Investment Manager's Report

PERFORMANCE

The most interesting developments in this latest quarter have been in the US. The slackening of their long-running economic expansion that we saw earlier in the year proved to be no more than a temporary hesitation. As growth resumed so hopes of Fed. action to cut short-term interest rates faded. Long-dated bonds sold off with the yield in the 10 year note rising from 4.6% to 5.1%. It is far from clear, however, whether this reflected increasing inflationary pressures or simply a partial correction to an abnormally shaped yield curve.

Away from the US, confidence in continued growth, already high, strengthened further. There was a rebound in energy prices and strength in commodities generally including foodstuffs. This did not, perhaps surprisingly, lead to any noticeable inflationary fears and the price of gold, often used as a hedge against inflation, was largely unchanged, if anything slightly weaker.

A discordant note came from the development of concerns in the US sub-prime market where several hedge funds had problems with establishing the true value of their portfolios. This has not, so far, significantly affected the availability of funds for leveraged buyouts, though super heated areas of the market, such as REITS, have certainly lost some of their lustre, being down by about 20% from their February peak. We would expect further turbulence in the sub- prime/collateralised debt obligations markets and with it, deeper scrutiny of the nature of the risks lenders are taking. This might well impinge on the LBO market and the valuations of their agents. As you are aware, careless lending practices have been something of a hobbyhorse of ours so we will spare you further sermonising. A telling development is the listing of Blackstone with others to follow.

While our performance versus the market opportunities has improved in the last three and six month periods, the annual figures are still disappointing. Drilling down into the regional contribution over the first half of the year we see the following picture in A$ terms:

Investment Manager's Report

continued

31/12/06 – 30/6/07

	COMPANY RETURN %	REGIONAL RETURN %	COMPANY WEIGHTING %
Asia	7.6%	17.0%	17.0%
Japan	-3.7%	-5.2%	26.0%
North America	13.7%	1.3%	24.0%
Europe	8.7%	4.0%	21.0%
Long equities position	**6.0%**	**2.3%**	**88.5%**

Source: Platinum

Our stock selection was clearly respectable overall although we should have done better in Asia ex-Japan. Our timing and focus in China was particularly unfortunate although we believe we are well positioned to recover lost ground in coming months.

MSCI* World Index Country Performance (AUD)

SECTOR	QUARTER	1 YEAR
Brazil	18%	41%
India	15%	41%
Korea	13%	17%
Germany	11%	30%
Australia	5%	26%
France	5%	15%
UK	2%	12%
Hong Kong	1%	13%
US	1%	5%
Japan	-5%	-6%

Source: MSCI

Our most telling error over the full year was the amount of money committed to the weakest market of all, Japan. This unfortunately was a function of the way we go about managing your money which is to pick individual companies based on value, regardless of their geographic location. This has not been rewarding recently but such apparent misallocations have been experienced in the past only to be revealed later as more to do with timing than anything else.

This leaves us with the much more critical "errors" of shorting in a rollicking bull market and of having an associated hedge by owning the yen. These actions virtually halved the Company's return. As it became clearer that the fundamental drivers of this bull market are still in place, so we reduced both of these defensive positions to attempt to capture a greater portion of the prevailing opportunity. This does not mean that we plan to eliminate these positions. On the tenth anniversary of the debt-induced meltdown in Asia, we are acutely sensitive to the prevailing credit risks.

The Company's performance trailed the MSCI by 0.2% for the quarter, exceeded it by 0.7% for six months and trailed by 4.2% for the year*. While slightly trailing the MSCI over the last three years our performance should be judged in the context of the protection afforded clients by our hedging policy. It is certainly true, however, that the strong Australian dollar and startling performance of the ASX, does for the moment, make all international funds look pedestrian.

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

30 APRIL 2007	31 MAY 2007	30 JUNE 2007
162.18	164.11	164.29

Source: Platinum

* Editor's note: Platinum launched the Platinum International Unhedged Fund earlier this year to address those clients who would prefer to run unadulterated exposure to the markets.

Investment Manager's Report

continued

CURRENCY

The sustained growth outlook and large interest rate differentials again favoured the commodity producing currencies. The yen suffered further loss of support among Japanese domestic investors as they flocked to alternative currency funds which are promoted on the basis of their yields, with only small print warnings about currency mismatching. At present it requires an ingenious mind to find the attractions of the yen, yet as we have seen in the past, currencies have the capacity to surprise and it can be boldly asserted that the yen is the least owned and cheapest major currency around. We have nevertheless cut some of our yen holdings in favour of the US dollar and we remain 26% hedged back into the Australian dollar.

SHORTING

We continue to gradually replace stock specific shorts with sector specific alternatives. The short sale of REITs is paying off but not sufficiently to give us an overall reward for challenging the majority view. There have been no major changes geographically and a modest reduction in hedging.

ASSET ALLOCATION

Disposition of Assets

REGION	JUN 2007	MAR 2007
Japan	24%	26%
North America	27%	25%
Western Europe	21%	22%
Emerging markets	18%	16%
Cash	10%	11%
Shorts	29%	34%

Source: Platinum

There have been no major changes geographically and a modest reduction in hedging.

