

MLC-Platinum Global Fund

QUARTERLY INVESTMENT MANAGER'S REPORT

PERFORMANCE

Fund Size: \$924.7m	Last quarter	Last 12 months	5 years (compound pa)	Since inception (compound pa)
MLC-Platinum Global Fund	-0.3%	5.9%	10.6%	11.1%
MSCI All Country World Net Index (A\$)	6.5%	19.0%	14.4%	7.2%

Fund returns are after fees and expenses. Portfolio inception date: 30 June 1994

Source: MLC Investments Limited and Platinum Investment Management Limited for fund returns, and FactSet for MSCI index returns.

Past performance is not indicative of future performance. The value of an investment may rise or fall with changes in the market.

The Fund returned 5.9% for the past year with a loss of 0.3% over the last quarter. These returns lagged significantly behind broad market returns, with global markets¹ up 19.0% and 6.5% over these respective periods.

In our Macro Overview this quarter, we highlight how concerns around a potential slowdown in China, exacerbated by a trade war with the US and rising US interest rates, have led to greater risk aversion among investors. Specifically, this has meant avoiding companies that face any degree of uncertainty, particularly those that are seen as being potentially impacted by these issues. Instead, high growth companies that are considered relatively immune from these external factors are preferred. The result has been very strong stock price performance over the last six months from high growth sectors such as software, internet and biotech, while companies perceived to be more cyclical have lagged or been sold down. The exception to this was the energy sector where rising oil prices have driven strong stock price performance. Please refer to the Macro Overview on page 4 for a more in-depth discussion of trade and other macro issues.

Over the last quarter, the trends observed above have been clearly demonstrated by the stocks that contributed to, and those that detracted from, the Fund's performance. Among the strongest contributors were Alphabet (+7%) and Schibsted (+23%), a Norwegian company with strong positions in online classifieds in a number of markets. Pharmaceutical companies Roche (+8%) and Sanofi (+12%) were also solid contributors to performance, along with our Indian banks ICICI (+11%) and Axis Bank (+20%). Major detractors from performance included our metal stocks, including Glencore (-6%) and Sumitomo Metal Mining (-6%). Other poor performers included Chinese internet company Sina (-18%) and Chinese liquor producer Jiangsu Yanghe Brewery (-3%).

The Fund's lagging performance is largely the result of a far greater weighting, relative to the MSCI All Country World Index, in those areas that have performed poorly over the last six to 12 months. **Clearly, for the present, we are well and truly out of step with the market in terms of where we believe the attractive investments are in the current environment.**

PORTFOLIO REVIEW AND COMMENTARY

When a stock in our portfolio performs poorly, it is imperative that we review the case for holding the investment. There are, of course, times when we have made mistakes in our analysis. On other occasions, the unfolding of our investment case may simply be taking longer than expected. When we invest in any given company, we have expectations on what its business will produce over the coming five years and beyond with respect to sales and profits, and we track its progress against these metrics. We look for outcomes that are broadly in line with the estimates underlying our investment case.

Over the last six months, the businesses of our portfolio companies have by and large performed as expected, even though some of their share prices have not. The result is that today many of our portfolio holdings represent, in our view, extraordinary value. The remainder of this report will discuss a number of the Fund's major holdings that have had particularly weak share price performance over the last six to 12 months.

¹ MSCI All Country World Net Index (A\$)

DISPOSITION OF FUND ASSETS (NET INVESTED POSITIONS)[^]

Region	30 Sep 2018	30 Jun 2018
Asia	34.3%	34.4%
Europe	19.6%	21.7%
North America*	14.9%	5.3%
Japan	10.5%	16.4%
Cash	20.6%	22.2%

[^] The table shows the Fund's effective net exposures to the relevant regions as a percentage of the Fund's net asset value, taking into account direct stock holdings and both long and short derivative positions. Numerical figures are subject to rounding adjustments.

