

MLC-Platinum Global Fund

QUARTERLY REPORT

PERFORMANCE (as at 31 December 2010)

Fund Size: \$1.39 bn	Last Quarter	Last 12 months	5 years (compound pa)	Since Inception (compound pa)
MLC Platinum Global Fund	2.0%	0.2%	2.6%	11.4%
Morgan Stanley Capital International All Country World Net Index (A\$)	2.7%	-1.1%	-3.3%	4.4%

Source: MLC Investments Limited and Platinum

The markets continued their run that started in August, ignoring the festering issues around the Euro and deleveraging. This shift in the mood coincided with Federal Reserve Chairman, Mr Bernanke's pronouncements about quantitative easing, with the market taking the cue as it had following the pattern of earlier Fed bail outs (1994 and 2001).

The intervention didn't go entirely to script as the US treasury bonds weakened significantly despite the Fed creating money to exchange for existing government liabilities. The US 10 year government bond rose in yield from 2.4% in early October to 3.5% by year end. Worse still, the TIPS (treasury inflation protected securities/government bonds) suggested that the deterioration in bond prices was being influenced by inflationary concerns as they moved upwards, meaning a higher real cost of borrowing to the Exchequer.

At the same time, tight supply conditions and fickle weather led to heightened speculation in the commodity markets with surges in grains, industrial commodities like cotton and rubber, while oil trundled higher to close above \$90 a barrel at year end.

Currencies have also been seen as an extension of this bet on strong commodity prices and hence growth. With the shakiness of the Euro and the seemingly imperturbable progress of the developing countries, the currencies of Brazil, Canada and Australia continued to climb. Having looked quite robust in the opening weeks of the quarter, the currencies of Asia quickly lost momentum when it became clear that the Chinese had no intention of allowing the Renminbi to succumb to the full forces of the market.

The developing confidence in the growth outlook found expression in the cyclical components of share markets. Those sectors with defensive qualities lagged by a large margin, even declining in the case of utilities and healthcare—see table over.

MSCI* WORLD INDEX SECTOR PERFORMANCE (AUD)

Sector	Quarter	1 Year
Materials	10%	7%
Energy	9%	-2%
Information Technology	5%	-2%
Industrials	5%	9%
Consumer Discretionary	4%	10%
Financials	0%	-7%
Consumer Staples	-1%	0%
Telecommunications	-2%	-2%
Healthcare	-2%	-10%
Utilities	-4%	-12%

* Morgan Stanley Capital International

Source: MSCI

The surprise to some may be the way the developed markets gained momentum in the last quarter at the expense of the strong economic performers of India, Brazil and China. Time and again, one is reminded that when all are clamouring, the upside potential has often been fully expressed!

For the year as a whole, the MSCI World Index fell by 1.1% when expressed in A\$ but was much stronger in their home currencies. The Index rose 2.7% (in A\$) for the quarter. The performance of the MLC Platinum Global Fund was disappointing; caution being the main culprit. Firstly, this approach led us to avoid the Australian dollar, which we still do as we regard it as a call option on growth, and secondly, the index short positions which we treat as insurance didn't help in this rising market. Importantly, several of our largest holdings (what some would classify as 'blue chips') have reported sound earnings growth yet the market has de-rated them as it chased those with more leverage to the recovery. These holdings are now trading well-below the rating of the market average despite superior track records.

MLC-Platinum Global Fund Quarterly Report (Continued)

The Fund gained 0.2% for the year and 2% for the quarter. Over two years and longer, our performance is well-ahead but we are conscious that investors look to the short-term for corroboration about the proficiency of their manager.

CURRENCIES

We reversed our position on the Asian currencies back into the US dollar when it became apparent that the Chinese were determined to restrain the appreciation of the Renminbi. We also cut exposure to the Euro and ended the quarter with the following exposures:

US dollar 30%, European currencies 28%, Australian dollar 14%, Asian currencies ex the Hong Kong dollar 13%, Hong Kong dollar 7%, Canadian dollar 6% and Japanese yen 2%.

It is not as though we particularly favour the US dollar but in the short-term, evidence of the US economy recovering will provide support. (Incidentally, concerns about fiat money is the principal reason for our holding gold shares).

