

# MLC-Platinum Global Fund

## QUARTERLY INVESTMENT MANAGER'S REPORT

### PERFORMANCE (as at 30 June 2012)

Fund Size: \$918 mn	Last Quarter	Last 12 months	5 years (compound pa)	Since Inception (compound pa)
MLC Platinum Global Fund	-8.5%	-7.5%	-1.9%	9.6%
Morgan Stanley Capital International All Country World Net Index (A\$)	-4.6%	-2.3%	-6.3%	3.9%

Source: MLC Investments Limited and Platinum

The last 12 months reveal a dispersion of outcomes for the Fund that are quite different from those that one may have expected. The first part of the puzzle was to accept that Quantitative Easing (QE) would buoy asset prices even if one held reservations about its longer term efficacy. We unfortunately chose to believe that QE, and deep suppression of interest rates, has limited long-term benefits for real asset values and hence have had too little exposure to US based equities. Importantly, it was the US and the UK markets which adopted QE with alacrity that have performed positively. Of necessity, this meant that we had large exposures to other markets; nearly all of which fell, in some cases by up to 23% in A\$ terms.

### MSCI\* WORLD INDEX REGIONAL PERFORMANCE (AUD)

Region	1 year	2 year compound pa
France	-23%	-7%
India	-22%	-19%
Germany	-21%	-4%
<b>Europe</b>	<b>-13%</b>	<b>-3%</b>
China	-12%	-12%
<b>Emerging Markets</b>	<b>-12%</b>	<b>-6%</b>
Korea	-11%	0%
Asia ex Japan	-10%	-5%
Australia	-7%	1%
Hong Kong	-4%	-2%
<b>Japan</b>	<b>-3%</b>	<b>-7%</b>
<b>Developed Markets</b>	<b>-1%</b>	<b>1%</b>
United Kingdom	0%	3%
<b>United States</b>	<b>9%</b>	<b>6%</b>

\* Morgan Stanley Capital International  
Source: MSCI

Remarkably, in markets where one would have intuitively believed we would have lost a lot of money, namely Japan and Europe, we outperformed handsomely though still recorded negative returns.

With our large exposure to Asia, China and India were costly while we made strong positive returns in Thailand, Korea and Singapore.

On currency, there were small losses primarily on the Euro and Asian currencies.

We would be the first to argue that our principal criterion is to pick companies and to down play the geographic location of the head office but the above analysis may help to frame a 'relative performance' picture for you. In addition, as we have acknowledged before, we have made errors in stock selection, particularly the timing of entry. We calculate that this difference between good value and what we paid was perhaps 3% of the portfolio.

Looking at the performance from a sector perspective, we observe that losses were inflicted by our exposure to materials and notably, gold miners. Also, industrials, materials and consumer durables performed poorly, yet we did well in financials and information technology.

The weakness in the large gold miners stemmed from rapidly escalating costs and hence they experienced disappointing profits in the face of a booming metal price. This outcome is particularly disappointing given our relatively clear understanding of the need to avoid the resources sector and yet we continue to hold the view that gold is in a bull market.

### CURRENCY

At quarter's end, the currency exposure of the Fund was as follows: US dollar and Hong Kong dollar 55%, Asian currencies ex Hong Kong dollar 12%, other European currencies 11%, Euro 10%, Canadian dollar 7% and the Australian dollar 3%.

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## CHANGES TO THE PORTFOLIO

### DISPOSITION OF ASSETS (NET INVESTED POSITION)

Region	Jun 12	Mar 12
Europe	31.1%	29.8%
North America*	23.4%	23.6%
Asia and Other	16.4%	14.9%
Japan	15.8%	16.6%
Australia	1.0%	1.1%
Cash	12.3%	14.0%

Source: MLC Investments Limited

\*At 30 June 2012, the Fund had a short position in the US against the Russell 2000 Index of 5.7% (31 March 2012: 3.9% and Nasdaq Index of 0.5%).

It is a dangerous market to describe in sweeping generalisation and according to our quantitative work, Price Earnings (P/E) compression *prima facie* remains high. However, when segmenting the markets between idealised categories like **price makers** and **price takers**<sup>1</sup> we see some interesting features. The former has achieved steady margins and relatively stable sales growth over the last 20 years while the price takers have been more effervescent on both these counts. When adjusting for a partial return to the profit margin levels of earlier years, and by projecting flat revenues, the attraction of price takers is much diminished. Despite this, we believe there are exceptions across the portfolio where supposed price takers, which are often cyclical in nature, offer great value. Oil producer, **Nexen** is such an example; currently valued at \$5 per proved barrel of reserve and \$1 per barrel of resource, with the prospect of solid production gains over the next several years. Others, that one would conventionally describe as having a stronger influence over its pricing such as healthcare company **Qiagen** (described later), is attractive because of transient uncertainties. Hence, rather than getting caught-up in the cyclical versus defensive debate, we are more concerned about the characteristics of the underlying franchise, whether the company is likely to be stronger or weaker in five years' time and whether these factors are reflected in the price we are currently paying

