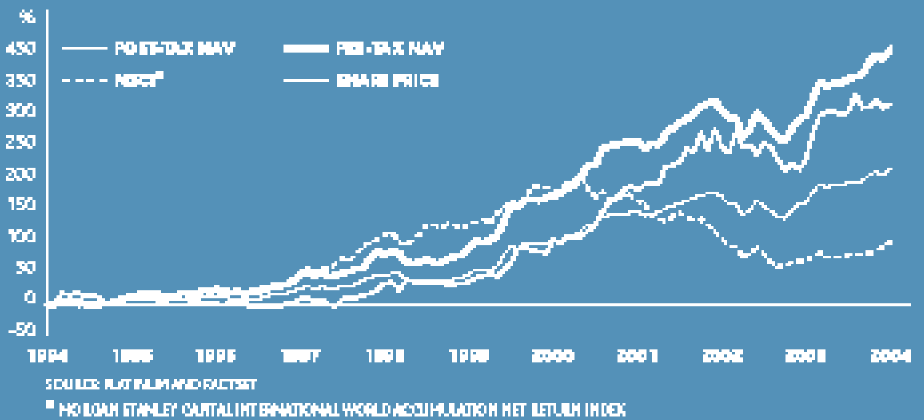
PCL NAV (PRE AND POST-TAX), **SHARE PRICE VS MSCI INDEX** (CUMULATIVE RETURN SINCE INCEPTION)



INVESTMENT MANAGER'S REPORT

Performance

Share prices lost momentum in the June quarter as doubts crept into investors' minds. The emerging markets of Asia and Latin America mostly declined, by between 1% and 14%, while growth in Europe and America ranged between zero and +8%. The Yukos affair hurt sentiment towards Russia badly with that market selling off by 20%. The wash-up from all this was an advance by the Morgan Stanley World Index of 1.6% when measured in local currency. For the year, this index is up 21%. However, the rebound of the US$ in the quarter saw the A$ fall from $0.76 to $0.70 and this translated into a gain by the World index of 10.6% in A$ terms. The annual figure was 19.4%. This currency move was to the detriment of Platinum's short term performance as we had low exposure to the US currency. In addition, our emphasis on Asia, which has tended to be weak recently, was disadvantageous. Hence the Company underperformed during the quarter, achieving only a 4.4% pre-tax gain. We outperformed for the full year, however, with a pleasing 26.9% advance.

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

30 APRIL 2004	31 MAY 2004	30 JUNE 2004
169.87	**168.45**	**172.51**

SOURCE: PLATINUM

Performance (continued)

As one would expect in a year of recovery, the cyclical industries way out-perfomed the defensives. Health care and telecommunications, the two worst performers had specific problems; the pharmaceutical giants suffering from patent expiries, disappointing drug pipelines and the latent threat to prescription prices, while telecoms were threatened by the internet.

MSCI* WORLD INDEX INDUSTRY BREAKDOWN (A$)

SECTORS	QUARTER	1 YEAR
MATERIALS	**9.2%**	**29.4%**
INDUSTRIALS	**13.8%**	**26.5%**
INFORMATION TECHNOLOGY	**9.4%**	**21.9%**
ENERGY	**15.9%**	**21.4%**
CONSUMER DISCRETIONARY	**10.0%**	**19.7%**
FINANCIALS	**6.6%**	**18.2%**
CONSUMER STAPLES	**10.9%**	**15.4%**
UTILITIES	**8.7%**	**12.4%**
HEALTH CARE	**12.6%**	**5.4%**
TELECOMMUNICATIONS	**5.8%**	**5.0%**

SOURCE: BLOOMBERG

* MORGAN STANLEY CAPITAL INTERNATIONAL WORLD ACCUMULATION NET RETURN INDEX

A conspicuous development has been the massive out-performance of small capitalisation companies versus large caps in the last three and a half years. Valuation differentials have reversed with larger companies now typically being on lower valuations than small companies. More recently there has also been a widening of the valuation gap between "high beta" and "low beta" stocks. Having had some benefit from this trend since 2000, we have been adjusting our position in the expectation of a reversal.

