Platinum Capital® Limited Quarterly Investment Manager's Report

31 March 2015

Platinum®
CAPITAL LIMITED

ABN 51 063 975 431

Performance

Economies of the Western hemisphere, led by America, continued to expand with the weaker participants enjoying the benefits of a sagging Euro which infused greater competitiveness and vigour back into commercial life. The Euro and the price of crude oil fell by about 11% over the first quarter of 2015. As the quarter progressed, there was evidence that most market players had reached that exalted point of "knowing" the US dollar was a one-way-bet, with concomitant positions to reflect this apparent certainty. Markets, as ever, rejected this proposition when the US Federal Reserve chose to use language in its March statement that was interpreted as yet further deferment of a rate rise. However, as the Euro had fallen by 21% versus the US dollar over 12 months, it in no way disturbed the belief that Euro-based companies would experience wider margins and the spreading glow of greater activity.

Asia was treated to further evidence of the commitment to reform in the populous economies of China, India and Indonesia. Most encouraging was the redirection of speculative zeal from the now smouldering Chinese property market to the red hot equity market. This was amplified by the government's stimulatory efforts to increase the availability of credit and to lower its cost. As reforms are being rolled out sequentially across Asia, it is very clear that the new political brooms of recently contested elections are sweeping away some of the imperfections that have impeded competition and disrupted the price-setting function of markets.

The regions that are facing more stringent conditions are the former winners – the commodity rich economies – which are now finding that a long and forcefully protracted boom has dire consequences when the opportunity of windfall gains failed to be directed towards longer-term benefits for society. Russia, Brazil, South Africa and Australia find their terms of trade have reversed and are facing a less prosperous future. Their stock markets responded negatively with the exception of Australia which witnessed a long-awaited cut in official interest rates and a concurrently weak Australian dollar.

Overall, the MSCI All Country World Index (A$) achieved a return of +9.6% for the quarter and +27.9% for the last 12 months. The Company returned +8.7% (pre-tax) for the quarter and +18.8% for the 12 months to March. The Company is trailing for the last 12 months on account of its net 88% invested level, but the commitment to Asia carried the benefits noted above. Thus with a disposition that is completely different to that of most managers, Platinum Capital Limited is being rewarded for following its investment approach of seeking neglect.

The accompanying tables give some idea of investors' **desire for certainty** on one end of the scale (consumer staples and discretionary) and the **effect of abundant cheap funding** on the other which is finding expression in yield companies and white-hot biotechs as displayed in the performance of health care. Some of these biotechs are little more than small product-less research establishments.

MSCI* World Index Regional Performance (AUD)

REGION	QUARTER	1 YEAR
Developed Markets	**10%**	**29%**
Emerging Markets	**10%**	**22%**
United States	**8%**	**36%**
Europe	**11%**	**14%**
Germany	16%	18%
France	12%	11%
United Kingdom	6%	15%
Japan	**18%**	**36%**
Asia ex Japan	**12%**	**34%**
Korea	12%	15%
China	16%	50%
Hong Kong	14%	40%
India	13%	46%
Australia	10%	14%

* Morgan Stanley Capital International

Source: MSCI

MSCI* World Index Sector Performance (AUD)

SECTOR	QUARTER	1 YEAR
Health Care	16%	47%
Consumer Discretionary	13%	35%
Consumer Staples	10%	31%
Information Technology	10%	41%
Industrials	9%	24%
Telecommunication Services	9%	24%
Materials	9%	13%
Financials	8%	26%
Energy	4%	1%
Utilities	2%	22%

* Morgan Stanley Capital International

Source: MSCI

Currency

The portfolio remains heavily hedged back into the US dollar (80%, including 13% in Hong Kong dollars) and we shifted some of the residual 8% of Euros (6% as at 31 March) into Norwegian krones (5%), with an eye to an improvement in the oil price later this year. There is virtually no exposure to the Australian dollar or the Japanese yen.

Shorting

The Company's short positions were adjusted and are now principally against the S&P index. This is now preferred to the Russell 2000 because of the former's greater exposure to foreign earnings, some 46%.

Net Asset Value

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 five cent interim dividend declared on 12 February 2015 and paid on 13 March 2015.

