PLATINUM CAPITAL LIMITED

ACN 063 975 431

Quarterly Report

30 SEPTEMBER 2001

Performance

It has been a most testing quarter. Shares were sold in a seemingly indiscriminate manner. This looked alarmingly like panic although it also gave rise to some good buying opportunities. The signs of panic were most pronounced in Europe, less evident in the US.

For the period, the MSCI World index declined by 11.7% in A$ terms. Of the ten designated sectors, information technology fell the most, -31%; followed by consumer discretionary -23%, industrials -20% and materials -13%. (This last sector was strong in the previous quarter as investors bought into the idea that a recovery was around the corner). The sectors that rose were health care +2% and consumer staples +0.6%. Compared to these outcomes, Platinum's performance was satisfactory even though it lost 1.6% (pre-tax). Mitigating the severe markdowns to some of our holdings, which the market viewed as sensitive to a recession, was the strong performance of several holdings that benefited from the uncertainty, especially in sectors such as defence and gold mining. In addition, our shorts on consumer stocks and those sensitive to employment levels paid off well.

Over the last 12 months, your company has achieved a positive return of 22.0% (pre-tax), while the MSCI fell by 21.1%.

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

Currency

The US$ has been remarkably resilient in the context of the assault of 11 September. Apart from a temporary strengthening of the Yen, which experienced strong demand as money was funnelled home in response to uncertainty and mid-year repatriation, the currency markets were pretty uninteresting. We chose to extinguish any exposure to the US$ by buying Swiss Francs but otherwise held our stance. At quarter end we were long A$ to 47%; Euro/European currencies 53% and remained fully hedged out of US$, Yen and Won.

NET ASSET VALUE

31 July 2001	169.78*
31 August 2001	172.73*
30 September 2001	172.96*

* This is before making provision for a 10 cent final dividend to be paid on 9.11.01.

Changes to the Portfolio

On a geographic basis there was a continuing drop in our exposure to the US and Japan while more funds were employed in Europe and developing markets. Holdings of cash were raised significantly.

DISPOSITION OF ASSETS (%)

REGION	SEPT 2001	JUN 2001
Western Europe	36.9	36.6
Japan	16.1	17.8
North America	14.6	20.9
Emerging Markets (including Korea)	14.2	12.1
Australia	1.2	1.1
CASH	17.0	11.5

The company's short position is 30% against individual companies, mainly US.

We were particularly active in the US. At the start of the quarter we were busily following a policy of selling tech stocks, especially those we bought not so long ago at lower levels such as Peoplesoft and Foundry Networks. By the end of the quarter, after very large price falls, we were repurchasing these stocks together with other leading companies in the sector such as Sun Mircosystems and Parametric. We also continued to add to i2 Technologies, Agere Systems and some of our non-tech holdings.

While we are very aware that there was a super-cycle in tech capital spending, and that capex will be subdued for some time to come, we believe this is now adequately reflected in prevailing weak share prices.

Changes to the Portfolio continued

In Japan, we chose to dispose of some long-held shares such as Fujitsu, Nomura and KDDI, while at the same time building larger holdings in NTT, Toshiba, MEI and Furukawa. The latter is an interesting example of the market severely punishing a company sensitive to the capital spending cycle. Furukawa which manufactures optic cable and components, has suffered a price fall of 80%, back to its pre-boom base, having once enjoyed the reflected glory of JDS Uniphase of which it owned nearly 20%. It sold down part of its JDS holding, raising some US$2 billion and used this to acquire the optic cable interests of Lucent, together with cross licence technology rights with Corning. In earlier negotiations, Lucent had been hoping to raise US$5.5 billion from this sale but both Perelli and Alcatel withdrew and Furukawa paid US$2.5 billion. Clearly spending in cable has entered a cyclical downturn but Furukawa shares at ¥680 are priced as they were before the boom and before the company had enjoyed the windfall gains on its trade investment in JDS Uniphase, worth approximately ¥400 per share.

