



**Platinum Asia  
Investments Limited  
Quarterly Investment  
Manager's Report**

30 June 2017



**Platinum**<sup>®</sup>

ASIA INVESTMENTS LIMITED

ABN 13 606 647 358

# Portfolio Update

by Joseph Lai, Portfolio Manager

## Performance

(to 30 June 2017)

	QUARTER	6 MTHS	1 YEAR	SINCE INCEPTION P.A.
Platinum Asia Investments Ltd	6%	14%	20%	8%
MSCI AC* Asia ex Japan Index	8%	16%	23%	12%

After fees and expenses. Refer to note 1, back cover.

Historical performance is not a reliable indicator of future performance.

Source: Platinum Investment Management Limited, RIMES Technologies.

\* Morgan Stanley Capital International All Country

## Net Tangible Assets

The following net tangible asset value per share (NTA) figures of Platinum Asia Investments Limited (PAI) are, respectively, before and after provision for tax on both realised and unrealised income and gains.

	PRE-TAX NTA	POST-TAX NTA
31 March 2017	\$1.0554	\$1.0367
30 April 2017	\$1.0921	\$1.0675
31 May 2017	\$1.1089	\$1.0817
30 June 2017	\$1.0920	\$1.0705

Source: Platinum Investment Management Limited.

The MSCI AC Asia ex Japan Index was up 8.7% over the quarter in local currency terms, or 7.7% in Australian dollars. PAI returned 6.4% over this period. Over the past 12 months, PAI's portfolio appreciated 20.2%.

Performance was generally positive across the region, with Korea being particularly buoyant as its market recovered from recent uncertainties surrounding both domestic politics and regional geopolitics. The MSCI Korea Index was up 12.8% for the quarter in local currency, led by strong-performing stocks such as Samsung Electronics.

The Philippines market rose 7.7% (in local currency). Last year, President Duterte issued some controversial policies that deterred multinational businesses from continuing to outsource their call centres and various middle-office

functions to the country. After a brief lull, outsourcing by multinationals is returning, as witnessed on our recent field trip, with many taking up entire buildings to support their global operations.

Business process outsourcing (BPO) is the official name given to this sector. The cost advantage of an educated and English-literate workforce earning an average monthly salary of A\$800 proves attractive. The impact of BPO on the bottom lines of foreign businesses is great, but its impact on the Philippines is even greater.

With some 200,000 Filipinos joining the BPO sector every year, the country is seeing a rapid expansion of a young working class that earns superior wages to its traditional white collar workers, significantly lifting demand for consumer goods and residential property. Snack food companies are seeing a need to upgrade their product offering, while real estate developers are experiencing robust demand across residential, commercial and retail properties. The Filipino property companies in PAI's portfolio stand to benefit from this trend of rising income and growing consumption.

The MSCI China H-Share Index (up 2.8% in local currency) held its gains from the last quarter as economic activity remained strong, and the Chinese government is using this window to tackle longer-term problems. After months of buyer enthusiasm, the property market in major Chinese cities is now under-supplied and conditions are supportive of construction and other economic activity. On the supply side, closure of idle factory plants and heavy polluters is reducing excess capacity, helping commodity prices (steel, coal, cement, etc.) to firm up. This will improve producers' profitability and reduce the risk of loan default, in turn improving the health of the banking system.

The Chinese authorities are also taking steps to clean up the shadow banking sector (the so-called wealth management products), often cited as a source of financial risk for the country. While this is certainly a positive move for the long-term, stricter regulations, together with a mild tightening of financing conditions, can lead to a marginal slow-down in the economy and have indeed led to some volatility in the Chinese domestic A-share market.

The good news is that the A-share market seems to have already adjusted and, moreover, at the end of the quarter news came that A-shares were officially accepted into the MSCI Emerging Markets Index. Inclusion of companies on other exchanges by the MSCI has tended to lead to out-sized returns, and initial market reaction in the A-share market is hinting at a similar outcome. Interestingly, we are seeing a shift in the kinds of companies favoured by the market. Those with strong fundamentals and attractive valuations, some of which feature in PAI's portfolio, received a boost, while the expensive, high-growth stocks previously favoured by domestic Chinese investors were left behind.

With rising income and an ever-improving social safety net, Chinese consumers are upgrading their consumption pattern, benefiting the e-commerce stocks and premium domestic brands held in PAI's portfolio. Product quality has become a vital attribute in consumer products. The apparent insatiable demand for health supplements, baby formula milk powder, luxury goods, high-end cars and overseas travel is reflective.

Rising labour costs and stronger demand for quality also mean that China's growth is increasingly driven by technological innovation that can deliver quality at an affordable price. The fact is that China has already achieved global standards of excellence in a number of technology industries – telecommunication equipment, high-speed rail,

auto manufacturing, etc. Robotics and automation are one of the key secular themes within PAI's portfolio, and the sector showed particular strength during the quarter.

