Platinum Capital® Limited Quarterly Investment Manager's Report

30 June 2013

Platinum® CAPITAL LIMITED

ABN 51 063 975 431

Performance

After a strong start to the quarter, helped by gargantuan quantitative easing (QE) promised by the Bank of Japan, and the casting-off of doubts about Cyprus and its banks, markets became more hesitant by early to mid-May. At that point doubts crept in regarding growth which saw commodity prices and the emerging markets lose favour. Currencies sensitive to growth such as the Australian dollar began their descent against the US dollar. The trend continued into late June as the People's Bank of China (PBoC) proved less accommodating than had been hoped which signalled enforcement of a harder-edged policy regarding credit growth in that country. This of course has huge implications for commodity producing nations and indeed the Asia Pacific. Not helping matters were an indication from the US Federal Reserve Board that QE would diminish as the recovery in the US economy became self-reinforcing.

In the March quarterly report, we suggested that there were some useful markers to assess the changing sentiment of markets. These included a weak gold price to reflect improving confidence; relative strength among banks to reveal improving economic conditions and falling solvency fears; and an upward trend in bond yields to suggest an improvement in underlying growth and the demand for credit. All of these indicators gave positive readings over the last three months with gold being remarkably weak, tumbling by 23% to US$1,223 per ounce. The redemptions from Exchange Traded Funds (ETFs) and gold funds have been colossal, falling by 600 tonnes over the first half of 2013, which has seemingly swamped the reported enthusiastic buying by individuals from gold stores, souks and coin dealers. The gold price is now nearly $600 p/oz lower than in early September 2011.

Last quarter we also noted that investors were far from convinced about the safety of investing in shares even though there were numerous high-profile commentators warning of meagre return prospects from holding bonds or cash. This tendency continued into the second quarter with growth sensitive sectors such as energy and materials being weak while defensive areas such as telecommunications, healthcare and somewhat surprisingly, consumer discretionary, being strong. The returns shown in the accompanying table reveals that these sectors have outperformed strongly.

The tide has certainly changed for Australians who invest abroad. After five years of a strongly rising currency, the trend has broken. For the first time in years the quotation of returns in Australian dollars is now accretive rather than the detractive. Thus the return for the quarter in A$ of the MSCI World All Country Index was 13.4% and 30.5% for the last 12 months. This incidentally also gives a positive 3.3% compound pa return over the last five years.

By contrast, the Company has done well, outperforming both for the quarter and the year with pre-tax returns of 18% and 42.3% respectively and returning 10.4% compound pa over five years.

MSCI* World Index Regional Performance (AUD)

REGION	QUARTER	1 YEAR
Japan	**19%**	**37%**
Germany	17%	42%
France	17%	37%
United States	**17%**	**34%**
Developed Markets	**15%**	**33%**
Europe	**13%**	**32%**
United Kingdom	11%	25%
Hong Kong	9%	31%
Asia ex Japan	**8%**	**22%**
India	8%	19%
China	6%	18%
Emerging Markets	**5%**	**15%**
Korea	3%	12%
Australia	-2%	24%

* Morgan Stanley Capital International
Source: MSCI

MSCI* World Index Sector Performance (AUD)

SECTOR	QUARTER	1 YEAR
Consumer Discretionary	20%	44%
Health Care	17%	42%
Telecommunication Services	16%	23%
Information Technology	14%	23%
Financials	14%	41%
Industrials	13%	33%
Utilities	12%	17%
Consumer Staples	12%	30%
Energy	10%	20%
Materials	2%	8%

* Morgan Stanley Capital International
Source: MSCI

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

Net Asset Value

30 April 2013	31 May 2013	30 June 2013
$1.2901	$1.3956	$1.4176

Source: Platinum

Changes to the Portfolio

Geographical Disposition of Platinum Assets*

REGION	JUN 13	MAR 13
North America	29%	26%
Europe	25%	27%
Asia	19%	21%
Japan	15%	15%
Africa	4%	4%
South America	1%	1%
Australia	0%	1%
Cash	7%	5%
Shorts	13%	10%

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

Top 15 Stocks – Long Positions

STOCK	INDUSTRY	JUN 13
Bank of America	Banks	3.3%
Microsoft Corp	Software	3.0%
Ericsson LM-B	Communications Equipment	2.5%
Sanofi SA	Pharmaceuticals	2.4%
Google Inc	Internet Software & Services	2.2%
Bangkok Bank	Banks	1.9%
Samsung Electronics	Semiconductor Equipment	1.9%
Jacobs Engineering	Construction & Engineering	1.8%
Anton Oilfield Services	Energy Equipment & Services	1.8%
Micron Technology	Semiconductor Equipment	1.7%
Johnson & Johnson	Health Equipment & Services	1.7%
Intel Corp	Semiconductor Equipment	1.7%
Carnival Corp	Hotels, Restaurants & Leisure	1.7%
Amadeus IT Holding	Software	1.6%
Toyota Industries Corp	Auto Components	1.6%

