PLATINUM CAPITAL LIMITED

ABN 51 063 975 431

Quarterly Report

30 SEPTEMBER 2003

Performance

In response to the brightening economic statistics and torrents of fresh liquidity, stock markets continued their advance. There was a clear preference for the more levered opportunities as investors sought growth sensitive sectors such as IT, materials and industrials. Simultaneously they eschewed the defensives such as health care and utilities **– see the accompanying table**.

By region, there was corroborating behaviour as the emerging markets way outperformed their industrialised market counterparts. The stock markets of developing countries, which are generally regarded as higher risk and dependent on commodity prices, typically rose between 11 and 24%.

The developed markets were comparatively sluggish, rising by a few percentage points.

The outstanding exception was Japan, which bolted by 21%. All the above figures are given in A$ terms which, on account of its strength, tends to understate the US$ increases.

Thanks to its emphasis on Asia, helped by good stock selection, the company acquitted itself well and outperformed the MSCI by 7.8% for the quarter and by 20.9% for the twelve months. You should be aware that we have a very different tilt of assets than the typical global company. For the moment this is proving rewarding but there are likely to be times when it will work against us.

MSCI WORLD INDEX – INDUSTRY BREAKDOWN (A$)

SECTORS	3 MONTHS	1 YEAR
Telecommunications	-4.6%	9.0%
Health Care	-3.3%	-11.2%
Energy	-1.6%	-10.9%
Utilities	-1.1%	-8.9%
Consumer Staples	2.1%	-16.8%
Consumer Discretionary	4.2%	-2.7%
Financials	4.7%	1.3%
Industrials	7.1%	-1.9%
Materials	10.2%	0.8%
Information Technology	11.2%	26.2%

Source: MSCI, FACTSET

NET ASSET VALUE (CPS)

30 July 2003	165.04
31 August 2003	172.62
30 September 2003	170.56

Source: Platinum

Changes to the Portfolio

Our tendency was to continue to shift the emphasis to Asia at the expense of the US and Europe.

Regular readers will know that we are long term positive about the Eastern hemisphere on the basis of its superior growth prospects and attractive valuations. In Japan, China is proving a valuable stimulus for exports and on the domestic front there are signs of the property market stabilising, some inner precincts of Tokyo are even recording property price rises. The Yen is likely to show some strength versus the US$, so we have emphasised domestic oriented companies such as Aiful Corp (consumer credit), Credit Saison (credit cards) and introduced Mitsubishi Tokyo Financial Group (Japan's largest bank). We have also added further to the general insurers, Millea Holdings and Mitsui Sumitomo Insurance. House builders – Daiwa House and Panahome Corp are promising an attractive recovery on the back of improved demand and Mitsubishi Heavy Industries looks well placed for much stronger performance. Exporters such as Shimano, Fanuc and Sony, whilst all outstanding businesses, were sold on the basis of poor relative profit growth and high valuations.

In Europe we reduced or eliminated some of the heavier industrial holdings such as Linde, ThyssenKrupp and Michelin due to their loss of competitiveness caused, among other things, by the strength of the Euro. We re-entered Munich Re, after it had a setback, in preference to Allianz AG.

Two new holdings are Deutsche Post (DP) and Nordea. The former is an interesting transformation play as it is using its enormous cash flows from the postal monopoly to augment investment in logistics. DP acquired a well known and leading company in the field, DHL, in 2002 and this business is now at the heart of the group's international expansion. Adding near term excitement to the share is the prospective listing of its

BREAKDOWN BY INDUSTRY

CATEGORIES	EXAMPLES OF STOCKS	SEP 2003	JUN 2003
Cyclicals/Manufacturing	Schindler, Siemens, Bayer, Linde, Océ	19%	21%
Financials	Assiurazioni Generali, Allianz, Alleanza	12%	9%
Technology/Hardware	Agere, Samsung, AMD	11%	8%
Medical	Yamanouchi, Draegerwerk, Novartis, Merck KGaA	10%	9%
Gold and Other	Barrick Gold, Newmont Mining, Gold Fields	9%	9%
Consumer Brands	Adidas Salomon, Lotte Confectionary	8%	6%
Software/Media	Sky Perfect Communications, Seoul Broadcasting	7%	4%
Retail/Services/Logistics	Hornbach	6%	8%
Telecoms	Hellenic Telecom, Ericsson, NTT	6%	8%

Source: Platinum

German postal savings bank, which is thought to be worth 25% of the group's market capitalisation.

