PLATINUM CAPITAL LIMITED

ABN 51 063 975 431

Quarterly Report

31 MARCH 2004

Performance

Every share market in the world has risen in the last twelve months. Looking at them in their local currencies, we find the wildest being the Caracas exchange which is up 263%, while the tamest is the UK, up only 27%. The pattern we noted last quarter, of the emerging markets tending to outpace the traditional markets, continued in the March quarter although there was some hesitation as China, India and Thailand retraced some ground over the last month. Converting everything back into the relatively strong A$, which has risen 27% versus the US$ in the last 12 months, we find the MSCI World index 14% higher than a year ago and 1% higher than at the beginning of 2004. In comparison, Platinum returned 35% (pre-tax) over 12 months and 6% over the quarter (A$).

By industry categorisation, investors were more ambivalent than earlier tending to run hot and cold on pro-growth versus defensive plays. Hence, materials and IT which had been very strong, lost some momentum versus defensives like utilities and consumer staples.

It has been a thought-provoking time for fund managers as volatility in shares as well as currencies provided great opportunities as well as hazards. Fortunately we made more good choices than bad. Stock selection was the main differentiator but it was important to recognise the effect China was having on commodity prices and on igniting Japan's recovery and then to position currency exposure accordingly.

MSCI WORLD INDEX – INDUSTRY BREAKDOWN (A$)

SECTORS	QUARTER	1 YEAR
Materials	-3.2%	20.6%
Financials	2.0%	20.5%
Information Technology	-1.2%	19.7%
Consumer Discretionary	0.9%	16.7%
Industrials	0.1%	15.9%
Utilities	3.3%	6.7%
Telecommunications	-1.2%	6.7%
Energy	0.3%	3.5%
Consumer Staples	2.3%	2.2%
Health Care	-2.8%	-6.4%

Source: Bloomberg

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

NET ASSET VALUE (CPS)

31 January 2004	166.06
29 February 2004	162.03*
31 March 2004	167.08

* After provision for the 5 cent interim dividend paid 27 February 2004.

Source: Platinum

Currency

The strength of China's growth combined with the billowing US trade deficit have been important factors in currency markets. As we noted last quarter, the US dollar was conspicuously friendless and this together with other factors, encouraged us to introduce US dollars into the Company's portfolio in mid-January for the first time since mid-2001. We also cut back further on the A$ and the euro in favour of the yen. This is a significant shift in our view about the yen and reflects the export momentum the country is deriving from Asian trade.

Changes to the Portfolio

The portfolio was rebalanced to give more exposure to Japan and less to Europe. In terms of economic sensitivity there was a slight shift away from cyclical companies towards more defensive stocks. This came out of valuations more than an overt desire to become more defensive.

Among the big sales were the removal of Munich Re, Allianz AG, Hellenic Telecom and Weyerhaeuser. The German financials proved to be highly profitable purchases as we took advantage of the market's over-reaction in last March's panic. Even now they are defensible holdings but we felt that having nearly doubled they were losing momentum. The Greek telco Hellenic, is a less satisfactory story. This we bought in the days of irrational exuberance feeling that it was neglected and its mobile business under-appreciated. Versus other telcos it has been fine but in absolute terms it cost us money. Weyerhaeuser has responded well in a more growth-secure world.

DISPOSITION OF ASSETS

REGION	MAR 2004	DEC 2003
Japan	30%	26%
Western Europe	29%	33%
Emerging Markets (incl. Korea)	16%	15%
North America	12%	14%
Australia	2%	1%
Cash	11%	11%
Shorts	29%	36%

Source: Platinum

Apart from topping up many of our existing positions we introduced some new ones, namely Credit Agricole, Newscorp, Docomo, NEC and Toyota.

The attraction of **Credit Agricole** stems from its central position within the French banking system. It is an extremely large enterprise encompassing Credit Lyonaise, the life insurance business of Predica, a funds management business with assets of euro 350 billion and 25% of the *caisses régionales* of France. On paper it looks to be capital deficient but much depends on the interpretation of the unique holding structure which allows considerable devolution of power to the *régionales* and yet retains remarkable privileges in the Centre. Overall the group controls assets in excess of euro 1 trillion. Recent results show the benefits of the integration of IT systems and the early results from cost cutting. There is still a lot to come so by the time Basel II's new guidelines on capital adequacy come into force we believe capital adequacy will not be a problem.