CHANGES TO THE PORTFOLIO

We have been gradually concentrating the portfolio in the top 15 positions and these now account for nearly 40% of our long holdings. However, our largest holding, Mosaic has been exceedingly strong lately (+46% in 3 months) and we have been reducing the position. Other sales were the entire position of the paper maker UPM to make way for more pure pulp exposure, the reduction of Samsung Holdings, another hot stock over the quarter, in favour of Samsung Electronics, and additions to our theme of a long cycle of investment in energy-related plant namely JGC and KBR. An emerging theme is the broadening use of LEDs (light emitting diodes) in all lighting categories. This together with our enthusiasm for solar power, has led us to a handful of interesting companies.

With the harsh memories of the IMF crises now fading in Asia, together with the prospect of strong earnings growth, sound balance sheets and sensible valuations, we have been attracted to financial stocks in the region. Improving faith in their economies will favour the investment banks and brokers. Importantly, in both Taiwan and Korea, deregulation of the financial system is encouraging the development of Western-style product distributors.

When looking at companies in China one is often discouraged by valuations, particularly among consumer shares. Having heavily provided for its bad loans, the Bank of China is an interesting beneficiary of the ongoing boom on the mainland. This stock has been relatively weak since listing last year due to concerns about its exposure to the strengthening yuan and its somewhat weaker position than the big three in deposit gathering. On 15.5 times forward earnings and twice book, however, the growth prospects do not look fully appreciated.

CHINA

From virtually all perspectives, China is progressively moving to centre stage. The re-emergence of this behemoth is changing the balance of the world economy. The sheer scale of its currency interventionist policy is unprecedented and consequently difficult to comprehend. With a freely floating exchange rate, demand

Investment Manager's Report
continued

for the yuan would drive up its value significantly. However, under a managed float, the People's Bank of China (PBC) stands in the market matching inflows with an equivalent increase of yuan in circulation. To control what would otherwise be an explosion of domestic money supply, its first line of defence is to issue bonds to recover the newly printed yuan. In addition, it needs to impose increasingly stringent reserve requirements on the banks to control money growth by effectively locking away part of their balance sheets. This circle of intervention is completed by the PBC redeploying the accumulating foreign exchange reserves in the debt markets of its trading partners through the purchase of foreign debt paper and the inevitable downward pressure on global yields.

History indicates that mercantilist policies such as described above result in domestic asset bubbles. Significantly, the greater an economy's ability to export the greater has been the resultant bubble. The best example of this was Taiwan in 1986 when the trade surplus reached over 20% of GDP and even though the currency appreciated by some 30%[1], money supply rose by over 20% fuelling a massive bubble. From September 1985 to April 1990 the stock market exploded upwards 12 fold. As the currency rose it induced a self-fulfilling expectation of further rises and locals brought more funds on shore to participate in the boom even though the authorities did their best to encourage outflows. The introduction of capital gains tax and warnings of impending trouble did nothing to calm the speculative excesses.

A surprising feature of the bubble was that the banks prospered, partly because there was no conventional inflation but mainly because of asset growth. The cauterizing of their balance sheets which involved special reserves requirements that peaked at 40% of deposits, caused them to amplify risk-taking with the residual funds at their disposal… yet investors kept chasing bank shares. They rose on average by 20 fold in THREE years! The other beneficiaries were companies that were domestically orientated, while exporters languished. The same pattern was seen in Korea and

1 At the Plaza Accord in Sept 1985, G5 pressure forced an appreciation of the yen and by default the Korean won and Taiwanese dollar.

Japan but the bubbles there were more modest, the respective market indices rising by ten fold and two and a half fold in about four years from 1985.

The position of China today suggests a similar paradigm. We can expect all manner of policies to be introduced to alleviate the pressure on the yuan, though, rather like sitting on a water bed, pressure relieved in one part will be transferred elsewhere. Outward flows are likely to be encouraged, initially to the likes of Hong Kong and Singapore, with the consequential impact on values. It is unlikely to be a smooth trajectory upward as investors respond to the phalanx of measures introduced to try to calm things down, yet past patterns suggest the market will rise well beyond sustainable value.

One remarkable feature of the industrialisation of China is that despite the distortion of factor input costs, the growth of productivity has been colossal. This has been assisted by the investment by Government in infrastructure (the World Bank unofficially puts this figure at 9% of GDP[2]) with the result that growth has been accomplished without the normal bottlenecks that cause inflation. Another notable feature has been the willingness of world markets to absorb the additions to industrial output made available by the massive expansion of domestic production and the much more constrained growth of domestic consumption. It is also true that economic conditions have been favourable to capital formation in the private sector[3].

At present the US economy is robust but should it falter the fact that it absorbs some 20% of Chinese exports, which accounts for 14% of total US imports will raise concern. Fortunately China's export dependency on the USA is diminishing as new markets take up the running, notably large countries such as India, commodity rich regions like Latin America, Africa, and Russia and its former satellites. Markets other than the US, Europe and Japan now account for 50% of Chinese exports. Unlike Japan during its growth spurt in the 70s, where exports

2 Personal income's share of the economy drifted down over the last 10 years from over 50% to 42%.

3 The lack of a social security net, and the profitability of industry skews the capital to labour share, ensuring a disproportionate allocation to the export sector.

