Platinum Japan Fund

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Portfolio Manager

Disposition of Assets

REGION	31 DEC 2017	30 SEP 2017	31 DEC 2016
Japan	94%	93%	95%
Korea	2%	2%	0%
Cash	4%	5%	5%
Shorts	-2%	-2%	0%

Source: Platinum Investment Management Limited. See note 3, page 4.

Sector Breakdown

SECTOR	31 DEC 2017	30 SEP 2017
Information Technology	25%	27%
Industrials	17%	17%
Consumer Discretionary	14%	15%
Materials	12%	10%
Financials	9%	9%
Energy	8%	7%
Telecommunication Services	5%	5%
Health Care	4%	4%
Consumer Staples	-1%	-1%
TOTAL NET EXPOSURE	94%	93%

Source: Platinum Investment Management Limited. See note 5, page 4.

Currency Position

	31 DEC 2017	30 SEP 2017
Japanese yen	71%	69%
US dollar	24%	28%
Korean won	2%	2%
Australian dollar	3%	1%

Source: Platinum Investment Management Limited. See note 6, page 4.

Performance

(compound pa, to 31 December 2017)

	QUARTER	1YR	3YRS	5YRS	SINCE INCEPTION
Platinum Japan Fund*	9%	22%	19%	27%	15%
MSCI Japan Index	9%	15%	13%	18%	3%

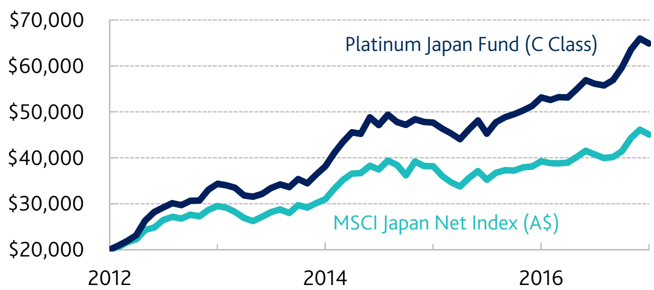
*C Class – standard fee option. Inception date: 30 June 1998.
Refer to note 1, page 4.
Source: Platinum Investment Management Limited, RIMES Technologies.
Historical performance is not a reliable indicator of future performance.

The Fund rose 8.7% for the quarter and 22.1% for the twelve months. Portfolio performance contribution was broad based for both periods.

The long term performance of the Platinum Japan Fund has been good with an annual compound return since inception of 15.4% in a roughly flat market. Recent returns have also been strong with five year returns of 26.5% per annum and three year returns of 19.4%. It is possible to argue that recent returns have been amongst the best in the history of the Fund. Against this backdrop it is appropriate to consider future returns. As outlined below, there are many reasons why current opportunities are just as attractive as those seen in recent years and our assessment is that the investments currently in the portfolio will generate good medium to long term returns.

Value of $20,000 Invested Over Five Years

31 December 2012 to 31 December 2017



Refer to note 2, page 4.
Source: Platinum Investment Management Limited, RIMES Technologies.
Historical performance is not a reliable indicator of future performance.

For further details of the Fund's invested positions, including country and industry breakdowns and currency exposure, updated monthly, please visit https://www.platinum.com.au/Investing-with-Us/Investment-Updates.

Changes to the Portfolio

New opportunities continue to be identified which are more attractive than current holdings. There are many businesses in Japan which have been fallow for almost a decade and are now showing signs of renewal.

Top 10 Holdings

STOCK	COUNTRY	INDUSTRY	WEIGHT
Nexon	Japan	IT	4.8%
Nintendo	Japan	IT	3.6%
Itochu Corporation	Japan	Industrials	3.6%
Inpex Corporation	Japan	Energy	3.5%
Mitsubishi UFJ Financial	Japan	Financials	3.4%
Sumitomo Mitsui Financial	Japan	Financials	3.2%
Lixil Group Corporation	Japan	Industrials	3.1%
Sumitomo Metal Mining Co	Japan	Materials	3.0%
Kyocera Corp	Japan	IT	2.7%
Ebara Corp	Japan	Industrials	2.7%

As at 31 December 2017.
Source: Platinum Investment Management Limited. See note 4, page ɟ.