* At 30 September 2018, in the US market the Fund had a -4.7% short position against the S&P 500 Index (-10.9% at 30 June 2018) and a -2.2% short position against the Russell 2000 Index (-4.0% at 30 June 2018).

Source: Platinum Investment Management Limited

NET SECTOR EXPOSURES[^]

Sector	30 Sep 2018	30 Jun 2018
Info Technology	24.3%	26.2%
Financials	13.4%	11.0%
Industrials	12.1%	12.5%
Materials	9.3%	9.4%
Energy	7.3%	8.6%
Health Care	6.4%	8.0%
Con Discretionary	5.6%	8.5%
Consumer Staples	3.7%	3.8%
Real Estate	1.9%	1.8%
Telecom Services	1.6%	1.8%
Utilities	0.8%	1.1%
Other*	-7.0%	-14.9%
Total Net Exposure	79.4%	77.8%

[^] The table shows the Fund's effective net exposures to the relevant sectors as a percentage of the Fund's net asset value, taking into account direct stock holdings and both long and short derivative positions. Numerical figures are subject to rounding adjustments.

* Includes index short positions.

Source: Platinum Investment Management Limited

TOP 10 HOLDINGS[^]

Company	Country	Industry	Weight
Alphabet Inc	USA	IT	3.7%
Samsung Electronics	Korea	IT	3.4%
Siemens AG	Germany	Industrials	3.2%
Ping An Insurance	China	Financials	2.9%
Intel Corporation	USA	IT	2.8%
TechnipFMC	UK	Energy	2.6%
Glencore PLC	Switzerland	Materials	2.5%
Schibsted ASA	Norway	Con Discretionary	2.4%
Jiangsu Yanghe Brewery	China	Consumer Staples	2.3%
Lixil Group	Japan	Industrials	2.3%

[^] As at 30 September 2018. The table shows the Fund's top 10 long stock positions as a percentage of the Fund's net asset value, taking into account direct stock holdings and long derivative positions.

Source: Platinum Investment Management Limited.

Samsung Electronics is a long-term investment of the Fund, and has produced good returns over the life of our investment. However, over the last 12 months, the stock price has declined 18% while earnings are expected to rise around 18% in 2018. The stock trades on a price-to-earnings (P/E) ratio of 6.5 times expected earnings² and a dividend yield of 3%. The valuation appears even more attractive when one considers that the company's cash holdings are equal to almost 20% of its market capitalisation. While Samsung is known by many for its mobile phones, TVs and appliances, its most profitable division is its semiconductor business, which today accounts for around two-thirds of its profits. Key to this division are its memory chips, DRAM and NAND (or flash memory) which are integral components in our phones, PCs and servers. The memory chip business through time has produced highly volatile profits, but in recent years the rising technical challenge of squeezing more and more transistors onto each silicon wafer has resulted in the industry consolidating to three or four key players, with Samsung the technology and cost leader in both DRAM and NAND chips. The industry will no doubt remain cyclical, and indeed in recent months the prices of DRAM and NAND have been falling. However, even though earnings may fall in the years ahead, we do not expect these down cycles to be as dramatic as they have been in the past. As such, today's stock price, in our view, represents a very attractive entry level.

The Fund has a number of investments in mining companies, notably with exposure to **copper and nickel**. For these metals, the glory days were during the Chinese investment boom, with prices hitting their peaks in 2010-11. These extraordinary prices encouraged new mines to be opened and a period of oversupply subsequently resulted in high inventory levels and prices falling below cash costs. Recently, a tighter supply-demand situation has seen these inventories draw down and prices broadly recover. Our expectation is that this improved situation will continue to hold and may indeed improve further as the ongoing roll-out of electric vehicles in Europe and China accelerates from 2020 onwards. However, over the last six months the prices of copper and nickel both fell over 20% from their recent highs as a result of concerns that China's economy was slowing down. But despite this sell-off in the commodity prices, inventories have continued to fall, indicating that demand remains firm in spite of fears in financial markets.