Our Chinese Internet holdings continued to be key contributors to performance. Sina Corp (social media platform) was up 28% (here we have to add 7% more for its distribution of Weibo shares), Alibaba and JD.com (e-commerce) were up 31% and 26% respectively, and Tencent was up 25%. Midea (whitegoods and robotics) and ZTE (telco equipment) were up more than 30% each, while Hon Hai Precision (assembler of the iPhone and both a maker and a user of robotics) was up 28%.

Elsewhere, the Indian market was up 2.4% for the quarter (in local currency) as the economy continued to recover from the demonetisation shock and the government carried on with its reform programs. A big part of PAI's Indian exposure is to the private sector banks that have strong positions in Indian cities, banks that have found their way out of bad debt problems over the last four years and have come out stronger. Attractively priced, we believe they are primed to make strong returns when loan demand recovers. What makes this sector particularly appealing is that sensible interest rate policy has dampened inflation rate to close to 2%, which is extremely low by Indian standards, paving the way for eventual interest rate cuts.

## Portfolio Disposition

REGION	30 JUN 2017	31 MAR 2017
China (Ex PRC Listed)	38%	34%
China (PRC Listed)	8%	10%
Hong Kong	1%	<1%
Taiwan	4%	4%
India	13%	14%
Korea	11%	13%
Thailand	6%	6%
Philippines	6%	4%
Vietnam	2%	2%
Singapore	1%	2%
Malaysia	1%	1%
Indonesia	<1%	<1%
Cash	9%	9%

Refer to note 2, back cover.

Source: Platinum Investment Management Limited.

## Top 10 Holdings

STOCK	COUNTRY	INDUSTRY	WEIGHT
Alibaba Group	China Ex PRC	IT	4.0%
Ayala Corp	Philippines	Financials	3.7%
Kasikornbank PCL	Thailand	Financials	3.2%
Axis Bank Ltd	India	Financials	3.2%
Jiangsu Yanghe Brewery	China	Consumer Stap	3.1%
Samsung Electronics	Korea	IT	2.9%
Midea Group	China	Consumer Disc	2.8%
Sina Corp	China Ex PRC	IT	2.5%
Tencent Holdings Ltd	China Ex PRC	IT	2.4%
Anta Sports Products Ltd	China Ex PRC	Consumer Disc	2.3%

As at 30 June 2017. Refer to note 3, back cover.

Source: Platinum Investment Management Limited.

For further details of PAI's invested positions, including country and industry breakdowns as well as currency exposures, updated monthly, please visit [www.platinum.com.au/our-funds/platinum-asia-investments-limited/#MonthlyUpdates](http://www.platinum.com.au/our-funds/platinum-asia-investments-limited/#MonthlyUpdates).

## Changes to the Portfolio

We took advantage of share price weakness and deployed some cash into the longer term prospective ideas.

We started a position in **ZTE**, one of China's leading manufacturers of telecommunication equipment. The Chinese telecom giants are well-endowed with the know-how to build the next generation 5G technologies, and they have the money to build a gold-plated network in the next few years, likely before most other global players. This will likely help ZTE achieve cost and technological leadership globally in the years ahead. With the stock trading on 14 times 2017 earnings, its prospects appear to be under-appreciated by the market.

We also initiated positions in **BAIC Motor** and **Geely Auto**. BAIC Motor is a Chinese auto joint venture partner for global brands like Mercedes and Hyundai. Mercedes' China sales is skyrocketing by 40% a year, thanks to locals' desire for quality and prestige. Recent political tension between China and South Korea led to an opportunity to buy this stock at a tantalisingly attractive price. Geely Auto is a Chinese domestic carmaker that is evidently reaching global standards, having acquired Volvo in 2010. Chinese consumers are voting with their feet, leading to sales growing by 50% from a year ago. Geely is set to launch a mid-end

brand globally at the end of this year, which promises high quality at a reasonable price. Trading on a P/E of 16 times 2017 earnings, this Chinese auto champion looks promising.

We have removed the portfolio's exposure to the Australian dollar.

## Outlook

Strong economic activity in China and the de-risking of the financial system are both positives for the Chinese market. Over the longer term, one may expect to see the entrepreneurial private companies in a broad range of industries swiftly climb up the technological ladder. The level of concern over China has subsided, but the market is still far from enthusiastic, hence offering up buying opportunities.

Given the enthusiasm that has been surrounding the Indian market, improvement in economic activity is yet to catch up to the optimistic expectations of the market. The possibility of an interest rate cut is interesting, as it can potentially ignite a long-awaited capex cycle. PAI's exposure largely relates to areas that are sensitive to interest rate cuts and are less "hyped" than other parts of the market.

Despite the recent run, markets in the Asian region continue to present us with new opportunities.

