PLATINUM CAPITAL LIMITED

ACN 063 975 431

Quarterly Report

30 SEPTEMBER 2002

Performance

The prospect of war, continuous glum surveys of consumers in the major economies and disappointing earnings guidance all contributed to a miserable quarter for shares. By contrast, the search for income and other factors that are covered later in this report, pushed the yield on long dated bonds back to levels last seen in the 1960s.

There was wide disparity in the performance between geographic regions as well as between industries. Asia generally held relatively firm, showing smallish losses, Wall Street was weak, with the S&P down 18%, while Europe was clobbered. The European Stoxx index ended with a 28% fall and the German DAX fell 37%. Europe's poor showing is partly due to its index having a heavy bias towards financials and cyclical industrial companies. Poor economic performance, disappointing surveys of business and consumer confidence and the obstinate refusal of the European central bank to reduce interest rates all combined to persuade investors to run down their holdings of stocks sensitive to the trade cycle. Insurance companies and banks were treated particularly harshly on solvency fears as their listed holdings cascaded down in a somewhat self-reinforcing manner.

On a global basis, as the table above shows, Information Technology was again the sector where share prices fell most sharply. Only Health Care and Consumer Staples demonstrated any worthwhile defensive qualities.

MSCI WORLD INDEX – INDUSTRY BREAKDOWN (A$) Source: MSCI

SECTORS	3 MONTHS	1 YEAR
Information Technology	-23.8%	-38.4%
Materials	-19.2%	-13.3%
Financials	-18.1%	-26.6%
Telecommunications	-17.8%	-51.1%
Industrials	-17.2%	-24.9%
Energy	-16.1%	-21.0%
Consumer Discretionary	-15.0%	-20.8%
Utilities	-13.8%	-32.2%
Consumer Staples	-7.5%	-12.8%
Health Care	-6.6%	-30.0%

Platinum's performance during the quarter was disappointing in absolute terms although less bad than the MSCI World Index by a useful margin. We must expect to suffer losses when markets generally have large setbacks. We would, however, have achieved a smaller loss had we concentrated more aggressively on defensive sectors. Instead, our main priority continued to be to build holdings of strong companies, typically with few serious competitors and the ability to exercise some pricing power, with good earnings prospects on a two to three year view. These will not always be the companies whose share prices outperform the market in any one quarter.

We suffered our share of poor stock choices. The most costly was EDS which revealed a significant earnings disappointment and fell by over 50%. Our European insurance holdings were also treated mercilessly as described above and our IT holdings were severely beaten. From point to point companies such as Alleanza, Generali and Allianz fell over 35%, a considerable over-reaction we believe, while Ericsson, AMD and National Semiconductor typically declined by 55%. We have been progressively migrating our short sales towards consumer staples which, because of their apparent earnings certainty, are being used as hiding places by dedicated long funds. Shorts on the financials have been highly successful and profits were taken as we shifted our attack to the still relatively strong 'earnings-conjurers' and retailers.

Looking at the actual numbers, the value of the company fell by 10.3% over the three months, while achieving 3.9% for the year (pre-tax). By contrast, the MSCI world index fell by 15.7% for the quarter and is down 26.6% for the 12 months.

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

NET ASSET VALUE (CPS)

31 July 2002	174.26
31 August 2002	173.21
30 September 2002	164.64

Changes to the Portfolio

BREAKDOWN BY INDUSTRY

CATEGORIES	EXAMPLES OF STOCKS	SEP 2002	JUN 2002
Cyclicals/Manufacturing	Schindler, Siemens, RMC, Bayer, Linde, Océ	22%	19%
Financials	Assicurazioni Generali, Allianz, Alleanza	11%	9%
Consumer Brands	Citizen Watch, Adidas Salomon, Lotte Confectionery	11%	12%
Retail/Services/Logistics	Hornbach, Jones Lang LaSalle, Fraport	8%	13%
Technology Hardware	Agere, National Semiconductor, Samsung, AMD	8%	7%
Telecoms	Hellenic Telecom, Verizon, Ericsson, NTT	7%	7%
Gold and Other	Barrick Gold, Newmont Mining, Gold Fields	6%	5%
Medical	Yamanouchi, Takeda, Draegerwerk, Novartis, Merck KGaA	5%	7%
Software/Media	Sky Perfect Communications, Mediaset, Seoul Broadcasting	3%	7%

Platinum's main activity during the quarter was adding to existing holdings. As noted previously the price decay in some areas was astounding. It is ironic that one was criticised during the bull market for taking so-called "directional bets". Now as the market seems to be in free fall, the same observers are doing just that and wishing to avoid the difficult decisions regarding when to purchase. The cases in point are the insurance companies like Allianz (Germany) and Alleanza (Italy). The former is one of the world's premier insurers with premium income of some E60 billion pa, a massive solvency surplus and an AA+ credit rating from S&P. That it squandered resources during the boom is not in dispute. Its management fell in love with the bank assurance model and exchanged a partial ownership of Hypovereinsbank for full ownership of Dresdner bank which went on a balance sheet expansion splurge just in time to catch many of the tail-end bad credits of the boom. Appraisal of Allianz's statutory filings suggests there are still approximately E4 billion of outstanding write-offs although they do not seem to have been caught with the really nasty securitisation strips that many will rue. We believe that Allianz's mistakes are well understood by the market as is the possibility of a credit down grade. This leaves one with an entity that is vigorously addressing its cost base, a giant competing in a capital-constrained industry so giving it that rare quality of pricing power. The main concern of the stock market appears to be directional because each 10% move in equity markets adds or subtracts 14% from the firm's embedded value. The collapse of the share price allowed us to top up our holding late in the quarter when we also added to Generali and Alleanza. Under current circumstances we would treat further price weakness as a buying opportunity.