Unsurprisingly, the stock prices of our mining holdings were impacted. **Glencore** has seen its stock fall by more than 20% from its recent peaks in response to lower copper and zinc prices. However, the prices for coal, which is also a major contributor to Glencore's earnings, have been strong, and around 30% of the company's earnings come from its

² We usually prefer to look at the earnings yield of a company, which is the inverse of the price-to-earnings ratio. In this case, a P/E ratio of 6.5 times becomes an earnings yield of 15% p.a. In simple terms, we can consider this the starting yield on our investment even though over time a company's earnings can vary greatly. For a more in-depth discussion on this topic, please refer to our article "**Why Indices Lead Investors Astray**", available on our website at www.platinum.com.au/Why-Indices-Lead-Investors-Astray.

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trading business which has relatively stable earnings. Today, the stock trades at 8.8 times estimate 2018 earnings, and the company has a production profile that is expected to see significant increases in copper and cobalt production volumes over the next three years. Admittedly, there are additional complications with this company, which operates in challenging political environments and faces an ongoing US Department of Justice investigation. Nevertheless, we think Glencore's current stock price, as well as that of a number of the other mining companies in the portfolio, imply highly attractive prospective returns based simply on the future cash flows that will be produced with commodities trading at sensible clearing levels. We did not purchase these stocks on the assumption of a bull market in commodity prices.

Ping An Insurance is China's leading insurance business, with strong positions in life and general insurance. The group has grown profits at around 20% per annum for the last 10 years. The company has also been a leader in the application of technology (for example, using artificial intelligence in claims assessment for smash repairs) and is considered one of China's leading players in fintech. The company also owns a majority stake in Ping An Bank, which is focused predominantly on small-to-medium-sized enterprise (SME) and consumer lending. The Fund has held an investment in Ping An for a number of years and has enjoyed good returns. Over the last 12 months, the company's A-share³ is up 26%, though it is down 12% from the highs reached in January this year. Today, Ping An's shares are trading on a P/E multiple of 12 times estimate 2018 earnings.

Facebook is a relatively new entrant to the portfolio, bought when the stock sold off following reports that Cambridge Analytica had used Facebook user data to influence elections. Expectations for the company's profit growth have been significantly reduced as the company has increased spending to improve the quality of the content on its platform and deal with issues around "fake news". The stock today trades at levels close to our average entry price and is on a P/E ratio of 22 times estimate 2018 earnings, with short-term expectations of 15% earnings growth. Interestingly, revenues have been growing at a much faster pace, suggesting that there is the potential for a re-acceleration of earnings growth at some point in the future.

It is worth taking a moment to examine the relative merits of each of these investments, as they each have quite different characteristics. Samsung and Glencore are both cyclical and price takers. Ping An Insurance, as a financial entity, operates in a highly regulated and changing environment. And Facebook faces the ever present threat of others trying to steal away the attention of its users. None are perfect, but based on our assessment of their future prospects and today's valuations, we expect each to provide good long-term returns for the Fund.

Each of these companies has performed poorly over the last six months compared with the market. It is instructive to contrast them with two stocks that are much loved by the market, Amazon and Netflix. Both these companies have achieved extraordinary success, growing revenues by 24% p.a. and 26% p.a. respectively over the last five years. Their stock prices have appreciated by 108% and 107% respectively over the last 12 months. Today, Amazon trades on a P/E ratio of 71 times estimate 2018 earnings while Netflix is on 112 times! While using earnings as a metric to assess the value of these companies poses the risk of under-appreciating their potential to become more profitable as their businesses mature, it nevertheless highlights the extraordinarily high levels of expectations investors have for them. In our experience, the lofty valuations of these companies and the enthusiasm shared by many for Amazon and Netflix, contrasted with the pessimism that has been circulating around Samsung, Glencore, Ping An Insurance and Facebook, suggest that the prospective returns from our stocks are far greater, even if their share price performance in recent months has been less than encouraging.