# Facts, Feelings and the Importance of Composition

by Kerr Neilson, CEO

Among the gifts of the Internet is the ability to gain access to almost **inexhaustible flows of information**. It can be a blessing to analysts who are trying to become familiar with a new industry or process. For example, when we were examining aspects of a new chip design affecting Intel, we were able to attend remotely a course run by a well-respected university on some of the technical issues that impinge on the semiconductor manufacturing process. This was available on YouTube. The drawback to this access to world-wide information and knowledge is that it can also give one a **false sense** of knowledge, a false sense of control.

The Internet also results in one being bombarded with news and viewpoints, and some may be inclined to respond to this deluge by using heuristics and relying on gut feel to cope with the overload. The alternative may be to read only those sources of information or news that accord with one's own comfort zone.

Let's take a concrete example of how **news can be nuanced**. Consider what constitutes news, who chooses the headlines, what or who prioritises what we see or read. For example, weather patterns are presumably far more interesting to a drought-stricken farmer than an urban millennial. And even when it has been determined what should be transmitted, there is still the need to understand the **perspective of the reporter** or the editor.

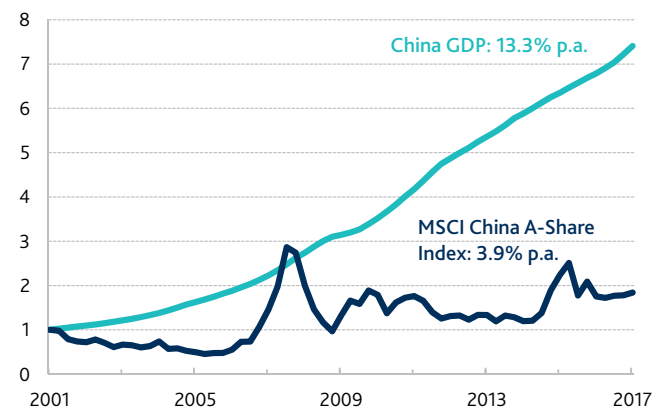
Think of yourself as a reporter for CCTV, China's national broadcaster. In view of the national admission that China can no longer guarantee food self-sufficiency for its 1.3 billion inhabitants, how would you report on China's behaviour in one of its critical supply routes, the South China Sea? Protection or aggression? By contrast, a Washington-based reporter may see matters from a completely different position and report the same events as a demonstration of the territorial ambitions of a new hegemon.

Let's now turn to the purpose of this note. **Some may believe that the stock market directly reflects the health of the economy**, that there is a tight correlation between an economy, profit growth and the stock market. **Academic studies show that there is virtually none** – though this may still leave many sceptical! Take for example the Chinese domestic market, despite the economy growing feverishly at an average annual rate of 13% over the last 16 years,

magnifying economic activity by more than sevenfold over that time, the stock market has risen by only 1.8 times.

## China GDP vs. MSCI China A-Share Index

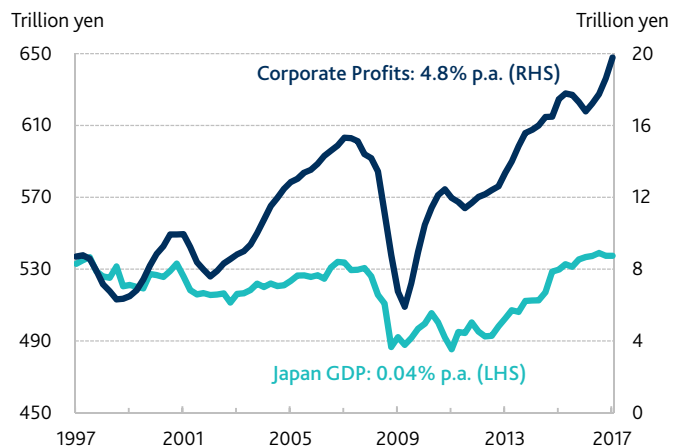
Index, March 2001 = 1



Source: FactSet, Platinum Investment Management Limited.

Consider also the experience of the Japanese market. The Japanese economy has grown very little over the last 20 years, yet corporate profits grew by nearly 5% per annum since June 1997. Stranger still, Japan's stock market for the most part was in chronic decline over the same period. Incidentally, with a falling population, real GDP growth per head in Japan has not been so different from that of the USA over this period, at 1% per annum.

## Japan GDP vs. Corporate Profits



Source: FactSet, Platinum Investment Management Limited.

Q1 2002 TO 30 JUNE 2017 (4Q AVERAGE)	STOCK MARKET PERFORMANCE (USD)	GROWTH		VALUATION		PROFITABILITY	
	15 yr p.a.	Earnings per share (EPS) 15 yr p.a.	Book value per share (BPS) 15 yr p.a.	Current forward price-to- earnings (P/E)	15 yr average forward P/E	Current return on equity (ROE)	15 yr average ROE
World	7%	6.4%	5.0%	18	15	10%	12%
North America	8%	6.1%	6.0%	22	18	13%	14%
Western Europe	7%	4.6%	4.5%	20	15	10%	12%
Asia ex Japan	11%	9.9%	7.3%	17	15	11%	13%
Japan	5%	16.4%	4.7%	17	18	8%	8%
India	15%	8.7%	8.9%	24	17	12%	17%
Greater China (China, Hong Kong, Taiwan)	12%	10.8%	7.7%	16	16	11%	13%

Source: FactSet, MSCI Inc, Bloomberg.

