# Platinum Capital® Limited Quarterly Report

## 31 March 2006

Platinum® CAPITAL LIMITED

ABN 51 063 975 431

## PERFORMANCE

The strong upward momentum seen in markets late last year continued into the first quarter. This was all the more impressive when evaluated against a backdrop of high and rising oil and other raw material input costs and rising interest rates. These burdens were evidently offset by the belief that the gathering pace of growth in Japan, Asia and Europe is reducing the world's dependence on US growth.

It was, again, the emerging markets that led the field, with the BRICs (Brazil, Russia, India and China) each up by between 13% to 20% in local currency. The developed western markets rose by 3% to 6%. The relatively weak performers were Thailand, Malaysia, Taiwan and Korea which barely moved in the three month period. As the A$ was generally weak these moves translated into an extra 3% to 5% on returns when translated into A$.

The Company matched the MSCI over the last three and 12 months, notwithstanding having an average net long exposure of only around 55%. Over the quarter, the Company's pre-tax return was 8.2% versus the MSCI of 10.1%. Contributing to our performance was gathering enthusiasm for some of the previously rather sleepy holdings bought over the previous 14 to 20 months, stocks like Alcatel, News Corp, Credit Agricole and Samsung Corp. Some of those bought more recently also behaved well with rises of around 50% within six months; purchases like Canon, Nintendo and Mitsubishi Heavy Industries (MHI). As is virtually always the case, there were offsets too, including having a 26% exposure to the A$ which was weak against most currencies in the last three months. Though our target is to outperform the MSCI by a considerable margin over time, we are relatively satisfied with matching it over the last 12 months given our less than full exposure to general market risk. Over the period the Company rose by 29.5%, versus the MSCI's 29.9%.

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 2006** | **172.62** |
| **28 FEBRUARY 2006** | **170.69*** |
| **31 MARCH 2006** | **177.48** |

* After provision for the 5 cent interim dividend paid 27 February 2006
Source: Platinum

## SHORTING

With such strong markets, shorting has been expensive, although losses on the equity side have been partially offset by our shorts on Japanese Government Bonds.

**MSCI* WORLD INDEX INDUSTRY PERFORMANCE** (AUD)

| SECTOR | QUARTER | 1 YEAR |
|---|---|---|
| **MATERIALS** | **16%** | **44%** |
| **ENERGY** | **13%** | **39%** |
| **INDUSTRIALS** | **12%** | **32%** |
| **FINANCIALS** | **11%** | **36%** |
| **UTILITIES** | **9%** | **29%** |
| **CONSUMER DISCRETIONARY** | **9%** | **22%** |
| **TELECOMMUNICATIONS** | **9%** | **14%** |
| **INFORMATION TECHNOLOGY** | **8%** | **29%** |
| **CONSUMER STAPLES** | **7%** | **19%** |
| **HEALTH CARE** | **6%** | **23%** |

Source: Factset
* Morgan Stanley Capital International All Country World Net Index

## CURRENCY

As noted above, this was a quarter to have no exposure to the A$, which declined by between 2.7% and 4.8% against the US$, the yen and the euro. Late in the period, as the dynamic hedgers swung into action, we chose to increase our A$ holdings to around 30%, taking the view that, despite our high external debt, continued world growth and the prospect of higher domestic interest rates, this should result in a strengthening of the A$ at least versus the US$. We now have very little exposure to the US$ and hold slightly more yen than underlying assets.

**GEOGRAPHICAL DISPOSITION OF PLATINUM ASSETS**

| REGION | MAR 2006 | DEC 2005 |
|---|---|---|
| JAPAN* | 29% | 34% |
| WESTERN EUROPE | 28% | 26% |
| NORTH AMERICA | 22% | 20% |
| EMERGING MARKETS (INCLUDING KOREA) | 15% | 15% |
| CASH | 6% | 5% |
| SHORTS | 37% | 36% |

* The Company also has a 9.4% short position in Japanese Government Bonds

Source: Platinum

## CHANGES TO THE PORTFOLIO

Highly volatile prices test one's agility as strong moves rapidly change the relative attraction of holdings within a portfolio. We used the surge in prices in Japan to extinguish holdings in Takeda (drugs), Toyota Motor Corp, Millea (general insurance), Mitsubishi Corp (trading house with large exposure to energy) and reduced positions in Canon, Nintendo and Dai Nippon Printing. In their stead we added to positions in Hitachi (heavy electrical machinery and electronics), Mitsubishi Chemical (chemicals and drugs), Mitsui Corp (trading house with participations in iron ore deposits and energy), TDK (magnetic heads and passive components), Sharp (the world's leading TFT TV maker and solar cell producer), SMC (the world's largest producer of pneumatic controls), and the regional banks. We also removed Samsung Electronics, the power providers in India; CESC and Tata Power, and the large drug producers GlaxoSmithKline and Schering AG.

After a dynamic relationship of adding to and reducing our position – to good effect – we finally exited AMD which, at three times our first entry cost, is now priced to reflect its ability to compete effectively against Intel. Failed investments such as Livedoor and Premiere AG are being sold at considerable loss.