In terms of changes to the portfolio, we have taken advantage of the market sell-off to add to our most prospective investments including **Microsoft**, **Google**, **Ericsson**, **Vodafone**, **Qiagen**, **Bank of America** and our North American energy focused engineering companies – the latter three having sold-off hard. These acquisitions were funded from cash and the sales of TNT (subject to takeover offer) and Yahoo! (subject to an asset restructuring saga). We also sold down our holding in auto components company **Denso** to fund a larger holding in **Toyota Motor** as we believe the latter

will surprise with its new product roll-out and hopefully benefit from greater non-Japanese production costs.

The case for **Vodafone** was enunciated in some detail in the September 2010 quarterly report. In many markets, the decay in incumbent voice charges has run its course and the disruptive new entrants that survived under this profit umbrella are now finding it difficult to sustain discount strategies. As data traffic explodes, in consolidated markets such as the US, the gradual move towards usage- or speed-based data charging continues with little resistance from customers who seem increasingly addicted to their mobile devices. It will be interesting to see whether the proliferation of smartphones also tilts the bargaining power away from the likes of Apple. Vodafone derives more than 50% of profits from such markets (the Verizon US joint venture now represents 50% of profits). Available on a P/E of 11x and dividend yield of 7%, we think this utility-like earnings stream with some growth is undervalued.

**Qiagen** is a global leader in molecular diagnostics (MDx) having developed automated testing platforms. Qiagen's machines run a growing range of tests on genomic material that is taken from blood or tissue samples – the frontier of medical testing. The largest market for this platform is hospitals, reference and pathology labs, representing just under 50% of sales. Importantly, whilst Qiagen has put in place over 450 major testing machines (costing >\$100,000 each), 85% of revenues are derived from consumables that have an annuity-like characteristic. MDx at Qiagen cater to the prevention of disease such as cervical cancer by testing for the Human papillomavirus (HPV, 18% of total sales). The tests can profile a patient or tumour to identify the likely efficacy of certain drugs.

Whilst the entire MDx business is deemed to be high growth, personalised medicine, currently accounts for only 8% of Qiagen's sales, is likely to experience the highest growth rate. As the major drug companies increasingly launch targeted drugs, they must work very closely with MDx companies such as Qiagen to develop tests necessary to target these expensive treatments to the appropriate patients. This is the medicine of the future and whilst **Roche** (another investment we hold) has a good position here with its own in-house MDx business, Qiagen is a major non-aligned provider of this service.

<sup>1</sup> Price makers are those companies which have a degree of freedom to set prices i.e. companies that provide unique products and services such as drug makers, strong consumer brands, both durable and consumable, as well as some IT companies. By contrast, price takers, the vast majority, the price is dictated entirely by market forces (miners, energy producers, pulp and paper makers, financials and some industrials).

# Quarterly Report (Continued)

Last year, Qiagen's performance was disappointing, due to stagnant volumes in the MDx business as patients delayed doctor visits with the consequent effect on pathology test volumes. We judge these to be temporary woes and that growth will resume with the recovery of HPV tests; the continued rollout of new tests and high volume automated testing platforms and lastly, the expansion of the tuberculosis tests that Qiagen acquired recently.

Last year's disappointment provided us an opportunity to buy into the company on a P/E of around 14x, a significant discount to intrinsic value for this above average growth annuity-like cash-flow.

## COMMENTARY

We understand the markets current concerns extremely well as it goes to the core of Platinum's investment philosophy; that humans tend to be hardwired towards over-weighting the recent experience. When there seems to be no let-up in the stream of bad news, most of us tend to seek refuge in a more comfortable environment. For the moment that is cash.

Ironically of course, it is this very high level of uncertainty that gives rise to interesting investment opportunities. The great diversity of choices that is thrown-up by economic turmoil is accompanied by a battery of indicators which points to extreme anxiety, with some of these indicators close to panic levels. These extreme readings have historically been associated with market lows. However, even as some progress is made in Europe regarding closer integration with a path to a unified banking regulator, fiscal unity and some funds being made available to augment growth, most believe that there will follow a protracted period of uncertainty and weak economic performance for a region that comprises close to a half billion people. By contrast, America seems much more prospective because it has been able to generate growth with the attendant benefits to confidence. Lurking in the distance though is the threat of the so-called 'fiscal cliff' which under the new administration will have to be addressed almost immediately after inauguration. Depending on the outcome of the presidential election, one can barely believe that America too will not face somewhat softer economic conditions as the government deals with its huge spending deficit.