We see **Newscorp** as a bi-polar company. On the one hand it has

BREAKDOWN OF PCL'S LONG INVESTMENTS BY INDUSTRY (% of assets)

CATEGORIES	EXAMPLES OF STOCKS	MAR 2004	DEC 2003
Cyclicals/Manufacturing	Toyota Motor, Schindler, Siemens, Linde, Océ	23%	23%
Financials	Credit Agricole, Credit Saison, Mitsubishi Tokyo Financial, Mitsui Sumitomo Insurance, Nordea	16%	12%
Technology/Hardware	Agere, Infineon Tech, Samsung, AMD, Sun Microsystems, NEC	9%	8%
Medical	Takeda, Schering, Novartis, Merck KGaA, GlaxoSmithKline	8%	8%
Gold and Other	Shell, Barrick Gold, Newmont Mining, Gold Fields, Noranda	7%	8%
Consumer Brands	Henkel, Adidas Salomon, Lotte	7%	8%
Software/Media	Sky Perfect Communications, Seoul Broadcasting, Newscorp	7%	8%
Retail/Services/Logistics	Veolia Environ., Deutsche Post, Hornbach, Mitsubishi Corp	8%	10%
Telecoms	Ericsson, NTT Docomo	4%	4%

Source: Platinum

all the virtues of the cash generating businesses of newspapers, TV and other content production. However, to cement the company's position on the distribution networks, Newscorp faces what the market judges to be an endless stream of losses and/or the danger of embarking on yet another crusade to embed its global model. Having now secured control of DirecTV and Telepiu in Italy we anticipate an acceleration of profit growth. This should emerge as losses from these new ventures diminish and the leverage over content pricing improves. Against the peer group, Viacom, Comcast, Disney and AOL, this company, together with Liberty, its principal non-family shareholder, is very attractively priced.

Docomo, along with most telcos, has been severely downrated by investors. Just as the internet dream springs to life we find the share languishing as investors chase Japanese companies with stronger profit momentum. We, however, remain attracted to the prospect of internet ubiquity which is promised by 3G technology. Docomo commitment to R&D (US$1 billion pa) has earned it a place as the leading implementer of broad band mobile. Last month alone it signed up 700,000 new broad band subscribers bringing the total to three million. Assisting sign-up from here will be the availability of a broader selection of just-released handsets. The trick will then lie in "clipping the ticket" as users discover the growing array of applications, from booking theatre tickets to news-clip streaming.

A long story can be told about **Toyota** but the essence is that it has never been stronger and yet it has virtually never been cheaper. As many of its peers have been out-sourcing and restructuring, Toyota has been pioneering hybrid electric autos while at the same time developing its own fuel cell solution. It is gaining market share in almost all the principal markets and is not burdened by the legacy costs that face its two giant US competitors. While they are resorting to extravagant marketing deals to eke out meagre net margins of 1-2% on sales, Toyota is operating at record profitability, earning 5-6% net on sales.

Commentary

Zaitech and Tokkin funds epitomised the closing period of the Japanese bubble of the late eighties. The equivalent today is the explosion of **hedge funds** and the captivating allure of the **yield curve carry** (borrowing at present ultra-low rates and investing in longer term, riskier assets). In the heyday of Zaitech the story surrounding land price appreciation, tightening cross holdings and the apparent advantages cheap credit and high stock valuations gave to the Japanese banks, trading houses and brokers, created an impenetrable barrier to critical analysis. To get a bigger and better participation of the action, companies set aside special, tax protected, funds to play the market. At the height of the boom, the great trading houses carried $9 or $10 of debt for each $1 of shareholders equity. At the same time property developers and other adventurers were hoovering up property everywhere, golf courses in America, beach resorts in the Pacific etc, allowing some remarkable perspicacious Australian bureaucrat to sell part of the Tokyo embassy's grounds for US$450 million, equivalent to US$19,000 per square foot!!

