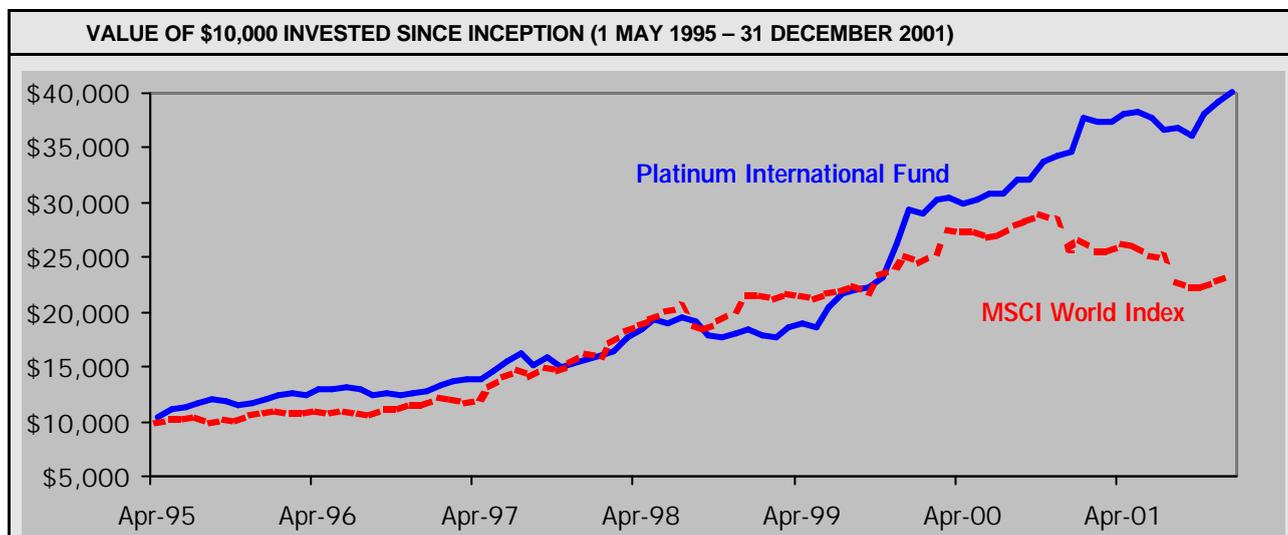


The Platinum International Fund

REDEMPTION PRICE: \$1.7430

Performance



Markets continued to recover their composure as the quarter progressed. The information technology sector led the recovery with a gain of 28%, followed by consumer discretionary, industrials and materials. Energy, which had been an early favourite on the assumption of an early economic rebound, lost momentum as investors migrated to industrials. Health Care, telecoms and utilities were all slightly lower over the quarter. The net outcome was a 4.7% gain for the MSCI for the quarter and a fall of 9.7% for the year.

Your Fund had performed relatively strongly in the September quarter, though down 4.6% compared to a

decline in the MSCI World Index of 12%. We would have expected it to have been something of a laggard this last three months because of there being fewer gains to be had from short selling. However, the Fund returned 11.3% for the quarter and for the calendar year it smartly outpaced the benchmark with a 16% return. When examining our long-only accounts, we can see that stock picking is an important contributor to this outperformance. We benefited also from our willingness to add aggressively to our existing holdings during the ferocious sell-off in September.

Changes to the Portfolio

DISPOSITION OF ASSETS		
Region	Dec 2001	Sep 2001
Western Europe	39%	34%
Japan	15%	16%
Emerging Markets (incl. Korea)	14%	11%
North America	13%	18%
Australia	0.4%	1%
Cash	19%	19%
Shorts	24%	21%

On the buy side, we have tended to add to existing positions. As regards disposals, we used the strong rebound to offload a proportion of the tech stocks we had acquired in September, particularly old favourites such as PeopleSoft, Agere, AMD, Sun Microsystems, Foundry and i2 Technologies. In some cases this selling was premature and at the close of December we were once again engaged in shorting tech names which in our view have little likelihood of meeting investors sales, let alone profit expectations. Non-tech sales included Bouyges and Schneider in France and DSM in Holland. These are

economic sensitive companies that were sold following unusually strong price performances in the last few months. In their place we bought Freeport McMoran and started to acquire Inco. These two mining companies are world leaders in terms of their mineral resources, respectively copper and nickel, which ensures that they operate at the bottom of the cost curve.

