

# MLC-Platinum Global Fund

## QUARTERLY REPORT

PERFORMANCE (as at 30 June 2008)

Fund Size: \$1.74 bn	Last Quarter	Last 12 months	5 years (compound pa)	Since Inception (compound pa)
MLC Platinum Global Fund	-7.9%	-18.6%	8.1%	11.7%
Morgan Stanley Capital International All Country World Net Index (A\$)	-6.4%	-19.8%	5.3%	5.9%

Source: MLC Investments Limited and Platinum

As a general statement, we can argue that equity markets are most happy when inflation is around 2%, less than that and we find ourselves in the difficult position recently experienced by Japanese companies; customers are highly sensitive to price increases and it is often better to absorb the pressure of costs than to lose sales from *sticker-shock*. However, as inflation rises to higher levels it **progressively erodes the valuation of equities**. This is so for several reasons, some relate to the availability of credit but of greater importance, is the effect of taxation on illusory profits.

Hence, as concerns about inflation become embedded, the price investors will pay for forward earnings starts to drop.

Should this concern begin to grow, fund managers will start to look for those companies that are relatively protected from inflation. This could lead to defensive, non-capital intensive businesses to be favoured over those which are pure price takers and have a lot of money tied up in plant and working capital. For example, food retailers would look very good versus steel mills, and of course, steel mills are presently the flavour of the month.

Looking slightly further out, we believe we are **at the cross-over point** where behaviour must shift in the West. We anticipate savings to rise at the expense of consumption, and the backlog of investment in public infrastructure plus the need to address alternative energy sources and conservation, to make a positive contribution. At the same time, one can expect the reverse in China and most of Asia, excluding India, where savings need to make way for consumption. China is at the extreme where investment and the trade surplus dwarf the consumer, such that one is inclined to believe there will be some painful adjustments as their appreciating exchange rate takes its toll.

This, along with the previously mentioned concern about inflation may be an important issue when constructing portfolios in the next few years.

In the last three years we have displayed a pattern of being too preemptive in our long and short index positions. Far from being pessimistic, we attempt to identify what is coming up next. This does carry the risk of being too early — you will have read our concerns about credit, the weak US dollar and so on which were relatively slow to arrive and caused us to fail to capture

the opportunities on offer. However, we are now barely exposed to energy and resources, except pulp and paper, and instead, are positioning the portfolio for the inevitable burst of activity in creating alternative fuels and the whole investment program this will entail. Further, we own a group of very stable and well-run companies whose valuations are well below their longer-term averages. This implies either a greater contraction of profitability or that the downturn will be protracted. Going off the valuations of several cyclical sectors, we deduce that a protracted downturn is not a widely held view.

### OUTLOOK

There are plenty of issues for the market to worry about. Consumers everywhere are feeling the pinch of rising costs, principally food in the poorer countries and energy in the richer ones. However, among the richer countries there is also a housing slump, tighter credit and in due course the real prospect of lay-offs. As we have been saying for a while, profits in aggregate will fall as companies face reduced pricing power and higher input costs.

Investors are well aware, however, that the stock market is an anticipatory mechanism and their conundrum is to assess the degree to which current prices already reflect a miserable outlook. Our view is that the magnitude and length of the boom was such that investors are likely to still view the future with a slightly rose-tinted blush. Unlike the tech wreck of 2001, at the peak of this boom there were fewer obvious places to hide because of the convergence of valuations, with the good being cheaper than the bad, but not cheap enough to deal with profit downgrades. This is rapidly changing and those companies with the qualities we sought and highlighted last year, namely having prominent business positions that support pricing power; no or low debt; margins close to trend and valuations that are below their historic average, now represent good absolute value.

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

**132 652** from anywhere in Australia or  
**0061 2 9466 7180** from overseas

**Platinum Asset Management is an Australian based international fund manager.  
For greater insight into our process, please visit our website at [www.platinum.com.au](http://www.platinum.com.au)**

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Markets have been most challenging since evidence of the excesses of the credit cycle first came to light in May 2007. In the most recent quarter there has been a division between those companies that are seen as beneficiaries of continued growth in the developing world (particularly the BRICS – Brazil, Russia, India and China) and those that are on the receiving end of the credit unravelling. In stock market terms it has seen the commodity and resource producers continue to roll while the financials have slumped. This clear distinction was less evident at the country level where the developed and developing markets moved in similar ways. The striking exceptions were Brazil and Russia where energy and resources predominate with companies like Vale, Petrobras and Gazprom soaring, while China and India lost their lustre to tightening credit and inflation pressures. A table of global sector and regional returns are shown below.

While doing slightly better than the index for the year at -19% versus -20%, it should not surprise long-standing investors that our absence from resource companies and our currency allocation were detrimental to performance over the last three months. In hindsight, had we joined the momentum brigade and loudly proclaimed 'stronger

for longer' over this period, we would have been better placed. Alas, this slogan is likely to be tested in coming months but for now it has held the Australian dollar high, and we own few, and reduced the potency of our index shorts. While the underlying stocks in Japan are showing resilience, the currency has sold-off.