Commentary

There are widespread concerns about Japan, both subliminal and widely discussed. At a group dinner in Tokyo late last year, a loud and opinionated American confidently told the whole group repeatedly about the failings of the country. It reminded me of a site visit to Mount Isa Mines fifteen years ago where I witnessed a raucous local fund manager laying accusations at management in an embarrassing manner. MIM was subsequently purchased for a song at the start of the commodity super-cycle.[1]

Some major concerns about Japan and a brief comment follow, most of which are backward-looking:

- Corporate governance – there has been a multi-decade process of improvement which is now finally accelerating.
- Demographics – this is a well understood issue at many levels in Japan and steps are being taken to address it.
- Nominal GDP – after decades of deflation, signs of inflation are emerging. The price of goods and services in Japan often seems cheap relative to leading developed countries, especially when adjusted for quality.
- Geopolitics – There are many concerns about China, especially military activities in their adjoining oceans. North Korean missile launches are a headline topic of debate. Russia and the irritation of the Magnitsky Act[2] are surely lurking beneath the surface. These are complicated relationships with millennia of history.
- Government debt levels – the Bank of Japan now owns the majority of the outstanding Japanese Government Bonds. There is no clear plan for the resolution of what looks like an extreme experiment in monetary policy. The outcome will be very path dependent.
- Fiscal deficit – the government deficit has been decreasing through a combination of increased sales tax and broad based economic improvement. There has been a long-term focus on fixing this situation, and more changes are expected in a stable political environment.

Other concerns about Japan's future include:

- Low R&D productivity
- Lack of innovation and fast growth companies
- Limited global brands
- Labour immobility and inflexibility
- Depopulation of regional centres
- Low labour productivity
- Energy and commodity import dependence
- Aging corporate leadership

Some of these concerns are real; many are mere distractions.

What is new is old. The Romans poisoned themselves with lead pipes and polluted their air with smelters across the Empire. The Chinese seem to have read *Silent Spring* (Carson, 1962) and are focused on remedying the environmental degradation resulting from decades of helter-skelter development. There were 9,000 windmills in the Netherlands in the 1800s, a precursor to the spread of wind and solar installations across the world today. The British Pound has devalued consistently since the Sun set on the British Empire, and the current hegemony is following their footsteps. With actual or potential regime changes in Zimbabwe, Russia, Saudi Arabia, Iran and Venezuela, the treadmill of tyranny seems to be accelerating despite the delightful misunderstanding that it's too early to assess the impact of the 1789 French Revolution.[3]

1 Platinum was a shareholder in MIM at the time. We vociferously opposed the Xstrata takeover in 2003, arguing that the bid grossly undervalued the company's long-term potential. But there was no stopping the short-sighted institutional holders.

2 A law passed by the US Congress in 2012 intended to punish Russian officials who were thought to have been responsible for the death of Russian tax accountant Sergei Magnitsky by prohibiting their entrance to the US and their use of US banks. Magnitsky died in a Moscow prison after investigating fraud involving Russian tax officials.

3 During Richard Nixon's historic visit to Beijing in 1972, the then Chinese premier, Zhou Enlai, was asked about the impact of the "French Revolution", to which he answered "too early to say". What was once thought a diplomatic quip was in fact a misunderstanding by Zhou – he had in mind the events of 1968 while the question referred to the Revolution of 1789.

