Platinum Capital® Limited Quarterly Investment Manager's Report

30 June 2014

Platinum®
CAPITAL LIMITED
ABN 51 063 975 431

Performance

Markets edged progressively higher over the last quarter. It was not without dissent as the highly rated Internet, big data and biotechs got hammered, falling typically by 30% as the market reassessed their virtues. Preference moved to their 'old economy' tech forebears like Intel, Microsoft, Oracle and Qualcomm which in some cases are rated below the average of the US market. More attention was paid to cyclical stocks.

The scare about the emerging markets and the adverse effect of rising US rates dissipated. Flows into markets turned positive by quarter's end. These fears are well-founded in the case of Russia, Brazil, Turkey and South Africa as they have squandered the resource bonanza by shunning economic reforms. Their soft political underbelly was further exposed by the evident machinations in the border region of the Ukraine, the pre-World Cup demonstrations in Brazil and sinister revelations regarding the political elite.

Concerns also arose in China as some wealth management products became unstuck, bonded holdings of commodities were found to be missing and residential property prices crumbled. By quarter's end all was forgiven following reassurance by the leadership and prospects of continuing reform. The jubilation that surrounded the emphatic win by the Bharatiya Janata Party (BJP) led by Narendra Modi set the Indian market on fire.

The MSCI World Index in Australian dollars finished the quarter 3.1% higher and up 19.2% for the last 12 months. Noting the improving tendency of the more cyclical sectors, the Company achieved 2.1% (pre-tax) for the quarter and 17.3% for the year.

MSCI* World Index Regional Performance (AUD)

REGION	QUARTER	1 YEAR
India	11%	24%
Hong Kong	6%	14%
Asia ex Japan	**5%**	**13%**
Japan	**5%**	**7%**
Emerging Markets	**5%**	**11%**
Korea	4%	21%
United Kingdom	4%	23%
China	4%	12%
United States	**3%**	**20%**
Developed Markets	**3%**	**20%**
Europe	**2%**	**24%**
Australia	1%	17%
France	0%	24%
Germany	0%	25%

* Morgan Stanley Capital International
Source: MSCI

MSCI* World Index Sector Performance (AUD)

SECTOR	QUARTER	1 YEAR
Energy	10%	24%
Utilities	5%	19%
Information Technology	4%	27%
Consumer Staples	3%	11%
Health Care	3%	25%
Materials	3%	19%
Telecommunication Services	2%	15%
Consumer Discretionary	2%	17%
Industrials	1%	21%
Financials	1%	15%

* 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 gain.

Net Asset Value

	PRE-TAX	POST-TAX
30 April 2014	$1.5771	$1.4800
31 May 2014	$1.6141	$1.5067
30 June 2014	$1.6399	$1.5251

Source: Platinum

Changes to the Portfolio

Geographical Disposition of Platinum Assets*

REGION	JUN 14	MAR 14
Asia	29%	28%
North America	26%	24%
Europe	23%	26%
Japan	12%	14%
Russia	3%	2%
Africa	3%	3%
Australia	1%	1%
South America	1%	1%
Cash	2%	1%
Shorts	10%	10%

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

Growing excitement about opportunities in some metals, noted last quarter, and financials in China, caused us to exit or cut some very successful and long-held companies like **Amadeus IT Holding**, **Roche Holding AG**, **Yonyou Software**, **Toyota Motor**, **Hoya**, **Rohm Semiconductor** and **SBI Holdings**. We also cut the holding in **Jacobs Engineering** even though the US investment cycle is still young because of disappointment with its recent acquisitions. Using the proceeds, we added to a beaten-up competitor, **KBR**. Funds were removed from Intesa Sanpaolo after it had doubled in less than a year.

The thrust of our buying was in Asian financials, metals and minerals and the new Internet opportunities. Around 2.5% was employed in nickel plays like **Sumitomo Metal Mining** and **Norilsk Nickel**, and a derivative concept thereof in stainless steel, Outokumpu. We added further to our oil play, **Canadian Oil Sands**.

It is the antiquated regulation of interest rates that sits at the heart of the surge in so-called wealth management products in China. This in turn is distorting the fluid flow of capital and this is subject to review for change. As interest rates are allowed to function freely (to ration and allocate capital) so the benefits will accrue to those who **control large pools of savings**, namely, the insurance industry and prospectively, the banks. We, however, favour the life insurers as they have been the most penalised by these restrictions through their large holdings of cash and bonds and will potentially gain the most from their liberalisation.

Following the problems of the industry around 2005, the insurance regulator in China has set very conservative guidelines as to the deployment of insurance investment pools. Both China Life Insurance and China Pacific Insurance are the most conservative of the domestic providers.

