MLC-Platinum Global Fund

QUARTERLY REPORT

PERFORMANCE

Fund Size: $1.28 bn	Last Quarter	Last 12 months	5 years (compound pa)	Since Inception (compound pa)
MLC-Platinum Global Fund	2.2%	9.9%	11.2%	14.4%
Morgan Stanley Capital International All Country World Net Index (A$)	1.4%	8.2%	5.0%	7.5%

Source: MLC Investments Limited and Platinum

There have been some interesting turns in investor sentiment over this last quarter. Firstly, the long forecast slowing in the US economy proved illusory as it sped-up again and consequently the anticipated action by the Fed to cut rates has been pushed further into the future. Long dated bonds sold off with the yield on the 10 year note rising from 4.6% to 5.1%. Whether this reflects a change in sentiment regarding inflation or merely the deferral of action by the Fed remains to be seen. At the same time confidence in growth elsewhere strengthened, causing a rebound in energy prices and favouring commodities in general. Though food prices are rising (to re-establish its inimitable long term relationship with energy that we have highlighted in the past) there is little concern of more generalised inflation; one indicator of which, gold, is tending to move slightly weaker from $663 to $648 per oz.

The discordant note came from further concerns in the US sub-prime market where several hedge funds had problems with establishing the true value of their portfolios. As yet the availability of funds for leveraged buyouts has hardly been dented though super heated areas of the market such as REITS have certainly lost some of their lustre (down by about 20% from their February peak). We would expect further turbulence in the sub- prime/collateralised debt obligations markets and with it, deeper scrutiny of the nature of the risks lenders are taking. This should impinge on the LBO market and valuations of their agents. As you are aware, careless lending practices have been something of a hobbyhorse of ours so we will spare you further sermonising now. A telling development is the listing of Blackstone, with others to follow.

The Fund's performance has exceeded the MSCI for the quarter and is above for the year. However, the strong Australian dollar and startling performance of the ASX does for the moment, make international fund returns look pedestrian

Regional analysis of our returns shows that the opportunities in Asia were not fully taken – particularly in China. (We feel though that this is partly because of timing and focus that should change in coming months). The more telling error was the amount of money committed to the weakest market of all, Japan. This unfortunately is a function of the way we go about managing your money which is to **pick individual companies based on value, regardless of their geographic location**. For the present this is not rewarding you but such apparent misallocations have been experienced in the past only to be later revealed as prescient.

This leaves us with the much more critical 'error' of shorting in a rollicking bull market and by having an associated hedge by owning the yen. As you may read further in this report, we acknowledge that the fundamental drivers of this bull market are still in place and so we have reduced both of these defensive positions to attempt to capture a greater portion of the prevailing opportunity. This does not mean that we plan to eliminate these positions. On the 10th anniversary of the debt-induced melt down in Asia, we are acutely sensitive to the prevailing credit risks.

CURRENCY

The sustained growth outlook and large interest rate differentials again favoured the commodity

Platinum ASSET MANAGEMENT

MLC

PLATINUM & MSCI* WORLD INDEX INDUSTRY WEIGHTINGS

Industry	Platinum	MSCI
Industrials	21%	9%
Materials	14%	7%
Financials	14%	25%
Information Technology	13%	8%
Consumer Discretionary	10%	6%
Consumer Staples	6%	9%
Health Care	6%	9%
Telecommunications	5%	7%
Services and Media	0%	6%
Energy	2%	10%
Utilities	2%	4%

* Morgan Stanley Capital International
Source: Platinum and MSCI

MSCI WORLD INDEX COUNTRY PERFORMANCE (AUD)

Region	Quarter	1 Year
Brazil	18%	41%
India	15%	41%
Korea	13%	17%
Germany	11%	30%
Australia	5%	26%
France	5%	15%
UK	2%	12%
US	1%	5%
Hong Kong	1%	13%
Japan	-5%	-6%

Source: MSCI

producing currencies. The yen suffered further loss of support among Japanese domestic investors as they flocked to alternative currency funds which are promoted on the basis of their yields (and small print warnings about currency mismatching). At present it requires a devious mind to find the attractions of the yen, yet as we have seen in the past, currencies have a nasty habit to surprise and it can be boldly asserted that the yen is probably the least owned and cheapest major currency around.

CHANGES TO THE PORTFOLIO

We have been gradually concentrating the portfolio in the top 15 positions and these now account for nearly 40 % of our holdings. However, our largest holding, **Mosaic** has been exceedingly strong lately (+46% in 3 months) and we have been reducing the position. Other sales were the entire position of the paper maker **UPM** to make way for more pure pulp exposure, the reduction of **Samsung Holdings**, another hot stock over the quarter, in favour of Samsung Electronics and additions to our theme of a long cycle of investment in energy-related plant namely **JGC** and **KBR**. An emerging theme is the broadening use of LEDs (light emitting diodes) in all lighting categories. This together with our enthusiasm for solar power leads us to a handful of interesting companies.