If there is a parallel today, it is incorporated in the idea that **untrammelled market forces** are the origin of economic "success". The concept is that economic reform has diminished the friction within the system to ensure accurate and timely reading of supply and demand so as to optimise resource allocation. This seems eminently sensible. However, the argument is then extended to explain the apparent superiority of the performance of the Anglo Saxon countries. The fact that this has been fuelled by a more than doubling of personal debt over the decade, which is reflected in vast current account deficits and generally decaying social infrastructure, is brushed aside as part of the market efficient paradigm. No good explanation is thought necessary for the leap in real housing prices, nor is there much commentary on why persistent current account deficits will not ultimately result in diminished living standards. For now, the model is assessed as excellent and such blemishes as the pessimists perceive are deemed inconsequential.

The present focus of market participants is all on growth. This seems well entrenched with the last piece of the US recovery puzzle falling into place with the publication of the March employment report. Further, the broadening of the global economic expansion is taking place against a back-drop of seeming **equilibrium between the forces of inflation and deflation**. Price competition from Asia is exerting downward pressure on manufactured goods prices, as well as some services, while exuberant demand from Asia is lifting the price of many raw material inputs. This, together with central bank intervention in the currency markets, has permitted interest rates to stay at low levels and to create the impression that the risk of a change in interest rates is far off. Like all exciting bull markets, the longer the trend remains intact the more adherents it attracts. Better still it creates the illusion in some minds that there will be time to adjust positions when the trend does indeed change.

We have written before about the **leverage in the US financial system** and the more we look, the more wary we become. Who would have thought that an industry that is more fragmented and hence more competitive than its European counterpart would earn approximately two times the income on assets employed. The reason for this is principally the higher credit risk and the fact there is a preponderance of refinancable borrowing supported by floating funding. This has not caused problems to date because of the primary downward trend of interest rates but now, with short rates at 1%, further falls will be likely to compress margins. Alternatively if rates were to rise, mortgagees would stay put while lenders would crowd to refinance their funding.

Our work suggests that many thrifts are more than twice as leveraged to the yield curve as they were in 1994, the last time that interest rates rose sharply.

Looking further back, the most recent occasion when interest rates rose more than a few percentage points was 1983 when interest rates were deregulated and the Fed Funds rate rose more than 5 percentage points. This left many thrifts near insolvency which the government "solved" by relaxing lending guidelines which in turn, ultimately led to a larger "savings and loans crisis" in the early 1990s.

Funded with floating rate borrowing, thrifts are once again tempting fate by purchasing large quantities of an assortment of securitised instruments. This mismatch of duration is highly profitable – so long as interest rates do not rise. Most thrifts are levered something approaching

20 times to their tangible capital with some holding more securitised assets than traditional loans. We think it possible that many currently highly valued small banks will be severely squeezed, even imperiled, if interest rates rise. They can also be squeezed, although not imperiled, if interest rates fall and the yield curve flattens.

In an extreme case, we know of an internet stockbroker that sweeps excess funds from its clients to lend to buyers of mobile homes. Again there is a fixed/floating interest rate game being played, and, most outrageously, the lender is providing for only half a percent of credit losses when the industry average is typically 4-5 per cent.

Very low interest rates have allowed the relaxing of **credit standards** as well. Some auto finance companies have been spectacularly generous with their terms, extending *interest free* loans for more than the sticker price and for as long as 72 months. The customer you attract with a 72 month zero interest loan is much more sensitive to the monthly payment than the customer you attract with a 36 month zero interest loan. This fall in credit standards has increased the addressable market but at some stage the arithmetic of the subsidies will disentangle itself.

Our seeming obsession with interest rate and credit risk arises from the potential dangers it creates for the capital markets. It also provides the opportunities for short selling. Half of our shorts are geared to these risks.

Were it not for the above, we would be looking at markets with greater equanimity than in recent months. As we have mentioned before, we believe China and India will continue to experience abnormally strong growth for some years, even though inevitably hitting various speed bumps along the way. This in turn is pulling sophisticated machinery exports out of Japan, Korea and the West and helping to bolster their recoveries. Commodity prices are responding to near term shortages and ameliorating deflationary fears though simultaneously squeezing some companies' profits.

Conclusion

In coming months it seems likely that there will be less discussion about the "recovery" and the focus may shift to the rise in interest rates and perhaps inflation. It is also likely that China will be running a trade deficit thus diminishing discussion about a revaluation so the pressure may move to the yen. Valuations, and the concerns we have expressed above relating to credit and interest risks, may cause a decoupling of stock markets.

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