Nordea is a fallen angel. Formerly considered the perfect Nordic bank consolidator, it is now viewed with suspicion and dismay. There have been all manner of rumours about management dissension, failed promises etc. What we find is a perfectly respectable banking conglomerate passing through a difficult integration phase, accentuated by abnormally low interest rate spreads in parts of its business. This is unlikely to persist as the Nordic economies will eventually see interest rates rise and increased fees will be earned on selective services. It sounds dull but we are being recompensed while we wait with a 5% dividend and experience has shown us that these types of investment are often remarkably profitable.

We have continued to reduce the Tech holdings that we acquired during the bust. Their valuations suggest outcomes that we regard as highly challenging.

Shorting

Some value was lost from shorting in the quarter. Manulife fell sharply on its proposed acquisition of John Hancock but the rest of the US financial shorts were dragged up by the market's rise. The predictables, housing and earnings manipulators drifted up lethargically.

DISPOSITION OF ASSETS

REGION	SEP 2003	JUN 2003
Western Europe	31.9%	33.5%
Japan	26.5%	17.5%
Emerging Markets (incl. Korea)	15.6%	14.2%
North America	12.4%	12.8%
Australia	1.1%	0.3%
Cash	12.5%	21.7%
Shorts	36.8%	21.6%
Japanese Government Bonds	10.3%	8.9%

Source: Platinum

Currency

We allowed our ownership of Yen and Won to creep up during the quarter as the flow across the exchanges suggested they would strengthen. This slightly reduced the hedges into the A$ from 59% to 52%. We have no US$ exposure.

Commentary

Markets have come a long way since the gloomy days of March. Activity has picked up across the globe and stock markets have been pricing in the anticipated profit recovery. Nonetheless, the Cancun and Dubai meetings late in the quarter highlighted the lack of international co-operation and have refocussed investors' minds on the imbalances in the system, which creates continuing anxiety.

From the American side we hear incessantly about free markets and the dangers of unfair trade practices yet, as Australian farmers will attest and as the poor agricultural countries found at Cancun, reality is rather different. There is, on the other hand, the view that America is acting in the interests of all by virtue of its consumers continuing to borrow and spend.

China and the rest of Asia see it from a different perspective having endured a loss or potential loss of output following the IMF crisis of 1997-98. They delight in their improved competitiveness and are extremely reluctant to allow the trade and payments surpluses, which they see as a springboard to growth and economic independence, to be reflected in higher exchange rates versus the US. The irony lies in the consequent recycling of these growing foreign exchange reserves back into *foreign* bonds, mainly US treasuries and corporates. Apart from the paradox that the normally capital-hungry developing world is lending money to the Industrial giant of our time, the real problem lies in the magnitude of the imbalance. Each day foreigners need to acquire some US$1.5 billion of American assets to keep the books in balance.

It is becoming widely accepted that the US cannot simply grow its way out of its dilemma so it is a matter of **sharing the burden of adjustment**. This entails a period of high risk. The US consumer and for that matter, the politically sensitive Fed are reluctant to recognise the need for belt tightening. Equally, Central Bankers in Asia are loath to abandon the mercantilist policy that proved so successful in Japan's post war transformation. For their part, the Europeans are quick to point out the need for lower levels of consumption in the US but if they do not take faster action to improve their own economies, they run the danger of the Euro carrying a disproportionate share of this necessary rebalancing. Currencies will in any case need to adjust and the fulcrum of this action and the danger lies in the US$ losing value too fast.

With the US$ under pressure, what will happen to interest rates? Mr Greenspan can continue to manipulate the short end of the yield curve but as the sell-off of the treasuries in June revealed, the longer-term cost of money is hostage to those foreigners who own over 40% of US bonds outstanding!!

There are masochistic aspects to the recycling of funds into the US bond markets. It is at the same time denying consumers in the lending countries the higher living standards a stronger exchange rate would bring, and also exposing their central banks to loss when their currencies do eventually revalue and/or the yields on bonds rise. The latter could arise from a buying strike in the US and/or an early reversal of policy by one of the recent significant recyclers.
The picture coming to mind is one of musical chairs. There is no dispute about the loss of chairs but uncertainty about the number that are to be removed at each interlude and who will be left stranded when the music stops.