The above table tends to cement the argument that our **impressions are often very different from the underlying facts**. In aggregate, earnings across the globe have grown by around 6.4% a year over the last 15 years (somewhat higher than the 100-year nominal average). Earnings growth among Japanese companies (16%) has far outshone that of investors' favourite, India (9%), and yet the Japanese stock market has been a sad laggard.

Clearly, time frames matter for this type of exercise. For example, though the Japanese market has lagged, if one focuses only on the last five years, it looks far better, having doubled in a strong burst off the bottom in mid-2012.

For all the talk of a dysfunctional Europe, European shares have nevertheless risen faster than earnings. This is explained partly by the relatively low valuations back in 2002, and the subsequent lift in prices. Either way, the link between stock market moves and earnings is far from precise.

Earnings forecasts can be just as rickety. Back in 2008, optimistic analysts were forecasting the S&P 500 Index to earn over US\$100. We nearly got there several years later, and only now, with the aid of possible tax cuts and furious share buy-backs, is the S&P 500 Index likely to earn US\$130. Yet, the stock market is up 58% from the 2008 peak.

The table also shows that Asian shares have risen faster than their earnings with the consequent re-rating showing in the rise in the price-to-earnings (P/E) ratio.

#### ***How often do you check whether your "feelings" are backed by facts?***

For all their experience, fund managers are also prone to being influenced by impressions and the prejudice of stale information or an out-of-date understanding of a company's status. One way of reducing and coping with the complexity

is for fund managers to concentrate on the principal companies within a large index. This is rather less challenging than trying to pick the eyes out of, say, the 6000+ listed entities that have a market capitalisation of more than US\$1 billion, which is the Sisyphian endeavour we have tasked ourselves with here at Platinum.

The approach favoured by the majority tends to lead to portfolios that mimic the underlying index as these managers over-weight here or under-weight there, so-called "index awareness" or "**index-hugging**". Alternatively, if a manager's style is driven by news events, they may have a tendency towards **momentum investing** and bet on the latest hot topic: lithium, autonomous driving, artificial intelligence, you name it.

We at Platinum try to eschew both these approaches with **our contrarian style** which is **augmented by solid quantitative analysis**. One needs to inculcate independent thinking and use tools to assess when there is a wide divergence between "feelings" and the underlying data.

This leads to the essence of this note – **how does the weight of evidence compare with the strength of conviction**.

Essentially we are verifying the strength of our emotional conviction against the strength of the evidence underpinning it. When does one feel over-confident and when is more conviction warranted? The importance of this matrix in markets is quite unlike that of a personal exchange of opinions. In stock markets, indeed in markets in general, there is the extra dimension. **That dimension is price**, and it changes with information flow, fashion and other very human frailties. It is almost certain that the day-to-day volatility of a company's share price bears little correlation to the real changes in the intrinsic value of the business!

Having a hunch about the weather or some other matter may not be threatening, but in markets “feelings” matter because they pertain to the **price** at which one transacts.

Do the feelings match the realities, or are market participants acting with **availability bias, anchoring, framing or other heuristics that individuals subconsciously use to simplify their choices**? Should short-term considerations, which in the moment can seem so blindingly certain, form an important part of the decision?

To apply this **matrix** to the real world, let’s cast our mind back to early/mid 2016. The over-riding fear about negative interest rates, weak growth, the over-supply of commodities, banking fears in China, the solvency of the European banks and so on was all-consuming, so much so that to most people it seemed at the time that these issues could not possibly be transitory.

At that time the market was **fixated on avoiding uncertainty** and investors favoured companies that they “knew” would grow (conviction) and, indeed, had every likelihood of continuing to grow as they had done since their inception (evidence). The so-called “FANG” companies (Facebook, Amazon, Netflix, Google) were much in demand and this showed in their high valuations (**high conviction/strong evidence**).

In sharp contrast, **commodity producers** were the companies that investors loathed with a visceral fear, accentuated by the prevailing uncertainty. This was so despite the baseline logic that low commodity prices would clear away high cost supply and in due course allow lower cost producers to earn at least a modest return on assets – demand was not in contention. At that time commodity producing companies were selling at valuations previously seen in the depths of despair of the post-Lehman carnage. The logical case to own them was strong, but the conviction was pitiful (**low conviction/strong evidence**).