Currency

We sense that the highly lop-sided position that many investors had against the US$ has been squared. This, together with our longer term concerns, has caused us to exit the US currency again in favour of the Yen and Euro. We added to the hedge into A$, which is now around 29%, although we are not unreservedly optimistic as to its prospects versus the Euro and believe it will be slightly weaker than the Yen.

Changes to the Portfolio

GEOGRAPHICAL DISPOSITION OF PLATINUM ASSETS

REGION	JUNE 2004	MARCH 2004
WESTERN EUROPE	**31%**	**29%**
JAPAN	**30%**	**30%**
EMERGING MARKETS (INCLUDING KOREA)	**13%**	**16%**
NORTH AMERICA	**13%**	**12%**
AUSTRALIA	**2%**	**2%**
CASH	**11%**	**11%**
SHORTS	**34%**	**29%**

SOURCE: PLATINUM

Platinum has been relatively inactive in share trading terms recently. The main emphasis being on switching out of stocks where the market price ran ahead of real growth prospects and strengthening positions in neglected areas. In Japan this included adding to the Toyota group of companies at the expense of the likes of Nippon Yusen K.K., Mitsubishi Heavy Industries and Citizen Watch. The latter has been very strong on profit performance and the appeal of its electronic components subsidiary. We switched out of Yamanouchi Pharmaceutical to add to the position of its rival, Takeda Chemical. The valuation gap had become too great on account of the market's excitement with Yamanouchi's near term prospects, and its neglect of Takeda's possibly stronger longer term potential.

One new position was Sumitomo Mitsui Financial Group which, along with Mitsubishi Tokyo Financial, which we also own, we see as being in a position to take advantage of the much weakened banking sector and to expand as a diversified provider of services to the consumer.

In the US, we have added to Agere and Agilent and have shuffled the biotechs after losing Tularik to a bid from Amgen.

In Europe, the most significant new purchase was Alcatel. This traditional provider of telephone switchgear and other electrical engineering services has morphed into a more streamlined company to focus on *next-generation* communication. By this is meant high speed internet access, Voice over Internet Protocol (VoIP), satellite and mobile communication, as well as converting traditional copper wired networks to function as fully digital systems. These complex solutions go by acronyms like DSLAM (digital subscriber line access multiplexing) or FTTH /FTTN (fibre to the home or to the node). Technical developments have been extremely useful in upgrading some existing networks which were previously threatened with obsolescence. So now we find that DSLAMS are allowing the telecoms to continue to use their installed paired copper wires to deliver full video, high speed data and voice to the home.

Changes to the Portfolio (continued)

FTTH is an even more elegant solution, giving remarkable bandwidth with the added attraction of low maintenance costs, though installation costs are high.

Large telecom companies are being forced to spend huge sums on capital investments as the internet has permanently changed the structure of their business. Cable TV operators and satellite transmission are eroding their position while the regulatory environment has deteriorated and often forces them to give new competitors access to their networks.

Alcatel is well placed to supply this demand. Having dominated the global market in traditional closed circuit switching, it has an excellent understanding of the telecoms needs in a digital convergent world. Moreover, it has developed the necessary *kit* (software and hardware) to meet their needs. It is also able to help large corporations move to VoIP by virtue of being a global leader in this arena. The company is behind others in third generation mobile technology, but that may be compensated in due course by its leading position in optical networking. This division has seen sales more than halve since the glory days but metro DWDM (dense wavelength division multiplexing) is improving and prospects are brightening. Alcatel has virtually always had a lower rating than its peers, like Ericsson which we also own, but this valuation gap has now become excessive.