	PRE-TAX NAV	POST-TAX NAV
31 January 2015	$1.6800	$1.6094
28 February 2015	$1.6771	$1.5923
31 March 2015	$1.6947	$1.6052

Source: Platinum

Changes to the Portfolio

Geographical Disposition of Platinum Assets*

REGION	MAR 15	DEC 14
Asia	39%	37%
North America	23%	24%
Europe	23%	22%
Japan	8%	8%
Africa	1%	2%
Russia	1%	1%
Australia	1%	1%
Cash	4%	5%
Shorts	8%	7%

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

Source: Platinum

For all the effervescence in the indices there is a lack of depth in the ability to shift sizeable volumes in smaller companies. Several of our older holdings of small companies have risen well since the middle of last year and, in view of our concerns about liquidity, we have been using this time to sell into the strength and concentrate the portfolio in larger and more liquid companies. We have also adopted an about-face on some of the cyclical metal plays that we had bought just a few quarters ago, selling down **Alcoa** and **Hindalco**. You may recall that these were predicated on an improved balance in the metal markets caused by export bans and capital rationing. As it transpired, there was only a short-lived rally in metal prices and metal shares, but it allowed us to realise a substantial gain. The lesson one learns at the end of any great resources boom is the ability of miners to cut costs to meet the now much lower price of their commodity, but, of course, at the cost of margins for themselves and their suppliers.

The significant purchases over the last three months were **Qlik Technologies**, **Cheung Kong Holdings**, **Qingdao Haier** and **Gree Electric Appliances**. We also continued to buy the utilities in India which we envisage will benefit from reforms but which, for the time being, are ignored by investors for their apparent lack of immediate growth or "sex appeal".

Qlik was for a time a much favoured company which lost support after a fantastic start when its sales growth faltered. It has subsequently launched a second product that is simpler to implement but which has advantages over the competition for its multi-device availability, scalability and common data sharing. The company's speciality is to provide software that enables users to visualise sets of data, the so-called business intelligence tools that can allow line operatives to understand inter-linked relationships within vast amounts of data and to manipulate them at will.

Its principal competitors are the old tech heavyweights like SAP, Oracle and Microsoft as well as start-ups like Tableau. As elsewhere, it is the smaller companies that are the most virile and at present Tableau, though smaller, is growing faster than Qlik. However, business intelligence application is still a frontier market and there is space for more than one supplier. Some may argue that Tableau could become the product of choice and hence, through user familiarity, become the entrenched dominant player. It is however priced at 10x sales, while Qlik seems to have more robust features and trades on half this valuation.

Cheung Kong is a classic fallen favourite. It is currently going through a significant asset reshuffle that will leave it with a strong position in several mobile infrastructure markets, a wonderfully successful retail chain, interests in infrastructure, principally in Britain, and a network of ports world-wide. Owned by Li Ka-shing, one of the most successful and wealthiest entrepreneurs of the age, the market seems to have lost belief on account of a long string of losses from his foray into telecoms. We can identify why this will now change which, together with his other manoeuvres, cannot lead us to the negative viewpoint apparently held by the market. We are buying this pool of valuable assets at less than book value!

Haier and **Gree** are respectively the leading suppliers of white goods and air conditioners to the Chinese market. As we see in India, local investors tend to be more taken by the excitement of super high growth stocks than hugely profitable, steady strong growers that operate in already concentrated industries. From their overwhelming domestic origins, both companies are beginning to make inroads into foreign markets and seemingly at no cost to their profitability. Along with the **white spirit purveyors**, we see these shares giving us very handsome returns with starting valuations of less than 14x earnings and, what's more, no debt.

Commentary

As one re-reads earlier quarterly reports, it is conspicuous how the concerns that internally preoccupied us at the time were not fully developed on paper. Seldom was the urgency and magnitude of the issues fully transmitted. For example, in the run-up to the global financial crisis (GFC), we were constantly discussing, even obsessing about, the segregation of origination (of mortgages) from ownership and where this would lead. Yet when we look back at the comments we wrote, there is far less coverage than we remember.

Why do we mention this? We would like to emphasise two important points.