BREAKDOWN BY INDUSTRY (%)

CATEGORIES	EXAMPLES OF STOCKS	SEP 2001	JUN 2001
Cyclicals/Manufacturers	RMC, Akzo, Bayer, Linde, Océ	23	18
Technology Hardware	Toshiba, Samsung, AMD, Foundry, Sun Micro	11	12
Retail/Services/Logistics	Hornbach, Jones Lang LaSalle, Fraport, Stinnes	10	12
Financials	Lippo, Deutsche Boerse, Nordea, HBOS	8	12
Consumer Brands	Coke Bottlers, Adidas Salomon, Lottecon	8	10
Telecoms	NTT, Verizon, Korea Telecom	7	6
Software & Media	Mediasat, Novell, Peoplesoft, Nippon Broadcasting	7	3
Medical	Draegerwerk, Merck KGaA, Novartis	6	5
Gold and Other	Gold Fields, Newmont Mining	3	3

In Europe, we sold out of Wella and reduced the Halifax position. The defensive qualities of these companies were being priced at a premium. Halifax has now merged with Bank of Scotland and the earlier undervaluation has been largely corrected. We continued to add to existing positions and introduced Novozyme, the world's leading industrial enzyme producer, and perhaps more interestingly, Mediaset. This Italian media giant accounts for about 44% of the free-to-air TV audiences through three channels, and has 66% of TV advertising spending. Along with other media plays it has been hammered as the fairy dust of the internet has settled and as growth expectations have shrivelled.
It is now back to valuations that reflect the impending contraction of media spending and very little recognition is being given to its dominant position and free cash flow generating capacity.

Commentary

The attack in the USA on 11 September exacerbated what we believe was an already deteriorating economic picture. The appaling loss of life and destruction has escaped no one's attention. What is more difficult to gauge is the likely impact on the behaviour of ordinary citizens. Regular readers will know of our deep concern about the rise in the use of debt, by both companies and individuals.
(For a fuller appraisal, I recommend that you read John Hempton's piece on Securitisation with its insight regarding the forces at work that promote debt creation).

To appraise the current economic situation in the US, many commentators have focused on the historic pattern of economic adjustment and the swiftness of the response of the Federal Reserve Board. The Fed funds rate has now been cut by 4 per cent since January to 2.5%, which reduces the cost of money to below the current inflation rate of 2.7%. Many still argue that lower interest rates will promptly and significantly turn confidence around, even in the face of companies laying-off workers. Admittedly the change in US employment is still relatively low, some half million workers, but the populace is made keenly aware of these actions as the media almost delights in trumpeting the startling scale of lay-offs by some companies – Boeing being conspicuous with its 30,000 slash. Given the prior commitments of the average family, corroborated by rising finance delinquencies and foreclosures, we believe that consumers will be inclined to constrain their spending. The economists' term for this is a 'rise in liquidity preference'. Simultaneously, companies are entering a subdued business environment with all the capacity they need. Against this there could be an improvement in exports and increased spending by the Government but these stimuli will not be immediate.

The rest of the world is also feeling a chill. Euroland has been very disappointing as exports have slowed and private consumption has barely increased. Asia is in a similar predicament. We, along with others, have been dismayed by the lack of progress with the Japanese reform program. Ironically the social contract which requires firms to honour employment obligations may prove helpful to sustaining private consumption but at a heavy cost to industry. Essentially the social burden of over-employment is loaded on to company profitability.

Recent share price movements make it clear that none of the above is a mystery to the market at large. The Japanese index is at a 17 year low, the French and German markets are now about half the value of March 2000, while London and New York are down some 30%. The puzzle here is that European analysts are forecasting much smaller changes in company profits and yet share prices have fallen more than in the US. The consensus is for earnings in Europe ex-UK to drop by 9% this year followed by an 8% increase in 2002. The same figures for the US are respectively -21% and +10%. Even prior to September, the consensus was for European earnings to be less affected than those of the S&P500 index.

Many investors are still inclined to take a long view and to place their faith in the contra cyclical powers of the US Federal Reserve. They believe markets remain in a primary up-trend and continue to be holders, even buyers of depressed levels. Against this it cannot be denied there is a large constituency of frightened and disillusioned sellers. Technically, there is huge volatility, robust inter-market rotation and a broadening number of share prices in three month, six month and 12 month declines.