BREAKDOWN OF PLATINUM'S LONG INVESTMENTS BY INDUSTRY

CATEGORIES	EXAMPLES OF STOCKS	JUNE 2004	MARCH 2004
CYCLICALS/MANUFACTURING	TOYOTA MOTOR, SCHINDLER, SIEMENS, LINDE, OCÉ	**21%**	**23%**
FINANCIALS	CREDIT AGRICOLE, MITSUBISHI TOKYO FINANCIAL, MITSUI SUMITOMO INSURANCE, NORDEA	**16%**	**16%**
TECHNOLOGY/HARDWARE	AGERE, INFINEON TECH, SAMSUNG, AMD, SUN MICROSYSTEMS, NEC	**9%**	**9%**
MEDICAL	TAKEDA, SCHERING, NOVARTIS, MERCK KGaA, GLAXOSMITHKLINE	**8%**	**8%**
RETAIL/SERVICES/LOGISTICS	VEOLIA ENVIRON., DEUTSCHE POST, HORNBACH, MITSUBISHI CORP	**8%**	**8%**
CONSUMER BRANDS	HENKEL, ADIDAS SALOMON, LOTTE	**8%**	**7%**
GOLD AND OTHER	SHELL, BARRICK GOLD, NEWMONT MINING GOLD FIELDS, NORANDA	**7%**	**7%**
SOFTWARE/MEDIA	SKY PERFECT COMMUNICATIONS, SEOUL BROADCASTING. NEWSCORP	**7%**	**7%**
TELECOMS	ALCATEL, ERICSSON, NTT DOCOMO	**5%**	**4%**

SOURCE: PLATINUM

Commentary

The downward revision of the US GDP numbers for the first quarter, together with some disappointing releases and company announcements, should be treated with caution as until now most of the indicators suggested the lure of cheap money was working its magic to induce a solid expansion of that economy. One explanation may be that householders are responding to pressure on real wages from the delayed impact of higher costs, notably fuel, and the expiry of the tax refunds. We subscribe, however, to the view that employment will gradually rise in synchrony with the expansionary trend and that this will allow real wages to grow. The recovery has now been in effect for around 2.5 years and it is too early to conclude that a significant shift in consumer behaviour has taken place, particularly as we have not been able to detect as yet any signs of debt aversion.

The main distortions to the US economy remain the high and still expanding levels of government and consumer debt. The latter is doubtless partly due to the abnormally low level of short term interest rates, pushed down by the Federal Reserve Board to soften the impact of the 2000/2001 recession and held down to encourage the subsequent recovery. Even after the recent 25 basis points rise to 1.25%, the cost of overnight money is still about 1.75% below the base line of the 1994 trough.

It is widely believed that short rates are now on a rising trend and will have to be re-established at more normal levels to head off inflationary expectations and check house price rises and credit card borrowings. But it is very interesting to observe that long term rates have not reflected this. On the contrary the yields on US long bonds have been edging down for some while, without any evidence of foreign government buying or other extraneous influences. If these market messages are to be believed we must conclude that while specific pressures in certain areas of the US economy need to be controlled there are few fears of widespread inflation.

This is by no means unreasonable. Contrary to the popular view that inflation is a more or less normal state, it can be shown that there have been long periods of economic history when prices have been stable to flat. In his excellent book, *The Great Wave**, David Hackett Fischer identifies four episodes of great waves of inflation since the middle ages each followed by a protracted period of price stability. These coincided with the Renaissance, the Enlightenment and much of the 1800s. This latter episode is particularly interesting for it was a period which included civil wars, mass population growth and migration, and, indeed, the discovery and production of significant amounts of gold. Prices were flat for some 80 years. They spiked around times of war but then fell back to earlier levels. What is more, this price stability seems to have been evident across continents. In each of these periods of price stability, Fischer identifies that real wages rose, returns on capital diminished as measured by rents on land and bond yields, and importantly, inequalities narrowed.

Commentary (continued)

Clearly this addresses decades rather than the much shorter time horizons focused on by stock markets. However, we have long believed that the early 1980s witnessed the taming of inflation in developed countries so that we may experience a similar pattern to that seen in the 19th century. Behavioural psychology can explain the unwillingness of investors to believe in this new paradigm. This is particularly so when historically the effects of inflation have so helped borrowers. As many shareholders will know, we strongly believe the property boom in the US, Australia, the UK etc is a direct consequence of tax and interest rate distortions, combined with a latent trust in the "inflation bail-out". Globalisation, with its facilitation of the free movement of goods, capital and technology, is clearly exerting significant downward pressure on the prices of traded goods and services. We are not suggesting all prices will be flat, on the contrary we suspect that many commodities will reach new higher clearing levels as a consequence of expanded markets. These will, however, be off-set by continued falls in the prices of some traded goods.

