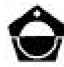


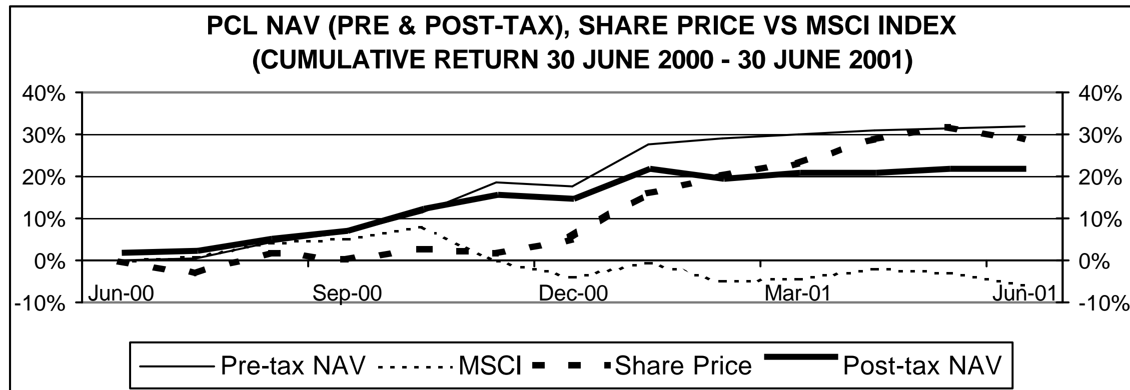
PLATINUM ASSET MANAGEMENT

# Platinum Capital Limited

## Quarterly Report

## 30 June 2001

### Performance




The prospect of improved economic conditions sometime in the second half of 2001 failed to lift markets in the June quarter. Interestingly, the European exchanges have fared worse than the US and UK, with the composite Euro index having fallen some 8% over the year, versus -2% for the US and +2% for the UK. Japan and Korea were particularly weak, declining by 18% and 28% respectively. The above figures are all expressed in A$ which, on account of its own weakness, tends to understate the inherent weakness abroad. In US$ terms, for example, Wall Street is off 17% over 12 months and Euroland around 23%.

Looking at the global markets, according to official industry classification the weakness has been principally IT and Telecoms – down 46% and 36% respectively in A$ over 12 months, while defensive areas, such as utilities, consumer staples and financials, have risen by 20%, 20% and 17% respectively. Faith in the recovery is revealed in the performance of "materials" – up 1% for the quarter and 16% for the year.

It is partly because of this massive divergence among market segments that our performance has been strong. In addition, the decision to short sell the formerly popular area of technology has paid off. Hence the Company has shown positive returns each quarter to give a total return of 32.0% (pre-tax) for the year. The MSCI World Index was down nearly 6% over this time.

The following Net Asset Value figures are after provision for tax on both realised and unrealised income and gains.

| 30 April 2001 | 31 May 2001 | 30 June 2001 |
|---|---|---|
| 172.37 cps | 173.15 cps | 173.78 cps |

### Disposition of Assets

| Region | June 2001 | March 2000 | December 2000 |
|---|---|---|---|
| Western Europe | 36.6% | 34.5% | 35.0% |
| North America | 20.9% | 19.9% | 20.2% |
| Japan | 17.8% | 19.7% | 21.5% |
| Emerging Markets (incl. Korea) | 12.1% | 7.7% | 6.0% |
| Australia | 1.1% | 0.7% | 0.0% |
| Cash | 11.5% | 17.5% | 17.3% |

**Breakdown by Industry**

| Categories | Examples of Stocks | Jun 2001 | Dec 2000 |
|---|---|---|---|
| Cyclicals/Manufacturers | RMC, Akzo, Bayer, Linde, Honeywell, Oce | 21% | 19% |
| Retail/Services/Logistics | Hornbach, Raytheon, Rinascente | 14% | 6% |
| Technology Hardware | Toshiba, Samsung, AMD, Fujitsu, National Semi | 13% | 11% |
| Financials | Lippo, Deutsche Boerse, Nordea, Halifax, HDFC | 12% | 12% |
| Consumer Brands | Coke Bottlers, Adidas Salomon, Wella, Lottecon | 11% | 10% |
| Telecoms | NTT, Verizon, Korea Telecom | 7% | 11% |
| Medical | Draegerwerk, Merck KGaA | 6% | 6% |
| Software & Media | Novell, Nippon Broadcasting, Seoul Broadcasting | 3% | 7% |
| Gold and Other | Gold Fields, Newmont Mining | 1% | |

The company's short position is 29% against individual companies, mainly US.