The case could be made that in an uncertain environment one should **concentrate the portfolio** in a small set of companies that have demonstrable virtues of low financial leverage, high persistence of growth and profitability, and broad economic diversity etc. While the portfolio does have many companies of this description, we are always searching for the less obvious opportunity where there is a large discrepancy

between perceived value and the current market price. Bear in mind that our investment philosophy rests on finding neglect. Invariably those companies which are most favoured at present are those that feel the safest and have long histories of persistent growth.

Yet even among this group of solid corporations one can observe disappointments affecting their share prices. In some cases it is because they have been raising their prices persistently faster than inflation or because they are starting to lose leadership in their markets because of the activities of emerging competitors. Recent announcements by Procter and Gamble (P&G), Danone, Yum Brands, Nike and others have brought into question the robustness of earnings growth and the price investors should be willing to pay.

P&G remains a formidable company and yet years of carefully managing their consumers up the product and price ladder has left them vulnerable to competitors. P&G have highlighted several categories where they have used innovation to increase the spending by consumers. Razors, where the price has been built through multi-blade or battery assisted offerings from the humble twin blade. Laundry detergents, nappies, household products have all been developed to the point where once profligate consumers are questioning whether the utility of the innovation is worth the price premium.

In the US tracked channels, P&G's prices exceed their branded competitors by an average of more than 40% and higher in categories such as laundry. Compared to private label products P&G is, on average, some 80% more expensive. These price umbrellas haven't deterred P&G from continuing to enhance their revenue with yet more price increases. In just the last year, P&G added an incremental \$3.5 billion from price increases. Acknowledging that there is need to address the difficult and competitive circumstances, P&G have allocated \$200 million to reduce prices?! Who will notice?

It is quite a different matter to use price to ration a resource that is hard to replicate, such as aged Cognac, where it's near impossible for new competitors to source product laid down over decades and the creation of a new competitive brand is a remote possibility.

Yoghurt though is an entirely different proposition. Danone has built an impressive international yoghurt business with attractive growth and margins. This has not gone unnoticed, with Pepsi and General Mills making acquisitions to build their dairy capabilities. Surprisingly though, it hasn't been a powerful multi-national that has exposed the corporate complacency of the yoghurt segment. All it took was an individual with an idea.

Three years ago Greek Yoghurt made up just 3% of the \$6 billion US yoghurt market, now it's approaching 30%. Turkish immigrant Mr Ulukaya, with his Greek Yoghurt brand Chobani, is credited with the success of this segment, and that is without the benefit of a major multi-nationals prowess in marketing or distribution. Chobani retains more than half this market compared to market shares of 15% for Danone and 5% for General Mills. Kraft discontinued their Athenos branded product earlier this year.

The belief in earnings growth from consumer multi-nationals appears intact with analysts and market participants isolating each shortfall as specific only to that company. We remain concerned that years of marginal innovation, packaging changes to disguise price rises and a relentless focus on expanding margins, have left many of these companies unduly exposed to competition for today's more value conscious consumers.

With this in mind, we are not readily seduced by the idea that somehow one will perform better by hiding in supposed predictable companies. What we see clearly is that uncertainty is being punished and perceived excellence has been rewarded; not to the degree that is totally unacceptable but it is evident that companies that face uncertainties are already trading at valuations that reflect expectations of deteriorating profits.

## OUTLOOK

There is no doubt that the world economic order is in deep turmoil. Most developed countries are invariably burdened with too much debt, while emerging countries face problems of restructuring their economies to correct the biases that have built-up over the last decade or so. After experiencing a long period of upward revisions to earnings, investors will now probably experience a period of under-achievement in terms of company's earnings reports.

All is not lost, however, because in its inimitable way, the market has already built in a degree of caution in the valuations of companies that face cyclical headwinds. Our challenge is to manage the portfolio through this uncertain time without allowing fear to drive us to myopic behaviour which would discourage us from owning sound companies which have already been priced for a poor short-term outcome.

If we were to categorise the portfolio in terms of **price makers and strong growers** this would account for perhaps 44% of our holdings, (and incidentally these categorisations change with time), another 39% could be classified as price takers and a further 10% are held in financials. Cash accounts for the balance of 7% (long invested position). In this uncertain environment we would expect there to be a continual oscillation of market interest between these so-called price maker and price taker categories.

Kerr Neilson  
Managing Director

**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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