

MLC-Platinum Global Fund

QUARTERLY REPORT

PERFORMANCE

| Fund Size: \$2.6 bn | Last Quarter | Last 12 months | 5 years (compound pa) | Since Inception (compound pa) |
|--|--------------|----------------|--------------------------|----------------------------------|
| MLC-Platinum Global Fund | -0.6% | 4.7% | 14.4% | 14.1% |
| Morgan Stanley Capital International All Country World Net Index (A\$) | -0.8% | 4.6% | 9.3% | 7.9% |

Source: MLC Investments Limited and Platinum

As you will see from the body of this report, the trend of world stock markets has been set by the conviction that the world is "growing stronger for longer". Years of underinvestment by many processed commodity industries, ranging from mining to refining has resulted in dramatic price rises, a resulting surge in profitability and explosive gains in their share prices. Australia, with its abundant natural resource base has been a prime beneficiary of this trend as it enjoys its fifteenth year of uninterrupted growth.

We have been inadequately positioned for this trend even though we were early to recognise the significance of China and India in terms of the physical off-take of commodities they lacked. This view found expression in holdings such as MIMS and Noranda. We then moved too aggressively into the one laggard in the piece, Japan, with the logic that growth would be good for one of the world's leading exporters. However, *ideal* positioning called for maximum exposure to highly cyclical companies and financials, with the currency exposure being hedged fully into commodity rich currencies. We were not so positioned.

DISPOSITION OF ASSETS (NET INVESTED POSITION)

| Region | Sept 2007 | Jun 2007 |
|--|-----------|----------|
| North America* | 23.9% | 23.9% |
| Japan | 23.4% | 26.1% |
| Other* (emerging markets eg. Korea) | 18.8% | 17.7% |
| Western Europe* | 15.4% | 18.1% |
| Australia* | -2.6% | -2.7% |
| Cash | 21.1% | 16.9% |

Source: MLC Investments Limited

* At 30 September 2007, the Fund has a short position in the US against the Russell 2000 Index of 4.3% (30 June 2007: 3.5%); in Australia against the SPI 200 Index of 2.6% (30 June 2007: 2.7%); in Germany against the Dax of 2.1% (30 June 2007: 2.8%) and in Korea against the Kospi of 1.6% (30 June 2007: 1.8%).

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MSCI* WORLD INDEX COUNTRY PERFORMANCE (AUD)

| Region | Quarter | 1 Year |
|-----------|---------|--------|
| Hong Kong | 19% | 27% |
| Brazil | 16% | 66% |
| India | 15% | 38% |
| Korea | 9% | 22% |
| Australia | 7% | 31% |
| Germany | -1% | 24% |
| US | -2% | -2% |
| UK | -4% | 3% |
| France | -5% | 5% |
| Japan | -5% | -10% |

* Morgan Stanley Capital International

Source: MSCI

For those of us trying to read the tone of the market, the surprise has been the relatively mild sell-off of equities in the face of a clear “market failure” in the credit markets. Skyrocketing share prices since the Fed cut short-term rates, by a surprising fifty basis points, simply reinforce the bullish sentiment of the day.

For the quarter, our cautious positioning has barely helped our performance. Even as the markets recovered, the Australian dollar acted like a lead weight on our recovery just as its weakness had shielded the down-draught. The short sales helped with some profits being taken but some of this was undone as the markets quickly resumed their uptrend within days. This has left us feeling most frustrated and ever more eager to remove our protective strategy, relegating it to the “bad-idea bin” of portfolio management.

For the quarter and 12 months we fractionally outperformed the MSCI All Country World Index. The five year and longer numbers are still very respectable.

CURRENCIES

We presently have virtually no US dollar exposure. We are 29% long the Australian dollar, 24% long the Japanese yen, 22% long the European currencies and the balance remaining in underlying Asian currencies.

By way of background, **there follows a brief description of the market’s recent travails.**

Just as all is progressing smoothly, along comes a surprise. On this occasion it was ostensibly related to sub-prime lending. Regular readers would have anticipated such an outcome having been exposed to a high dosage of disapprobation about easy lending and cheap money which would leave lenders unrequited for the risks they had run. However, it was unsettling to find that supposedly deep markets could freeze almost overnight.

The **common belief had been that securitisation dispersed the risk among many.**

This contrasted with earlier times where problems from careless lending would emerge in the banking system, eventuating in a subsequent rationing of credit and withdrawal of lines in the face of credit losses and equity write-offs. This most recent episode of securitisation not only segregated originators from eventual owners but co-mingled and geared the resulting collateralised debt obligations, CDOs,* the value of which was consequently magnified by this leverage, both up and down. When trouble struck, those trading in these markets became uncertain as to the inherent value of their paper and this resulted in sharp and often unpalatable markdowns. At these prices, most lacked the will to transact. Simultaneously, several leading banks were discovered to have established off-balance sheet entities that were also heavily geared. Fortunately the central banks were able to tide over most of those institutions caught with long-term lending obligations funded with short-term money but not before we were all reminded again of the risks of high leverage.

Gradually the freeze has thawed and as we end the quarter many of the signs of stress have diminished and it is almost back to business as usual. Well, not quite, the leveraged buy-out brigade aka private equity is in some instances reneging on their deals or at least attempting to renegotiate their terms. The banks are trying to extricate themselves from some of their more extravagant commitments and are landed with contingent liabilities that they never envisaged would be called upon. They are still reluctant to lend to “nobodies” and even among themselves there is a clear divide between big and small institutions, with poorly funded long-term lenders such as RAMS or Northern Rock needing to find new owners as losses have impaired their solvency. (The global write downs by

Quarterly Report (Continued)

the banks alone will run to many billions. Also, as these special off-balance sheet vehicles are brought back on balance sheet, capital constraints could lead to equity raisings.)