Investment Manager's Report

continued

accounted for mid teens of GNP, China's economy derives a full third of its activity from exports. This clearly exposes the country to economic shocks.

Internally the main risk is inflation. There are already worries about the cost of foodstuffs and any more general price inflation will make the authorities' task of managing the economy materially more difficult.

There is often no substitute for *in situ* discovery and from our recent visit to the two large coastal provinces of Zhejiang and Fujian, where we visited a large number of companies, we can report the following:

1. Cost pressure from labour is rising as willing supply tightens. Wages are growing at about 10% pa. Inducements for skilled supervisors seem to have increased.
2. There is increasing pressure on large and mid-sized companies to pay their proper taxes particularly those relating to workers benefits, healthcare and pensions and this is hurting their competitiveness compared to smaller pirate companies.
3. Invariably those we met were pricing their exports 20 to 30 % below "Western" competitors and yet still made high returns on funds employed, often 20% plus.
4. Many of the companies we saw believed that their export efforts were at an early stage as they were progressing through "supplier accreditation" with foreign multinationals – suggesting that even if and when the yuan strengthens, there is inherent momentum to their sales. It is impossible to say conclusively but perhaps this applies across the country at large.
5. Most managers were looking to move up-market in terms of their technical competence to ameliorate price competition in commodity products. It was astonishing how quickly these skills were being acquired, often with the help of retired Japanese and Korean technicians[4].

4 This is no illusion; an independent auto manufacturer we visited is now barely keeping up with demand, yet just one year ago its assembly plant seemed more like a warehouse of ill-pressed steel panels. Conditions were shambolic, there were more bodies on the remedial line getting the sledgehammer treatment than those entering the inspection bays!

6. Few regarded their "core business" as sacrosanct; some were willing to consider selling off factories to develop other activities; in one case to move from furniture manufacturing to furniture retailing. Their agility and speed of decision-making and implementation reflected an almost cavalier "can do" optimism.
7. Land is no longer quite as cheap, having escalated by three or four fold since 2003, but it is still cheap by global standards at say, US$250,000 per hectare.

At the political level we formed the view that the Government is serious about tackling the degradation of the environment and pollution and is clamping down on inefficient users of resources through forced closures and tax inducements, reinforced by the mid June '07 removal of tax rebates on energy-hungry and other highly polluting exporters. There is also greater emphasis on industry restructuring and amalgamation among State owned enterprises (SOE), again, to streamline and reduce waste.

Overall, then, while the Chinese economy is vulnerable to slowing exports, the structural imperative to save and the profitability of the corporate sector is such that balance of payments surpluses will continue to mount. Even if domestic rates are raised to attempt to slow the economy and if bank lending is restricted, the system may well be able to circumvent these traditional channels. An upward adjustment of the exchange rate will eventually have to play a part to correct internal bloating expressed in the value of assets, namely property and shares.

OUTLOOK

Our inherent aversion to risk has clearly retarded our performance. It is well known that markets often overshoot but the scale of the recent expansion in credit markets is unprecedented.

Investors in stocks are behaving in rational accordance with the signals they are receiving. They can see that money is cheap and plentiful, company profits are at record levels, and there are no imminent signs that the cost of funds is about to destroy the arbitrage possibilities which exist when earnings yields are way above the cost of borrowing.

Investment Manager's Report
continued

The emerging economies of Asia together with the oil producing regions are continuing to build up foreign exchange reserves and recycling them overseas in volumes that inevitably distort the cost of money.

Among the signals of danger will be the momentum of US economic activity, the levels of protestation regarding "unfair" trade practices, Chinese domestic inflation, the movements of the yen, and a shock to overconfidence resulting in an adverse credit correction.

Our predicament is to gauge how much insurance to run on account of the system's unsound footing and the degree to which we should provide for an "outlier event"[5]. Wary of overplaying our hand, we have reduced our shorts and have cut back on the associated play of holding yen. Our share holdings themselves are characterised by low financial leverage and typically our holdings are not trading at peak margins, are favoured by structural growth drivers and have valuations that are sensible. Importantly, although market valuations are generally high, we are still able to identify pools of opportunity.

Kerr Neilson
MANAGING DIRECTOR

On a separate matter, I owe many of you an apology regarding the floatation of the management company of Platinum Capital. We grossly underestimated the level of interest that would be shown in the listing of the funds management company and when allocating shares in the IPO failed to set aside enough shares for long standing and loyal holders of PMC. Many of you who applied for shares were left empty handed even though you went through the necessary steps of filling in the application form, drawing cheques etc. I have written to many who have expressed their disappointment (and more) regarding this. Please accept my unconditional apology.

5 For those with time and the inclination we can recommend the book *The Black Swan* by Nassim Nicholas Taleb who is an author and mathematical trader with unsettling views about certainty.