Our reading is that on anything but the longest of views most world markets are well into the second phase of what could turn into a three phase bear market. Our caution mainly stems from high valuations. It is possible to put together a very attractive collection of companies with highly defensible franchises and excellent medium term growth prospects. The average price/earnings ratio of such a group is, however, over 30 times. This we judge to be high in a slow growing world without even much in the way of inflation to help nominal turnover figures. Duller companies, which includes commodity and other cyclical companies, are generally more attractively priced and, as we have noted before, smaller companies tend to be cheaper than the leviathans.

Conclusion

Investors reacted very negatively to the WTC attacks and shares tumbled, presumably to fully reflect the change in the world environment. That we will now witness a strong bounce is a better than even chance. Aiding and abetting such enthusiasm is the action of the Federal Reserve Board and the favourable affect of lower oil prices. However, the indicators we shall be watching for are corporate profits and lay-off activity. We expect many companies to use the excuse of the bombings to take write-offs that in fact relate to earlier indiscretions ie. previous over-statement of profits. We have been using this uncertain period to look for good companies at attractive prices but are failing to come up with much. Further, we have been very active in shorting those companies which are being treated by investors as safe havens and are on improbable ratings. In addition, our concern about credit is reflected in short positions in sub-prime lenders and other over-ambitious granters of loans. We have removed most of our shorts on tech names as we believe many of these companies have reached more appropriate values. When regarded as growth cyclicals, this group now offers some good buying opportunities.

Kerr Neilson
Managing Director

Feature Article: Securitisation

The US consumer's have more debt than they have ever had. Despite *much* lower interest rates, debt service costs are as high as they have ever been (averaging 14% of household income). The US economy has (at least until very recently) been supported by consumers who are willing to spend *despite this very high debt burden*. It's our view that **cut-throat competition amongst lenders has lowered lending standards** and fuelled this consumer boom. At the edge, some of these lenders are using very questionable practices to make their accounts look good. These make excellent shorting candidates for the Company.

Old-style US banking and the new competitors

The US banking industry used to be very diffused. Literally thousands of small banks and savings and loans (S&Ls) had local deposit bases and local lending. Two factors have changed this dramatically. These are the expansion of two Government Sponsored Enterprises (GSEs) in the mortgage market and the entrance to the lending market by new classes of lenders who are *not dependent on a deposit base from which they lend.*

The GSEs – Fannie Mae and Freddie Mac

In the late 1960s Congress gave a legislative charter to two companies in the mortgage market – the GSEs. These two companies, "Federal National Mortgage Association" and the "Federal Home Loan Mortgage Corporation", now known as "Fannie Mae" and "Freddie Mac", over-extended themselves in the early eighties but subsequently prospered and now dominate the mortgage business.

The charters gave the GSEs a huge cost advantage over other institutions. In particular, they were given a large and "free" line of credit from the US Treasury to support their capital base and *implicitly* have a Federal Government guarantee. They are also exempted from various Federal and State taxes and charges.

The companies have used their advantages to grow rapidly – more than 15% per year. Their stated goal is to maintain this growth rate even though they already insure almost half of all mortgages in the USA. In their search for growth they have widened the range of mortgages that they will underwrite. Also they have taken to holding the mortgages on their own balance sheets whereas before they would simply insure mortgages created by others for a 0.25% fee per year.

As the GSEs have grown they have squeezed the original S&Ls. The GSEs are now (a) underwriting credit risk, and (b) hold the paper mortgage on a large proportion of US mortgages - competing with the core business of the S&Ls and smaller banks.

The new-style "securitisation" lenders

Simultaneously the smaller banking participants are being squeezed by new-style lenders who facilitate lending by "securitisation" of mortgage pools.

Lenders have long realised that if an assortment of mortgages (say 10,000 mortgages) are mingled, it is almost certain that the lender will get 80% of his money back. The next 5% is slightly less certain (riskier), while the 5% after that is riskier still and the last 5% (depending on the quality of the borrowers) has considerable risk. The last slither is known as the "equity tranche".

By means of clever software, the packager (securitiser) can tier the rights to payment from even poor quality loans, to produce very secure rights and offsetting highly dubious ones. The top quality paper trades at Triple A ratings (say 0.15% more than government bond yields) while the low quality end can offer as much as 6% more than government bond yields.