### CURRENCIES

While the Yuan has continued its climb, rising by 10% versus the US dollar over the year, the other Asian currencies have lost momentum and those without natural protection against the rising oil price, have started to sag. This was detrimental to our position as we had expected them to move-up with the Yuan. These positions have been cut. Further, the Australian dollar tilted higher as investors paid more heed to revised expectations about our current account deficit, in the light of strong iron ore, coal and natural gas prospects. We ended the quarter with only 7% long the Australian dollar and with most of our physical share holdings being reflected in their underlying currencies. We remain of the view that the US dollar is bottoming—perverse as this may seem but competitiveness and flows are now in the currency's favour.

### MSCI\* WORLD INDEX REGIONAL PERFORMANCE (A\$)

Region	Quarter	1 Year
United Kingdom	-6%	-23%
India	-24%	-23%
Korea	-12%	-23%
US	-7%	-23%
Japan	-3%	-22%
France	-9%	-22%
Germany	-7%	-17%
Australia	-1%	-14%
Hong Kong	-9%	-9%
Emerging Markets	-6%	-8%
Brazil	13%	36%

### MSCI\* WORLD INDEX SECTOR PERFORMANCE (A\$)

Sector	Quarter	1 Year
Financials	-16%	-38%
Consumer Discretionary	-13%	-33%
Industrials	-11%	-22%
Health Care	-5%	-19%
Information Technology	-4%	-19%
Telecommunications	-8%	-18%
Consumer Staples	-11%	-13%
Utilities	-2%	-7%
Materials	4%	4%
Energy	12%	9%

\* Morgan Stanley Capital International  
Source: MSCI



# MLC-Platinum Global Fund Quarterly Report (Continued)

## PORTFOLIO CHANGES

### DISPOSITION OF ASSETS (NET INVESTED POSITION)

Region	Jun 2008	Mar 2008
Europe *	20.9%	18.9%
Japan	20.3%	22.9%
Emerging Markets	19.9%	20.5%
North America *	17.5%	18.3%
Australia *	-1.7%	-1.5%
Cash	23.1%	20.9%

Source: MLC Investments Limited

\* At 30 June 2008, the Fund has a short position in the US against the Russell 2000 Index of 8.3% (31 March 2008: 7.1%); in Australia against the SPI 200 Index of 1.7% (31 March 2008: 1.5%); and in Germany against the Dax of 3.3% (31 March 2008: 3.4%).

Strong relative moves during the quarter gave us the opportunity to rebalance several holdings. In particular we cut back on our positions in the Bank of China, Sony and Bombardier, which rose by 20 to 30%. Further, we consolidated holdings by selling Oracle for more SAP (IT business systems) and Chiyoda for more JGC (constructors of refineries and LNG plants). In other cases we exited companies that have held relatively well but which now are less attractive in a relative sense; Ajinomoto, Yamato and Rohm were used to fund initial stakes in the highly oil-punished segment of airlines and aircraft support. Other activities were to exchange Pfizer for Sanofi-Aventis and to sell the regional banks in Japan for the two largest city banks.

At a time when most banks have been revealed as under-capitalised and having weak deposit bases, one of the world's biggest banks with the opposite problems, is selling at book value. Mitsubishi-UFJ Financial Group has been recapitalised, has a loan to deposit ratio of 75% and for the first time in years, is facing an environment of rising prices and the prospect of repricing and expanding its loan book at relatively low risk. In addition, the completion of its IT integration is anticipated to give rise to substantial cost savings. Should the Japanese public change their stance to equities in the face of a deteriorating environment for bonds, we would get the additional boost from transactional fees and commissions. There is little need to try to pick the bottom of the western financials when this stock is already cheaper by most measures. Sanofi-Aventis is a similarly beaten-up (pharmaceutical) company that is being punished by concerns about the sector's pipeline of new drugs. The way we try to bring order to assessing a company like this, which is trading on under eight times earnings, is to strip-out the relatively safe vaccines business and look at the cash flow that will arise from the rump of the pharmaceutical portfolio. In Sanofi's case

it will generate approximately the company's net capitalisation (some Eu43bn) over the next five years. This implies that the R&D pipeline, which is absorbing Eu4.5bn a year, is apparently almost worthless in the eyes of the market! There are other considerations we have addressed but suffice to say this rating is the epitome of value and neglect.