Firstly, **the world order is changing** and yet most investors are shackled to the familiar. In Australia, it is about franking credits attached to Australian-sourced dividends; for other investors, it is about growth in Europe and the USA. We have no problem with the recovery in Europe or the sixth consecutive year of expansion in the USA, but their growth is still pitiful compared to that which we may expect in Asia. How is it that Developing Asia, with more than half of the world's population and 30% of the world's output[1], is given such scant representation in global portfolios? The MSCI All Country World Index has a weighting of 17% for all of Asia (and a mere 9% for Asia ex Japan) and it is rare for global portfolio managers to have a weighting above 15%. As a shareholder of Platinum Capital Limited, please **recognise that about HALF of the Company's *invested* position is in Asia (including Japan)**. We do not believe that over the next 10 to 15 years Asia will be the origin of only a tiny minority of the world's interesting investment opportunities. It is possible, but **completely contrary to the experience of the last 10, 20 or 30 years!**

Many investors have concerns about Asian companies' corporate governance and book-keeping practices. We cannot refute these concerns. However, **detailed analysis**, which pays particular attention to the nature of the business of each company, its cash flows, the ownership structure and a comparison of management's words with their deeds, can reduce some of these risks. In addition, the effect of a portfolio of holdings spreads the specific risk of individual holdings.

Secondly, the most important question to ask is **what price we are paying** for these companies. The market is a weighing machine and commonly held doubts, legitimate or not, tend to be reflected in prices. The big investment opportunities, in our experience, are born of low expectations.

At the time we began to enthusiastically accumulate Chinese stocks in the second half of 2014, the Shanghai composite index had already fallen 65% from its peak of 6100 reached in October 2007 to a low of 2100. Expectations were very low because of concerns emanating from the country's slowing and changing economy and the effect the corruption blitz was having on deferring business decisions.

A more penetrating question is whether the economies of Asia, which we favour, will **continue to grow and experience a deepening of free markets.** We feel this is inevitable and attributable to the power of ubiquitous wireless connectivity and the Internet. Apart from the pro-development win by the Modi-led government in India and a **first budget that reinforced the move to cooperative federalism and outcome-based spending**, we can point to daily evidence of the removal of obstacles to business and the desire to attract capital. In China, the **reform train is slipstreaming following the anti-corruption vanguard**[2]. We see no evidence of the leaders of these countries being any less concerned about their power base than leaders in the West. The difference lies in their understanding of the need for reform and their greater ability to push through the changes necessary for a deepening of their market economies. Yes, the issues they face are colossal, but so is their competitive advantage in terms of being able to leap-frog with technology and by having a massive cost advantage in labour. By way of example, over 700 million Indians are now electronically registered on the biometrics-based national identity system.

We therefore pose the question in a different way by asking, "**what are the prospects, adjusted for probability, and how do they compare with the price we are required to pay elsewhere?**"

China has no alternative than to urbanise. This, together with a huge expansion of infrastructure, including a vibrant e-commerce sector, is of itself a strong driver for growth. **The service sector** has become more potent and in the last decade accounted for **nearly half the GDP *growth*** in the region and at the margin created 2.3 times more jobs than manufacturing, according to Citi Research. They elaborate further by suggesting that **labour productivity in "market services"**[3] in China is similar to that of manufacturing and hence the transformation to more of **a service economy needs not result in lower incomes.** The growth in the service sector is showing up in labour pricing power in China where wages continue to grow across-the-board several times faster than inflation. There are evident shortages in skilled middle management and factory workers are gladly moving into service jobs for better condition. Of course, the economy will grow at a slower pace than it has over the last 15 to 20 years.

1 Developing Asia (Emerging and Developing Asia) GDP Share of World Total (PPP) Statistics for the Year 2014 (http://www.economywatch.com/economic-statistics/Developing-Asia/GDP_Share_of_World_Total_PPP/), data source: International Monetary Fund (IMF), retrieved on 7 April 2015.

2 These reforms relate principally to State-owned enterprises (SOEs) in areas such as freeing up commodity prices (water, oil and gas, electricity and cement), consolidation of excess capacity sectors (steel, cement, coal and shipbuilding), asset sales and injections for SOEs, management incentivisation through share ownership, and liberalising foreign ownership rules.

3 Market services are those with a specific price, as against social services which are provided by the government for no specific charge.

Careless lending against real assets, rather than cash flows, will damage bank balance sheets at the cost of lending to the private sector, but small businesses have long faced such discrimination, relying instead on family and friends. See the following tabulation that highlights the flexibility that is afforded to both China and India as a consequence of their high savings rates.