CHANGES TO THE PORTFOLIO

DISPOSITION OF ASSETS (NET INVESTED POSITION)

Region	Dec 10	Sep 10
Europe	29.0%	27.4%
Japan	20.8%	18.6%
Asia and Other *	18.7%	19.9%
North America *	17.8%	18.8%
Australia	0.5%	0.4%
Cash	13.2%	14.9%

Source: MLC Investments Limited

* At 31 December 2010, the Fund had a short position in the US against the Russell 2000 Index of 5.2% (30 September 2010: 3.6%) and in Hong Kong against the Hang Seng Index of 1% (30 September 2010: Hang Seng 0% and Dax 1%).

Full valuations after strong rises caused us to remove eBay Inc, Qualcomm and Canon while we reduced holdings in other powerful performers such as Ping An Insurance, BMW, Siemens and Infineon Technology to make way for new names and to top-up laggards. We also trimmed our Chinese exposure on concerns about interest rate tightening, and reduced Johnson & Johnson and Merck because of some temporary product issues and delays in earnings improvements.

The bigger purchases include Shin-Etsu, Inpex, Shanda Interactive, AMD and some rare metal miners:

Shin-Etsu, described in detail later, highlights the nuances of our analysis.

Inpex might be classified as a cheaply priced call option on energy prices as it creeps closer to exploiting two large resources; the Ichthys wet gas deposit off Australia's North West coast and the Abadi offshore field

in Indonesia. It became very cheap after it tackled the market with a rights issue to fund the Ichthys project.

Shanda Interactive is a Nasdaq-listed portal and game publisher operating in China. It has grown strongly and the market is concerned about its ageing gaming portfolio and whether the new portal model it is pioneering will work.

Over half the capitalisation is in cash, implying a low-teen valuation in a fast growing yet still nascent market.

We have owned **AMD** before and believe that with the launch in mid-2011 of new chipsets including an integrated logic/graphic chipset for PCs and laptops, it stands to gain share from Intel.

We have also invested about 1.5% of the Fund in a select group of rare metal miners; molybdenum, tungsten, tin and palladium. These are very low tonnage markets, essential in sophisticated industrial processes and with the exception of palladium, are dominated by Chinese producers.

MLC PLATINUM GLOBAL FUND – TOP 15 STOCKS

Stock	Industry	Dec 10
Shin-Etsu Chemical	Chemicals	2.5%
Bangkok Bank	Banks	2.4%
Samsung Electronics	Semiconductor Equipment	2.4%
Microsoft Corp	Software	2.4%
Hornbach Holdings	Retail	2.3%
Cisco Systems	Communications Equipment	2.3%
Siemens AG	Misc. Manufacturing	2.2%
Johnson & Johnson	Health Equipment/ Services	2.1%
Henkel AG	Household Products	2.1%
Royal Dutch Shell	Oil and Gas	2.1%
Denso Corp	Auto Components	1.9%
BMW	Autos	1.9%
Sanofi-Aventis	Pharmaceuticals	1.8%
Pernod Ricard	Beverages	1.7%
Allianz AG	Insurance	1.7%

Source: Platinutm

COMMENTARY

It is curious how negatives come to the forefront when there is uncertainty. Over the years, investors' funds have had exposure to so-called 'unattractive' markets like Thailand, Brazil, Peru and India.

This was at a time when each was seen as a no-go area and certainly perceived to have no investment merit. Times change as do opportunities—but the immutable fact of investing is that great investments are all about buying at the right price.

The no-go zone today is Japan. The market, as a whole, is very cheap by almost all measures though readers will be quick to remind us of the perils of a shrinking population, fiscal disorder, deflation and so forth. However, rather than bore you with macro economic diversions, it is evident that there are many companies that do grow regardless of their home market. A case in point is **Shin-Etsu Chemical** which is based in Japan yet runs a global business. In the 1990s, profits grew by 9% pa compound and this accelerated to 14% pa from 2000 to 2008. (Over this period the Japanese economy has grown by about 1% pa).

At its heart, Shin-Etsu is a chemical company active in the fields of organic and inorganic chemicals, principally polyvinyl chloride (PVC); electronic materials, predominantly semiconductor silicon wafers; and functional materials such as high purity synthetic quartz, rare-earth magnets and liquid fluoro-elastomers. Driving growth has been a high commitment to innovation and the broadening of the company's product portfolio. This was accompanied by massive spending on physical plant amounting to ¥1.384 trillion in the last 10 years (approximately US\$12.6 billion) yet because of its use of accelerated depreciation and having earned solid profits, the company was able to build-up its cash/investment balances alongside this strong growth. In other words, it was not "buying business" and hence has grown its market share profitably and without the need to resort to outside funding. Even during the global financial crisis, the company continued to make profits, albeit down 55% from the March 2008 peak year. Yes, there are some chemical companies that have done as well but do they trade close to book value with 25% of that lying around as cash?