**Changes to the Portfolio**

On a geographic basis, the big adjustments over the quarter was the 2% decline in exposure to Japan and the 4% rise in emerging markets. This represented the introduction of some mainland Chinese shares listed in Hong Kong, the purchase of more Indian shares, a reshuffling and addition to holdings in Korea, and the introduction of gold mining companies.

The Chinese companies purchased are engaged principally in infrastructure such as toll roads and Beijing airport. These companies are modestly rated on 11-12x earnings and represent a relatively low risk way to participate in that country's burgeoning domestic economy. Starting from a low base, utilisation rates of this infrastructure are rising in the teens which promises some interesting cash flow growth.

India is even more self-contained than China, having a small external sector and receiving only minute foreign direct investment compared to its more business-friendly, north eastern neighbour. The economy, which had been growing at around 6% per year, has slowed recently because of two successive poor agricultural seasons. Fall-out from the IT boom has also had an effect. However, exports are growing strongly and the prospect of a lower oil price has important consequences for both the balance of payments and internal liquidity. One of our purchases, Housing Development Finance Corporation Bank, has a record of 20% profit growth over time and looks well positioned to continue to outstrip its competitors, the somnolent and clumsy State banks.

Within Korea we engaged in switching from both SK Telecom and Samsung Electronics to their respective holding companies which had become abnormally cheap. We also bought Korea Telecom which was depressed ahead of new supply of stock in the form of an ADR issue.

In Japan, the focus of the portfolio moved to smaller companies, that are both cheap and beginning to see the benefits of restructuring; Seino Transport is an example.

There was a fair amount of movement among our US holdings where we reduced our positions in several strong performing tech stocks such as Foundry Networks, Peoplesoft, National Semiconductor and Verisign while discarding companies that we had incorrectly assessed such as Agilent Technologies and Lucent Technologies. We also sold Diagnostic Products following a trebling in the share price over the last 14 months. We originally purchased this company four years ago. It performed in line with our expectations but at first modest growth was seemingly not enough. Subsequently, it became linked with several sexy themes which together with accelerating earnings growth, provided an explosive mixture. Subsequent to our sale the share price has pulled back one quarter. Positions have begun to be built in Agere Systems, i2 Technologies, Manpower, Honeywell and Health Management. With the exception of Health Management, all of these stocks have been suffering downward market evaluations; their longer term prospects now look sensibly priced.

The action of the gold price has drawn our attention. It looks as though it is bottoming out even though deflation now looks as much a risk as inflation. Treating it principally as a commodity, we observe that demand is about 1,000 tons greater than new supply, which is running at about 2,600 tons per annum. That there is above-ground supply of over 30,000 tons is common knowledge but there are several reasons to believe official sales and leasing will be less of a threat in the future. Combine this with unsettled currencies

and turbulent markets and we can readily see the price spike by 10% or 20%. In that case, the companies selected could experience improvements in cash flow of 50% or more. The risk/reward trade-off after a 20 year bear market is tantalising.

Within Europe, we selectively added to existing holdings and participated in the IPO of the Deutsche Stock Exchange. We seldom participate in IPO's believing that the market tends to over-pay in the face of accompanying promotional hype. This issue came without the normal exuberance of the bull market – with the Dax down 27% since its peak in March 2001, the pricing was accordingly more modest. Further, we believe that because this is a relatively new market sector it is not thoroughly covered by analysts and investors do not fully appreciate its growth and operating characteristics.

Our short positions continue to emphasise companies that are likely to disappoint in the context of US consumer retrenchment and deteriorating credit quality. Many are finely managed companies but are over-bought and over-priced in the deflationary and profit elusive environment they face.

**Currency**

There has been virtually no change in our currency stance. Investment flows continue to favour the US$ as Europeans buy US based companies and, increasingly, US corporate paper. Movement in the Euro/dollar exchange rate is accentuated by money managers trying to second guess the next move by the European Central Bank. We believe the Euro is now at the bottom of its trading range versus the dollar. We continue to regard the Yen as the safety valve for the Japanese economy and expect further weakness. The Korean Won is unlikely to be much stronger than the Yen. Our principal positions are long the Euro and A$, and short the Yen, Won and US$.

**Commentary**

We have not moved to any great extent from the views expressed in the last few quarterly reports. Breadth on the New York Stock Exchange is encouraging as those shares that are rising significantly outnumber those declining. This process has been evident since November but at the same time the Dow index has shown deteriorating breadth and both the Dow and S&P index have declined. The commonly held view is that the steepening yield curve (following the Fed's six interest rate cuts since January 2001) has historically presaged a recovery in the economy and stock market.

