Platinum Capital® Limited Quarterly Investment Manager's Report

30 September 2013

Platinum®
CAPITAL LIMITED

ABN 51 063 975 431

Performance

The principal instruction one gathers from recapping the actions of the markets in the preceding 90 days is to note that many of the passing events proved inconsequential, yet at the time they seem significant. It would be a wonderful gift if one could better calibrate the significance of the daily clatter and it would undoubtedly lead to a more productive life.

This quarter we progressed through the Japanese election; a positive. Then there was the tightness in the Chinese interbank funding market that was resolved thanks to a more accommodative stance by the People's Bank of China (PBoC). Syria emerged as the next hurdle, and after much huffing, the Americans accepted the Russian brokered deal and matters quietened down even though the suffering continues. By September the mood had lightened with continuing positive readings from growth indicators like the Purchasing Manager's Index (PMI) for all the leading economies, the US, the Euro zone, Japan and China. As the quarter came to a close there was the strange change of course by the Federal Reserve Board which declared that tapering of bond purchases would be deferred. This initially excited the market, but then caution crept in.

Underlying this montage are the following realities, or so we believe:

- **Cheap money** is allowing many damaged economies to gradually heal. In particular, the passing of time and large interest rate spreads is helping banking systems to rebuild their equity and adjust their balance sheets. At the same time, reallocation of resources and cost adjustments in many countries with chronic current account deficits, like those in peripheral Europe, is establishing a base for future gains in activity.
- There is **surplus capacity** in many areas **which reduces the chance of a rise in the inflation rate**, meaning that interest rates can stay lower for longer than is common in an economic recovery.
- For now, the **tampering with the price of credit** is encouraging a re-pricing of tangible assets like property and shares, with a relatively benign effect on nominal assets like bonds.
- After a protracted bull market in bonds, the historically low level of available yields is driving **investors to accept more exposure to the risk** of equities and to leverage in general.

In large, part of the strong performance from equities this year can be attributed to a significant re-rating of shares rather than to positive earnings surprises. In the first five months of the year there were some solid gains in the smaller emerging markets like Indonesia and the Philippines, while in the developed markets this "risk-on" trade has been evident in biotechs and the mobile-related plays of the Internet.

The accompanying table reveals the surge in interest in continental Europe this quarter as fears subsided and the more positive view formed about the emerging markets. The latter had previously been pressured by growth concerns and the worries about their currencies as the US contemplated Quantitative Easing ("QE") tapering which was expected to draw money away from emerging markets and thereby raise interest rates.

By sector, there are also clear signs of greater interest in the more cyclical sectors of the markets at the expense of predictables.

MSCI* World Index Regional Performance (AUD)

REGION	QUARTER	1 YEAR
France	13%	47%
Korea	12%	16%
Europe	**11%**	**37%**
Germany	10%	40%
China	10%	25%
United Kingdom	10%	30%
Australia	10%	25%
Hong Kong	7%	26%
Developed Markets	**6%**	**34%**
Japan	**4%**	**46%**
Emerging Markets	**4%**	**12%**
Asia ex Japan	**4%**	**17%**
United States	**3%**	**33%**
India	-7%	-3%

* Morgan Stanley Capital International
Source: MSCI

MSCI* World Index Sector Performance (AUD)

SECTOR	QUARTER	1 YEAR
Materials	9%	12%
Industrials	9%	40%
Consumer Discretionary	8%	49%
Information Technology	6%	24%
Energy	6%	18%
Telecommunication Services	5%	23%
Financials	5%	38%
Health Care	4%	40%
Utilities	2%	20%
Consumer Staples	1%	27%

* Morgan Stanley Capital International
Source: MSCI

Against a rise of the MSCI World Index of 5.6% for the quarter and 30.9% for the year, Platinum Capital Limited returned 4.8% and 43.3% pre-tax respectively.

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 five cent dividend paid 9 September 2013.

Net Asset Value

31 July 2013	31 August 2013	30 September 2013
$1.4149	$1.4008	$1.4185

Source: Platinum

Changes to the Portfolio

Geographical Disposition of Platinum Assets*

REGION	SEP 13	JUN 13
North America	27%	29%
Europe	25%	25%
Asia	25%	19%
Japan	13%	15%
Africa	3%	4%
Australia	1%	0%
South America	1%	1%
Cash	5%	7%
Shorts	14%	13%

Source: Platinum

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

As a general statement, we have continued to migrate the portfolio away from predictables towards cyclicals with the full disposal of Johnson & Johnson, PepsiCo, Vodafone and the partial sale of Microsoft, Sanofi (pharmaceuticals), Adidas and Bank of America. We also sold the remnants of holdings such as Shin-Etsu Chemical, Nintendo, Obic, CyberAgent and Reed Elsevier. (Apart from Nintendo, these were all very profitable investments.) Significant new positions were established in Internet plays eBay, Naver Corp and Zillow, and financials like Intesa Sanpaolo SpA, KB Financial, PICC Property and Casualty, and ICICI Bank.

eBay has come a long way since the Internet boom where it made its mark as an auction site. These days it considers itself as a facilitator in the converging world of on-line and off-line retailing and payment. It has considerably enhanced its IT capacity and through clever acquisitions and thoughtful actions, it has repositioned itself to be among the leaders in e-commerce.