On a recent visit to GS Yuasa, a lead acid and lithium ion battery maker in Kyoto, the display in their office lobby was an electric car from 1917 with the following description: "The history of the electric vehicle dates back to 1873 when the first electric vehicle was assembled in England. In 1915, 2,000 vehicles were in use in New York and around 1926 29,000 electric vehicles were being used in various fields all over the USA. The electric vehicle 'DETROIT' was imported from the USA in 1917 by GS Yuasa. Powered by the company's lead acid battery, it was used for nearly 30 years until 1946." Detroit had a range of 33 km propelled by an 11 kWh battery at 24 volts with a kerb weight of 1,440 kg.

A 1917 electric vehicle named 'DETROIT' on display in GS Yuasa's Kyoto office lobby. Source: author

Yet, the modern world is full of wonder and amazement. Would the intrepid intercontinental traders of prior millennia puzzle over the instant connectivity possible between the globe's five billion adults? Would ancient Chinese retailers recognise a GPU accelerated data centre as a modern abacus? Is the nascent blockchain just a shiny shell or a piece of gold? Global development enabled by technology and communication is seemingly inexorable despite the many diversions and depredations. World poverty has been in clear decline for decades and again reached a new low last year. 2017 was the first year in the history of modern aviation with no commercial air deaths.

Our assessment is that Japan is reasonably well positioned for both the new and the old of the coming decades.

- E-commerce – Japan has been slower than leading countries to migrate to online shopping. However, the current environment feels like 2005 in North America and there are a wide range of Japanese companies with B2C (business-to-consumer) and C2C (consumer-to-consumer) platforms in place, which are growing exponentially.
- Quantum computing – NF Corp and Fixstars are Japanese companies which supply software and components to a Canadian company selling quantum computers today. Japanese companies are using quantum computers to optimise advertising networks and develop new polymers. In both cases, better real world solutions are being found.
- Artificial Intelligence/Machine Learning – Japanese companies are neither the software nor hardware leaders, but are fast followers across multiple industries.
- Self driving cars – The Japanese auto OEMs have been building safety and self driving features for many years. The industry is moving so fast that it's not yet clear which components, solutions, processors or software will prevail, but it seems likely that the Japanese will be in the leading group.
- Cloud computing – Software-as-a-service (SaaS) and other cloud computing services are widespread across the Japanese economy.
- 5G networks – NTT is one of the global leaders; capex starts in March 2019 with a full rollout across the 23 wards of central Tokyo in preparation for the 2020 Olympics.
- EVs – Toyota is the largest electric car company in the world. There are supply chains for cathode, anode, separator and electrolyte materials across the country, including for Tesla and the Gigafactory.
- Robots – Japan is the undisputed global leader in the area of joints, controls, motors, integration and software. The full list of Japanese robotics companies is extensive.
- Blockchain – the largest blockchain investor is a Japanese company and significant amounts of cryptocurrency trading occur in Japan. Japan is at the forefront of nations embracing the dawn of the Internet of Value. Real world uses of the blockchain are only just beginning as Patrick Byrne of Overstock turns from e-commerce to new ventures that include a blockchain-based global property registry.

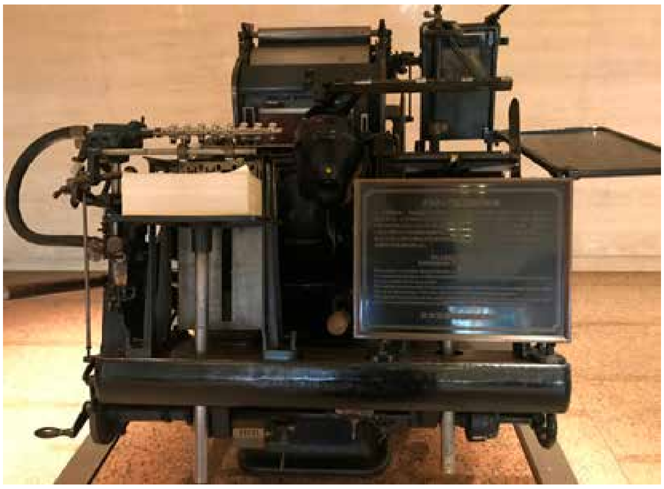
- Internet of Things (IoT) – SoftBank bought ARM and is building a global platform which will be integrated with their mobile networks to provide hardware and services with increased bandwidth, lower latency and orders of magnitudes more allowable connections. Japan excels at passive components essential for the trillion connected devices enabled by 5G.
- 3D printing – Japanese machine tool companies have many active development paths.
- Virtual reality (VR)/augmented reality (AR) – Nintendo developed commercial VR products in 1995 and launched the mobile AR game Pokémon GO in 2016.
- Environmental protection – Japanese companies excel across the full range of water and air pollution prevention machinery and chemicals.
- Distributed services – Japan has embraced car sharing, micro delivery networks and home sharing, where appropriate.