Pension reforms in Italy will benefit the entrenched asset managers like the Generali Group, including its life insurance subsidiary Alleanza. The government is trying to augment the present, and unsustainable, pay-as-you-go arrangement with a compulsory income-based levy to build a fully funded pension pool similar to that seen in Australia. With its dominant position in the Italian life insurance market, and being number two in Germany, we can see how this group can maintain its historic mid-

teens growth rate. This is not fully reflected in the share price because of a history of faltering reform and a loss of confidence among private Italian investors which we believe will only be temporary.

In Japan, we have been adding to companies which benefit from a weakening yen while adding new names such as Sony, Citizen Watch and Shimano. We have also bought into Nippon TV and Tokyo Broadcasting. Contrary to what one might have thought, these two free-to-air stations have had enviable growth records throughout the last ten years of economic sluggishness. Trading on under 20 times earnings, these cash generative and highly profitable companies will have a central role to play as direct broadcasters once digital broadcasting begins and also as content providers to the 200 projected channels of satellite transmission.

BREAKDOWN BY INDUSTRY

Categories	Examples of Stocks	Dec 2001	Sep 2001
Cyclicals/Manufacturers	RMC, Akzo Nobel, Bayer, Linde, Océ	22%	22%
Consumer Brands	Adidas-Salomon, Coke Bottlers, Lottecon	11%	8%
Retail/Services/Logistics	Hornbach, Jones Lang LaSalle, Fraport, Stinnes	10%	9%
Financials	Nordea, Deutsche Boerse	8%	7%
Technology/Hardware	Toshiba, Samsung Electronics, AMD, Foundry	8%	11%
Medical	Draegerwerk, Merck KGaA, Novartis	7%	6%
Software/Media	Mediaset, Novell, Nippon Broadcasting, Seoul Broadcasting	7%	6%
Telecoms	NTT, Verizon, Korea Telecom	4%	6%
Gold and Other	Gold Fields, Newmont Mining	4%	3%

Currency

As we suggested in the last quarterly, the short term strength of the yen proved transitory. It has now turned decisively weaker and we believe this tendency will endure for some time. Apart from running a small short position on the yen, our

currency posture is largely the same as before, namely long euro and European currencies to 47% and long the A\$ to 45%. We have virtually no net exposure to the US\$ or Korean Won.

Commentary

Despite important differences between this recession and previous downturns, investors have been willing to assume that the Federal Reserve Board's actions will re-energise the US economy. The differences range from the degree of synchronisation among global economies, to the high level of recent capital investment and the manner in which both corporate profits and earned incomes have fallen. Indicators

such as forward rate spreads and the strong performance of share prices of companies that are susceptible to the business cycle, all point to investors adjusting their view to a "v" shaped type of economic rebound. This could be driven by the rebuilding of stocks and presumably the consumer's willingness to spend more in response to plentiful credit, epitomised by the interest-free deals on

consumer durable goods, and further government stimulation of the economy. Investors seem willing to ignore the facts of continuing lay-offs and the rare experience of shrinking gross incomes.

As we have recognised in earlier pieces, fretting about the world's leading economy will not get us very far. On balance we agree with the consensus view of a recovery within six months, but we suggest it may splutter into life rather than burst upon us and confidently accelerate. An interesting feature in the US has been the alacrity with which companies have exploited investors' growing appetite for risk by issuing convertible paper - no less than \$100 billion in 2001. Though less aggressive than the huge share buy-backs of earlier years, the favourable terms of these deals are noteworthy, as are the discredited names involved and the way that raisings have been expanded to accommodate strong investor interest. Cheap money is clearly working, but for this magic to come so soon after the bursting of the liquidity-induced internet bubble is a surprise.

Puzzling also is the relatively calm acceptance of one of America's great corporate failures, namely Enron. Here we have a failed hedge fund that had its origin as a gas pipeline company. Utilities are capital intensive businesses. A typical utility requires between two and three dollars of assets to produce one dollar of sales. In Enron's case, sales were about US\$140 billion compared with shareholders' funds of some US\$14 billion. Implicitly this suggests it had control over assets of between \$280 to \$420 billion. Put in banking parlance, each dollar of equity supported between \$20 and \$30 of productive assets. Moreover, equity itself was somewhat overstated as a consequence of the pre-booking of as yet unrealised profit. None of this is apparent from a casual reading of the balance sheet where the debt to equity ratio seemed to be one to one. Off balance sheet debt and long term trading arrangements were the real burden. Unlike a typical utility, Enron did not have the typical, if boring, cash flow. This became all too apparent from the subsequent fall-out and the withering share prices of related parties. As noted in previous coverage, the extent of debt and leverage within the US economy is of worrying proportions and yet the Fed deems it appropriate to continue to stoke the fire. (Do refer to our feature article for more on the Enron debacle.)