With the harsh memories of the IMF crises now fading in Asia and the prospect of strong earnings growth, sound balance sheets and sensible valuations, we have been attracted to financial stocks in the region. Improving faith in their economies will favour the investment banks/brokers and importantly, in both Taiwan and Korea, deregulation of the financial system is encouraging the development of Western-style product distributors.

When looking at companies in China one is often discouraged by valuations, particularly among consumer plays. Having heavily provided for its bad loans, the **Bank of China** is an interesting beneficiary of the ongoing boom on the mainland. This bank has been relatively weak since listing last year on concerns about its exposure to the strengthening yuan and its somewhat weaker position than the big three in deposit gathering. However, on 15.5 times forward earnings and twice book, we believe the growth prospects are not being fully reflected.

CHINA

From the perspective of international investors, China is progressively moving to centre stage. The re-emergence of this behemoth is changing the balance of world power and growth. The sheer scale of its currency interventionist policy is unprecedented and consequently difficult to comprehend. With a freely floating exchange rate, demand for yuan would simply drive up its value. However, under a managed float, the People's Bank of China (PBC) stands in the market matching inflows with the equivalent increase of yuan in circulation. To control what would otherwise be an explosion of domestic money supply, its first line of defence is to issue bonds to recover the newly printed yuan, but in addition, it needs to impose increasingly stringent reserve requirements on the banks to control money growth (effectively locking away part of their balance sheets). The circle of intervention is completed by the PBC redeploying the accumulating foreign exchange reserves in the debt markets of its trading partners – hence the purchase of foreign debt paper and the inevitable impact (suppression) of global yields.

From history we can observe how mercantilist policies inevitably result in massive domestic asset bubbles. **Significantly, the greater an economy's exposure to exports, the greater seems to have been the resultant bubble.** The best example of this was Taiwan in 1986 when the trade surplus reached over 20% of GDP and even though the currency appreciated by some 30%[1], money supply went out of control by over 20%, fuelling a supreme bubble. From September 1985 to April 1990 the stock market exploded upwards 12 fold. This was accompanied by two significant retracements of 50%, (associated with the 1987 world crunch), and 35% respectively. As the currency rose it entrained a self-fulfilling expectation of further rises and locals brought more funds on shore to participate in the boom even though the authorities did their best to encourage outflows. In an attempt to diminish speculation, capital gains tax was introduced along with dire warnings of impending trouble.

The surprising feature of the bubble was that the banks prospered in this environment, partly because there was no conventional inflation, but mainly because of asset growth. Most significantly, the cauterizing of their balance sheets which involved special reserves requirements that peaked at 40% of deposits, caused them to amplify risk-taking with the residual funds at their disposal yet investors kept chasing bank shares. They rose on average by 20 fold in THREE years! The other beneficiaries were companies that were domestically orientated, while exporters languished. To reiterate, the same pattern applied in Korea and Japan but the bubble was much more modest with their respective indices rising by ten fold and two and a half fold in about four years from 1985.

The position of China today suggests a similar paradigm. We can expect all manner of policies to be introduced to alleviate the pressure on the yuan. Though, rather like sitting on a water bed, pressure in one part will be felt elsewhere. Outward flows are likely to be encouraged, initially to the likes of Hong Kong and Singapore, with the consequential impact on values. It is unlikely to be a smooth trajectory as investors respond to the phalanx of measures introduced to try to calm them, yet past patterns **suggest the market will rise well beyond**

DISPOSITION OF ASSETS (NET INVESTED POSITION)

Region	June 2007	March 2007
Japan	26.1%	24.7%
North America*	23.9%	18.2%
Western Europe*	18.1%	19.6%
Emerging Markets*	17.7%	15.0%
Australia*	-2.7%	-2.4%
Cash	16.9%	24.9%

Source: MLC Investments Limited

* As at 30 June 2007, the Fund has a short position in the US against the Russell 2000 Index of 3.5% (31March 2007: 6.2%); in Australia against the SPI 200 Index of 2.7% (31 March 2007: 2.4%); in Germany against the Dax of 2.8% (31 March 2007: 2.0%) and in Korea against the Kospi of 1.8%.

1. At the Plaza Accord in Sept 1985, G5 pressure forced an appreciation of the yen and by default the Korean won and Taiwanese dollar.

sustainable value. That the Bank of China will have learned from these past patterns we do not doubt, so **it will be intriguing to see what innovations they foster.**

The remarkable feature of the industrialisation of China is that while factor input costs have been distorted, the growth of **productivity has been colossal**. This has been assisted by the investment by Government in infrastructure (the World Bank unofficially puts this figure at 9% of GDP[2]) with the result that growth has been accomplished without the normal bottlenecks that cause inflation. Of course, it is necessary for there to be willing consumers abroad to absorb this additional output, because home consumption is growing slower than industrial output; or as economists would say, the **structural bias in the economy tends to favour savings**[3].