A Comparison of Debt Levels and Growth Expectations

		CHINA	INDIA	USA	EURO AREA	WORLD
GDP Growth %^	2015	6.8	6.3	3.6	1.2	3.5
	2016	6.3	6.5	3.7	1.4	3.7
Debt-Government*	% GDP	39	61	80	95	
Debt-Corporate#	% GDP	167	56	78	122	
Debt-Household†	% GDP	30	8	77	48	
Mkt Capitalisation‡	% GDP	46	60	143	86	
Corporate Profits	% GDP	2.7	3.1	8.0	4.3	
Equity Markets						
RoCE incl. Goodwill	%	10	13	14	10	
Return on Equity	%	14	12	12	7	
Price to Book Value		2.5	2.7	2.8	2.0	
Price to Earnings Expected 2015		15	21	19	17	

Source: International Monetary Fund (IMF), Bank for International Settlements (BIS) and Factset

^ Note these growth expectations from the International Monetary Fund (IMF) look rather high for China and may be too high for the US given the adverse effect of a strong US dollar.

* Observe the low level of debt owed by the Chinese government and, to a lesser extent, India.

However, the Chinese SOEs are clearly over-borrowed and indeed face a period of restructuring and probable asset shedding.

† Household debt in both India and China is conspicuously low in sharp contrast to the maxed-out experience of the West, reflecting nations with savings rates of 30% or more.

‡ Market Capitalisation does not reveal much, but registrations for personal broking accounts in China are running hot at over 1 million per day, six times higher than last year!

But this forecast strays from our area of core competence. When we look at the consumer companies we have been buying in China:

- they tend to be debt-free,
- have all grown in the high-teens or more,
- are extremely profitable, and
- surprisingly, are already operating in relatively consolidated industries.

Compared to similar companies in India which trade on 30x to 40x earnings, or Western defensives in the mid-20s, these plays are veritable gifts on less than 15x 2015 earnings.

We cannot bring ourselves to buy these types of predictable earners in India on account of valuations, but instead are very comfortable accumulating the infrastructure plays and private banks. These are characterised by having serious management, relatively ungeared balance sheets and an ability to step into the void that has been created by the over-leveraging of balance sheets that is common among the recent batch of new entrepreneurs. Further, they are the principal beneficiaries of the Bharatiya Janata Party (BJP) government's ideology of deregulation and greater fiscal rectitude. Even without the passing of the goods and services tax (GST) legislation, which is slated for 2016 and will be a major test of Prime Minister Modi's skill and toughness, we expect interest rates in India to progressively drop over the coming months. This is to the benefit of bank spreads and should lead to higher valuations for utilities.

In Japan, promising things are happening: companies are reforming, margins are improving – thanks to the Yen, wages are lifting into real increases and banks have been increasing their loans by 5% per annum. We remain confident that the Japanese market is in a rising trend.

It is not as though we are uninterested in the **great Western companies that have the theoretical and applied know-how to provide the highways of the future**, be it Intel, Cisco, Oracle, eBay, Google, Ericsson or new concepts like data visualisation. These companies are seen by many as passé compared to so-called "growth tech", but to our way of thinking are perfectly sound businesses that are **being diagnosed with symptoms they do not have**, namely, being ex-growth. The closest we can get to owning the much favoured defensive growth plays are the pharmaceutical companies in Europe that account for 8% of the Company's portfolio, but, in the main, the delight in the certain and perfect cannot be achieved at a price we consider worthwhile.

Yes, the market is efficient at determining the appropriate clearing price for risk, but at times of stress there is a tendency to exaggerate the *apparent* risk.

Outlook

We continue to be highly enthusiastic about the companies we are finding. As emphasised above, it is not where the majority are investing. Rates will be rising, led by the US Federal Reserve, and presumably the discussion will then pass to the shape of the trajectory. The ability to extinguish debt remains the great detractor and movement in exchange rates could exacerbate the effect of even a gradual tightening cycle. Our preference is to stay with those companies with some pricing power and in areas that will be able to achieve some growth. Capital flight is a potential cause of concern, but we do not envisage this being a serious problem in the markets we have emphasised.

Kerr Neilson
Managing Director

Level 8, 7 Macquarie Place
Sydney NSW 2000

TELEPHONE
1300 726 700 or 02 9255 7500
0800 700 726 (New Zealand only)

FACSIMILE
02 9254 5555

EMAIL
invest@platinum.com.au

WEBSITE
www.platinumcapital.com.au

Platinum® CAPITAL LIMITED