The other area that was attracting investors in early/mid 2016 included **high conviction/weak evidence** companies

such as consumer packaged goods producers, like Kellogg’s, Colgate-Palmolive, The Campbell Soup Company, and General Mills. Here was a group of companies that had barely seen any sales growth for several years, but through various devices were sustaining their profits or lifted their EPS, and this met the prevailing need for certainty, almost regardless of price. We contend that these companies should be classified as “weak evidence” because they were being priced well above the average (with P/E ratios above 20 times) while achieving EPS growth that barely matched the average company.

The last group – the **low conviction/weak evidence** companies – were left to their own devices and satisfied neither optimists nor pessimists. Our quantitative model will generally steer us away from these candidates. Priority is given to the first two groups where there is **dissent** caused by fear or greed.

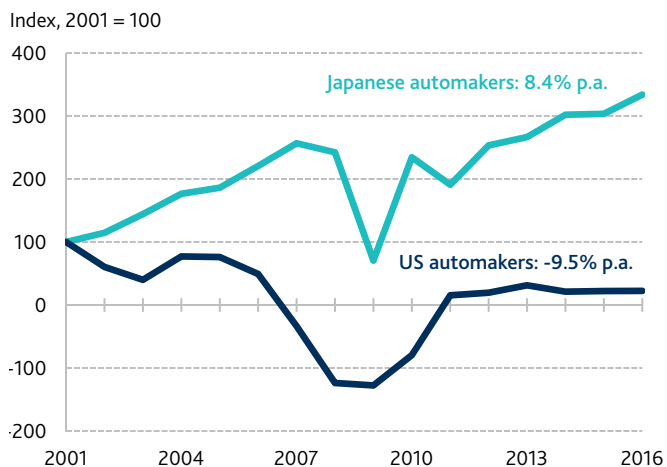
Another common error made by investors as they participate in the daily battle to find

opportunities is that of **composition**. The general should not be mistaken for the specific. We have for a long time argued that the Japanese stock market is refulgent with opportunity. Invariably, we are reminded by the interlocutor of the aging population and, when we skilfully evade that ambush, are parried with the many other imperfections that investors would rather not expose themselves to. The fact that the market has more than doubled off a 35-year low carries no weight among the doubters, as their conviction, shaped largely by news headlines, carries them blithely along with the crowd. The point that we are able to buy international corporations that simply have their headquarters in Japan and most of their business and assets abroad is conveniently ignored.

So let’s look at the particular. The accompanying charts on the next page illustrate the aggregate performance of two pairs of leading car companies, Toyota and Honda on the one hand versus Ford and GM on the other. For simplicity, we have created a composite number to represent each pair’s **growth in sales, profit and book value per share** over the

A Matrix of Facts vs. Feelings		
	WEAK EVIDENCE	STRONG EVIDENCE
LOW CONVICTION	<ul style="list-style-type: none"> <li>• Mid-range companies</li> <li>• Neither great price-makers nor price-takers</li> <li>• Moderate growth</li> <li>• Average valuations</li> </ul>	<ul style="list-style-type: none"> <li>• Commodity producers in early 2016</li> <li>• Perceived as weak businesses</li> <li>• Little regard shown to producers low in the cost curve</li> <li>• Prices relative to replacement cost at decade lows</li> </ul>
HIGH CONVICTION	<ul style="list-style-type: none"> <li>• Consumer packaged goods companies in mid-2016</li> <li>• Virtually no inherent profit growth</li> <li>• Well above average valuations</li> <li>• Trend followers accentuate over-valuation</li> </ul>	<ul style="list-style-type: none"> <li>• “FANG” stocks (Facebook, Amazon, Netflix, Google)</li> <li>• Strong and persistent growth</li> <li>• Qualities recognised with high valuations</li> <li>• Highly crowded institutional ownership</li> </ul>

### Japanese vs. US Automakers' Earnings Growth



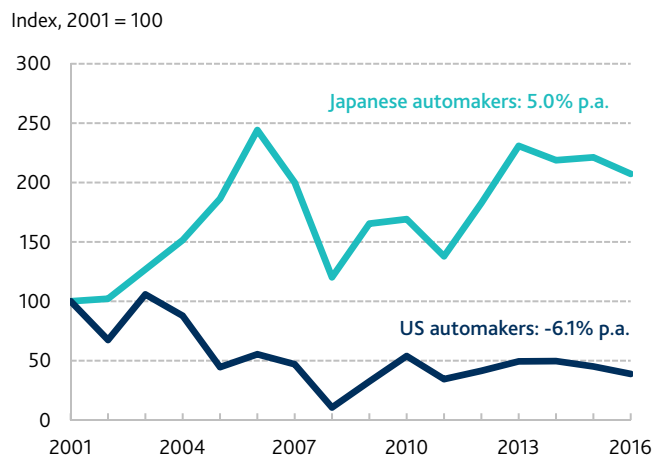
Source: FactSet, Platinum Investment Management Limited.

last 15 years. These are numbers generated after taking into account all of those headline-grabbing issues, varying from product recalls and consequential excruciating fines to Japan's supposedly sleepy management.