In securitising a bundle of mortgages, the owner of a tranche has the right to receive interest and principal. The equity tranche is retained by the "new style lender" – from which they earn spread income over the life of the loan. Some lenders often can't fund even the equity tranche out of their own resources so they borrow further.

These securitisation lenders have several advantages over traditional smaller banks. Firstly, they do not need to maintain a deposit base and hence do not need an expensive branch network. Secondly, as most of the funding is the very low risk "first 80%", they can fund themselves very cheaply. (Most of this funding trades at Triple A credit ratings). Finally, deposit taking institutions are regulated to ensure deposits are safe. However, the securitisers often take no deposits and consequently are not heavily regulated and can operate with very little equity capital. Many of these companies have BB credit ratings (mild junk debt ratings) and some have B ratings (deep junk debt ratings). Running a financial institution with a single B credit rating was unheard of a decade ago. Now it is not uncommon. We believe that this is a case of technology outstripping legislation.

What has happened to the traditional lenders?

Competition from the GSEs and competition from securitisation funded new-style lenders has made life very difficult for old-style lenders.

Effectively they have either had to sell out (which most have done) or become compliant with the GSE system (which generally means getting smaller and less profitable) or underwrite the loans that the GSEs won't ie. extend riskier loans.

Many have taken the last route – but here a plethora of new style lenders pose competition almost as intense as the GSEs. This intensity is not just in mortgages but in credit cards and car loans and many other classes. Be clear how significant securitisation has become. From a small base in 1990, total securitisations (not including those done by the GSEs) account for at least $1.7 trillion – about 14 per cent of all household and commercial debt in the US.

The range of non-GSE compliant loans made common in the last decade is breathtaking. There are high-loan-to-value lines of credit. There are mortgages with 125% loan to value ratios. There are sub-prime mortgages to chronic defaulters. It is even possible to get a loan with no documentation (no proof of ID, no proof of income etc) in rapid time. These products are risky and competition has forced many old-style lenders into these fringe areas. Cheap funding and competition mean there are plenty of new lenders there as well.

The fringe-dwelling companies (those outside the GSE led establishment) have some pretty strange characteristics. There are some good lenders there. But there are some whose books are deceptive and there are strange practices used to make the books look better than they might.

Strange practices amongst the fringe dwellers

Regular disclosures by the trustee allows lenders to monitor the quality of the securitisation pool ie. repayment and delinquency rates. Hence it is very important to the securitisation issuer that their credit data and profits look good. This enables them to get a low funding cost for the securitisation paper they sell and also to raise equity cheaply. Most of these companies also need equity because they can't otherwise fund ownership of the equity tranches of securitisation pools.

The first strange practice is "gain-on-sale" accounting. In gain-on-sale accounting all the profit likely to be recognised over the life of a loan is declared as profit when the loan is "sold" in a securitisation (even where most of the credit risk is maintained). This gives lenders an incentive to (a) under-estimate the credit losses they are likely to have so as to over-estimate the profit that is brought forward and (b) lend higher and higher amounts each year to keep the gains-from-sale accounts growing. This has further increased the competition in lending and increased willingness to write loans to poor credits (dubious borrowers).

The second strategy is simply to fudge the data collection processes. The securitisation holders are entitled to cash flows from the loans when those cash flows come. However, a company can reduce the measured default rate and delinquency rate by delaying the cash flows. We have found mortgage lenders who will give serial forbearances (deferment of payment) to borrowers so they do not have to show a delinquent account. (Strategy: If you have someone that can't pay you give them permission not to pay for three months. Result: They are no longer delinquent because *they have no obligation to pay.*) We have also found an auto lender who has slowed the rate at which they sell repossessed cars - important because they only have to show a default *when the repossessed inventory is sold.*

These problems have increased as the economy has slowed. We are short selling several of these companies – looking carefully at credit data to determine which companies are using these practices. Several will go insolvent. The historic default rate for double B rated credits is over 4% per year and these companies are BB credits and there is a downturn going on so their default rate should be much higher. The ones which were hiding problems with suspect collection practices a year ago will almost certainly go bust because the problems are now getting worse.

We are not sure whether the problems caused by excessive lending (driven by competition amongst lenders) will lead to general systemic problems. They will however lead to a consumer slowdown because at some point it will be patently unprofitable to lend more to ever more stretched consumers.

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