DISPOSITION OF ASSETS

REGION	SEP 2002	JUN 2002
Western Europe	34%	40%
Japan	18%	18%
Emerging Markets (incl. Korea)	14%	14%
North America	14%	12%
Australia	1%	2%
Cash	19%	14%
Shorts	35%	28%

We have also made modest additions to existing tech holdings and bought Nvidia (US) and LSI Logic (US). As the prospect of recovery is pushed further out, these companies are experiencing investor surrender. Long gone are 'buying the dip' and the illusion of perpetual growth; the focus now is on IT capital spending surveys, cash burn, balance sheet robustness and survival. In many instances tech companies with good growth potential are not even flattered with the ratings attached to dull cyclicals.

We also started to buy China Mobile. This company is the principal provider of mobile telephony in China having 100 million subscribers and covering 21 provinces. The important feature of its business has been the shift of the bulk of its revenue from long term contracts to pre-paid subscribers. This has clearly stimulated growth at the cost of Revenue Per User. The so-called RPU has fallen dramatically and has now stabilised at around US$15 per month with usage of 209 minutes. With the death of the internet hype, the share has fallen from HK$80 to $18 and is on a prospective PE of

11 times. While growth will slow from the frenetic pace of recent years, we cannot identify many factors that will adversely affect the rating from here.

Sales included Pernod Ricard, Givaudan and Stinnes. The first two performed splendidly on account of their defensive qualities but, as suggested in the last quarterly, as markets sell off relative valuations can become misaligned as investors pay too much for perceived excellence only to find later that there was better value elsewhere. Stinnes is in a different category having been bid for by Deutsche Bahn. It was a very successful holding, again bought when its pivotal role in European logistics was poorly priced, earning your company nearly 100% in 24 months.

Currency

We did not change our currency positions over the quarter. At quarter end, 73% of assets were hedged into A$; 18% held in Euro/European currencies, with the rest mainly in Korean Won.

Commentary

The fierce sell off over the last three months has certainly winded the bulls badly as almost any purchase has proved wrong within a short time. Price action in Europe suggests the bulls are in full retreat and in the US there are only pockets of determined resistance. Even so we do not see investors as having done much to reduce their exposures overall.

As we have noted on numerous occasions, we believe the nature of the tech boom and the high degree of consumer indebtedness precludes a strong economic rebound. What has become clearer through this last quarter is just how difficult trading conditions really are. This is evident from the many profit warnings and equally from official statistics which show wide-spread retail price deflation. This is true from China to Europe and the US. In each case retailers are selling goods for between 2 to 3% less than last year; this makes overhead absorption considerably more difficult. Further, we are witnessing a change in "behavioural patterns". In the US consumers are beginning to save again and even more interestingly, there is clear evidence that they are trading-down. This pattern ranges from quasi fashion statements, shoes (Nike) to tobacco (Philip Morris) and cosmetics (Estée Lauder). It is not clear that this is confined to the US where one might put it down to individual caution and financial strain as evidenced by growing mortgage and credit card delinquencies, both, coincidentally, running at 4.77% as at June.

For the months immediately ahead it is difficult to become particularly optimistic. It seems probable that there will be an easing of credit conditions in Euroland but the high oil price is debilitating to consumers world-wide and the threat of war is destructive to confidence. On this subject we can look forward to a frenzy of muddled media coverage. What is clear is that the inhabitants of the cradle of western civilisation, Mesopotamia, will not welcome foreign visitors whether UN endorsed or not. Writing in a calmer time of the late seventies [1], Peter Ustinov, the actor and writer, eloquently observed, "Just over two hundred years ago, the United States emerged like a phoenix from just such a third world. Has she forgotten so quickly what it was like to be poor, and pure, and young? Must she so soon filch the musty robes of power from the wardrobe, and behave as the British, and others did when they were the flagellating fathers of the pupil world? Why this pharisaic impatience with those just fallen from the nest? Is it merely the impatience of the young with those still younger, or is it a trap laid by stealthy nature to try and lure America into a posture which was the cause of her own rebellion, her own birth". Pardon this philosophising but military history is strewn with examples of

[1] "Dear Me" by Peter Ustinov, published by Mandarin 1977, p 283

consequences, intended or not, that haunt subsequent generations.

