Platinum Capital® Limited Quarterly Investment Manager's Report

31 March 2014

Platinum®
CAPITAL LIMITED

ABN 51 063 975 431

Performance

More circumspection crept into the markets as the quarter progressed. The valuation-driven gains began to tire as investors assessed the prospect of higher rates later this year and the effect it has on discounting the distant earnings power of the much-favoured growth stocks. Late in the quarter the two strongest examples, biotechs and mobile Internet plays, swooned at this prospect.

The emerging markets were not helped by this or by the deteriorating Purchasing Managers' Index (PMI) from China which indicates a slowing economy. There was also evidence of pressure on housing prices in China and cash flow difficulties have begun to appear among the wealth management products.

Encouraging signs of recovery in Europe were spoilt by the fierce engagements in the Ukraine and Crimea, and consequent threats and counter threats.

Lastly, having slipped to 87 cents to the US dollar, the Australian dollar recovered to end the quarter up at 93 cents, which produces a negative effect on the MSCI World Index in A$ terms. Hence the Index was -2% for the quarter, but still a substantial +31% for the rolling 12 months. Hurting the Company this quarter was the exposure to the mobile Internet companies and Japan. However, gains in India and some of our cyclical holdings partly offset this and we recorded a negative 3% (pre-tax) for the quarter, but a positive 35.5% for the rolling 12 months.

MSCI* World Index Regional Performance (AUD)

REGION	QUARTER	1 YEAR
India	4%	20%
Australia	2%	14%
France	-1%	45%
Europe	**-2%**	**38%**
United States	**-2%**	**36%**
Developed Markets	**-2%**	**34%**
Germany	-4%	47%
Emerging Markets	**-4%**	**11%**
Asia ex Japan	**-4%**	**16%**
United Kingdom	-4%	31%
Korea	-6%	18%
Hong Kong	-7%	17%
Japan	**-9%**	**21%**
China	-9%	15%

* Morgan Stanley Capital International
Source: MSCI

MSCI* World Index Sector Performance (AUD)

SECTOR	QUARTER	1 YEAR
Utilities	4%	27%
Health Care	2%	42%
Information Technology	-1%	39%
Energy	-3%	25%
Materials	-3%	18%
Financials	-3%	30%
Consumer Staples	-3%	20%
Industrials	-4%	35%
Consumer Discretionary	-5%	38%
Telecommunication Services	-5%	30%

* Morgan Stanley Capital International
Source: MSCI

The following Platinum Capital Limited Net Asset Value figures are before and after provision for tax on both realised and unrealised income and gains, and the February and March figures have been adjusted for the three cent interim dividend declared on 13 February 2014 and paid on 10 March 2014.

Net Asset Value

	PRE-TAX	POST-TAX
31 January 2014	$1.6592	$1.5452
28 February 2014	$1.6838	$1.5536
31 March 2014	$1.6057	$1.4995

Source: Platinum

Changes to the Portfolio

Geographical Disposition of Platinum Assets*

REGION	MAR 14	DEC 13
Asia	28%	24%
Europe	26%	23%
North America	24%	24%
Japan	14%	18%
Africa	3%	2%
Russia	2%	1%
Australia	1%	1%
South America	1%	1%
Cash	1%	6%
Shorts	10%	10%

* The invested position represents the exposure of physical holdings and long stock derivatives.
Source: Platinum

We were quite active in trading around our mobile Internet holdings. After strong rises from the likes of Naver, Tencent, Baidu and Sina, we cut back exposure and took advantage of the sell-off of the US-listed Russian Internet plays like Yandex (Russia's search provider) and Qiwi (a payments platform). We also bought into Qunar (a leading travel vertical in China that seems to have outplayed the incumbent C-trip) and Autohome (the leading car auction vertical). These companies display high price volatility and we tend to treat them as a diversified subset within the portfolio. The ground rules are fast-changing with web-based classifieds having attractive business fundamentals, but in many areas it is still an open contest. In China, the three giants of the industry are Alibaba (to be listed in New York), Tencent and Baidu. The first two seem to be the best-placed by offering a comprehensive wrap-around service of social media, on-line payment and commerce, and search or video. Unlike Google, Baidu does not have the diversity of applications to mitigate the risks of substitution by users directly addressing 'verticals' via an app downloaded to their handset.