Thus over the last quarter we have continued to re-position the portfolio towards stocks that have sold down in recent months, while trimming our better performing names that have reached their full valuation in our estimation.

Positions that were newly initiated or increased during the quarter include **Intesa Sanpaolo** (one of Italy's leading banks), **ZTO Express** (China's leading e-commerce logistics provider), and **Transocean** (US offshore oil services).

Positions that were exited completely include **Royal Dutch Shell** (oil and gas) and **AstraZeneca** (pharmaceuticals), as each of these stocks has performed well and reached what we estimate to be its full valuation.

OUTLOOK

The Fund's net invested position is now 79%, and the portfolio is, on face value, reasonably conservatively positioned. One might naturally interpret this as an expectation of weaker markets ahead, but in reality this positioning, more than anything else, reflects the disparity of valuations between the popular and the less favoured stocks in the market, the reasons for which have been discussed in both this report and the attached Macro Overview.

Indeed, the valuations of our current holdings give us cause for optimism about their future returns, though predicting when our investment cases might unfold is always problematic. Any abatement of concerns around global economic growth and the trade war is likely to lead to improved share price performance from our holdings. Alternatively, if rising US interest rates start to impact on the market, our cash and short positions should leave us well placed to take advantage of any further weakness in stock prices.

³ Ping An Insurance is dual-listed on both the Shanghai Stock Exchange (A-share) and the Hong Kong Stock Exchange (H-share).

Quarterly Report (Continued)

Macro Overview

by Andrew Clifford, Chief Investment Officer, Platinum Investment Management Limited

US-CHINA TRADE TENSION

The trade war is the issue that has been preoccupying investors over the last quarter. At the end of June, the US applied a 25% tariff on US\$50 billion of Chinese imports, and followed up in late September with a 10% tariff on a further US\$200 billion of imported goods from China. And of course, President Trump has tweeted that he will put tariffs on all remaining Chinese imports if they don't toe the line. China has followed suit and has now applied tariffs on almost the entirety of their US\$130 billion worth of imports from the US. The questions that arise are "for how long will this go on" and "what is the impact on the economy and markets".

The consensus view is that President Trump will not back down and that on the trade issue he generally has bipartisan support. It is also expected that China will not passively accept the US actions and will continue to respond with countervailing measures. The conclusion of this consensus view is that we are entering a new era of rising protectionism and trade friction. The problem for investors is that, when faced with a political issue such as this, no amount of reference to any logical reasoning will provide one with a definitive answer as to what will happen. One can only try and assess the significance of what has happened so far and attempt to make observations about possible outcomes.

The obvious place to start is to consider the importance of trade to both sides in this dispute. For China, exports to the US, totalling US\$505 billion, represent around 4% of GDP, and so far approximately half of these exports are subject to tariffs of 10% to 25%.¹ While this will lead to some loss of economic activity in China, there are a number of reasons why the impact will be well short of losing the entirety of these exports.

Firstly, one would expect the exchange rates to move, offsetting in part the price rise for US buyers, and indeed the Chinese Yuan has depreciated 8% against the US Dollar since April this year. Of course, the US administration may accuse the Chinese of currency manipulation, but as China's foreign exchange reserves have remained stable, the accusation will be difficult to substantiate.

Many goods will be difficult to source from other locations. An interesting article in *The Wall Street Journal* cites a study on the value added in smartphones which found that the Chinese labour cost in the assembly of iPhones accounted for

as little as 1% of the finished product's value.² The study concluded that assembly of such phones in the US would raise the price to the end consumer by approximately US\$30, a fairly small increase relative to the total retail price ranging from US\$449 to US\$1,099. However, to transfer the assembly of US-bound iPhones to the US would require finding approximately 60,000 workers. The article cites the example of Motorola who, in 2013, wanted to assemble a line of its smartphones in the US, but ultimately couldn't source the labour. And this won't be the only challenge. Chinese assemblers are able to rapidly find large numbers of labourers as production ramps up for a new product launch, and then lay them off when volumes recede. The benefit of Chinese assembly is not just the slight improvement in cost, but also the extraordinary flexibility in production that it brings to the smartphone producer, something that labour laws in most parts of the world, including countries such as Indonesia and India, simply do not allow.