Evidently, the difference in share price performance has been night and day. The lesson again is to rely on a baseline numeric assessment rather than the far less reliable yardstick of one's intuition. Here we have a classic extension of the same problem described earlier where general impressions can corrupt clear judgment. Even though the host markets were very different, the opportunities given by these Japanese auto companies were just shy of those available from world markets over the last 15 years, viz 5% p.a. for Japan versus 7% p.a. for the MSCI All Country World Index in USD terms!

Mind you, **this is not a one-off**. Take China today, overall the market may not be so interesting, particularly if one pays heed to the press about all the careless lending and state-sponsored capex. All are reasonably accurate, but the question that needs to be asked is where the opportunities lie, and whether the bad lending does anything to diminish the prospects of those attractive companies. Chinese banks will in all likelihood have large bad loan write-offs, which will likely impair their equity. However, they won't be taken in one hit. Rather, the bad loans may be tantamount to writing off a good part of the next five years' earnings. The question that interests us is **where else in the world one can buy insurance companies that are growing at 10 to 15% p.a., yielding 3 to 4%, are priced at 1.5 times book value and less than 15 times earnings**. Recall that the global P/E average is now 18x while historic EPS growth rate is under 7% per annum. The market's general aversion to China has

### Japanese vs. US Automakers' Share Prices



Source: FactSet, Platinum Investment Management Limited.

allowed us to own some marvellous consumer companies like liquor-maker Moutai, which we have recently sold after a huge run, regardless of the fears about the economy.

The experience in India has been very different. Local investors are very active and companies that will benefit from rising living standards tend to be very enthusiastically priced. They have grown strongly, but with P/E ratios above 30, there is little margin for error. By contrast, one can own relatively slow growers among the utilities that have a promised return on assets, where earnings will grow with high probability and which sell on low teen P/E multiples. Our choice is to favour this **opportunity of composition** by owning the utilities rather than the more obvious high growth consumer companies.

In Europe, we had the same experience by owning the Italian banks which we believed were being tarred by availability bias, i.e. investors' attitude towards them were unduly influenced by feelings heightened by recent events.

There will be many times when there is high emotional conviction but weak factual evidence, and yet investors want to support these causes. The chances are that they are backing an index, because it *feels* safe, while in all likelihood they are falling into **the wrong quadrant in the matrix**.

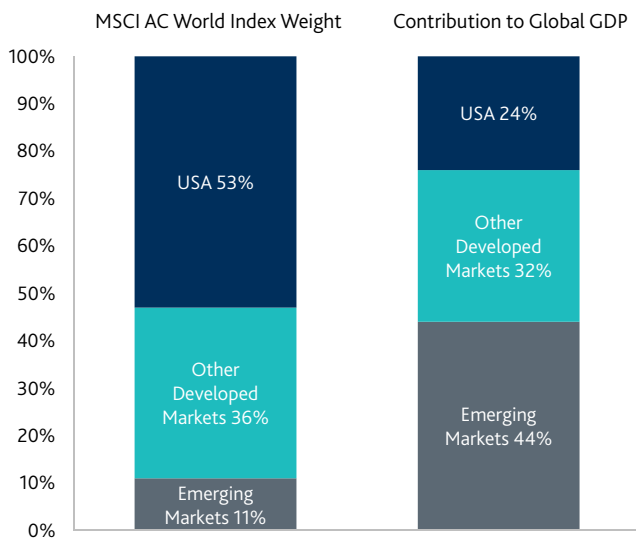
For those that find it challenging to deal with this paradox or with the ambiguity of markets, owning a global ETF may seem to be the solution, but it may run the risk of backing yesterday's winners. From our perspective, we believe there is a place for investors to apportion part of their assets to fund managers who are obsessed with the opportunities created by the imperfections in this matrix.



To conclude, today one might have the feeling that the US represents the best and brightest opportunity, but there are two snags with this.

Firstly, it is "over-indexed" in the MSCI (a term consumer product marketing companies use to denote a disproportionate market share versus market relevance). Secondly, the historical outperformance is approaching a significant extreme and we all live in the same round world!