For those of you who are concerned about our errors we can only reiterate that, at its core, equity investment is risky. We manage your funds with a diversified portfolio comprising over 100

**BREAKDOWN OF PLATINUM'S LONG INVESTMENTS BY INDUSTRY**

| CATEGORIES | EXAMPLES OF STOCKS | MAR 2006 | DEC 2005 |
|---|---|---|---|
| CYCLICALS/MANUFACTURING | TOYOTA INDUSTRIES, SCHINDLER, SIEMENS, INTERNATIONAL PAPER | 30% | 29% |
| FINANCIALS | CREDIT AGRICOLE, SUMITOMO MITSUI INSURANCE, SAMSUNG FIRE & MARINE | 16% | 17% |
| TECHNOLOGY/HARDWARE | AGERE, INFINEON TECH, SAMSUNG, SUN MICROSYSTEMS | 10% | 12% |
| RETAIL/SERVICES/LOGISTICS | HORNBACH, CARREFOUR, MITSUBISHI CORP | 10% | 11% |
| CONSUMER BRANDS | HENKEL, LOTTE, BEIERSDORF, PERNOD RICARD | 7% | 5% |
| SOFTWARE/MEDIA | LIBERTY MEDIA, NINTENDO, NEWS CORP | 6% | 6% |
| TELECOMS | ALCATEL, SK TELECOM, ERICSSON | 6% | 5% |
| GOLD AND OTHER RESOURCES | SHELL, BARRICK GOLD, NEWMONT MINING | 5% | 5% |
| MEDICAL | PFIZER, MERCK & CO | 4% | 5% |

Source: Platinum

holdings, of which the top 15 represent around 30% of long positions and the top 30, nearly 50%. The best measure of the soundness of our judgement lies in our three to five year returns.

The above sales allowed us to introduce the likes of Oracle (databases and enterprise resource planning applications), LG Corp (the Korean conglomerate of electronics, consumer goods and related activities) and Pernod Ricard (the world's second largest liquor and wine producer). We also added to International Paper, Liberty Media, our gold shares and other laggards.

## COMMENTARY

When we first presented the case for investing in India several years ago, some investors expressed dismay that we were not paying attention to the more obvious candidate, China. Interestingly, in the intervening period India has way outstripped China in stock market terms and the investment story for India is now well told. With this in mind, our focus is back on China.

To state the obvious, China has followed a very different path to modernisation than India. The latter is a democracy that has erected every conceivable barrier to retard progress, starting with Mrs Gandhi's licensing raj of the 1970s, left-leaning state governments, a fondness for litigious actions, and social values that often placed materialism at the bottom of priorities! By contrast, following the visit of Deng Xiaoping to Southern China in 1992, his deconstruction of central planning controls unleashed perhaps the most remarkable episode of raw capitalism ever seen. In addition, the residual benefits of a command economy were mobilised to the full to facilitate the growth of trade and the enticement of foreign know-how and capital. Having started as subordinate partners, opportunities for foreign firms gradually broadened as internal competition at both the provincial and city government levels enabled them to negotiate majority ownership and managerial control.

This was, however, not without the surrender of important technology which was seldom licensed and mostly purloined. For example, Lucent had little choice but to accept the reality of counterfeits if they wished to deepen their access to the burgeoning domestic market.

The competition for foreign investment among the provinces is highlighted by the proactive mentality of the authorities with licensing, but above all in providing core infrastructure such as land, water, power, ports and roads ahead of immediate need. This anticipatory expenditure plus the availability of vast pools of labour with limited choice and very limited representation, together with, and, more importantly, the ability to expropriate land with paltry compensation, sets modern Chinese industrialisation apart from any other model. Less publicised than the virtuous cycle of cheap labour and free trade that induced outsourcing and foreign direct investment, has been the technology and know-how contributed by the Taiwanese and Chinese returnees. They and others have allowed the country to deepen its capital goods producing industries at a time when capital formation has almost matched consumer spending. At the same time, generous State bank loans to troubled state owned enterprises (SOEs) have lubricated their ability to cope with the changed environment and with over-manning.

Our most recent tour, which included the back-blocks of China, highlighted the sophistication of infrastructure in and around the provincial cities. Beijing's policy of decentralisation is going according to plan and is helping to spread the nation's growing prosperity. There was a pervasive sense of optimism among both the local companies and multi-nationals that we met, despite pricing pressure remaining intense. Profitability, which was seldom mentioned during our 2003 grand tour, is causing there to be talk of the need for "industry consolidation". Apart from the inability to pass on rising raw material costs, labour shortages are also a growing concern. Wages are generally rising by close to 10% pa for assembly type work, while supervisory and professional management are able to extract increases of around 30%. Job-hopping by skilled workers is fast becoming a national past time [1].