"So what?" you may ask. Well, we do not understand why in the face of these risks, the market is so willing to pay such high prices for tomorrow's earnings. Clearly, on 2001 earnings, Wall street is extremely expensive, trading on 27 times, but even on Year 2000 *peak* earnings with all the attendant accounting fiddles, the market is on 21.5 times.

Though the economy is likely to recover, history suggests that earnings need not surpass these peak levels for some years!! Note the following table.

S&P500 EARNINGS			
Year	Operating Earnings \$	Year	Operating Earnings \$
1970	5.15	1987	18.02
1971	5.79	1988	24.65
1972	6.48	1989	24.02
1973	8.16	1990	23.03
1974	8.97	1991	19.60
1975	7.94	1992	21.71
1976	9.90	1993	25.92
1977	11.01	1994	31.02
1978	12.44	1995	36.51
1979	14.92	1996	40.49
1980	14.76	1997	44.71
1981	15.22	1998	44.10
1982	12.76	1999	50.78
1983	14.29	2000	55.86
1984	16.94	2001e	44.00
1985	16.31	2002e	51.00
1986	15.89		

Source: Sanford Bernstein

It is worth remembering that the long term *real* growth in corporate earnings is around 2% pa. Further, that the S&P index has yielded an average *capital* return since the 1920s of about 7% a year. There was a time when shares were required to yield more than bonds. Now we find an S&P index composed of low yielding and highly geared companies. Shareholders seem willing to believe that equity investment involves close to zero risk and that high rates of growth of corporate earnings are inevitable.

Contrary to the beliefs created during bull markets, fast growing companies are scarce. When conducting a search of our database for companies that have grown earnings at 15%pa, a mandatory figure that is commonly cast about by promotional company executives, the list is short. We searched for companies anywhere in the world with a market capitalisation above US\$900 million which had achieved 15% trend earnings per share growth regressed over the last, favourable, 15 years. By using the best fit over 15 years, the screen does include companies that have negative year on year comparisons ie. some years of declining earnings per

share. Out of a sample of 1402 companies only 136 passed the test. When the net is drawn wider to find companies that have achieved 7% pa over 15 years, the catch rises to 507 entities – but still this represents only 36% of the whole sample! A rise in the valuation placed on each dollar of earnings can do great things for stocks in a bull market (ie. PE expansion) but in the end, earnings drive stock prices.

The above observations apply equally to the markets of Europe and Asia. The emphasis on the US stems from its leadership position in terms of market capitalisation and the likelihood that it will recover ahead of the other developed markets.

Clearly the news coming out of Japan is extremely disturbing. We do see, however, that cash flow constraints and chronic disappointment with the behaviour of the economy is now starting to galvanise change at the company level. Simultaneously, the yen continues to weaken and we see a weak yen and falling aggregate income as the principal solutions to the country's problems. We are finding companies that meet our valuation

criteria and even if some are not growing at present, there is still underlying strong compounding of their net worth.

In Europe we have been somewhat dismayed at the unhelpful interventionist approach by the competition commission. On the back of an unresponsive central bank, which is encountering the problems of the different rhythms of economic activity among member countries, this has not helped to engender faith in the smooth workings of Euroland. Nevertheless, at the country level we are seeing interesting developments. In Italy, pension reform is gaining momentum as the Berlusconi Government addresses the problem of developing a funded private system. The regime is also working on lowering direct taxes. Tax reform in Germany is likewise helpful; the sale of long held investments will be treated as capital gains free as from January 2002 which should accelerate the restructuring of businesses and allow the equity market to play a more significant role in this largest member of Euroland.

Conclusion

In several markets, particularly the US, we detect an unusual degree of optimism buoying prices of many leading companies to levels which may prove unsustainable. Platinum has, however, been able to

load its portfolio with enough companies priced to offer good value to enable us, we believe, to deliver positive returns over the next year.

Kerr Neilson
Managing Director

Feature Article - Enron (US)

Enron filed for bankruptcy on 2 December 2001. This was no ordinary filing – not only was Enron the biggest bankruptcy in US history – there was very little alarm about Enron even one month earlier – and almost none six months earlier. *This very big bust was a very big surprise.* This once again reminds investors of the financial leverage within the system which adds to the vicissitudes of managing businesses and of investing.

