Platinum Capital® Limited Quarterly Investment Manager's Report

30 September 2011

Platinum®
CAPITAL LIMITED

ABN 51 063 975 431

Performance

The lurching, staggering, ducking and diving of the markets this year is evocative of a "Rocky" style Hollywood movie. Like the engrossed viewer, one fears the worst yet cherishes the flickering flame of hope.

The saga of the deficit reduction debate in the US set the stage for a series of other disappointments as the quarter advanced. Mid-August was something of a crescendo as the flight to the safety of the Swiss franc and gold reflected the sense of confusion enveloping Continental Europe. The credit default swaps on sovereign debt blew out and the stock markets slumped. As this fear subsided, the growing realisation that China too faced problems, forced the markets further against the ropes.

Company earnings reports thus far have been resilient though analysts are beginning to cut their forecasts. Noteworthy is the observation that those taking an economic overview (so-called 'top down') are more pessimistic than those in daily contact with the firms they research (so-called 'bottom-up' analysts). However, there is strong empirical evidence that the bottom-up analysts, together with the management teams with whom they associate, tend to be late to adjust their forecasts! Importantly, the market has probably spoken for this disparity by marking down prices in anticipation of what is to come.

MSCI* World Index Regional Performance (AUD)

REGION	QUARTER	1 YEAR
Japan	3%	-1%
US	-5%	0%
UK	-7%	-6%
Developed Markets	-8%	-5%
Hong Kong	-12%	-18%
India	-12%	-25%
Australia	-12%	-9%
Asia ex Japan	-13%	-15%
Emerging Markets	-15%	-16%
Europe	-15%	-12%
Korea	-15%	-7%
China	-18%	-24%
France	-23%	-18%
Germany	-24%	-14%

* Morgan Stanley Capital International
Source: MSCI

By geographic distribution (see accompanying table), the recent champion, the emerging markets, saw significant foreign selling and sold-off by 15%, though Europe did as badly because of the expected costs of Euro survival with France and Germany dropping by over a fifth. Having had a 20 year bear market, Japan seems to have adjusted enough and was the only stock market to actually rise this quarter though it was trumped by the US over 12 months. Both, however, were close to flat. By sector, there was a continuation of the trend that became evident from the beginning of the year, namely the defensives being sought relative to cyclicals. The big casualties were materials, industrials and financials. Conspicuous for their strength have been healthcare, consumer staples and durables, and IT.

For those who read the quarterly report regularly, there should not be too many surprises though we acknowledge that the shearing of some share prices was shocking. To see the market capitalisation of very fine companies slashed by over one third is most unsettling. This tends to start the process of an adjustment of the relative prices of other similar companies. Another way of saying, in a de-rating of risk assets, there are few places to hide.

Our Company is doing better in a relative sense with the defensives we favoured last year holding-up well and the shorts and currency starting to reel back some of our under-performance. For the quarter, the Company is down 6.8% (pre-tax) and down 9.8% for the rolling 12 months. By comparison, the MSCI All Country World Index is down 9% for the quarter and 6.4% for the rolling 12 months.

Currencies

We have actively changed our currency stance over the last three months; exposure to Asian currencies, excluding the Hong Kong dollar, have been cut from around 25% to about 18%. The reasoning for this change lies in the concern about capital flight back to their developed country origins. Also, the willingness of the Pacific Rim countries to revalue remains for the moment in limbo. China has indeed allowed the Renminbi to drift stronger but this is not being matched by the behaviour of the Renminbi in the Hong Kong non-deliverable market. These changes have lifted the Company's exposure to the US dollar (including the HK dollar) to some 57%. Not the most desirable of choices but reconcilable for now. We continue to hold a minimum of Australian dollars (about 11% at quarter end) as we view it as vulnerable to global slowing and lower domestic interest rates.

Shorting

As the quarter progressed, we gradually migrated our shorts towards individual companies which have become conspicuously expensive as most cyclical names collapsed. We are beginning to read the changing mood of the market better and are making reasonable returns from some of our bigger exposures.

The following Platinum Capital Limited Net Asset Value figures are after provision for tax on both realised and unrealised income and gains, and after provision for the 1.9 cent dividend paid 1 September 2011.