What is troubling is that the rest of the world is slowing more quickly and to a greater extent than was generally expected as little as three months ago. Further, it seems as though the lessons of the tech bubble are not being applied to other areas of the economy. In particular, investment banking, housing and retail space are each being deluged with capital as individual firms continue to expand aggressively without thought to the consequences of their combined actions ie. creating over-supply and thereby removing surplus returns.

The traditional pattern of an economic slowdown being brought on by a tightening of liquidity has somewhat distorted this cycle. The second half of last year was significantly influenced by both the spiking of the oil price and the fallout from the tech bubble. Lay this on top of the deflationary pulses being emitted principally from Asia and so-called globalisation, and one has a pattern quite different from the cycles common since the 1960s. Regular readers will be bored to be reminded of our concerns about debt. Not satisfied that the average US consumer surrenders 14% of his monthly income to service debt payments, Mr Greenspan is trying to induce an even higher level of indebtedness. Worse still, the US corporate sector is similarly loaded with debt with management preferring, for dubious reasons, stock repurchases to debt reduction.

Notwithstanding the recent battering of Nasdaq, 18 years of happiness, engendered by a trending fall in short term interest rates combined with the corporate sector winning a greater share of the economic cake, at the expense of labour's share, has been deeply etched into investors minds. In their eagerness to deploy their assets at better rates than those available in the money markets, investors have moved into defensive sectors or those which will be early beneficiaries of a growth recovery. This has resulted in the unusual phenomena of valuations being driven to the very top of their range even before a recession has been declared or a recovery has been registered.

Such is the general optimism that a trailing earnings yield of 3.7% for the S&P 500 index is being accepted by investors. In all likelihood this will be only 3% once this year's lower earnings are posted. Is the market essentially saying that with inflation tamed, the investment scene is less risky and/or that come the next upturn, the share of the cake won by the corporate sector will expand further? We cannot imagine this, although were it not for the fact that we recognised the craziness of the recent bubble, we might show

greater humility and acquiesce to the superior wisdom of the crowd. As it is, we cannot help suspecting that even dropping the cost of money by 2.75% in six months may prove no more than a short lived though potent elixir for the market.

Over the coming months one can expect the US economy to receive rapt attention. For all the benefits of lower tax rates and tax rebates, there are the important offsets of high debt, minuscule personal savings, the fall out from an extraordinary capital expenditure boom that has left extreme over-capacity in some parts of the economy with the associated drag on company profitability. Capping this is the high US$ and weak or deteriorating conditions among the other large consuming nations. Corporate profits are high by historic standards and seem unlikely to expand further short term. Much is likely to be said about the profit drought in the months ahead.

In Asia, we see sluggish growth in most regions with perhaps China being an exception, and India to a lesser extent. Japan continues to wallow in gradual restructuring but, ironically, confidence is holding up well on account of the life-time employment structure - which, of course, also acts to retard change. There is hope for good deeds from the new Prime Minister and some support for the view that his election represents a changing of the guard within the LDP.

Korea has made good progress to reduce debt at the national and corporate level. This has come from surging net exports and a more measured approach to capital expenditure by companies. Though capex is still high by world standards, at around 28% of GNP, it is a full 10% points lower than was common in the early nineties. The consequent improvement in the trade balance, puts the economy on a sound footing although it remains highly dependent on world trade.

Europe continues to struggle from the one-size-fits-all management policies of the ECB. However, at the individual country level, there are far fewer distortions and fundamental problems than the weak Euro might suggest. Tax levels are coming down, government finances are sound, corporate capex and balance sheets are largely harmonious and the consumer has savings and carries little debt.

**Conclusion**

Trying to read the ebb and flow of economic news over the next few months will cause more heartache than benefit we suspect. Our attention will be directed at companies with clear growth prospects and we shall attempt to profit from short selling those shares on high valuations that are likely to fail to meet expectations. We remain reluctant to simply buy cyclicals on the basis of some impending broad-based recovery.

Kerr Neilson
Managing Director

The following excerpt from the Emerson Electric press release dated 10 July shows the extent to which form is having precedence over substance. Emerson Electric is a great company, capitalised at US$23 billion and with a share price rise of 10 fold over 20 years. What does this statement say for lesser operators?

"After careful consideration, our management team made a proactive decision to not continue Emerson's record 43 consecutive years of increased earnings per share. We could have pared back restructuring and other investments, or taken other operating actions as we have done in the past, to continue the record. Doing so would not have been in the best interest of the company and our shareholders, who have clearly expressed a preference for faster growth. We have no intention of changing the way we manage operations for consistent performance, and taking this action now should position us to return to double-digit earnings per share growth sooner than would otherwise be possible."