have on the commodity prices and on igniting Japan's recovery, and to position the currency exposure accordingly.

Currency

The strength of China's growth together with the billowing US trade deficit have been important factors in the currency markets. As we noted last quarter, the US dollar was conspicuously friendless and this together with other factors encouraged us to introduce US dollars into the Fund in mid-January, for the first time since mid-2001. We also cut back further on the A\$ and the euro in favour of the yen. This is a significant shift in our view about the yen and reflects the export momentum the country is deriving from Asian trade.

MSCI All Country World Index Industry Breakdown (A\$)

Sectors	Quarter	1 year
Energy	12.2%	14.7%
Consumer Staples	10.6%	8.1%
Utilities	6.6%	4.7%
Health Care	6.5%	1.0%
Consumer Discretionary	6.4%	15.2%
Industrials	4.0%	14.0%
Financials	3.3%	12.7%
Materials	2.8%	16.7%
Telecommunications	2.4%	4.0%
Information Technology	-4.5%	13.0%

SOURCE: BLOOMBERG

Platinum Global Fund C

Disposition of Assets (Net Invested Position)

Region	Apr 2004	Jan 2004
Western Europe	31.9%	32.3%
Japan*	25.8%	25.3%
Other (emerging markets eg. Korea)	13.2%	13.1%
North America*	0.3%	9.4%
Australia	1.7%	0.7%
Cash	27.1%	19.2%

SOURCE: MLC Investments Limited

* At 30 April 2004, the Fund has a short position in the US against the Standard & Poors 500 Index of 4.4% (2.1% at 31 January 2004) and 6.7% against the NASDAQ Index (2.4% at 31 January 2004) and 3.6% against the Nikkei Index.

Changes to the Portfolio

The changes to the portfolio resulted in more exposure to Japan and slightly less to Europe. In terms of economic sensitivity there was a slight shift away from cyclical companies towards more defensive companies. Again this came out of valuations more than an overt desire to become more defensive.

Among the big sales were the removal of Munich Re, Allianz AG, Hellenic Telecom and Weyerhaeuser. The German financials proved to be highly profitable purchases which took advantage of the market's over-reaction in last March's panic. Even now they are defensible holdings but we felt that having nearly doubled they have served us well. The Greek telco, Hellenic, is a less satisfactory story. This we bought in the days of irrational exuberance feeling that it was neglected and its mobile business under-appreciated. Versus other telcos it has been fine but in absolute

terms it cost us money. Weyerhaeuser has responded well in a more growth-secure world.

Apart from topping up many of our existing positions we introduced some new holdings: Credit Agricole, Newscorp, Docomo, NEC and Toyota.

The attraction of **Credit Agricole** stems from its central position within the French banking system. This is an extremely large enterprise encompassing Credit Lyonnaise, the life insurance business of Predica, a funds management business with assets of euro 350 billion and 25% of the *caisses régionales* of France. On paper it looks to be capital deficient yet much depends on the interpretation of the unique holding structure which allows considerable devolution of power to the *régionales* and yet remarkable privileges to the Centre. Overall the group controls assets in excess of euro 1 trillion. Recent results show the benefits of the integration of IT systems and the early results from cost cutting. There is still a lot to come so by the time Basel II's new guidelines on capital adequacy come into force, we believe capital adequacy will not be a problem.

We see **Newscorp** as a bi-polar company. On the one hand it has all the virtues of the cash generating businesses of newspapers, TV and other content production. However, to cement the company's position on the distribution networks, Newscorp faces what the market judges to be an endless stream of losses and/or the danger of embarking on yet another crusade to embed its global model. Having now secured control of DirecTV and Telepiu in Italy, we anticipate an acceleration of profit growth. This should emerge as losses from these new ventures diminish and the leverage over content pricing improves. Against the peer group, Viacom, Comcast, Disney and AOL, this company, together with Liberty (its principal non-family shareholder), is very attractively priced.