Source: Platinum

There are times when it may seem that there is relatively little change in our principal holdings. This is because good ideas tend to mature over a protracted period. In addition, when we enter a new position, particularly in choppy markets, we may begin with a relatively small holding and progressively add on any pull backs. This can mean that a new position only appears in the top 20 holdings six months after the initial purchase. Sometimes we may miss the chance to fulfil an order because the price moves more quickly than anticipated and we fail to achieve a full position. Apart from small trading positions, in the last 12 months we have introduced over 20 new holdings which on average account for nearly a fifth of the portfolio. More than half are still being added to gradually though in some instances there has been a loss of conviction as a consequence of new insights and an exit strategy begins.

Good examples of positions that were added to this quarter are Ericsson, Baidu, Micron Technologies, Carnival Cruise Lines, Casino Guichard Perrachon and Baker Hughes with exposures that vary from 2.5% to 1.5%. At the same time we exited the long-held Siemens, on account of competitive concerns regarding the Yen versus the Euro; Dai-ichi Life, Nintendo and Mitsubishi Corp after their strong runs; and reduced the likes of Shin-Etsu Chemical, Deutsche Boërse, United Spirits and Sohu.com. Amongst others, new positions were taken in **Intel**, **FedEx**, **Canon** and **Aeon**.

Intel is a classical example of a neglected stock. Here we have the undisputed leader in logic chip design and manufacture that is facing temporal change: its core business of supplying logic chips and motherboards to PC and laptop makers is under threat from the mobile world of tablets and smart phones. Blind-sided by its emphasis on high priced performance chipsets, the company has been very slow to adapt to the emerging threat of the Google-initiated Android operating system that tends to be built on the circuit designs provided by Cambridge-based ARM.

Outwardly, it seems that Intel faces a dreary future of threats and reduced selling prices for its full suite of products.

We, however, can conjure up a much brighter future for the company where it is able and likely to gradually win a sizeable share of the mobile chip market, which is presently valued at $30 billion pa. Further, the decay in its traditional PC and server business will prove less severe than many now think.

The important divergence of views stems from the fact that miniaturisation and the associated complexity of circuit design gives integrated producers the edge in producing frugal yet powerful devices. Only Intel and Samsung are integrated with design and fabrication plants while the *fabless* designers like Qualcom *et al* rely on outside fabricators to manufacture to their designs[1]. At present, battery life is the rallying call from device makers and Intel's new chips are already proving to be superior to those of the competition. Importantly, this is before it shrinks its feature sizes where it is at least 18 months ahead of the competitors, particularly with its highly complex *Finfet* circuit solution and its attendant power savings. The end game is the most appealing for it raises the question as to who is going to be able to fund and fully load their new fabs which cost at least US$7 billion when the entire revenues of the 'fabless industry' is only slightly more than Intel's current PC related chip sales of US$30 billion a year. Far from being the puny victim, we believe Intel will return as the industry champion. It is available today at a P/E discount of 15% to the S&P Index!

FedEx too is going through change as consumers look for cheaper ways of doing business. This has disrupted the freight loading of the company's traditional next-day-delivery system as customers are prepared to wait a little longer for lower cost. The company is addressing the problem by scrapping its older planes and using passenger aircraft freight capacity on some routes. While profitability is under pressure in this business, the growth in on-line retailing is allowing its home delivery service to grow at around 15% a year. FedEx, together with United Parcel Services, remain very interesting businesses and we believe will continue to grow strongly and profitably over the coming years.

With regard to Japan, the companies purchased are largely laggards that replace some very strong performers we have discarded. We have held **Canon** before and it suffers periodically from concerns about the paperless office and pressures in the camera markets. We need to remind ourselves how profitable this business is (even when the Yen was high) with operating margins of close to 50% and that is after a research and development charge of about 15%. It is a company that gradually evolves and is trying to expand into related areas such as medical equipment and 3D imaging. With well-above average profitability and at least average growth prospects, Canon does not deserve a below average rating of 12x earnings.

Aeon is a turnaround story with a light breeze indirectly from the weaker Yen but directly from operational changes.

1 The vulnerability of this model is partially revealed by the new supply terms common in the industry where chip fabricators sell the wafer to the chip designer with the latter taking responsibility for the production yield; physical and electrical interference grows exponentially as chips shrink!