This hardly fits into one's standard basket of neglect, but it seems that the market is perhaps underestimating the potential of the move to mobile commerce and the extraordinary potential of *PayPal*, if it is indeed successful in leveraging itself into the position of the most convenient and safest payment mechanism for e-commerce. As the CEO likes to remind the market, the convergence or blurring between on-line and off-line transactions increases the firm's addressable market 20 fold. Starting with an earnings yield of 5% and growing by 15% or more for the next several years, we find this a most fascinating option in the making.

Naver and **Zillow** are likewise stocks with unusual optionality derived from the acceleration of e-commerce (see commentary below). Based in Korea, Naver has been winning users to its "*LINE*" social media messaging service which is now growing fast outside of its Asian origins with over 250 million active users to date. Funded by a dominant position in search in native Korea, Naver has the cash flow and balance sheet to fund its ambitions and gradually monetise the social network.

Zillow is following the earlier format for success in e-commerce by becoming the portal of choice for those seeking to transact on residential real estate in the US. By aggressively marketing for eyeballs and by providing useful information about the local markets it has become the most visited real estate site in the US. There are issues about data ownership and quality, but the market potential is huge and the prospects for competitors other than Trulia, do not look bright.

The financials we have been acquiring are all about valuations and the receding risk of financial intermediation. Both **Intesa** and **KB Financial** are the leading banks in their respective countries of Italy and Korea and their markets are showing early glimmers of improvement. Trading at around 60% of book value, that has already been heavily provisioned, we like these companies for their running yields and recovery prospects.

Shorting

We have been relatively inactive with our principal shorts, but have traded around with some buying of short-term put options.

Currency

Our position is largely unchanged from last quarter. We own little Australian dollar, are short the Japanese yen 2%, with the portfolio long the US dollar to 50%, European currencies to 31% and Asian currencies to 18%.

Commentary

Rather like the disruptive technology of the railways in the 1800s, which spawned a succession of stock market booms, we believe the Internet could prove just as potent at exciting similar crowd behaviour. If you cast your mind back to the turn of this century, there was huge excitement about the power unleashed by browser technology and a resultant commercial war between Netscape and the dominant software provider of the time, *Microsoft,* with its alternative of Internet Explorer. There was a concomitant land grab for domain names as well as a proliferation of portals (e.g. Yahoo!) and mass adoption of e-mail and instant messaging. The significance of domain names was soon diminished by the indexing of the World Wide Web, the science of which was enhanced by *Google* search. As bandwidth has expanded, the paradigms around software development and databases have constantly evolved to facilitate the explosion of web traffic. In addition, the way in which people use technology has changed with even the browser now taking on some of the functions of an operating system. A repeated pattern of techno morphing is evident.

The great distinction of this Internet age has been the emergence of **new business concepts** where the **commercialisation** of the product or application is often discovered en route with entrepreneurs taking a build-them-and-they-will-come approach. What has not changed, but intensified and accelerated, is the degree of **creative destruction**. *MySpace* was soon superseded by Facebook which itself was an Internet iteration of a former paper application at Harvard University.

Before you lose interest in this journey, think about the power that has now been placed in the hands of the consumer. The **smart phone** has all the computational power of a super computer of earlier years, but what is critical is that it is at one's fingertips virtually whatever one's location. Importantly, **each phone is uniquely identifiable on the Internet**, tantamount to a mobile INTERNET ADDRESS. (In the first year of its introduction, the iPhone sold 14 million of these Internet enabled devices. With the arrival of others, the price has dropped dramatically and it is estimated that at least 1.6 billion people will be thus connected at the end of this year.) It is the power of this device that **re-invigorated the creative zeal** of developers who are often in the unusual position of needing very little money to make their start.

Being always-on (constantly connected to the Internet) has completely **changed the commercial proposition** of the Internet. Apart from untethering one from the desktop, the reality of being able to **pin point the physical locational** of a user allows commerce to change from passive acceptance to **active pursuit**; one can now actively hunt-down business opportunities. An example of this is *PayPal's* new Beacon which allows a retailer to recognise a PayPal member as they enter the store (or pass by) and to transact with a phone swipe or verbal acknowledgement with no credit card in sight.

The incumbent card franchises have themselves been evolving near field communications technology to speed up this process, but in this fast moving commercial battle, the challenger has discovered additional attractions for the retailer that may change what was hitherto regarded as an unassailable position of the card issuers.