The strong performers that were sold include FedEx, Las Vegas Sands (gambling), Micron Technologies (memory chips), Cisco, Microsoft, Eurotunnel and Sumitomo Chemical. Cisco has been the only disappointment among these and longer term faces the threat from software defined networks.

Later in the report we obliquely refer to China's deteriorating return on marginal investment. There are many reasons for this and no doubt this will receive a full airing in the months to come. However, it offers us interesting tangential opportunities. In particular, one can identify abnormal suppression of returns in other parts of the world as a consequence of misdirected investment in China.

We believe the **aluminium industry** offers a classic opportunity. Over-investment in China caused by regional growth targeting, stranded coal reserves, lax pollution regulations and inefficient pricing of capital has seen this **power-hungry industry**[1] grow to represent half the globe's output of around 52 million tonnes a year. This is not sustainable. The local bauxite, like Chinese-sourced iron ore, is well-below average grade and expensive to beneficiate into alumina. Temporally adding to their problems is the legislated ban on Indonesian exports of un-beneficiated ores, which incidentally has interesting implications for nickel as well.

1 For the whole life-cycle analysis of aluminium production (includes mining, refining, smelting, transportation) the CSIRO estimates there is 58,600 kWh/tonne of embodied energy in aluminium equivalent to 27 tonnes of coal (35% power station efficiency and a generous 6,150 kWh per tonne of coal). Using the simple measure of 13,800 kWh of electricity to convert alumina to aluminium, it seems that the aluminium smelter industry alone is responsible for 4% of the Chinese national grid's industrial consumption – consuming about 150 million tonnes of coal.

At present, half of China's 25 million tonnes pa aluminium metal capacity is loss making on a *cash* basis (i.e. before any charges for depreciation and interest etc) and cash breakeven is put at over US$2,200 per tonne. Some five million tonnes of new aluminium smelter capacity is coming on-line in the Far West, close to massive coal reserves, though Chalco, the largest State-owned enterprise (SOE) producer, and other high cost producers, are starting to close some of their older plants. The government has also introduced adverse discriminatory pricing of electricity to inefficient smelters.

This idea of buying into an over-supplied commodity in the face of a potential slowing in the hitherto growth engine of the world may not sound the smartest idea around. However, China is responsible for the entire rise in aluminium metal output world-wide and has effectively flattened the metal price for the last 20 years. This, when the oil price has gone from US$20 to $100 per barrel and the coal price has risen more than three fold. As a reminder, energy accounts for about half the selling price of the metal (presently US$1,780 per tonne) and fixed investment costs run above $3,000 per tonne. The industry itself has seen demand growth of 6 to 7% pa and any slowing of capacity additions could see a strong move in the metal price. The rise of the use of aluminium in the auto industry is causing much excitement as emission legislation tightens and weight reduction is seen as one remedy.

There are several ways to exploit this idea which plays to a repricing of capital; the abatement of pollution in China; the tightening of alumina supply with the closure of the Gove refinery and the export ban by Indonesia.

We like both Hindalco and Alcoa. **Hindalco** is an Indian-based pure play which is starting to ramp-up production having just spent over US$6 billion on a fully integrated bauxite-to-smelter-to-rolled-metal expansion binge. It is highly geared, but has nearby access to superior bauxite reserves and, where it generates its own power, has a highly competitive tariff of under three cents per kWh. Delays have added to their capital costs, but its funding is well-structured. In addition to its alumina/aluminium metal output in India, it also owns the aluminium rolling business formerly part of Alcan. This was bought expensively in 2007, but after some clever reconfiguration of its global mill network, it is generating over 15% cash flow on the $5.7 billion investment. It has continued to invest, particularly for automobile applications, with capacity tripling to 900,000 tonnes and in metal recycling. On account of the financial and operational leverage, Hindalco should be a big stock.