Breakdown of Fund's long investments by Industry (% of assets)

Categories	Examples of Stocks	Apr 2004	Jan 2004
Cyclicals/Manufacturing	Toyota Motor, Schindler, Siemens, Linde, Océ	22%	21%
Financials	Credit Agricole, Credit Saison, Mitsubishi Tokyo Financial, Mitsui Sumitomo Insurance, Nordea	16%	13%
Technology/Hardware	Agere, Infineon Tech, Samsung, AMD, Sun Microsystems, NEC	9%	10%
Medical	Takeda, Schering, Novartis, Merck KGaA, GlaxoSmithKline	8%	8%
Gold and Resources	Shell, Barrick Gold, Newmont Mining, Gold Fields, Noranda	7%	6%
Consumer Brands	Henkel, Adidas Salomon, Lotte	7%	8%
Software/Media	Sky Perfect Communications, Seoul Broadcasting, Newscorp	7%	7%
Retail/Services/Logistics	Veolia Environ., Deutsche Post, Hornbach, Mitsubishi Corp	7%	8%
Telecoms	Ericsson, NTT Docomo	4%	4%

SOURCE: PLATINUM

Quarterly Report (Continued)

Docomo along with most telcos has been severely beaten by investors. Just as the internet dream springs to life, we find the share languishing as investors chase Japanese companies with stronger profit momentum. We however remain attracted to the dream of internet ubiquity which is promised by 3G technology. Docomo commitment to R&D (US\$1 billion pa) has earned it the place as the leading implementer of this broad band mobile. Last month alone it signed up 700,000 new broad band subscribers bringing the total to three million. Assisting sign-up from here will be the availability of a broader selection of just-released handsets. The trick will then lie in "clipping the ticket" as users discover the growing array of applications, from booking theatre tickets to news-clip streaming.

A long story can be told about **Toyota** but the essence is that it has never been stronger and yet it has virtually never been cheaper. As many of its peers have been out-sourcing and restructuring, Toyota has been pioneering hybrid electric autos while at the same time developing its own fuel cell solution. It is gaining market share in almost all the principal markets and is not burdened by the legacy costs that face its two giant US competitors. While they are resorting to extravagant marketing deals to eke out meagre net margins of 1-2% on sales, Toyota is operating at record profitability, earning 5-6% net on sales.

Commentary

Zaitech and **Tokkin funds** epitomised the closing period of the Japanese bubble of the late eighties. The equivalent today is the explosion of **hedge funds** and the captivating allure of the **yield curve carry** (borrowing at present ultra-low rates and investing in longer term riskier assets). As was experienced in the heyday of Zaitech there was a real danger of calling off the party too early. At the time the perfection of the story surrounding land price appreciation, tightening cross holdings and the apparent advantages cheap credit and high stock valuations gave to the Japanese banks, trading houses and brokers, created an impenetrable shield to critical analysis. To get a bigger and better participation of the action, companies set aside special (tax protected) funds to play the market. At the height of the boom, the great trading houses carried \$9 or \$10 of debt for each \$1 of shareholders equity. At the same time property developers and other adventurers were hoovering up property everywhere, golf courses in America, beach resorts in the Pacific etc, allowing some remarkable perspicacious Australian bureaucrat to sell part of the Tokyo embassy's grounds for US\$450 million (equivalent to US\$19,000 per square foot!!).

If there is a parallel today, it perhaps surrounds the idea that **untrammelled market forces** are the origin of economic "success". The concept is that economic reform to the markets has diminished the friction within the system to ensure accurate and timely reading of supply and demand to optimise resource allocation. This seems eminently sensible. However, the argument is then extended to explain the apparent superiority of the performance of the Anglo Saxon countries. The fact that this has been fuelled by a more than doubling of personal debt over the decade, which is reflected in vast current account deficits and generally decaying social infrastructure, is brushed aside as part of this market efficient paradigm. No good explanation seems to be necessary for the leap in real housing prices, nor is there much commentary of how persistent current account deficits will not ultimately result in diminished living standards. For now, the model is assessed as excellent and such blemishes that the pessimists perceive are merely side shows to the central event.