* For more coverage on this topic, please see the John Hempton article on Platinum's website at the following link: <http://www.platinum.com.au/images/us-finance.pdf>

COMMENTARY

The key ideas one needed to have grasped immediately after the Internet bubble in 2001 were that:

1. the **Federal Reserve Board would act vigorously to support economic activity** in the face of weakening activity (even if Japan has shown that force-feeding credit is no use if people do not wish to borrow or lend);
2. the world would continue to experience a **different type of cycle to anything seen since the 1950s**; and
3. the trade-threatening mercantilist policies being followed in Asia would be **accommodated by the recycling of surpluses** back into the assets of the deficit nations and importantly this would maintain order in the currency markets.

Economic history reveals many events that are completely paradigm changing. On this occasion it is the **entry of say, one third or one fourth of humanity onto the world capitalist stage**. This (in simple terms) is suppressing the cost of labour and transferring jobs dependent on traded goods and some services to these lower cost

centres. This in turn is bolstering the profit share of capital in general - hence the super rents we have highlighted in past quarterlies. It is also disproportionately rewarding the nations and owners of the resources who in the past had neglected investment in the face of weak commodity prices. Until these bottlenecks are alleviated, through supply responses or substitution, these heightened rewards will accrue. This in turn has positive implications for resource-backed currencies and negative implications for chronic borrowers.

To date we have mistakenly fretted about the durability of the recycling process, fearing that credit defaults and/or chronic weakness in the US dollar that would create circumstances beyond the control of the central banks. We coincidentally underestimated the willingness of some Western consumers to borrow. Having taken this stance, one was then set on a path of unrewarded caution.

Where does this leave us now? As we noted in July, the outcome from these trade driven (mercantilist) policies is a **wall of liquidity which will find expression in asset prices at the source of these imbalances**. Early and aggressive cuts by the Fed may have the appearance of bailing out the system but we suspect they **simply raise the tempo of the asset chase**.

There are, however, some warning signs that the enthusiastic lending practices of the last several years have left an indelible mark. Firstly, the gold price has begun to move to yet higher ground even when

expressed in strong currencies such as the euro. Secondly, the Chinese buyers of longer dated US Government paper have been absent from the market since the May auction. This incidentally set-off a complicated rebalancing of duration by funds and institutions that in turn unleashed the sub-prime cascade.

Importantly, the recycling process that is at the heart of the equilibrating act, which compensates for trading imbalances continues. Those creditor countries attempting to manage their currencies' exchange rates are now recycling to the short-end of the yield curve and perhaps into real assets.

Thirdly, high growth markets or those with a surfeit of internal savings have moved to new highs while most of those dependent on foreign savings are still below their earlier peaks. There has clearly been a change of mood but mostly at the extremes. Those with strong internal drivers continue to flourish and those with weaker fundamentals may be losing momentum.

Domestic inflation of asset and other prices potentially threaten the *status quo*. Food inflation has more to do with a global repricing of resources - see previous commentary on our agricultural theme. To dampen down asset speculation, the Chinese authorities have also been proactively introducing selective measures. As we noted last quarter, the Taiwanese tried virtually everything to control asset prices post their currency float but the pressure was inexorably upwards. An important measure to watch is

the *rate of change* of urbanisation in China: this would forewarn of any tightening in labour supply and potential wage inflation. For the moment though, all the indicators point to the growing intensity of speculation in China and increasingly, in neighbouring countries and further abroad.

CONCLUSION

This period is somewhat reminiscent of the tech bubble where in the latter days we gradually shifted away from trendy areas to find refuge in non-tech “boring” companies. Today, there is not as wide a valuation gap between hot and cold. The areas of relative safety are the non-levered, non-resource, large capitalisation global companies which display modest operational leverage. Many have records of years of uninterrupted growth and yet have been partly overlooked by investors as they focused on buy-out candidates or simply

believe the commodity boom is too compelling to be distracted with other notions. That is not to say we cannot find a large number of interesting investments in Asia which on account of their perceived peripheral participation are still modestly valued. We are therefore **managing a barbell strategy**. This can be characterised as participating at the margin of the asset bubble centred in Asia and offsetting this with a large helping of quality globally dominant players which are trading at below trend valuations. If growth continues to be strong we will enjoy the slip stream and if it turns out to be weaker, we should avoid the nasty surprises.

We have reduced the short positions, hold some cash and do not wish to be too exposed to the currencies of those nations dependent on others’ largesse.

We believe our long duration themes such as data mobility, infrastructural deficiency, the pulp

and agriculture commodity cycle etc, are well on track. That most of these companies have virtually no debt is an important consideration as is our very limited exposure to financial companies and the Western consumer. While Japan is now perceived as a relic of an earlier industrial age, our exposure there has many companies that are participating in the current boom of world growth but without the financial risk. **Moreover, like other large capitalisation companies they may attract the interest of Sovereign funds who are now looking to invest in real assets, as opposed to nominal claims ie. bonds and bills.**

As we rue our earlier caution, we cannot for the moment identify factors that will dislodge the drivers behind the current upward trend in most equity markets. We have accordingly adjusted to a more optimistic investment stance.

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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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**

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