Shorting

During the quarter we used the weaker prices of some of our stock specific shorts to reduce positions. We also established and subsequently reduced shorts on the Nikkei futures, believing it had run up too fast. This was a rewarding play. We added to our generic shorts to cover likely short-term volatility.

Currency

We have remained long the US dollar and European currencies and have virtually no exposure to the Japanese yen and still have a 2% negative position against the Australian dollar.

Commentary

We have recently returned from a trip to the backwoods of China. As always one is astounded by the scale and energy of the place. It is with this in mind that one needs to be forearmed with as many reliable statistics as one can muster. As with other credit-induced booms, the mood of the crowd is infectious and can distract one from the main issues. We feel these are relatively plain and can be summarised as:

- Firstly, the state owned enterprises (SOEs) tend to hog the available credit (80%), yet create no more than a fifth of new jobs and earn low single digit returns on capital.
- Secondly, they are bad payers and as credit has tightened, the SOEs have deferred payments which are pressuring their suppliers, often private enterprises, causing a system-wide credit squeeze.
- Thirdly, the entire system of credit is based on asset values and not cash flows which have created a daisy chain of lending all founded on the value of property and land sales. The provincial and local governments derive as much as a fifth of their revenues from these sources. Compounding their cash flow challenges is their use of short-term borrowing to fund some of their long-term infrastructural projects which, in the foreseeable future, will have minimal cash flows. These funds often come from local banks and trust companies.
- On account of the regulation of interest rates (and lending targets) creative products have been hatched which attempt to circumvent restrictions on credit growth. The big four banks are in relatively good shape with loan to deposit ratios of 60 to 70% and relatively strong management following the shake-up associated with the non-performing loans episode of 2002. The real problem lies in the so-called shadow banking system which involves trust companies, private wealth products and commodity arbitrageurs.

The new regime is setting in place a wave of changes starting with a clamp down on improper practices by local administrators, party officials and SOEs. Having failed with moral suasion to control official credit channels, the PBoC resorted to market forces in late June to smoke-out non-conforming financial intermediaries with frightening effect on the Shanghai overnight interbank market. The resulting panic to secure book-balancing credit was a clear warning of a change in tactics by the authorities.

What is not yet clear is how the private sector, which accounts for 70% of economic activity, is going to manage through this period of adjustment. It faces rising costs of labour, some loss of competitiveness and some softening of demand. None of this makes us particularly panicky because in the end the large banks are likely to carry more than their share of the non-performing loans but it does point to a choke point for the official target of 7.5% real growth. Fortunately, the consumer, with the savings rate still at 40%, and an attitude and desire to enjoy the better things in life, will partially offset the likely contraction from a redirection of activity from infrastructure investment.

Such a trip is rich in anecdotal evidence but nevertheless valuable to improve one's reading of what might be happening on the ground. We kept away from the two principal cities of Beijing and Shanghai where residential property prices are as much as 14 times average household incomes versus six times in the tier two cities. It is in these smaller cities, with the property boom and oversupply of accommodation, that retail and commercial space seem at the greatest extreme according to figures provided by Cushman & Wakefield.

We caution readers from becoming too pessimistic about China. It is a highly dynamic economy; mass consumption has barely begun and yet emerging areas such as on-line shopping is growing at a prodigious pace, accounting for perhaps 6% of retail sales and covering an astonishing range of products even down to groceries. There is a huge need for improved logistical infrastructure as these costs are remarkably still twice those of the industrialised countries. As far as our investment activity goes, we are tending to favour these emerging themes and giving a wide berth to the traditional and alarmingly over-supplied parts of the economy. A full 4% of our 10% exposure to China is in internet-related entities.

Economic signals from the US remain reassuring and even Europe is tentatively showing signs of bottoming out. There are also some interesting initiatives being proposed by the European Commission and the German government to help fund small and medium enterprises (SMEs) in the peripheral countries. We remain convinced that Japanese corporate profitability is on the mend, thanks to their own initiatives and the benefits of a weaker Yen. Somewhat discouraging are the social issues that are coming to the fore in significant emerging countries ranging from Brazil to Turkey and Egypt. The internet is unleashing more power than even the enthusiasts would have imagined at the height of the stock market boom of 2000.

Outlook

Certainly there is risk but we keep finding companies we want to own. We tirelessly remind readers that globalisation relegates the notion of the geographic location of a company largely to the waste bin and that to the extent investors emphasise origins, this can be the source of opportunity.

After some strong runs it is possible that investors cool over the northern summer and fret about the speed of growth in China, the social resistance to change in Europe, notably France, and the sustainability of profits from sectors that have been market favourites for some while. We believe these will be mere distractions and should be seen as offering opportunities to buy fine businesses.

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