Of course, some Chinese production will move to other low cost locations such as Vietnam and Mexico. However, many lower value-add activities, such as textile and shoe manufacturing, have to a large extent already migrated to alternative locations. While this may reduce the US's trade deficit with China, it is unlikely to substantially change the country's overall trade imbalance. Indeed, returning to the smartphone example, the same study showed that key components for the iPhone are sourced from Japan, Korea, the UK, Taiwan, the Netherlands and the US! Moving where final assembly occurs will hardly shrink the size of the US deficit by very much.

To the extent that the US and China are unable to find substitute sources for their imports, then, the tariffs will either be passed on in higher prices or reduce the profit margin of the supply chain, or a combination of both. There does remain the potential for many unintended consequences. As we highlighted in our June Macro Overview, the application of tariffs on imported steel and aluminium had left US companies at a disadvantage when competing with offshore producers not just in their home market, but also in export markets. However, if we simply treat the tariffs as a tax on the US economy and assume that the announced tariffs are collected on the full US\$250 billion of imports, they will amount to approximately 0.16% of US GDP, a paltry amount particularly when compared with the individual income and corporate tax cuts passed

¹ The latest round of tariffs on US\$200 billion of Chinese goods are applied at 10%, with the possibility of increasing to 25% in January 2019 if the Chinese don't accept US demands for various changes.

² "Bringing iPhone Assembly to U.S. Would Be a Hollow Victory for Trump" by Greg Ip, *The Wall Street Journal*, 19 September 2018, citing a study on the value added in smartphones by Jason Dedrick of Syracuse University and Kenneth Kraemer of the University of California at Irvine.

earlier this year, which will amount to 0.9% of GDP per year in the first four years.

The initial conclusion, based on the actions taken by both the US and China to date, is that the impacts are likely to be relatively small across the broad economies of both countries. The concern, of course, is that it may not stop here. Indeed, the last round of US tariffs on US\$200 billion of Chinese imports will rise from 10% to 25% in the new year if China doesn't accede to US demands, and President Trump has tweeted that he will apply tariffs on all Chinese imports, if necessary. Indeed, why stop at 25%? Why not 50% or 100%? Perhaps it is all part of the theatre of the US mid-term elections that will be held this November, but who would know!

Meanwhile, the discussion from the US side has shifted from the size of relative trade deficits and surpluses to the alleged intellectual property theft and forced technology transfer by China. This change of focus is hardly surprising. As we enter 2019, the proponents of the trade war will need to start explaining why their trade deficit hasn't at least fallen to some extent with the imposition of tariffs.

The question of technology transfer is an interesting one. It has no doubt been a central part of China's industrial policy to require foreign companies wanting to access its domestic economy to set up local production, usually with a local partner. In this way, general know-how is gained by local employees who may ultimately end up enabling new local competitors. Of course, there are also examples of more blatant theft of proprietary intellectual property, which can be difficult to prove, particularly when the local legal system is unlikely to be especially helpful to the foreign partner. So the issue of intellectual property does appear as one that may be fought over and may well cause some friction in the foreseeable future.

But even this debate of "IP theft" seems to be a futile exercise. Arguably no foreign company is "forced" to transfer its technology to China or a Chinese joint venture partner, that the choice was always there to not enter China, though many chose the path. The rationale is simply down to the traditional market forces of competition. You either did it or stood by while watching your competitor move its operations to China and gain an immense advantage through higher profits and greater scale.