Turning back to developments in markets, we wrote last quarter about the privileged position of the Government Sponsored Enterprises (GSE) in the US leading them to become giant hedge funds. Their significance in the fixed interest markets has been particularly noticeable in recent weeks as they engage in the so-called convexity trades. This stems from the effect that the refinancing of mortgages has upon their balance sheets. To make up for the loss of long term assets as consumers renegotiate their mortgages (to take advantage of lower fixed interest rates), the GSE's have been actively, though indirectly, purchasing long term debt mostly through entering interest rate swaps. The consequence of this is to drive down the yield on long dated securities, giving the impression that the bonds are being priced for deflation. Thus technical factors emanating from the unbridled growth of the GSEs is reinforcing the downward move in long rates.[2] Today the market value of mortgage-backed securities is greater than the Government bond market. From being about 60% to 70% of Treasury debt, securitised mortgages now represent 130%. The GSE's have nearly "shot themselves in the foot" as the "convexity trade" has influenced the shape of the yield curve to the disadvantage of all the financial intermediaries who had hitherto exploited the large spread between call rates and longer term bonds. This provides some attractive shorting opportunities!

Dresdner Kleinwort Wasserstein do some interesting quantitative studies to assess market expectations. The recent findings are that share analysts have down-graded their implicit growth expectations to a 15-year low. Their forecasts have shown a pattern of steady deterioration but bottom-up estimates have in the past invariably proved to be too high. Some markets, notably in Europe, now seem reasonably valued, but expectations in the US are still high. We have often commentated on the unreal expectations that the protracted bull market embedded in forecasts and DrKW's findings are that US long term earnings expectations through the nineties rose on an almost continuous trend versus nominal GDP. The expectation is presently for long term earnings to grow at 2.6 times nominal GDP *even though, with the single exception of the nineties, the quoted sector's earnings growth has always trailed behind money GDP.* Among other important developments are the outcome of the German elections and the proposed buying of shares by the Bank of Japan. Another four years of rule by the SPD in coalition with the Greens is generally seen as negative by those who were hoping for economic reform to re-energise the moribund economy. Germany has been stagnating for some time and it may come as a surprise to learn that real GNP has risen only 12% over the last ten years, barely better than Japan's 10% and well behind the US figure of about 40% and Australia's 50%. Germany's unemployment rate of four million is in stark contrast to its more agile neighbours who moved early with labour reform.

The message coming from the Bank of Japan (BoJ) to buy shares directly from banks is a significant departure from its former position and at this stage it may merely reflect political intrigue among the ministries to give the Prime Minister more breathing space. One needs to recall

[2] Apart from insuring mortgages, the GSE's also borrow and invest in mortgages. In so doing, they attempt to match the terms of their assets and liabilities. However, as rates drop and consumers' refinance their mortgages, these assets on the books of the GSE's are repaid ahead of schedule. This put option of mortgagees causes the GSE's balance sheets to become lopsided – with too little asset duration. (The negative convexity of mortgages causing the duration of assets to decline faster than the duration of liabilities). Hence, the GSE's search for long-dated fixed income assets to redress the balance.

earlier protests by the public regarding the use of taxpayers funds to bail out the banks. It is possible, however, that by invoking a sense of crises, the BoJ will be able to nationalise some of the risks within the banks and ultimately free up capital for more productive uses. Even so, it is our contention that the main problems within Japan are proper financial intermediation and the debilitating effect of deflation rather than bad bank loans alone. The statistics clearly point to large corporations reducing their debt and meeting capex from their own resources but it is the small companies that are feeling the funding squeeze and going under. To be more than a short term palliative, the BoJ will need to expand the money base faster than hitherto and on this point there is as yet no clarification.

Outlook

There are many issues to trouble investors. The immediate concerns relate to consumer behaviour in the face of potential war, high fuel costs, weak employment growth and doubts as to whether low or even falling interest rates can reignite the growth flame. It is very clear that companies have become more cautious so one cannot expect buoyant investment spending until the profit cycle has started to recover.

Compounding a dreary outlook for corporate profits is the fact that we are continuing to witness a gradual erosion of valuations as measured by prospective price earnings multiples. We cannot know when this process will be completed although past experience tells us it will probably go too far before it reverses.

Our problem as investors is the knowledge that no bells will ring to signal the turn of the market and that anyway the upswing when it comes is likely to be sharp so nobody will be able to commit large sums right at the bottom.

Our solution is twofold. First, to continue building a portfolio of quality stocks with modest valuations, typically although not exclusively with prospective price earnings ratios of 10-14 times. Secondly, to short the well-owned and seemingly overvalued areas whenever the market has up-swings and to take profits on these positions as opportunity offers.

Even in the context of a continuing bear market, selective stocks appear now to offer good, long term value.

Kerr Neilson
Managing Director

PLATINUM CAPITAL LIMITED
LEVEL 4, 55 HARRINGTON STREET, SYDNEY NSW 2000, AUSTRALIA
TELEPHONE: 61 2 9255 7500 or 1300 726 700 (Aust. only) FACSIMILE: 61 2 9254 5555
EMAIL: invest@platinum.com.au WEB: http://www.platinum.com.au