Background – Energy deregulation and the rise of highly leveraged energy merchants

In the United States – as in Australia – there has been a trend towards deregulating energy markets. Formerly each district had its own monopoly gas and electricity supplier. With deregulation the *means* of distribution (pipes for gas or wires for electricity) gets separated from the *product* being distributed. The “lines” company gets regulated as a monopoly and competition is introduced in the product market with customers being able to choose from many suppliers.

The pure “merchant” business – a company buying and selling energy which it did not produce - was born. It happened first in gas (which was deregulated in the mid 1980s). Several gas companies (including Enron, PanEnergy, El Paso Gas, Dynegy and others) became merchant businesses. They found large customers and purchased gas from their own and other sources making a “trading profit”.

The trades became more exotic. These companies purchased gas storage so that they could “arbitrage” seasonal differences in gas prices. They started trading petrochemicals where the raw feedstock was gas. It might for instance be easier to alleviate a gas shortage in the US by closing a urea plant (which uses a huge amount of gas) and importing urea than by building additional storage. Moreover when the gas price was allowed to fluctuate week-to-week there might simply be weeks where it was unprofitable to produce urea in the US.

In 1996 electricity was deregulated – and gas merchant companies bought their trading expertise to the electricity market. *Almost all the largest players in the electricity merchant market were originally gas companies – the major exception being*

Duke Energy (who purchased their expertise in a merger with Pan Energy).

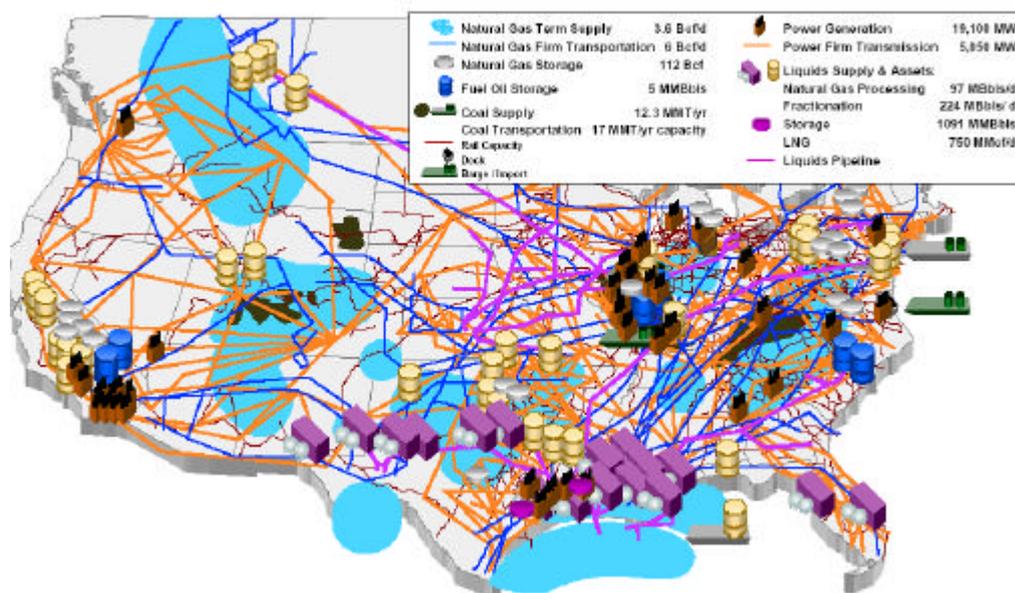
Electricity deregulation caused a massive acceleration of the merchant business and the trading business. Electricity is a *far more volatile commodity than gas* exacerbated by the almost total lack of storage and larger swings in usage. Electricity markets became very correlated with gas markets however, because the marginal generation of choice was gas turbines.

The trades became more exotic still. As electricity demand was correlated with gas demand and gas demand was correlated with chemical prices, swings between Californian electricity prices and say polyvinyl chloride prices were traded. This was also correlated to the weather, so energy companies started trading in weather derivatives and weather insurance. (If you wanted to insure a Rock concert against rain you would buy the protection from a gas company! Weather is correlated with electricity usage – so the energy trader could undercut the insurance company in providing this protection – hedging its exposure through its trading business.).

The trades also became very leveraged. Dynegy for instance has signed 14 year “tolling agreements” with power station providers. A “tolling agreement” is an arrangement where the buyer promises the power station a fee either for use, or for sitting idle. Dynegy then has to provide gas to the power station when it wishes to use the station – and in return takes the electricity generated. The power station has only to provide for the use of its turbines. This tolling agreement can be a “physical toll” (in which case there is a real power station and operating clauses) or a “financial toll” in which case all Dynegy is trading is a spread between a gas and electricity price at an assumed conversion rate (known as a “heat rate”). What has happened, however, is that Dynegy now has use of the power station *without putting up substantial capital*. Dynegy has implicitly got very large leverage.