Though not a trendy subject to raise, the price of gold is suggesting growing disquiet among players as they all try to hedge their risks. Also one is seeing more and more written about *fiat* money (the notion of governments being free to create money while the rest of us would be imprisoned for doing so). Plus, there are more articles covering the subject of so-called "hedonic" adjustments to both output and inflation which adds to the uncertainty of the worth of official statistics (see our website for more). Weak demand and central bank policy is ensuring that short term interest rates barely match the rate of inflation which we believe is leading to a major misallocation of resources. Banks have largely been disintermediated out of the corporate lending market and instead are aggressively expanding consumer and mortgage lending. Only the most Panglossian internet survivor would regard the property exuberance in the Anglo Saxon world as evidence that all is well.

The Australian median house price of $350,000 is some 6 times net disposable income – a modern day record[1]. In the US the comparable figure is US$182,000, some 4.6 times disposable family income.

Tax peculiarities regarding mortgage deductibility, together with record low interest rates in April boosted affordability in the US to a 27-year high. Against this, the use of mortgage debt has outpaced recent house price appreciation, resulting in homeowner's equity falling to a record low of 54.3% of current values.

The accompanying table produced by the Congressional Budget Office shows the magnitude of the problem. Compared to the surpluses of 1998 through to 2001,the deterioration of US finances is alarming and never before has this economy been so vulnerable to rising interest rates. The accompanying distortion to stock markets is similarly huge.
The Financial Sector accounted for 30% of the S&P's earnings and that does not capture other sources of interest rate sensitivity such as profit- on-sale of securitisations by companies such as Harley Davidson, John Deere, GM, GE etc

Yes, we have written about the problem of debt in the past and seem obsessed by it. We cannot, however, shake off a consciousness that indebtedness has reached a magnitude in some countries that suggests it has very little prospect of being repaid. The digital/internet world has not changed the immutable implications of debt.

[1] Source: HIA/CBA

CONGRESSIONAL BUDGET OFFICE "ALTERNATIVE" ASSESSMENT OF BUSH BUDGET POLICIES

ON-BUDGET ONLY	CLINTON	BUSH 1ST TERM				NEXT FOUR YEARS				FOLLOWING FOUR YEARS				2002-
FISC YRS,$BILL. EXCEPT DEBT	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2013
Baseline deficits	+31	-381	-562	-644	-520	-425	-421	-434	-426	-417	-298	-143	-105	-4,776
Adjustments	–	–	–	-67	-158	-257	-327	-390	-467	-545	-733	-881	-998	-4,822
Adjusted deficits	+31	-381	-562	-711	-678	-682	-748	-824	-893	-962	-1,031	-1,024	-1,103	-9,599
% of outlays borrowed	-2%	23%	31%	37%	33%	31%	32%	33%	33%	34%	34%	33%	33%	33%
Deficit/GDP	-0.3%	3.7%	5.2%	6.3%	5.7%	5.4%	5.7%	5.9%	6.1%	6.3%	6.4%	6.1%	6.2%	5.8%
National debt w/SS ($trill)	4.5	4.9	5.5	6.2	6.8	7.5	8.3	9.1	10.0	11.0	12.0	13.0	14.1	+9.6
National debt/GDP	45%	47%	51%	55%	58%	60%	63%	66%	68%	71%	75%	77%	79%	
Interest as % of domestic discret.		69%	62%	58%	65%	77%	87%	95%	101%	106%	111%	116%	120%	
Tax cuts w/o sunsets including interest		-129	-198	-275	-292	-320	-363	-402	-453	-519	-575	-609	-649	
% of deficit		34%	35%	39%	43%	47%	49%	49%	51%	54%	56%	60%	59%	
Deficits by term		-2,333				-3,146				-4,119				
Tax cuts by term		-895				-1,536				-2,349				
% of deficit by term		38%				49%				57%				

These "alternative" figures incorporate the following:

(a) Expiring tax cuts (such as the family spending rebate) are renewed whereas they are not renewed in the official estimates.

(b) $87 billion of not-yet-legislated Iraq spending is included whereas it is not included in the official estimates.

(c) $400 billion over ten years in Pharmaceutical spending which is promised but not yet legislated has been included.

Despite the intermediate adjustments needed, **we remain optimistic about the growth prospects for developing countries**. Their stock markets are vulnerable to short term shocks mainly because the marginal buyers who have been driving prices upwards are foreigners who, when trouble strikes, invariably reduce overseas share holdings. However, visits to India and China in the last ten weeks confirm our view that favourable trends will continue to carry them forward. Even if foreign direct investment were to slow, there is a growing cycle of domestic private investment.