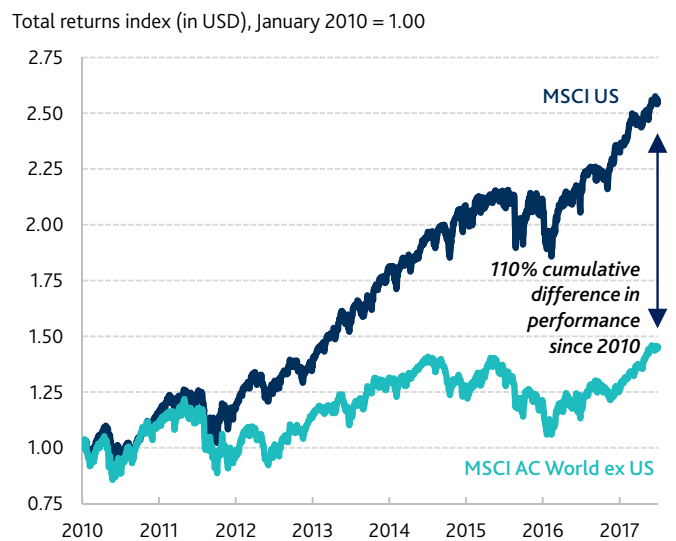
**The "Over-Indexing" of US Companies**



Source: MSCI Inc, RIMES Technologies, World Bank.

Do note that US GDP represents less than 25% of the global total, and even when adjusting for the reach of its highly successful multinationals, this variance in weighting is questionable. Our quantitative work suggests that there is no need for investors to have over 50% of their international share exposure in the US today, as would be prescribed by the "index- hugging" funds. Being the notable exception, the Platinum International Fund has 50% of its assets invested in Asia (including 13% in Japan).

**US vs. The Rest of the World – Can the Trend Continue?**



Source: FactSet, MSCI Inc, RIMES Technologies.

# Macro Overview

by Andrew Clifford, CIO

The focus in our last quarterly macro overview was on the massive imbalances in global trade that have arisen over the last 20 years. While China has been a well-known and recognised source of these imbalances, we noted that since the Global Financial Crisis, the Eurozone has moved from a small current account deficit to a surplus of over US\$400 billion, and that South Korea has seen a fivefold increase in their surplus to US\$100 billion. For comparison, China generated a surplus of a mere US\$271 billion in 2016, having peaked at US\$421 billion in 2008. What is important to remember is that when a country or region generates a current account surplus, these “excess earnings” (savings) are exported abroad and invested in other countries. Over the last two decades, the major recipients of these flows have been the US, the UK, Australia and Canada, who have benefited from this capital being invested in their real economies and financial markets – bonds, shares, and property alike. We think this pattern of trade and capital flows, which has been part and parcel of the global economy and financial markets, is set to change. In China, the ongoing strong growth in consumption spending, and in Europe a cyclical recovery, will result in lower current account surpluses and less capital exported abroad.

If this rebalancing is indeed underway, then we think there are potentially significant implications for Australian investors. Foreign capital inflows have long been a characteristic of the Australian economy. All of our investment cycles, whether it is the mining investment boom that is now coming to an end or the current cycle in residential apartment construction in the capital cities, have been in part funded by foreign money. At times foreign participation is clearly visible (as it has been in the case of property and mining), but it also plays an indirect and less conspicuous role via our debt markets and by funding our banking system. **There is nothing intrinsically wrong with this.** However, if the current account surpluses of the likes of Europe and China decline in the years ahead, we would be faced with a choice between:

1. saving more (and reducing our dependence on foreign money),
2. competing for our portion of a dwindling pool of funds by raising rates of return for investors (i.e. higher interest rates), and
3. experiencing a fall in our living standards via a fall in the Australian dollar.

If this occurs, it will come at a time when the Australian economy and markets are particularly vulnerable. We are hardly the first to make the observations that appear in the following paragraphs, and, indeed, the financial press has for some time been littered with predictions of a coming demise of our property market and, with it, our economy. We don't intend for this article to be another “bell ringing” prediction of an Australian property market collapse, though we do not discount this as a possibility.

The indebtedness of Australian households has been rising steadily over the last two decades and now stands at 189% of household income, high by global standards and ranking us fourth in the world. Of course, this has been brought about by ever falling interest rates. Nevertheless, it leaves Australian households vulnerable to either higher interest rates or falling asset prices, if and when either of these events occurs. Falling interest rates and expanding household debt have clearly been a driver of residential property prices across much of the country. A global study of property prices conducted in late 2016 shows that Sydney property prices were 12.2 times the medium household income (up from 7.6 times in 2004), making it the second least affordable property market in the world after Hong Kong.<sup>1</sup> Melbourne, at 9.5 times, is ranked the sixth most expensive market globally. That Australians are highly indebted and our property prices are high is hardly news to readers, and indeed these observations could have been made for much of the last decade.

The other variable worth noting is the use of “interest only” (IO) mortgages. According to the Reserve Bank of Australia (RBA), 23% of “owner occupied” mortgages are interest only, up from mid-teen levels a decade ago.<sup>2</sup> For investment properties, 64% of mortgages are interest only, though this has been relatively steady for some time. There are numerous reasons for using interest only loans. For investment properties, it can allow negative gearing benefits to be maximised, and for home owners it provides flexibility in the rate of repayment and allows for a simple redraw of funds. However, compared with a principal and interest loan, IO loans also allow a borrower to access more funds than one might otherwise be able to. To get a sense of the role IO loans played in the US housing crisis, one can watch the movie *The Big Short*, or for a more in-depth understanding,

1 13th Annual Demographia International Housing Affordability Survey: 2017.