Alcoa is a tamer rendition of the above with less debt, good leverage from being a medium cost metal producer, but with the underpinning of a strong and highly visible off-take of its special engineered products. These account for some 20% of sales, but is highly profitable and benefits greatly from the still expanding aero-building cycle, with nine years of orders.

Shorting

Late in the quarter we swapped our S&P 500 Index shorts for more shorts on the Russell 2000 (small company) Index. The latter is trading at extreme valuations by virtually all measures. We have made some small cuts to the individual stock shorts. Overall, the shorts were a benefit this quarter.

Currency

No meaningful changes were made to the currency exposure. We remain largely positioned in the US dollar, Euro and Asian currencies, with virtually no Australian dollar and little Japanese yen.

Commentary

As this year began, there was a lot of concern expressed about the adverse effects that rising interest rates in the US might have on emerging markets. Having been the pin-up of the investment community this same time last year, this was an interesting change of perception regarding emerging markets. As the quarter progressed, this concern seems to have ebbed just, to our minds, as the malfunctioning of the Chinese growth models has become more evident!

We posted these concerns about China on Platinum's website in the first half of 2013, emphasising the dependence of so much of its debt being set against elevated property values, rather than the loans being made against cash flows. There is growing media coverage of the number of property development companies that are discounting recently completed homes to try to clear their backlogs. The downward drift in house prices, particularly in the smaller cities, combined with the failure of several so-called wealth management products, which are actually bank loans repackaged to well-off individuals to circumvent interest rate regulations, is sapping confidence. The notion that the economy will achieve its targeted real growth rate of 7.5% pa seems improbable as the economy grapples with its many conflicting goals.

Like many other developing countries, China has found that the marginal dollar of investment has progressively returned a lower payback in terms of additional activity. Numbers for other countries show the marginal dollar invested creates less than 50 cents of economic growth, however, none is spending 47% of GDP on investment! Such has been the ambition for rapid development that expediency has ridden supreme and certainly over matters relating to the protection of the environment. In effect, industry had been given a free ride at the expense of clean air and water. The cumulative nature of this damage means it cannot be corrected overnight and one can expect the clamour for action to intensify to everyone's dismay. This will put the government in an invidious position as their powers to provide instant remedies will fail to match their hitherto hard-earned reputation of being all seeing and all doing. For now though, the government seems determined to attempt to counter this loss of momentum.

Having recently spent time in India, it was instructive to witness the effects that low growth (4.5% real versus 7 to 8% for the last 10 years) have had on sentiment and general commentary. One is reminded that both India and China responded aggressively to the GFC by flooding their systems with credit and engaged in deficit spending starting in 2008-9. Like the end of any credit boom, the ceiling of 'affordability' intervened and in the case of the Indian version of *Chaebols*, met the uncomfortable reality of rising interest rates and frightened bankers. The Reserve Bank of India (RBI) has actively tightened its supervision of the banks[2] which in turn is pressuring these family-run conglomerates to disgorge assets to reduce their debts. With its directed lending and specific priority allocations, the Indian banking system has similarities with that of China except that interest rates are market set. For the moment confidence is down and debt repayment the priority, but the currency has stabilised/appreciated and it seems that food inflation is dropping quickly. The prospects for lower interest rates have improved sharply.