Turning to the present focus of market participants. Growth seems well entrenched with the last piece of the US recovery puzzle falling into place with the publication of the March employment report. Further, the broadening of the global economic expansion is taking place against a back-drop of seeming **equilibrium between the forces of inflation and deflation**. Price competition from Asia is exerting downward pressure on manufactured goods prices, as well as some services, while exuberant demand from Asia is lifting the price of many raw material inputs to recent year highs. This together with central bank intervention in the currency markets has permitted interest rates to stay at low levels and to create the impression that the risk of a change in interest rates is far off. Like all exciting bull markets, the longer the trend has been intact the more adherents it attracts. Better still it creates the illusion in some minds that they alone will be able to adjust their position ahead of the others when the trend does indeed change.

We have written before about the **leverage in the US financial system** but the more we look, the more wary we become. Who would have thought that an industry that is more fragmented and hence more competitive than its European counterpart, would earn approximately two times the income on assets employed. The reason for this is principally the higher credit risk and the fact there is a preponderance of refinancable borrowing supported by floating funding. This has not caused problems to date because of the primary downward trend of interest rates, but now with short rates at 1%, further falls will likely compress margins. Alternatively if rates were to rise, mortgagees would stay put while lenders would crowd to refinance their funding.

Our work suggests that many thrifts are more than twice as leveraged to the yield curve as they were in 1994, the last time that interest rates rose sharply.

The last time interest rates rose more than a few percentage points was 1983 when interest rates were deregulated and the Fed Funds rate rose more than 5 percentage points. This left many thrifts near insolvency which the government "solved" by relaxing lending guidelines which ultimately led to a larger "savings and loans crisis" in the early 1990s.

Funded with floating rate borrowing, thrifts are once again tempting fate by purchasing large quantities of an assortment of securitised instruments. This mismatch of duration is highly profitable - so long as interest rates do not rise. Most thrifts are levered something approaching 20 times their tangible capital with some holding more securitised assets than traditional loans. We think it possible that many currently highly valued small banks will be severely squeezed (even imperiled) if interest rates rise. They can also be squeezed (but not imperiled) if interest rates fall and the yield curve flattens.

We also know of an internet stockbroker that sweeps excess funds from its clients to lend to buyers of mobile homes. Again there is a fixed/floating interest rate game being played, but most delectably the lender is providing for only half a percent of credit losses when losses in this industry are more typically 4-5 per cent.

Very low interest rates have allowed the relaxing of **credit standards** as well. Some auto finance companies have been equally generous with their terms - now even extending *interest free* loans for more than the sticker price and for as long as 72 months. The customer you attract with a 72 month zero interest loan is much more sensitive to the monthly payment than the customer you attract with a 36 month zero interest loan. This fall in credit standards has (temporarily) increased the addressable market but at some stage the arithmetic of the subsidies will disentangle itself.

This seeming obsession with interest rate and credit risk arises from the potential dangers it creates for the capital markets. Hence our use of short selling the index to remove some market risk. It also has implications for our currency positions.

Were it not for the above, we would address the markets with greater equanimity. As we have mentioned before, we believe China and India will continue to experience abnormally strong growth for some years - even when hitting various speed bumps. This in turn is pulling sophisticated machinery exports out of Japan, Korea and the West and helping to bolster their recoveries. Commodity prices are responding to near term shortages and ameliorating deflationary fears though simultaneously squeezing some companies' profits.

Conclusion

In coming months it seems likely that there will be less discussion about the "recovery" and the focus may shift to the rise in interest rates and perhaps inflation. It is also likely that China will be running a trade deficit thus diminishing discussion about a revaluation and the pressure may move to the yen. Valuations, and the concerns we have expressed above relating to credit and interest risks, may cause a decoupling of stock markets.

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If you have any questions about your investment in the MLC – Platinum Global Fund, please contact MLC MasterKey on

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**Platinum Asset Management is the leading Australian based international fund manager.
For greater insight into our process, please visit our web site at www.platinum.com.au**

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