In the context of a long bear market and wide value dispersion, some aspects relevant to the Japanese stock market are worth mentioning:

- The domestic economy is strong. Surprisingly to many, employment in Japan is at all time record highs. Corporate confidence and snug labour markets are resulting in higher wages.
- Profit margins are rising. After six decades oscillating between 2% and 4%, Japanese profit margins have risen above 6%, a combination of low interest expense, higher domestic margins and record foreign profits. Japanese corporate profits are at record levels, twice the previous peak, while the Nikkei is half of its previous peak.
- Domestic competition is easing. Game Theory, in particular Nash's Equilibrium, makes predictions of market behaviour. The practical world experience tends toward the theoretical construct, but with a delay. Decades of rough competition in Japan are now transitioning to a more benign environment. The beer industry is in the early stages of this: "the chain of communication between the four players is open and working well".
- Both retail and institutional domestic investors continue to sell the stock market, extending a 25-year trend. The only significant buyer of the market in recent decades has been foreigners. The balance sheet of the Japanese consumer is strong, with US$8 trillion of cash and US$1 trillion of equities relative to an overall market valuation of US$5 trillion. In combination with a large set of domestic pension funds and insurers who have low equity holdings, it would not be hard for a small shift in asset allocation to change the tone of the stock market.
- Valuation dispersion is currently a defining feature of the Japanese stock market with many indicators of dispersion near the widest seen in the last few decades. Many stocks have P/E ratios above 50x, some approaching 100x, but there are also whole swathes of the market with single digit P/E ratios.
- The overall market valuation is not extended. While nominally on a P/E multiple around 15 times, this ignores the extensive Treasury shareholdings, the widespread cross-holdings and large amounts of cash. These are perhaps almost 30% of the total market capitalisation.
- Post the 1989 bubble, Japan has experienced a 30 year bear market. This is perhaps the longest stock market bear run in modern financial market history. A lot of the indicators that one would expect are clearly evident: very cheap companies, low stock market participation, widespread corporate problems and early signs of rejuvenation.
- Interest rates in Japan for most deposits are effectively zero. There is clear demand for products with yield, including financial products linked to the share market. The need for higher dividends is pushing real improvements in corporate behaviour – it's a true economic incentive.
- Asian and global integration – inbound tourist numbers to Japan are growing rapidly, leading to intermittent hotel shortages and pressure in some areas of the economy. This is just one aspect where Japan's integration into Asia becomes apparent – the future of Japan is tied to and intertwined with Asia broadly. Imagine the scenario where China bridges the middle income gap and India shows even part of its true potential. ASEAN growth is currently robust and Japanese companies have strong businesses across Vietnam, Burma, Thailand and Indonesia.
- Many areas of the global production system are reaching limits. THK's lead time for linear guides and other complex machine parts has recently increased from three to more than eight months. Many greenfield expansion plans are being considered; but thwarted by lack of available machinery. In many ways, the current global macro situation seems strong, perhaps as strong as any stage of the last decade.