Net Asset Value

31 July 2011	$1.1331
31 August 2011	$1.0856
30 September 2011	$1.0848

Source: Platinum

Changes to the Portfolio

Geographical Disposition of Platinum Assets

REGION	SEP 2011	JUN 2011
North America	28%	24%
Asia and Other	24%	23%
Europe	22%	25%
Japan	19%	18%
South America	1%	1%
Australia	1%	1%
Cash	5%	8%
Shorts	20%	17%

Source: Platinum

Two of our smaller holdings have been subject to takeover bids, **Caliper Life Sciences** (a chip-based testing company) and **Hsu Fu Chi** (a significant sweet maker in China). Both are at good premiums to market value and better still against our cost.

With a view to falling momentum of economic growth we sold down several of our more cyclical holdings early in the quarter in favour of more stable earners. Thus we reduced **IP** (paper and packaging), **BMW**, **Allianz AG** (more a tactical reduction on Euro issues) and **Vodafone** (again tactical on the basis of the huge change in relative values).

We added to our positions in **China Mobile** early in the quarter (the world's largest mobile network operator with 616 million subscribers) when it was being ill-treated for its slow growth prospects. On ten times earnings and 4.5% dividend yield, we are satisfied.

Nintendo is now trading at just over its cash backing, with investors selling it down on disappointment at the level of sales of its 3D handheld device. We concur that this important part of the business could face greater competition than in the past because of the arrival of smartphones. However, next year will see the launch of its new console with a built-in screen that has excited game developers because of the additional functionality. Some might put this investment in the category of a value-trap but the company has become more co-operative with external game developers and is far from being a spent force. We estimate that prospective profits, well short of its previous peak, will put it on about eight times earnings and that is before share buy-backs.

An area that has caught our imagination is **optical switching**. During the dot com bubble this was the magical objective for carriers and the system suppliers alike. Having over-built during the boom, spending on the network has languished until recent signs of life. Investors clambered in only to find carriers back-pedalling on capital expenditure and the stocks have fallen by more than half. There is an inevitability of the need to spend but ironically we believe profitability of the carriers will determine the pace rather than the creative charts of internet video usage. We are participating through system suppliers like **Ciena** (bolstered by the acquisition of Nortel's optics business and its accompanying international distribution network) and **Infinera**.

The latter has an unusually elegant single chip solution which will allow it to either prosper as an independent or be subject to a takeover to provide it with marketing reach. Cisco too is making headway in this area via a recent acquisition but for now the principal contenders are Alcatel, Ciena and Huawei. Problems associated with older networks in the West, have blunted the concerns one would normally have for the private Chinese company Huawei

Commentary

Even though we met with a very long list of companies on our recent trip to China and the US, it was rather like a holiday. A holiday, that is, compared to the daily bombardment one experiences back at your desk from the barrage of noise and confusion that is the market. Focusing on companies is a much steadier experience as one tries to refine the short list of investable ideas.

Starting in Changsha, the capital in Hunan province in south-central China, we met with several **manufacturers of construction and earth moving equipment**. The budding global competitor to Caterpillar, Sany Heavy is very impressive, from the perspective of what they have achieved in such a short time, the quality of their product line-up and the magnitude of their ambition.

But here is the catch; both they and a handful of competitors like Zoomlion, Liugong, Lonking **see only opportunity!** Like so many one meets in China, the talk is all about market dominance and scale and the fear of being left behind in the race for supremacy. One can barely take issue with this as a believer in the virtues of natural selection that is the core of a market economy, but what sets the Chinese companies we met apart from the rest of Asia, is their **predilection to ignore the need for plan B**. When challenged about the sustainable end demand for their products, they now point to exports as an important solution, even though some of these companies have established manufacturing facilities abroad.

This is where an empirical observer may have cause for concern. Take excavators for example; in a boom year, the markets of the US, Western Europe and Japan have each only ever needed about 60,000 new heavy duty excavators a year, with normal demand about a quarter less than this figure. Despite this, and acknowledging that end users are now running their machines less intensively, the industry in China is planning to raise production next year by 50% to 300,000 heavy duty excavators (in addition to say 100,000 mini excavators). It is highly improbable that this will eventuate, yet the consequences of this sort of thinking are alarming for them and for international trade.