### MLC PLATINUM GLOBAL FUND – TOP 20 STOCKS

Stock	Industry	Jun 08
Microsoft	Technology	3.5%
Mitsubishi Tokyo Financial	Financial	3.3%
Hutchison Whampoa	Telco/Transport	3.1%
Siemens	Electrical	3.0%
Bombardier	Transport	2.8%
International Paper	Paper	2.5%
Barrick Gold	Gold	2.4%
Samsung Electronics	Electrical	2.2%
Cisco Systems	Technology	2.2%
Johnson & Johnson	Health Care	2.1%
Pernod Ricard	Beverage	1.9%
Denso Corp	Auto	1.9%
JGC Corp	Construction	1.9%
SAP	Technology	1.8%
Henderson Land Dev	Property	1.8%
Sanofi-Aventis	Health Care	1.7%
Toyota Industries Corp	Auto	1.7%
BMW	Auto	1.7%
Bangkok Bank	Financial	1.6%
Schneider Electric	Electrical	1.6%

Source: Platinum

### COMMENTARY

As we address the market each day we are exposed to a continual barrage of news and information. On the one hand, one seeks to make independent observations but because we are part of the process and can seldom have full knowledge, we are also guided by the intensity of the market's response to these cacophonous bursts. It is like watching a giant Catherine wheel. We tend to focus on the current hot topic which for the moment is say oil, having previously been agricultural prices, credit default swaps and bank solvency. At any one time there is a *new focus*; with others coming into sight

and as the wheel rotates, *others burning out*. As each new topic comes into focus, we look at the linkages as to how they may affect our portfolio. It is a **constant balancing act**; how much attention should be paid to the present and when does one change one's focus to the next important emerging theme and de-weight the current obsession?

Surely many fund managers would today be concerned about whether they have '*enough exposure to oil plays*'. The trouble here is that oil has doubled in the last 12 months. We in fact first wrote about the impending boom in the oil price in June 2003 (<http://www.platinum.com.au/images/drops.pdf>) so it is not news but nevertheless if one were a momentum fund manager, this would bear heavily on one's behaviour. The skill we require is to correctly gauge the tone of the market as we buy or sell shares that we favour, and yet neither be too anticipatory nor too reactionary.

At present, the market's focus seems to be on:

#### Growth

Developed economies slowing to a snail's pace; developing markets continue to grow but are threatened by rising inflation and in some cases, the contradiction of 'managed' currencies.

#### Inflation

The deflationary pulse from China/Asia is reversing and there are adverse surprises regarding input costs and in the movements of wages in Asia/Russia and other developing regions. Agricultural prices may ease but on account of the fundamental repricing of energy, it is unlikely that they will fall back below the current trading range. Energy prices should stay elevated as demand destruction in developed countries (eg. dramatic shifts to public transport and other measures) is being offset by developing world growth. There is very little tolerance in global supply to cope with incidents such as the Japanese nuclear generator fleet being taken offline, causing extra demand for oil (350,000 barrels per day).

#### Profits

Forward earnings are likely to sag in the face of weaker demand and strong cost pressures.

#### Credit

Banks are being recapitalised but the magnitude of the write-offs are causing boards to tighten credit standards and we can expect regulatory oversight to stiffen. Re-intermediation will continue and securitisations will be much rarer.

#### What is coming into view?

Accelerating inflation partly rests on the effects of currency intervention and the consequent massive build-up of foreign exchange reserves in Asia, Russia and the Middle East. Some of this has been sterilised by way of the issue of domestic bonds, but not in sufficient quantities to fully offset the expansionary effect on money supply. **Currency intervention** will be a hot topic. Note that in China, for example, the government still sets both the maximum rate on deposits and the minimum rate at which money can be lent. This has allowed the banks to recapitalise themselves and now, via special reserve requirements, these set rates are throttling the banks ability to lend (the credit multiplier has shrunk to about 5.5 times).

**Subsidies** are also likely to receive more press. These are widespread across Asia. Apart from the interest rate subsidy mentioned above, there are the issues of tax rebates (now being phased out in China), subsidised motor fuels, natural gas prices, electricity prices, fertilisers and so on across the developing world. In the case of India, these subsidies are exploding with the rise in the price of hydrocarbons and food, and now at 5% of the economy, threaten the central government's finances.

Just as inflation is starting to really frighten these regimes, with recorded inflation ranging between 7% and 14%, there comes the need to allow the true market price to ration the demand for basic necessities and to allocate resources. This will likely lead to a **change in perception about the risk of emerging markets**. This has already happened emphatically in the case of last year's top favourite, Vietnam. Seen as the next great miracle, that stock market has halved in the face of concerns about inflation (at 25%), the weakening Dong, and the foreign borrowings of some state owned enterprises and banks.

This growing concern about developing markets is likely to re-establish the risk premium at higher levels. As we all know, the attraction of superior growth in these countries had completely changed investors' risk/reward perceptions and many of these markets started to be rated on par with developed markets. Some of this new-found faith was always questionable in the case of several resource-rich countries. It was precisely because of their natural resource wealth that their political regimes were intolerant and stymied the development of strong institutions. The natural extension of this is the emerging trend towards resource nationalism — hardly reassuring to owners of capital.

There is also likely to be more attention to **corporate earnings**. Broker analysts have still barely revised their earnings estimates for next year. The majority of fund managers do not believe the analyst consensus of low teens earnings growth (going by the buy-side surveys) but there is still the glimmer of hope that things will improve in the second half — incidentally we're here now and it doesn't look great.