The most profitable division is that which supplies silicon substrates and materials to the chip making industry. Starting from mining the silica in Australia to the production of silicon metal, to growing defect-free single crystals that are then sawn into 300 mm wafers for further enhancement. It is now the dominant global supplier, meeting about one third of worldwide demand of some 3.5 million wafers per month¹ from production bases in Japan, Malaysia, the US, Britain and Taiwan. It has won similar leading positions in the principal materials needed for the subsequent lithography process of semi-conductor manufacture (photo-resist films for both krypton and argon fluoride laser exposures, photo-mask blanks and pellicles).

Shin-Etsu is also the **world's largest and lowest cost producer of PVC**—some 3.8 million tonnes pa, two thirds of which are produced in the US. One might conclude that Shin-Etsu is simply a commodity producer—defined as one that has no ability to differentiate its products or processes from those of competitors and consequently must accept a standardised price. This is partly correct but it has carefully chosen its locations and developed products and processes that give it a competitive edge. This is borne out by its return on investment (typically 12 to 15%) and a research and development budget of some US\$360 million pa.

In the US for example, gas prices trade well-below the global average and we believe this gives Shin-Etsu a competitive edge of about 20% against the torment of most manufacturers; Chinese competitors—who combined, account for about one third of world capacity.² Further, the company has been aggressively integrating backwards into VCM which is enhancing its competitiveness.³

More recently it has built the leading position in **rare earth magnets** with all their attendant attractions of energy savings in applications such as air conditioner motors and now, the potentially huge market of electric cars. This could be enormous as auto companies seek solutions for thrifty electric motors to drive tomorrow's urban vehicles. A gain in the energy efficiency of the motor translates directly into a car's travelling range. At present, Shin-Etsu's rare earth magnets are running Toyota's Prius hybrid cars. (Hybrid sales accounted for 11% of all car sales in Japan in 2010; Honda expects them to approach the high teens in 2011).

On account of the company directing its research thematically, it continues to show an ability to identify emerging areas of potential growth such as the rare earth super magnets noted above, materials used for encapsulating light emitting diodes (LED's)—silicone moulding materials, lenses and reflectors. It is strong in other silicone products such as liquid elastomers used as a heat cured flexible moulding or sealant in autos, aircraft and electronics.

With all these claimed virtues, **why then is the market pricing the shares so cheaply**; close to half of its historic valuation relative to sales, trend profits and book value? There has been an evident loss of sex appeal for semiconductor wafer manufacturers, supported by oversupply, with 300 mm wafer prices down by 45% since 2008.⁴ There are also short-term issues such as the strength of the Yen, the weak housing market in America and Europe adversely affecting PVC demand, yet prices are close to their 2008 peak!

¹ For all the progress made with line-shrink in semiconductor chip circuits, it may surprise some to find that the demand for wafers in terms of millions of cm² has faithfully risen in tandem with growth in physical chip demand. The 20 year growth has been about 8% pa according to Siltronic.

² The majority of Chinese production (80%) is via coal through a calcium carbide process (limestone + coking coal). Further coal is guzzled to produce Vinyl Chloride Monomer (VCM) using a mercury catalyst. Overall, we estimate 8,000 Kwh of energy is needed to produce one tonne of PVC via this route while producing PVC using ethylene, sourced from natural gas, is far more energy efficient, producing a superior PVC and in terms of materials alone (excluding pollution) costs at least one fifth less. This is equivalent to US\$250 per tonne for a product that sells for \$1,200–1,400 pt. We see Chinese coal prices likely to continue to rise steeply!

³ The PVC division has become much deeper as a result of the integration backwards into the production of chlorine (applying electrolysis to salt) and VCM. Output of this intermediary will have doubled by 2011 to 1.6 mt reducing Shin-Etsu's dependence on Dow Chemical—to become about 60% self-sufficient. As a by-product, it will have 530/-t of additional caustic soda to sell. The price of caustic soda in the US has risen from about \$100 pt in mid-2009 to over \$400 pt now.