At present the **US economy** is seen to be re-accelerating but should it falter, the fact that **it absorbs some 20% of Chinese exports** (and accounts for 14% of total US imports) will raise concern. Fortunately China's export dependency on the USA is diminishing as new markets take up the running. Notably trade is to large countries such as India, commodity rich regions like Latin America, Africa, Russia and its former satellites. Markets other than the US, Europe and Japan now account for 50% of Chinese exports. Unlike Japan during its growth spurt in the 70s, where exports accounted for mid teens of GNP, **China's economy derives a full third of its activity from exports.** This exposes the country to external economic risk. The internal risk lies with inflation. Publicity has been given to food price inflation (our agricultural price theme) and should domestic prices rise more generally, this will impinge on the cost of monetary intervention and make it all the more difficult.

RECENT IMPRESSIONS

There is often no substitute for *in situ* discovery and from our recent visit to the two large coastal provinces of Zhejiang and Fujian, where we visited a large number of companies, we can report the following:

1. Cost pressure from labour is rising as willing supply tightens and wages are growing at about 10% pa. Inducements for skilled supervisors seem to have increased.
2. There is increasing pressure for compliance on large and mid-sized companies to pay taxes particularly those relating to workers benefits (healthcare and pensions) and this is hurting their competitiveness compared to smaller pirate companies.
3. Invariably those we met were pricing their exports 20 to 30 % below 'Western' competitors and yet still made high returns on funds employed (often 20% plus).
4. Perhaps it was influenced by our sample, but many of the companies we saw believed that their export efforts were at an early stage as they were progressing through 'supplier accreditation' with foreign multinationals – suggesting that even as the yuan strengthens, there is inherent momentum to their sales (and perhaps this may apply across the country at large).
5. Most were looking to move up-market in terms of their technical competence to ameliorate price competition in commodity products. Again it was astonishing how quickly these skills were seemingly acquired – often with the help of retired Japanese and Korean technicians.
6. Few regarded their 'core business' as sacrosanct; some were willing to consider selling off factories to develop other activities; in one case to move from furniture manufacturing to furniture retailing.
7. Their agility and speed of decision-making and implementation reflected an almost cavalier 'can do' optimism[4].
8. Cheap land is now a dream, having escalated by three or four fold since 2003 but still cheap by global standards at say, US$ 250,000 per hectare.

At the political level we also formed the view that the Government is serious about tackling the degradation of the environment and pollution and is clamping down on inefficient users of resources through forced closures and tax inducements (reinforced by the mid June '07 removal of tax rebates on energy-hungry and other highly polluting exporters). There is also greater emphasis on industry restructuring and amalgamation among State owned enterprises (SOE), again, to streamline and reduce waste.

Where this leaves us is that while the Chinese economy is vulnerable to slowing exports, the **structural imperative to save and the profitability of**

2. Personal income's share of the economy drifted down over the last 10 years from over 50% to 42%.
3. The lack of a social security net, and the profitability of industry skews the capital to labour share, ensuring a disproportionate allocation to the export sector.
4. This is no illusion; an independent auto manufacturer we visited is now barely keeping up with demand, yet just one year ago its assembly plant seemed more like a warehouse of ill-pressed steel panels. Conditions were shambolic, there were more bodies on the remedial line getting the sledgehammer treatment than those entering the inspection bays!

the corporate sector is such that surpluses will continue to mount. Even if domestic rates are raised to attempt to slow the economy, and bank lending is restricted, the system seems able to circumvent these traditional channels. **The escape valve of the exchange rate will have to play a part as the internal bloating continues to find expression in the value of assets, namely property and shares.**

OUTLOOK

Our inherent aversion to risk is clearly retarding our performance. As we have tried to demonstrate, the current paradigm is not unique but is certainly unprecedented in scale.

Investors are behaving in accordance with the signals they are receiving; namely money is too cheap and plentiful, profits are at record levels and there is no imminent sign that the cost of funds is about to change significantly in relation to the perceived arbitrage (ie. earnings yields being way above the cost of borrowing). We concur that until internal reforms are in place there is little likelihood of the Chinese allowing the yuan to appreciate sharply. **Hence there will be an inexorable build-up of their foreign reserves and consequent recycling that distorts the cost of money (until it doesn't).**

Among the signals of danger will be the momentum of US economic activity, the levels of protestation regarding 'unfair' trade practices, Chinese domestic inflation, the movements of the yen, and of course overconfidence resulting in an adverse credit event.

Our predicament is to gauge how much insurance to run on account of the system's unsound footing and the degree to which we should provide for an 'outlier event[5]'. While recognising the dangers and wary of overplaying our hand, we have cut back on the defensive play of holding yen. Our share holdings themselves are characterised by low financial leverage and typically our holdings are not at peak margins, are favoured by structural growth drivers and have valuations that are sensible. Importantly, although market valuations are generally high, we are able to identify pools of opportunity.

Kerr Neilson

Managing Director

5. For those with time and the inclination we can recommend the book "The Black Swan" by Nassim Nicholas Taleb who is an author and mathematical trader with unsettling views about certainty.

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

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from anywhere in Australia or

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

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