The automotive market is the perfect example. China's passenger vehicle market is now the largest in the world, 40% larger than that of the US,³ and for the foreign OEMs with strong positions in the market, such as GM, Volkswagen and BMW, it represents as much as a quarter to a half of their profits.⁴ In recent years, local producers have been gaining back market share as the quality of their products has improved significantly, as demonstrated in quality surveys by the likes of JD Power. The ability of the local players to improve their products is a function of the broadening "know-how" within China, which undoubtedly is a result of a strong local industry led by the foreign players. Indeed, a significant local components industry has developed, which now exports nearly US\$17 billion of auto parts to the US.⁵

Has there been any misappropriation by local Chinese companies of foreign OEMs' or their suppliers' proprietary intellectual property? Almost certainly yes. But even in the "wild wild east", suppliers stealing IP would be excluded by foreign OEMs and from the export markets of developed countries. It is also worth observing that leading local auto producer, Geely Automobile, most certainly uses foreign "intellectual property" and know-how in its production. Its method of accessing this know-how was to acquire a struggling western auto producer, Volvo. Today, M&A is the way through which the best Chinese companies are acquiring technology and know-how, as seen in a plethora of transactions from Midea Group (Chinese household appliance maker) buying Kuka AG (German robotics and automation supplier) to Weichai Power (Chinese heavy duty Diesel engine maker) buying a controlling stake in Kion (German supplier of forklifts and warehouse systems).

Finally, it is worth noting the following investment projects by foreign companies in China, all of which have been announced since the beginning of July this year: BASF of Germany announced a US\$10 billion chemical plant in Guangdong province, ExxonMobil of the US a US\$10 billion petrochemical plant also in Guangdong, and Tesla a US\$5 billion plant in Shanghai. Each of these investments is to be fully owned by the foreign company, which typically is not permitted in the industries concerned. These announcements suggest that the Chinese have already begun to modify their approach and that major foreign companies remain confident to invest in the country.

3 Based on new car registration data between January and December 2017: www.statista.com/statistics/269872/largest-automobile-markets-worldwide-based-on-new-car-registrations/

4 24% for GM, 28% for BMW, 30% for Mercedes, 37% for Ford, 49% for Volkswagen Group, and 56% for Audi (based on 2016 China profits before tax as a percentage of global total). Source: Evercore ISI and Financial Times.

5 Source: US Department of Commerce, Bureau of the Census, Foreign Trade Division; Bureau of the Census USA Trade (<https://automotiveaftermarket.org/automotive-aftermarket-imports-exports/>).

So while the differences between the US and China on the issue of trade seem intractable, the question is “what really can be done”. The opening-up of China to foreign investment and trade has allowed the likes of Apple, BMW and Nike to earn enormous profits, and has given consumers access to new technologies and affordable running shoes. The system has delivered massive benefits to businesses and consumers across the globe. This is the hard economic reality that policy makers face. While they may be enjoying the political theatre of it all, the current pathway of ever rising tariffs, if continued, will simply result in lower consumer spending power, lower profits, and a loss of jobs, in both countries. This should provide both sides to the dispute with a compelling reason to start looking for solutions once the noise and excitement of the fight dies down. The drama may take some time to play out and no agreement is yet forthcoming, but ultimately a negotiated resolution seems to be a more likely outcome than returning to a trading system akin to that of the late 1970s and early 1980s with commensurate falls in global living standards.

OTHER DEVELOPMENTS

While the verbal battles of the trade war raged on, there have been some significant ongoing developments elsewhere that need consideration.

As we have discussed in our March and June Macro Overviews, China has been implementing a significant reform of their financial system, bringing the shadow banking activities back onto the balance sheets of the banks. This has resulted in a tightness in credit availability during the first half of the year, which has led to distress in some parts of the economy. Notably, peer-to-peer lending networks⁶ have come under pressure, and as a result individual lenders have suffered losses from investments in these loans.