Magnifying their problem is that the typical buyer of this equipment tends to own fewer than five machines[1]. To garner new sales, the equipment makers are standing behind their customers with guarantees to the banks. That is to say, to support even current volumes, the sale requires these companies to take on direct credit and product repossession risk.

Fortunately we moved further north and visited consumer and medical related companies and our hopes improved. We came upon several wonderful businesses that will prosper as the country makes **its faltering transformation to a consumer-assisted economy**. These businesses are typically growing at around 30% pa, twice the rate of wage growth, driven by rising sophistication and the winning of market share from western suppliers.

When in China, whether on the excellent inter-city highways lined 10 to 20 deep with recently planted trees, or in the great new cities with their strictly enforced green zones, or on a building site for economic housing remembering the paddy fields that used to occupy the spot, you are filled with awe and optimism.

Within this context of physical transformation and the relatively steady hand of (an omnipotent) government, reinforced by the likes of CCTV covering the issues facing the troubled West, it is **hardly surprising that a false sense of perpetual well-being pervades the air!**

Time spent at the **US tech conference** gave us a good opportunity to see many companies in a short time. These are speed-dating style of meetings where preliminaries are kept to a minimum and in the half hour allotted one can cover the three or four key questions that need to be resolved. It becomes a blur if one is not very focused and good note keeping is essential. Fortunately Doug, our tech specialist, was well-prepared and up to the task and we filled in the gaps on several companies and discarded others.

Those companies we met were generally cautiously optimistic and saw no need to revise down their forecasts. The industry is generally used to price declines and fickle markets; substitution being only a click away. To meet these extraordinary short product cycles, the industry has built a highly intricate supply chain of subcontractors and assemblers who have been able to marshal huge assemblages of workers across low cost countries. These Electronics Manufacturing Services (EMS) companies are now an integral part of the IT industry's business model.

It started with integrated chip designers **outsourcing to fabrication specialists and it is still growing as traditional integrated multi-nationals grapple with the disparities between developed market costs** and those of the emerging markets. So today there are a host of specialist sub-suppliers listed on Nasdaq in Taiwan, China and India which can grow almost regardless of economic conditions. The big names in high volume manufacture are Taiwan Semiconductor Manufacturing Company (IC chips), Hon Hai and Flextronics (electronic devices like phones and notebooks), Infosys and Tata Consulting Services.

Among the smaller players are companies like **Jabil Circuits,** which serves both the volume market and is developing a strong business in providing outsourced manufacturing of large items in batches of under 100 units pa for the likes of the Siemens healthcare division or that of GE. The philosophy of these global giants is changing to take care of product design, development and marketing, while they outsource production and customer support. This allows the leviathans to optimise their margins though one can picture the risks longer term as they bequeath their economies of scale and manufacturing know-how to the newcomers.

1 The large machines have built-in geo positioning systems pioneered by Komatsu, which allows the maker to monitor usage, equipment condition and location. Our sense of these financing deals was that some contractors see them as an opportunity to gain access to credit and to direct their cash flow to other uses.

Outlook

In this age of retrenchment, the rallying slogans of the bull market will gradually recede. Instead it will be a world of earnings revisions that are more likely to be down than up. The promise of the emerging markets, while somewhat begrimed for now, can in due course be expected to be burnished by their superior growth credentials. While not an easy environment in which to manage money, historically we have found reality an easier partner than fantasy.

When reviewing the portfolio we can divide companies into two broad categories; those companies which have a degree of freedom to set prices and those, the vast majority, where the price is dictated entirely by market forces. The former include companies that provide unique products and services such as drug makers, strong consumer brands, both durable and consumable, as well as some IT companies. These so-called **price makers**[2] account for over 35% of our longs. By contrast, **price takers** (miners, energy producers, pulp and paper makers, financials and some industrials) account for around 59% of our longs. This blend can be comforting in view of the current high volatility of markets but as we have noted so often in the past, **it is price that makes all the difference**. Even if the economic outlook is dull, investing is all about determining the appropriate valuation of a company in that environment. After recent price falls there are now a large selection of companies that are inexpensive.

2 This categorisation may vary in strength, can change over time and indeed may be in the eye of the beholder, but the segmentation is invariably "proved" by a demonstrable superiority of inherent profitability, as expressed in return on invested capital and supported by below average cyclicality.

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