Similarly, out of Asia are coming **potential challengers to existing social networks** (Facebook and Twitter) in the form of mobile messaging apps. At the outset they were simply designed to arbitrage the lower cost of data rates versus the cost of phone messaging. By interrogating users' contacts list, these services very quickly became viral. They have also evolved into commercial platforms where users are induced to buy stickers, of an animated variety; speech and movement, to attach to messages. Further monetisation occurs from selling skill enhancements to mobile gamers, or Twitter-like hosting of firms surfing the user-engagement wave. Names like *LINE, Kakao Talk* and *WeChat* have been signing up users by the millions per month and in the case of LINE, winning large user bases as far afield as Brazil, Chile and Argentina - apart from being dominant in Japan, Taiwan, Thailand and Indonesia.

The problem for investors is to **discern fad and fantasy from long-term winners**. Just when Google looked to be all conquering, there has been the rise of **on-phone applications** and so-called **verticals** that allow regular users to circumvent search and instead to click directly on the app of their chosen site. Sites like *Tripadvisor* for travellers, *Expedia* for booking flights, *Zillow* as the most viewed real estate and rental site in the US, *OpenTable* for restaurant bookings are really old fashioned portals that have established dominant mind share with large aggregations of users. Like the classified pages of old, they are where one goes for that particular speciality. They have often expanded globally by acquisition or fresh starts to gain access to unprecedented large addressable markets. Once established, these businesses have remarkable scale and are generally extraordinarily profitable with concomitant free cash flows. The stakes are enormous which can induce highly promotional behaviour and careless use of funds at that time when the concept seems to have established a toe hold in this precipitous climb to dominance.

The most favoured **monetisation** approach has hitherto been the sale of **advertising** space alongside the offer. Quite recently investors were concerned about the loss of revenue because of the migration to small mobile screens from desktops. Revenues from cost per click (CPC) or cost per thousand impressions (CPM) are lower on mobile devices, but with the advent of tablets and the rise of users' enthusiasm for transacting on smart phones, this concern has dissipated; Google has even re-priced their offer on a blended basis. In addition, the ability to **identify a user's physical location** has given rise to new applications and therefore new revenue sources.

There is constant **experimentation with monetisation**. Partnerships have been formed between user-originated content providers like *Urbanspoon* and booking services like *OpenTable* to share revenues from traffic originated. Strong positions are held by *Apple* and *Google* who offer the payment service element for on-line transactions. These **app stores** currently take a 30% clip from each transaction, which of course is attracting fresh interest from vendors and payment services like *PayPal*. Group buying sites like *Groupon* take an even more aggressive cut, but seemingly manage this because of the intensive nature of signing up a myriad of small local merchants who are prepared to deeply discount their product to attract new customers or to balance their offering seasonally. **Subscription** is an alternative model and music streaming services like Pandora offers users the choice of a fee or interspersed adverts.

This revolution will be accompanied by great uncertainty, opportunity on a global scale and of course, significant risk, both commercial and substitutional. There are already several on-line areas that are witnessing a **convergence of offers** with participants each looking to imbed the attractive features developed by adjacent competitors in an attempt to create a lock on the customer. The web is highly disruptive by nature with **retailing** having felt the first cold blasts of **price transparency**. This may now be taken to a new level with the UK on-line grocer *Ocado* having mastered an industrial scale pick-and-deliver model which may threaten the price umbrellas that the consumer brands have for so long prospered under. **Delivery services** in general have huge implications for logistics and the changing use of property which is too complex to examine properly here.

It is still early days with e-commerce still accounting for only an estimated 7% of retail sales. Even in advertising there is still a large mismatch between time spent on-line and its share of the advertising pie. It has already taken its toll on traditional print media, but the rise of the likes of YouTube has still to be fully felt by traditional TV.

The **professions** remain the last bastion of the old way, but the great power on the Internet is already encroaching on the institutions of higher learning with experiments of algorithmic marking already being undertaken. Will lecture theatres change in function and become collaborative workplaces for students who have 'studied' at home?

We are spending a lot of time trying to track down the more interesting companies that will win in this highly competitive frenzy. Apart from the opportunities on offer, it also allows us to understand the vulnerabilities of the traditional players. To **mitigate risk**, we have a relatively large range of plays, with large exposures only to those entities which span several elements of the game. The Company's exposure to the e-commerce element of this opportunity is around 10% (Google, eBay, Sina, Naver, Baidu, Youku Tudou, Zillow) while a further 10% is invested in the 'pipework' (Cisco, Ciena, Ericsson, Samsung, Intel and Microsoft).

Outlook

The markets have been unusually resilient to bad news. As noted earlier the risk-on trade has been evident in blue sky areas like e-commerce and biotech, and in recent weeks this hunger for open-ended opportunities has been met with a growing queue of placements and listings. It would be no surprise for the markets to have some retracement, but the general improving economic tone and still massive printing of money suggests that a retreat in prices should be used as a buying opportunity. At present we have no shortage of potential buys.

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