China Life Insurance is the largest life insurer in China with 177 million policyholders, 650,000 agents and a market share of about 30%. It has been slow to fully industrialise its sales force, and like its peers, went through a period of selling low-margin savings products (as the wealth management products introduced more competition in its traditional domain) and fretted about market share.

This emphasis is now changing as it realises the benefit of streamlining its sales force and focusing on the long-term profitability of its ever-growing book of business. By comparison with the performance of its peers in countries like India, the Chinese insurers have undersold life insurance with premiums running at only 33% of GDP versus 58% in India. We therefore believe that maintaining the historic premium growth rate of 15% pa is quite achievable in the foreseeable future. In addition, the spreads on their book should gradually creep upwards as interest rates are allowed to reflect real market conditions and developments such as a market in provincial bonds takes root. They should also benefit from the share component of their investment pools, which represent some 8% of the total, as the Chinese domestic equity market recovers. The Shanghai Index has more than halved while the economy has doubled in size and now trades on under 9 times earnings. Overall, the odds favour this company to give us a return of 20% pa for several years!

China Pacific Insurance which is controlled by the Shanghai Government is arguably more advanced in this transformation process. Having faced difficulties in 2005, it benefitted from an injection of capital and know-how from the Carlyle Group and other foreign insurance participants. It is well-capitalised and from what we can learn is successfully adopting the highly structured agent-based sales approach mastered by foreign experts like AIA. We are buying these businesses at a discount to comparable companies in other jurisdictions even though they are likely to grow faster. (Ping An Insurance is generally regarded as the most competent indigenous insurer but it owns a bank and also has much greater exposure to higher risk loans making it more susceptible to the unwinding of the property market in China.)

Weakness in Russia allowed us to add to our position in the Russian-based search provider, **Yandex**. This company dominates the local market with nearly 70% market share and has augmented its offering with ancillary services. As more sophisticated 4G phones fall in price, Yandex should benefit. It is not without risks on account of Google's stranglehold on the android operating system and products like Chrome. However, the company is likely to continue to grow strongly and at 25 times earnings, is good value. We also added to **Tencent Holdings** and **Youku Tudou** having cutback **Zillow** and **QIWI** after very strong moves.

We also initiated a position in **LinkedIn**.

Shorting

The shorts continue to see-saw, only giving the benefit of evening out some of the short-term volatility of the portfolio. There was little change in our positions at 10%.

Currency

We continue to hold no Australian dollar and little Japanese yen, favouring the US dollar and the underlying European and Asian exposures. We did, however, hedge out 5% of the underlying exposure to the Chinese renminbi in the belief that a slightly weaker currency would assist the economic transition that has now begun.

Commentary

There is persistent caution expressed by investors and financial advisors. Going back over our quarterlies we can trace a clear message of opportunity and it was only in March that we started to express concern about US valuations, particularly of those in the Russell 2000 Index.

We still hold the view that the global economy is gradually healing, that inflation risks are low in most countries; hence there is no need for Central Banks to tighten monetary policy quite yet. To the extent that the US economy is experiencing a sturdier recovery, it together with Britain, will be among the forerunners to experience higher rates but the European Central Bank (ECB) and the Bank of Japan (BOJ) are far from this point. This was underscored with the last ECB policy statement in early June when it announced a cut in rates and introduced penalties on the deposits of commercial banks held with itself (so-called negative interest rates). It is also now offering commercial banks special subsidised lines of credit provided these loans are directed to fostering economic growth. At the same time, the BOJ has been injecting funds directly into the equity market through purchases of Exchange Traded Funds (ETFs), in addition to swallowing every Japanese Government Bond in sight.

Inflationary fears are indeed occurring, though in financial assets. The early adopters of Quantitative Easing (QE) have seen strong equity markets and significant lifts in residential property prices while a basket of daily purchases has typically been rising by 1.5 to 2% pa. There may be some tightening of the labour markets as unemployment diminishes but thus far, pricing power has been remarkably subdued. This leads one to possible concerns about the **unintended consequences** of QE.

The most intriguing distortion is the low cost at which 'non-investment' quality US corporations can now raise money versus their investment grade peers. Having peaked at 12% during the GFC, these low rated corporations are now able to raise 4-5 year bonds at 3.5% pa versus the 2% being paid by higher quality companies. This is the **lowest rate and spread** for at least the last 25 years and in fact **well-below the average rate paid by the US government for 10 year bonds of 5.0% over the last 100 years!**[1] (There is no need to remind readers of the tax gathering capacity of governments.) As one might expect there has been a surge in issuance (a fivefold rise) compared to levels at the turn of this century, currently running at an annual rate of $237 billion and accounting for more than half of all US corporate issuance.

This cheap funding in turn is **facilitating an increase of merger and acquisitions and share buybacks**. The latter is running at around 2.3% of the capitalisation of the US stock market, which is currently US$17 trillion, while merger and acquisition (M&A) activity is withdrawing a further 2%.