We see most of these factors as transient. We have not been able to identify a case where the company's competitive position has actually deteriorated nor is there any evidence that it has been losing its competitive edge to newcomers, substitutes, market decay etc. We believe the exact opposite; seeing it gaining share, and inherent profitability and building know-how in emerging giant applications. Our explanation is that the market is still somewhat uncertain about the short-term end-market demand and is probably too cautious about longer term profit recovery. Foreigners already own close to 40% of the company's issued shares, and as most protest, why buy a Japanese-based investment!

As we have noted repeatedly in the past, there is a predilection for market participants to elude to bright and shiny objects and by so doing, overlook wonderful opportunities that are far superior yet lack immediate appeal. If Shin-Etsu continues to follow its historic pattern of innovation and steady internally-funded growth, we will earn handsome returns. If on the other hand, there is a change in investor perceptions and the excitement rises about the general application of LED lighting, super magnets in electric powered cars, the move to 450mm wafers and improved conditions in housing markets and growing substitution of PVC for aluminium window frames or the like, the shares will provide an investment bonanza.

Shin-Etsu is the Fund's largest holding.

Turning back to the general outlook, it was interesting to observe at year end how the markets, other than the A share market in China, brushed off that country's problems with inflation. Some take comfort from the recent retracement of vegetable prices but we suspect the issue is chronic. The country has been growing at breakneck speed for 30 years, capital flows are difficult to control and there is a booming trade in non-bank finance. This is no longer a simple command economy yet the centre, immobilised partially by the impending change of the guard, is trying to use directives to bring back order. The recent hike in the bank rate is way overdue but it

looks as though lending controls are going to be the tool of choice. Presumably investors believe slower growth in China and/or a twilight of lower growth and some inflation and Renminbi appreciation is beneficial to other markets and assumes that the spigot of Chinese credit controls will act like a perfect moderator.

OUTLOOK

Evidence of recovery has improved since we last wrote but equally pressures of inflation have become more pronounced in the developing countries. Almost free funding is finding its way into aggressive bets on commodity prices and this is washing into the real economy.

Importantly, we can still find a large number of companies that offer investment merit and we have been adding to these stocks. Our top 15 stocks, as outlined on page two, show the diversity in sectors. We are comfortable with these holdings regardless of the environment 2011 may bring. Defensive companies are well-represented and are notably cheap. However, we have also been adding new names which have substantial earnings leverage that should add to the Fund's momentum this year.

- 4 The 300 mm wafer price averaged around ¥15,000 from 2000 to 2006, and peaked at ¥18,000 in 2007/8. Since 2009 it has traded around ¥10,000. Even at this price Shin-Etsu should see a recovery in profits because of the fall in depreciation from ¥100 billion (FY 3/08) to about ¥25 billion this year. We see wafer profits quadrupling from ¥22 billion earned in FY 3/10 by March 2012.

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**

This document has been prepared by MLC Investments Limited (ABN 30 002 641 661), with fund and market commentary written by Platinum Investment Management Limited (ABN 25 063 565 006) and is current as at 31 December 2010. It is provided as an information service without assuming a duty of care. This communication contains general information and may constitute general advice. Any advice in this communication has been prepared without taking account of individual objectives, financial situation or needs. It should not be relied upon as a substitute for financial or other specialist advice. MLC Investments Limited is the issuer of both the MLC-Platinum Global Fund and the MLC MasterKey Unit Trust. The offer of interests in the MLC-Platinum Global Fund and the MLC MasterKey Unit Trust are contained in the MLC MasterKey Unit Trust PDS. Copies of this PDS are available on mlc.com.au. The MLC-Platinum Global Fund was closed to new investors from 1 July 2005. Existing investors wishing to acquire further units should obtain a PDS and consider that document before making any decision about whether to acquire or continue to hold the product. An investment in the MLC-Platinum Global Fund or MLC MasterKey Unit Trust does not represent a deposit with or a liability of MLC Investments Limited, National Australia Bank Limited (ABN 12 004 044 937) or other member company of the National Group of companies and is subject to investment risk including possible delays in repayment and loss of income and capital invested. None of the National Australia Bank Limited, MLC Investments Limited, or any other member company in the National Group of companies or Platinum Asset Management, guarantee the repayment of capital, payment of income or the performance of the MLC-Platinum Global Fund or MLC MasterKey Unit Trust.

Past performance is not indicative of future performance. The value of an investment may rise or fall with the changes in the market. Please note that all return figures reported are before management fees and taxes, and for the period up to 31 December 2010, unless otherwise stated.