Enron did similar things – but because Enron’s accounts are simply indecipherable it’s easier to look at Dynegy. Enron was about six times Dynegy’s size – and almost all its energy delivery assets were obtained through financial tolls and similar structures.

DYNEGY ENERGY DELIVERY NETWORK



The picture above – from a Dynegy analyst presentation – indicates just how wide the controlled asset base is. In addition to these assets, Dynegy controls energy assets in the UK and Europe and 16,000 miles of broadband cable. To imagine the financial scope of Enron multiply by six and Dynegy controls this from roughly \$4 billion in stockholders equity!

One thing is for sure – Dynegy does not own all these assets. Some it owns (there is considerable balance sheet debt), but in many cases it is just paying other companies for the right to use these assets. *A long term contract by which Dynegy controls these assets is just another form of leverage.*

The financial leverage has helped Enron (and Dynegy) to grow very rapidly. Before Enron's collapse its sales were running well over US\$100 billion per annum – about \$9 million per staff member. In 1996 its sales were just over \$13 billion. This growth was obtained by gaining effective financial control over more power stations, pipelines, hydro dams and other facilities than ever before – using tolling agreements and long term contracts.

With the power shortages in the United States last year, and with simply huge amounts of leverage, the energy merchants made what seem to be very large profits last year.

Sectoral pressure on Enron's trading model

Trading regional differences in gas price, or between gas prices and chemical prices was hugely profitable when only Enron did it. (If the chemical company in Asia doesn't know about the hot weather in the US

driving air-conditioning demand and hence gas usage they might be willing to take a lower price for their output from these funny Texans who are offering a short term contract.)

The problem is that soon-enough the easy trades were done. Enron's margin has fallen pretty consistently now for years. Their volume however soared. To deal in larger volumes Enron needed to control more delivery and other assets – and hence the implicit leverage in the structure soared.

Enron's response to the pressure on its trading model and the demise of Enron

Enron had two responses to greater competition. These were (a) to diversify into new areas such as "bandwidth trading" and water trading, and (b) to use opaque accounting structures which hid the decline in profitability. The problem however was that the new businesses (bandwidth, water, power in India and others) were highly unprofitable. On bandwidth for instance the losses will probably match those of other bulk bandwidth providers – say 80¢ in every invested dollar.

Enron hid these losses through staggeringly complex deals with off balance sheet entities managed by senior staff members. The "related party" statement in Enron's last annual accounts is extremely obtuse.

The losses however came out in cascading disclosures. We don't know how much they really lost but it was several billion dollars in bandwidth alone. The accounts for the past three years were "restated". This only happens when there are serious accounting "irregularities" (which may or may not include fraud).

Either way the trust in Enron disappeared. Short term capital markets dried up and counter-parties to trades demanded cash wherever they were owed it. The effect was the same as an old-fashioned bank run. Enron had become as leveraged as most banks and everyone who could get their cash out largely did. Insolvency loomed.

The insolvency was briefly delayed by a promised acquisition by Dynegy. Dynegy injected \$1.5 billion in funding allowing Enron to last a few days longer. However it was soon all over.

Lessons

What is startling about this case is (a) the notion that once boring utilities could get themselves so leveraged with funding that was implicitly so short term and (b) the vulnerability of structures outside traditional banks to “runs”. The related party dealing is also startling – however a culture of opaque accounts and managed earnings is widespread in the US – with Enron perhaps being an extreme (and extremely vulnerable) example.

Other companies in this sector are just as vulnerable to “runs”. Dynegy for instance has drawn its back up lines of credit by \$1.1 billion during the first two months of the quarter. It has available liquidity of approximately \$900 million. It is being sued by Enron (or by Enron’s creditors) for US\$10 billion for breaching its merger agreement. The consensus is that it will probably win the Enron court case – but even the perception that it might lose could trigger liquidity issues.

Sadly we were too sleepy to profit from the share price collapse of Enron. However, the hasty rescue arrangements by Dynegy gave us a second chance. We established a short position on the basis of Dynegy’s highly leveraged business model and the risks associated with Enron litigation. Since taking that position Dynegy has itself lost access to short term capital markets. The stock however is highly volatile – the bulls believing that the loss of the main competitor will make Dynegy’s trading operation substantially more profitable.

John Hempton
Investment Analyst