This pressure on profitability will, in due course, impinge negatively on investment, which at present is abnormally high, and ultimately retard economic growth. We believe, however, that this negative force will be offset by foreign investment flows which will remain robust, driven by the potential of the vast domestic market and the competitive imperative to outsource. Even if labour costs rise in aggregate by say, 15% pa, the relative gap afforded by present low costs in China, plus the growing sophistication of its products, will provide support for longer than some may believe. We certainly anticipate more outsourcing to Vietnam, Indonesia and so on, but we believe there is sufficient momentum in China to ensure that activity continues to rise, albeit at a slightly slower pace, say 5-7% rather than the 8-9% of recent years. The resources of the nation will probably begin to focus more on the domestic market and in our view begin a consumption binge. Wages are far outstripping inflation and skilled people are increasingly able to afford property and consumables which were formerly confined to dreams.

Property is identified by many Chinese as their most desirable purchase, and on account of income rises and relatively cheap land, it is proving highly affordable. One development we visited in Chengdu, Vanke, is developing 700,000 $m^2$ to provide 5,000 apartments. The first stage sold for about RMB3,200 per $m^2$. As in Hong Kong, this is the price for unfitted gross space and once subcontractors have "finished" the apartment to the buyer's specification, the cost is around RMB4,500 $m^2$. So a pleasant flat of 120$m^2$ (equivalent to 105 $m^2$ net usable) in a garden setting, costs around $US67,500! A recent Credit Suisse survey reveals mean disposable urban household incomes in 2005, of around $US7,600 pa, so it is not surprising that across the nation, 30% of new apartments are paid for in cash. Interestingly, there is a tendency for mortgages to be retired early and even with the current housing boom, housing sales up 20% year on year, the outstanding stock of mortgages is barely growing. The government bans banks from penalising early repayment.

The second-hand market in housing is still very undeveloped on account of slow title registration in cities other than Shanghai and the fact that those with capital are said to prefer to keep their properties as investments. Rental returns are about 5-6% and there is a prospective bonus of capital appreciation. To further encourage decentralisation there is a growing tendency by the government to ration land in the coastal areas. It is encouraging the public auction of larger blocks, to favour the stronger players, and is limiting developers' use of borrowed funds as well as stipulating the degree to which developers can depend on pre-sale finance from potential buyers. With most developers seemingly indifferent to the activities of their competitors in this helter-skelter building of new accommodation, these regulations may be insufficient.

We believe foreign investors may also underestimate the growing demand for automobiles. The CS survey hints at this. Responses from Shenzhen and Beijing reveal about 26% of households owning a car compared to the survey average of 15%. Our visit to Geely Automobile's assembly complex in Ningbo illustrated the speed of adaptation by local start-ups. Selling cars for as little as $US5,000, Geely sold 133,000 vehicles in 2005, and is planning to sell 180,000 this year with the launch of seven new models. It may, however, be preferable to participate in this boom with a well established company such as Dongfeng, formerly Second Auto Works, with its 50% interest in foreign-managed associates producing Hondas, Nissans, Peugeots, Cummins diesel engines and its own trucks. One cannot help but be impressed by the exuberance and commitment of local entrepreneurs when seeing their facilities and knowing their short histories.

1 A recent study by Credit Suisse corroborates the sharp rise of urban incomes with their 2005 survey of 2,700 people in eight major Chinese cities, suggesting that the mean after-tax household disposable income is RMB5,081 ($US633) per month, 13% higher than in their 2004 survey. Our anecdotal evidence suggests this figure may be conservative.

We are somewhat constrained by government restrictions on investment in quoted companies. As an alternative we have sought foreign concerns which have positioned themselves to benefit from increased consumer spending. We particularly favour Carrefour, which has already opened 78 hypermarkets, and Pernod Ricard which markets the locally best-selling brand of scotch, Chivas Regal.

Greater domestic demand within China will be particularly beneficial to South East Asia and continue to suck in sophisticated exports from the rest of the world. This will begin to remove trade imbalances and the much discussed "under-consumption" of the country.

Japan and Korea are important areas of investment for Platinum and will clearly benefit from increased business activity in China. The stock markets in both countries have risen sharply from previously depressed levels and look to have further to go. The ending of deflation has returned pricing power to company management with a geared effect on **net** profits. A return to modest inflation in Japan will push-up interest rates and influence a rebalancing of institutional portfolios away from bonds in favour of equities. This could have a major effect as the proportion of equities currently held is at a historically low level of 28% having been as high as 41% in 1979.

## CONCLUSION

Interest rates are climbing worldwide but there is little evidence that this is halting investors' thirst for equities, or inducing a higher risk premium in emerging markets. Companies in the US and to a lesser extent in western Europe have benefited from a period of sustained restraint of labour costs which has resulted in profits taking a larger and larger share of Gross National Income. This trend still seems to be in place and goes a long way to explaining continued investor confidence in the face of relatively high historic valuations and clearly above-trend profits.

It is hard not to scent the odour of complacency at a time when pressure on global liquidity is disturbing the balance of the low interest rate environment that has prevailed in recent years. The other side of this coin, however, is the speeding-up of consumption growth and import demand in Asia. From a micro-perspective, we are identifying companies we are comfortable to own at prevailing prices, partly because of the relative undervaluation of quality we have alluded to in the past.

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