Late in 2017 we visited 35 companies in Tokyo and Kyoto and checked in with some of our many contacts in the country. In some ways, Japan is a "solution looking for a problem" and, while for the moment there is no resolution to this conundrum, much of the country seems to have found enough activity to keep itself busy. There was a sense of calm and focus that has not been as evident over the last three years. The capacity expansion and the resulting capex has driven machine tool backlogs to record highs. The world is leaning towards Japan's strengths of precision and quality across semiconductor production equipment, miniature electronic components and mass automation of production capacity.

Nissha Printing is a Kyoto based business which is currently in the third generation of family management. They have been in the printing business for one hundred years and have been making touch panels for electronic devices for thirty years. They started working with Apple in 2010 and since 2013 have been the sole source supplier of the touch panel for the iPad, a monopoly position. With Apple's transition to OLED screens, Nissha is the sole supplier of the touch sensor and pressure sensor for the new iPhone X. We have been identifying many such opportunities in addition to the usual deep-value cyclicals and global leaders that are ever present in Japan.



A rare letterpress printing machine imported by Nissha from Germany in 1933. Source: author

Notes

1. Fund returns are calculated using the net asset value per unit (which does not include the buy/sell spread) of the stated unit class of the fund and represent the combined income and capital returns of the stated unit class over the specified period. Returns are net of accrued fees and costs, are pre-tax, and assume the reinvestment of distributions. The investment returns shown are historical and no warranty can be given for future performance. Historical performance is not a reliable indicator of future performance. Due to the volatility in the fund's underlying assets and other risk factors associated with investing, investment returns can be negative, particularly in the short-term.

   Index returns are in Australian dollars and assume the reinvestment of dividends from constituent companies, but do not reflect fees and expenses. For the purpose of calculating the "since inception" returns of the MSCI index, the inception date of C Class of the fund is used. Where applicable, the gross MSCI indices were used prior to 31 December 1998 as the net MSCI indices did not exist then. Fund returns have been provided by Platinum Investment Management Limited; MSCI index returns have been sourced from RIMES Technologies.

   Platinum does not invest by reference to the weightings of any index or benchmark, and index returns are provided as a reference only. A fund's underlying assets are chosen through Platinum's bottom-up investment process and, as a result, the fund's holdings may vary considerably to the make-up of the index that is used as its reference benchmark.

   The stated portfolio values of C Class and P Class of the Platinum International Fund (PIF) do not include funds invested in PIF by the Platinum International Fund (Quoted Managed Hedge Fund), a feeder fund that invests primarily in PIF. The stated portfolio values of C Class and P Class of the Platinum Asia Fund (PAF) do not include funds invested in PAF by the Platinum Asia Fund (Quoted Managed Hedge Fund), a feeder fund that invests primarily in PAF.

2. The investment returns depicted in this graph are cumulative on A$20,000 invested in C Class (standard fee option) of the fund over the specified five year period relative to the relevant net MSCI index in Australian dollars.

   Fund returns are calculated using the net asset value per unit (which does not include the buy/sell spread) of C Class of the fund and represent the combined income and capital returns of C Class over the specified period. Returns are net of accrued fees and costs, are pre-tax, and assume the reinvestment of distributions. The investment returns shown are historical and no warranty can be given for future performance. Historical performance is not a reliable indicator of future performance. Due to the volatility in the fund's underlying assets and other risk factors associated with investing, investment returns can be negative, particularly in the short-term.

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3. The geographic disposition of assets (i.e. the positions listed other than "cash" and "shorts") represents the fund's exposure to physical holdings and long derivatives (of stocks and indices) as a percentage of the fund's net asset value.

4. The table shows the fund's top 10 long stock positions (through physical holdings and long derivatives) as a percentage of the fund's net asset value.

5. Sector breakdown represents the fund's net exposure to physical holdings and both long and short derivatives (of stocks and indices) as a percentage of the fund's net asset value.

6. The table shows the fund's major currency exposure as a percentage of the fund's net asset value, taking into account currency hedging.

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