The most encouraging development in recent years has been the boom in rural India and in particular, agriculture. This is seen by officials as having origins quite separate from the transfers from the Centre to provide for the 100 days paid work entitlement scheme (National Rural Employment Guarantee Scheme – NREGS). With a loss of some 31 million workers to the cities, the rural labour market has tightened. This has had the dual effect of raising rural incomes and encouraging investment. From 2004 to 2011, rural wages rose by 16% pa (5%) real in contrast to a 2% pa contraction in the cities and investment rose from 12% to 20% of rural activity. This has been transformational for agricultural output with the country becoming a net food exporter[3].

2 The State owned (public sector) banks account for about 75% of the formal system's assets and the Governor of the RBI, the outspoken Raghuram Rajan, has been actively promoting the need for more competition including more banking licences and economic inclusion. The informal system is calculated by the National Statistical Commission to represent 40% of the whole!

3 There is now a net trade surplus in food products of US$21 billion pa. For the first time in 3,000 years, in the words of a high official, the country is a net exporter of rice; grain stores are running at 80 million tonnes against the normal level of 40 million tonnes, production of pulses has risen by 50% to 20 million tonnes pa and India now finds itself as the world's second largest exporter of beef (after Brazil) and cotton. Milk production is 50% higher than the US at 139 million tonnes pa. Remarkably, this has all occurred with still huge imperfections in subsidies, price support systems and restrictions on exports.

The juxtaposition of India to commentary on China serves to highlight the contrasts of the two systems. They are alike in some respects, but the legal and political impediments that have long been regarded as India's Achilles heel, may now be regarded as its salvation.

The outcome of the national elections[4] in May could see the Centre reassert its authority. The second five-year term of the rule by the Congress Party coalition has been marked by administrative paralysis. This can be partly attributed to the conflicts within the Congress Party itself, but equally significant has been the intervention by the judiciary. Fed-up with blatant corruption, the High Court has flexed its authority, aided by public interest pleas and the Right to Information Act, and according to some, has over-stepped its powers in an attempt to remedy blatant gaming of political power.

A strange phenomenon occurred in the State elections of November 2013, with the anti-corruption party, the AAP (Aam Aadmi Party) winning control of the Legislative Assembly of Delhi, in coalition. This party has found huge support from the average Indian citizen whose patience with bribery and corruption has seemingly reached breaking point. Apart from its strong base in Delhi, however, it doesn't seem likely to mobilise more than 10 to 12 seats in the national election and may be more of an irritant than an outcome-spoiler in the election.

The money is presently on Narendra Modi, of the Bharatiya Janata Party's (BJP) to romp home with perhaps 220 seats in the 543 seat house. Modi, along with the Chief Ministers of several other successful States, notably the traditionally backward Bihar, has shown the benefits of firm leadership led by an economic development agenda which may admittedly also have taints of crony capitalism. By contrast, the policies of the Congress Party have favoured hand-outs and subsidies. This is completely out-of-step with the prevailing mood as seen in the State elections and the tenor of discussion with senior civil servants. Long gone are references for the need for protectionism; the mantra of the day is the virtue of the market place where price helps match supply and demand.

Foreign investors have been actively adding to their Indian holdings in anticipation of stronger direction under a Modi-style of leader. We too have been adding and for all the higgledy-piggledy progress that characterises the Indian model, it has most of the ingredients for success. Masked by the crowded headlines proclaiming a succession of scams, there have been many successes such as in agriculture noted above, but also in areas such as energy supply and the growing sophistication and deepening of the economy in general. A free press and working democracy surely trumps the alternatives in this vocal Internet world!

Outlook

The principal drivers behind this bull market seem intact.

Most economies are expanding and even if China slows, one should not underestimate Beijing's willingness to use measures like fiscal stimulus to ensure a high level of growth from this now immense economy. Inflation is subdued and in Europe it looks to be particularly low and may cause the European Central Bank to consider further loosening measures.

We continue to find companies that are attractively priced and despite conflicting headlines, see opportunities for stock pickers.

Kerr Neilson
Managing Director

4 Almost 815 million citizens are eligible to cast their ballot in nine phases of voting over five weeks in April/May.

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