In China, there is an important realisation that the rural sector has fallen behind. Very specifically Beijing is cracking down on unfair taxes and fees and has reintroduced rural subsidies for health and education. The most important move, however, is **land reform** (Rural Land Contracting Law, promulgated in March 2003).

Hitherto some 220 million Chinese farming families had no security of tenure and could periodically face reallocation of their plots. (This followed de-collectivisation under the banner of the Household Responsibility System in the late 1970s). The important element of the reform is that farmers will now be able to plan ahead and invest in structures etc which under the previous order might have been forfeited. Even better, they gain certificate of title for 30 years – that will allow farmers to transact in land and mobilise credit.

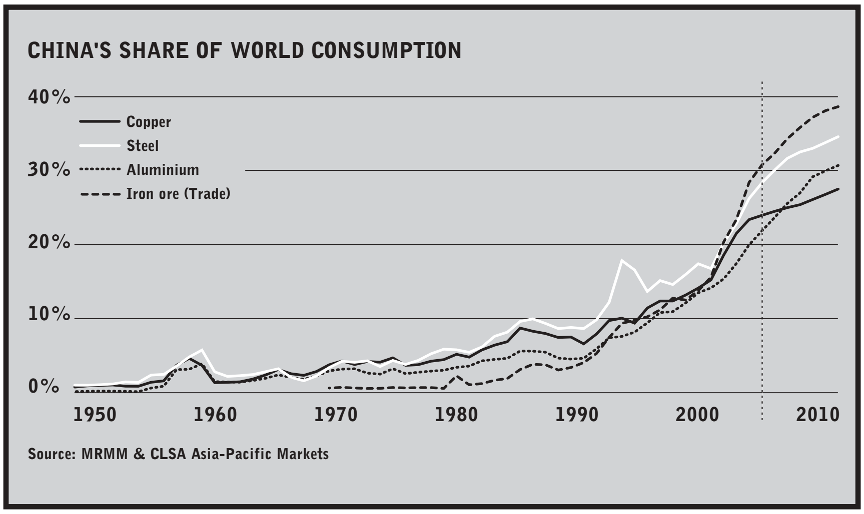
Experience in other countries that have implemented such reforms suggests that rural economic growth will take-off. Tied into this reform is greater freedom of movement and the establishment of new cities to accommodate the anticipated flood of rural migrants. Unfortunately this pressure of the under-employed torments the bureaucrats in Beijing and helps explain their intransigence regarding flexible exchange rates.

They regard a stronger Renminbi as likely to adversely affect growth and fear the consequences for the banking system. State owned enterprises would face yet one extra burden which is one more than they wish to test.

Accompanying the Chinese growth theme are observations relating to **rising raw material prices**, most notably metals. There are three influences here. Firstly, the demise of the Russian Empire had a suppressant effect on metal prices through the 1990s, as did the Asian crisis. Secondly, as noted in earlier pieces, current exchange rates understate the true size of markets such as India and China and hence

their demand for materials.
Lastly, exploration and development expenditure through the 1990s subsided in response to the 50-year-declining-trend in metal prices and the popular mantra of efficient use of capital.

Economists talk in terms of S curves that attempt to chart the likely course of physical demand in relation to living standards (more precisely GNP per head). If China and India, comprising some 2.3 billion people, come close to traditional patterns of materials use, it is probable that we are entering **a secular rise in the prices of many materials and metals**. Already China accounts for a fifth of world consumption of important metals such as steel, copper, aluminium and zinc, **see chart**.



Just when every Business School is extolling the virtues of service-based business models, capital intensive commodity producers could be having their share of sunshine. This also implies upward pressure on the currencies of commodity producing countries, particularly as their terms of trade simultaneously benefit from price deflation of traded manufactured goods.

Conclusion

Investors are presently taking comfort from evidence that most economies are back on the growth track. Corporate profits are undoubtedly improving and with interest rates so low, one could believe the bull market has returned. We suspect however that structural imbalances will prevent the economies of countries such as the US and UK from making much headway and their stock markets already look fully valued. Japan seems to be in a different phase. The pull of China and inter regional trade is helping to improve confidence among Japanese consumers, which suggests the deflationary spiral may be bottoming out. Companies have engaged in many reforms and their earnings should pleasantly surprise. Emerging markets seem the most prospective of all but as noted above they are and for some time will remain highly volatile.

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