The concern is the potential impact the credit tightening will have on consumption expenditures. Indeed July and August monthly passenger vehicle sales in China are down 5.3% and 4.5% respectively from a year ago. Into this potentially weaker economic environment, then there is the issue of the impact of the trade war on business confidence where, unsurprisingly, there is evidence of a cutback in investments by the manufacturing sector. Softness in infrastructure spending was also evident in the first half of the year as local governments faced a lack of funding following tightening measures directed by the central government.

Investors are concerned that a more generalised slowdown may have begun in China. Whether that is in fact the case remains debatable. Construction activity remains strong, as are sales of residential property. Steel production remains at near record levels. Nevertheless, Chinese policy makers have acted pre-emptively, presumably concerned by the potential impacts of both the trade war and their own financial reforms. Initiatives include extending the time frames for banks to bring back shadow banking assets onto their balance sheets, and granting approval to roll over existing loans. Funding for approved infrastructure projects is being made available. Tax cuts for individuals and businesses worth 1% of GDP⁷ have been announced. While these and other measures may seem far more modest than the stimulatory policies put in place during previous periods of economic weakness, it is also the case that, for the moment, the softness in the economy is not as apparent as it had been in past cycles.

The US economy continues to grow strongly, helped along by the tax cuts put in place this year. Employment remains robust, consumer and business confidence is high, and while inflation is on the rise, it remains at relatively subdued levels. During the last week of the quarter, the Federal Reserve increased interest rates by 0.25% for the seventh time this cycle (since late 2015), bringing the federal funds rate to 2.25%. As we have stressed in past reports, while rising rates will eventually bring an end to the current economic cycle, it is difficult to assess when the impact of higher rates will be felt. Conventional rules of thumb, such as the steepness of the yield curve, do not suggest any imminent downturn.

In Europe, growth has slowed through the first half of the year as the region deals with the UK’s messy exit from the European Union (EU) and concerns around the economic policies of the new Italian government. However, the region continues to grow employment with 2 million jobs added over the last year, and with countries across the EU close to achieving fiscal balance, there remains capacity for their governments to increase spending. Further, a current account surplus of 3.5% of the Euro Area’s GDP places the region on a strong footing for future growth.

The Japanese economy also remains in good health. Employment is strong with 1.1 million jobs added in the last year, and the ratio of open positions to applicants is running at 1.6, the highest level in 43 years. Wages are growing at just over 2% per annum. There is potential in the country, and many businesses still have excess labour. If higher wages can attract labour into more productive endeavours, the benefits to the broader economy could be quite significant. Japan’s labour costs are now globally competitive which should underwrite ongoing investment. Finally, it is worth noting that nationwide land prices registered the first increase in 27 years.

⁶ Peer-to-peer (P2P) lenders are intermediaries, typically online platforms, that match people who have money to invest with people who are looking for a loan. Well-known P2P lending companies include Lending Club in the US, RateSetter in the UK, and Society One in Australia. Chinese P2P lending platforms are largely similar to these.

⁷ www.fitchsolutions.com/country-risk-sovereigns/economics/chinese-policy-makers-speed-tax-cuts-and-infrastructure-projects-28-08-2018

MARKET OUTLOOK

The potential of a China slowdown, exacerbated by the trade war, and the impact of ongoing rate rises in the US, have seen investors once again become risk averse. Specifically, this has meant avoiding companies that face any degree of uncertainty and focusing instead on companies that are perceived to be immune from external factors like trade tariffs. Often this is expressed by commentators as a preference for “growth companies” over “cyclical businesses”, but many more companies have been caught up in the sell-off than the traditional cyclicals, extending to sectors such as financials and lower-growth technology stocks. The exception has been energy stocks which have been helped by higher oil prices over this period.

Geographically, this has translated into significant outperformance by the US market as it has a much higher representation from those strongly performing sectors than the rest of the world (the technology, healthcare and energy sectors together account for more than 47% of the MSCI US Index, compared to approximately 28% for the MSCI AC World ex US Index). Generally, the weaker geographic markets have been those with a greater weighting in cyclical and financial stocks throughout this period. Additionally, the emerging markets have suffered as a result of the stronger US Dollar increasing the cost of funding for external debts, most notably in the case of Turkey.