2 RBA Financial Stability Review, April 2017.

read the book of the same title by Michael Lewis. Recently there has been much focus on the regulatory changes limiting banks' ability to issue IO loans. The result has been an increase in the interest rates on IO loans relative to traditional principal and interest loans. Some commentators see this reduction in the availability of IO mortgages as well as the rise in the cost of these loans as the catalyst that will bring down the housing market. That may be so, but it is problematic to have any degree of certainty without much more detail on household finances. Nevertheless, the enthusiasm for IO mortgages certainly points towards a higher degree of speculative behaviour by property buyers than one might otherwise assume.

We think it highly likely that at some point the Australian property market will have some sort of setback, and that potentially along with it we will see significant distress in household finances and a significant jump in the credit costs of the banking system. However, as we have seen elsewhere, the catalyst for and timing of such crises are notoriously difficult to predict, and when they do occur, it can happen in an instant. And such events are not usually accompanied by numerous experts predicting their occurrence, as seems to be the case here (though we would caution readers not to take too much comfort in this). Trying to prepare oneself for an onslaught that may not happen for some time, or that may not happen at all, is difficult.

So what should Australian investors be doing? Our observation from meeting with many individual investors and their advisors is that there remains significant potential for Australians to increase their exposure to international markets. Not only will it have the benefit of significantly diversifying the "Australia risk" in one's portfolio, it also provides the added protection that a fall in the Australian dollar, which will likely accompany any calamity in the local property market, will add to the returns from offshore assets. Now you may be thinking, Platinum, as a manager of global share funds, of course would be saying this! Nevertheless, we do truly believe that there are investment opportunities beyond our shores, particularly in Europe and Asia, that are substantially more attractive than those afforded by the Australian market. I would encourage you to read the article by Nik Dvornak, *Europe's Road from Austerity to Prosperity*,<sup>3</sup> in which he explores the experiences of the German economy and investor in contrast to those of the Australian economy and investor over the last 30 years. The paper provides valuable insights as to why we think now, more than ever, is the time for investors to head offshore.

## Outlook

Over the last 12 months stock markets in Asia and Europe have handily outperformed the US as economic recoveries

have taken hold in China and Europe. In local currency terms, Europe gained 20%, Japan 30.5%, and the rest of Asia 25.6%, while the US returned 17%.<sup>4</sup> The result has been strong in terms of absolute returns across Platinum's full suite of funds which also achieved good relative returns in most cases.

After a strong year of performance across markets, and remembering that global markets have now delivered to Australian investors over 17% p.a. for five years, one should be more cautious about the year ahead.

In the US, the Federal Reserve raised interest rates in June, and has now raised rates in each of the last three quarters. Additionally, the Fed will start to reduce its holdings in US Treasuries and mortgage backed securities, acquired during quantitative easing. The issue is that monetary policy cycles tend to proceed until economic growth slows and stock markets decline. The combination of rising interest rates and the high valuations of US stocks is the main reason to maintain a relatively cautious approach to markets. With the federal funds rate at only 1%, it is tempting to assume it is still early in the tightening cycle, but given that we have already experienced additional tightening by the removal of quantitative easing, it is difficult to judge. Certainly markets appear to have shrugged off that latest increase, but at some point we will likely see a setback resulting from higher interest rates.

Asia and Europe, on the other hand, seem to be offering better opportunities. Despite their strong returns over the last year, our Asian and European investments are still showing a combination of attractive absolute valuations and underlying earnings growth, which we think will see these investments continue to produce good returns over the next three to five years.

During the quarter, one of the key developments has been the reform of the Chinese financial system where authorities have been enacting clearer regulations around securitisation and financial products (i.e. the so-called shadow banking system). These reform measures, if successfully implemented, are without question a very positive development for China, as the reckless use of credit has clearly been a key risk for the country's economy. However, we have seen credit growth slow very significantly, and the short-term concern is whether this tightening in credit will cut short China's recovery. While robust pricing of industrial materials such as steel, cement and glass suggests that all is intact for the moment, there will be swings and roundabouts in China's progress. Importantly, most of our holdings in China have at the core of the investment case a strong secular growth story and tend to be less dependent on the short-term growth factors.

3 Visit <https://www.platinum.com.au/journal/views/europes-road-from-austerity-to-prosperity/>

4 Respectively, MSCI AC Europe Net Index, MSCI Japan Net Index, MSCI AC Asia ex Japan Net Index, and MSCI US Index. Source: RIMES Technologies.

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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 underlying assets of PAI and other risk factors associated with investing, investment returns can be negative, particularly in the short-term.

PAI's portfolio inception date is 16 September 2015.

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3. The table shows PAI's top ten long stock positions (including company securities and long derivatives) as a percentage of PAI's net tangible asset value.

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