In short, we believe it impossible for the US economy to be continuously fuelled by ever rising levels of borrowing. But in the absence of widespread inflation we do not accept that sharp rises in interest rates will be needed to curb current excesses. It must be feared, though, that currency instability is likely to play a part in the adjustment process.

Turning to Asian markets, the curious phenomenon has been the absence of follow-through buying by domestic investors. Back in the halcyon days of the 1990s "Tiger economies", domestic investors exhibited great enthusiasm for their share markets. Valuations were high, PEs typically in the high 20s to 30s, and there was no interest in discussing inscrutable subjects such as the marginal return on factor inputs etc. Now these economies are growing again, financial rectitude has returned at both the national and company level and compliance is stronger, but foreigners are the only interested players. The scars of the 1998 IMF crisis do not seem to have healed.

If valuations are to be maintained domestic investors will need to be tempted back into markets as it is likely that foreigners will follow their traditional pattern and take profits. Substantial switching has already been seen out of China, India, Korea and Thailand into Japan. The repatriation of foreign funds could also put pressure on exchange rates.

Some observers are cautious in the aftermath of the Indian election and the formation of a new coalition government under the Congress party. Our interpretation is that the decline of the stock market reflects more an inevitable cooling off after a very strong run.

The compromises that the new coalition may be forced to accept are in our view no more worrying than the dangerous Hindu nationalist policies that the BJP periodically enforced. The economy is continuing to grow healthily and under Prime Minister Manmohan Singh reform is still fully on the agenda.

It is too early to assess the degree to which the current credit freeze will impact China. Inflation, particularly in basic foods, is rampant with some basic grain prices up over 30% on last year, and the official CPI is trending upward with May prices being 4.4% higher than last year. Early reports on the sale of cars and heavy construction machinery suggest a sharp contraction of demand, 20% and 60% respectively. However, the impact of less visible influences, such as the loss of revenue to the Provincial authorities from the cessation of land sales and reductions in the sale of the stock of new housing, has still to be felt. At this stage we are inclined to believe that a manageable slowing will be achieved from what was evidently an unsustainable and *disorientating pace*. We are mainly relying on the sheer excitement of the new order to carry the economy over this adjustment phase.

An issue that we feel receives less emphasis than it should is the country's impending water crisis**. Industrialisation and a higher protein diet is placing an unsustainable burden on available water supplies. Domestic planners are increasingly concerned about the faltering flow of the Yellow River which is showing a worsening trend with the river water failing to even reach the coastal province of Shandong for extended periods of the year. In addition, the depletion of aquifers is evident with the water table of the North China plain falling precipitously. This area accounts for 40% of the nation's grain harvest, which itself is 75% dependant on irrigation. There are schemes to divert some 40 billion cubic metres of water a year from the Yangtze but these flows are relatively insignificant in terms of the increasing needs caused by rapid urbanisation and industrialisation. More efficient usage will be essential particularly as statistics show the country to be way in excess of world standards in terms of tonnes of water used per tonne of steel or paper produced. The longer term *implications for employment and agricultural prices is of world significance*.

As China continues to grow, albeit at a less hectic pace, its neighbouring suppliers like Japan and Korea will enjoy the slip stream. These economies are anyway gaining momentum and we see no reason to revise our optimistic view regarding their prospects. As is the case in Europe, rather than macro economic views it is the quality of individual companies and their prospects that drives our portfolio construction.

Conclusion

World growth seems to be broadening but inflation is rising and consumers' real incomes are under pressure. As is common, analysts' forecasts are getting well ahead of themselves and are likely to lead to disappointments. We believe the peak of corporate earnings growth has been crested which, together with a tightening of liquidity, will limit overall market advances. Asia is behind in this evolution and so has more room for continued broad-based share price appreciation.

Kerr Neilson Managing Director

* The Great Wave, David Hackett Fischer, 1996, Oxford University Press

** For further information, please see World Watch Magazine, July/August 1998 issue, Worldwatch Institute