M&A is still relatively subdued but likely to accelerate strongly on the back of growing confidence, cheap money and the normal pattern of rising interest rates. Historically share swaps accounted for around 35% of these M&A deals but cheap money has tilted the equation to favour debt funding. We can therefore expect relatively tight share supply as we await the traditional lift in IPOs. The combination of high levels of profitability across the major economies and low borrowing costs has resulted **in interest cover being at least twice the levels of the 1990s**. Overall net debt levels, expressed as a percentage of book value, are well-down compared to the last 25 years at around 50% for the US, Europe and Japan, and under 40% for the rest of Asia.

Our conclusion is that there is **no immediate concern about funding risks** in markets and if anything, one should prepare for an acceleration of corporate activity and a late surge in low quality bond issuance as interest rates begin to move upwards. There will need to be a marked lift in capital expenditure and/or a drop in profits to change what has essentially been a **deleveraging of balance sheets** across Asia and North America, while Western Europe has seen leverage undulating between 55% and 65%.

Combine reasonable balance sheets and a trend of increasing profits, a shrinking quantity of shares outstanding, for now at least, and one can be reasonably optimistic about markets. **It is critical though that with valuations at the upper band of historic limits, earnings must meet current expectations**. There are enough uncertainties on both the geopolitical and economic front to argue that cheap money is creating a Panglossian world. Rates are likely to gradually change direction and growth in Europe is still fragile but we can also identify exciting **reform-driven change in the world's two most populous economies**, China and India.

Last quarter we wrote about the likely victory by Modi in the Indian national elections and it has been even more emphatic than we could have hoped. We look on eagerly to see the priority that is given to reforms. Should the headlines shrilly relate negative news about the weak monsoon rains or the loss of momentum from Delhi, we at Platinum will likely hold fast to our conviction that India can resume its growth trend of close to 8% pa. **The nation has unambiguously embraced the hope for economic reforms and a development bias over the former diet of handouts and subsidies**. While India may not have the leverage that the Chinese exploited to gain technology and foreign participation in its economy, the very institutions that precluded this will be, in all likelihood, brought to bear in transforming this market economy back to its high growth trajectory.

1 It is conspicuous that the average modified duration of US corporate debt has risen from the 25 year average of 4.5 years to over 5.5 years since 2010, while the duration of high yield borrowers has shrunk to around 4 years.

We have addressed some of the **perils within the Chinese economy** in these quarterlies over the last few years. The fall of property prices and the abrupt arrest of residential building starts is no surprise but with the easing of lending restrictions, we believe it will be a painful period for parts of the economy rather than cause a complete loss of economic growth. There are many areas that can augment the reduction of building activity, not least the need for **State-owned Enterprise (SOE)** reforms, greater investment in the protection of the environment, as well as greater assistance in healthcare, education and other services.

The importance of the SOEs has shrunk considerably with the enactment of three earlier bouts of reforms[2]. Having accounted for over 60% of the urban workforce in 1990, they now employ less than 20%. However, SOE wages are typically 60% higher than those of the private sector at RMB52,000 pa and in addition there are other perks and very-evident opportunities for self-enrichment. While their profitability is inferior to that of private firms, it varies according to the openness of the industry. The general belief is that less protection and more accountability will lead to a more equitable society and a much improved allocation of capital and other resources. Resistance to surrendering entrenched privilege is **one of the motivations behind the intensification to the anti-corruption drive** by the ruling *junta*. This serves to both mollify the general public as well as to bring extreme pressure on the upper echelons of the SOEs to change.

Outlook

We remain optimistic and are shifting the weight of the portfolio to the East.

Growth in the Western hemisphere is gaining impetus and higher share prices can co-exist with higher rates on account of dissipating economic risks. For now, inflation and credit markets risks appear subdued.

The engagement of reform in the world's two most populous nations underpins our belief in the durability of global growth. That there will be setbacks is likely but in the case of China, the domestic stock market has been in a severe downward trend for over six years and valuations are almost half of those in the Western hemisphere for an economy that is growing twice as fast! Other markets in Asia are equally interesting and we are finding companies we want to own.

Kerr Neilson
Managing Director

2 There are some 147,000 non-financial SOEs in China employing about 70 million urban workers. They have assets of about US$15 trillion and these generate profits of about US$400 billion. There number incorporates a plethora of small provincial as well as prefecture and county enterprises. Apart from stripping away protection and privilege, the reforms aim to introduce more rational industry structures (consolidation), to make way for more private sector participation and to change to partial or full private ownership through stock market listings. Already some of the leading SOEs are experimenting with stock options for the staff. Of the 2500 companies listed on the 'A' share market, 980 are SOEs.

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