From an investment point of view, it is worth observing that the strong performances in areas such as technology and healthcare have been driven by stocks that, based on our research, were already expensive by historical standards. Software stocks and internet companies that have been central to the strong performance of the technology sector in recent months are now valued against their revenue base at levels only exceeded in the technology bubble of 2000, as illustrated in the two charts on the following page.

While the valuation of biotech stocks is not so readily demonstrated by reference to comparable historical data, there are signs that valuations have become stretched in many cases. The record number of new biotech IPOs⁸ is also strong confirmatory evidence. By stark contrast, six months ago, the deepest value was to be found in the North Asian markets of Korea, China and Japan, and yet these markets have performed poorly over the period.

⁸ There were 47 biotech IPOs in the first nine months of 2018, already more than both the full years of 2016 and 2017. (Source: Renaissance Capital)

MSCI ALL COUNTRY WORLD SECTOR INDEX NET RETURNS (USD)

Sector	6 months to 30 Sep 2018
Health Care	13.7%
Energy	12.9%
Information Technology	10.1%
Consumer Discretionary	6.0%
Industrials	3.0%
Utilities	1.9%
Consumer Staples	0.8%
Materials	0.7%
Telecommunication Services	0.4%
Financials	-3.3%

Source: FactSet.

Total returns over time period, with net official dividends in USD.

Historical performance is not a reliable indicator of future performance.

MSCI REGIONAL INDEX NET RETURNS (USD)

Region	6 months to 30 Sep 2018
All Country World	4.8%
Developed Markets	6.8%
Emerging Markets	-9.0%
United States	11.0%
Australia	4.2%
Germany	-4.5%
France	2.4%
United Kingdom	1.2%
Italy	-11.5%
Spain	-6.6%
Russia	-0.3%
Japan	0.7%
China	-10.7%
Hong Kong	-2.1%
India	-2.8%
Korea	-8.5%
Brazil	-21.9%

Source: FactSet.

Total returns over time period, with net official dividends in USD.

Historical performance is not a reliable indicator of future performance.

US Software Companies – Enterprise Value / Sales



Source: FactSet

This has led us to conclude that, outside of the favoured growth stocks, markets are pricing in a future that is substantially different from the world that can be observed today. Essentially, cyclical stocks are factoring in a significant slowdown in global growth. While this could be the case, there are a number of reasons suggesting that the picture may not be quite so grim:

- As outlined above, the scope and impact of the trade measures put in place to date are limited relative to the broader economic backdrop. As such, the trade war would need to ratchet up significantly to further impact on markets.
- There is an underlying futility to the trade war that needs to be resolved with a face-saving political solution for its proponents. It is instructive that the US has now come to an agreement with Canada and Mexico on trade that achieves little substantive improvement on the existing North American Free Trade Agreement (NAFTA), but represents a political win for the Trump administration. While a resolution will take time and there may be further damage before one is reached, it is not entirely unrealistic to expect a deal with China at some point.

US IT Service Companies – Enterprise Value / Sales



Source: FactSet

- Meanwhile, China has moved to stimulatory policies to underwrite growth. As they have done in past, such policies will likely achieve some of their intended effect.
- While higher interest rates should ultimately slow the US economy, given the existing strength in labour markets and the availability of ongoing fiscal stimulus, a slowdown may well be further out on the horizon.

To sum up, markets are currently positioned in a very defensive manner, and any lessening of the fears that have driven stock prices in recent months could well see them move higher. Of course, there is always the possibility of some new issue arising, especially in a world where balance sheets are weak and interest rates unsustainably low. But for the moment, investors appear to be leaning very heavily in one direction. More often than not, it pays to head in the other direction.

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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