Platinum Capital® Limited Quarterly Investment Manager's Report

30 September 2014

Platinum®
CAPITAL LIMITED

ABN 51 063 975 431

Performance

It has been an interesting period in world markets this last nine months. Starting out strongly in January, the first hiccup occurred in late February/March in response to China growth scares. Investors started rotating out of the then market leaders, very highly-priced biotech and Internet commerce plays, into older tech stocks and some of the emerging markets. This retreat by strong market leaders tends to be a warning of changing market dynamics. At the same time, the high risk, high yielding bonds also started to weaken. There followed a recovery through to mid-year when again talk of higher rates and concerns about the Federal Reserve getting too complacent (falling behind the yield curve with appropriate rate intervention) led to another loss of momentum in the western markets. This was countered by an awakening of the Asian markets, particularly China, India and Japan. India rose on account of the perceived favourable election outcome; China because of diminishing concerns about its growth prospects and the opening of the local market to foreign investment. Japan rose on account of the weaker Yen and for having squeezed past the rise in the consumption tax.

By the end of the third quarter, momentum was again fading as the markets were besieged by the uncertainties in the Middle East and Ukrainian border region, the threat of deflation and soggy growth in the Eurozone, and further rotation out of the high yield bond markets on the prospect of rising rates in the US. One could also observe the beginning of doubts forming about the consequences of an ultra-strong US dollar.

This concern also washed across the sector indices with those sectors with perceived dependable earnings growth being favoured over the more cyclical areas.

For Australian investors who are long the underlying currencies, the weakening of some stock markets was masked by the depreciation of the Australian dollar by around 6.5%. Overall the US was up 9% (in Australian dollars), Europe was flat and Asia variously up by 6 to 8%.

We may appear to be clod-footed as we underweight the huge US component of the MSCI World Index in favour of those markets and companies that are being under-represented. Do recall that the US now represents 49% of this benchmark index even though it produces less than 20% of global output. For all the ingenuity of Silicon Valley, we doubt that the US will provide 49% of the best investments in the world over the next 15 years.

Our relatively low weighting in US stocks and the progressive build-up of cash and shorts has tended to act as a drag on our performance; the Company averaged about 85% exposure for the quarter. For the moment this is causing us to underperform the MSCI World Index though we are achieving respectable returns of 2.9% and 15.2% pre-tax for the last three and 12 months respectively. The MSCI World Index returned 5.4% and 19% respectively. We believe our stance will pay off shortly.

MSCI* World Index Regional Performance (AUD)

REGION	QUARTER	1 YEAR
India	10%	47%
China	9%	12%
United States	**9%**	**27%**
Asia ex Japan	**6%**	**16%**
Developed Markets	**6%**	**20%**
Japan	**5%**	**8%**
Hong Kong	5%	13%
Emerging Markets	**4%**	**12%**
United Kingdom	1%	13%
Europe	**0%**	**12%**
Korea	0%	7%
Australia	-1%	6%
France	-1%	9%
Germany	-4%	9%

* Morgan Stanley Capital International
Source: MSCI

MSCI* World Index Sector Performance (AUD)

SECTOR	QUARTER	1 YEAR
Health Care	12%	34%
Information Technology	10%	32%
Telecommunication Services	7%	17%
Financials	6%	16%
Consumer Staples	5%	16%
Consumer Discretionary	4%	13%
Industrials	4%	15%
Utilities	3%	20%
Materials	0%	9%
Energy	-2%	16%

* 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 gains. The August and September figures have been adjusted for the five cent final dividend declared on 14 August 2014 and paid on 8 September 2014.

Net Asset Value

	PRE-TAX	POST-TAX
31 July 2014	$1.6576	$1.5378
31 August 2014	$1.5935	$1.4786
30 September 2014	$1.6372	$1.5104

Source: Platinum

Changes to the Portfolio

Geographical Disposition of Platinum Assets*

REGION	SEP 14	JUN 14
Asia	29%	29%
Europe	22%	23%
North America	22%	26%
Japan	12%	12%
Russia	3%	3%
Africa	3%	3%
Australia	1%	1%
South America	0%	1%
Cash	8%	2%
Shorts	13%	10%

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

Source: Platinum

Over the last nine months we have changed both the regional and industry exposure of the Company. This was, as ever, motivated by the migration of relative prices and hence opportunities.

Since January the Company has cut its exposure to North America and Europe each by 2% to a combined figure of 44%, while funds deployed in Asia (including Japan) stands at 41%. Cash has risen to 8% from 6% and the shorts have risen to 13% (mainly against US indices, the German DAX Index and Hong Kong Index).

While US companies have clearly been the most effective in achieving earnings growth post the GFC, helped by a growing economy and very cheap money, this relative outperformance may now face greater challenges. Even in the June quarter, companies were generally finding sales growth more challenging while earnings continued to thrust higher. This retardant may become more pronounced as the US dollar climbs, which in itself is an implicit tightening, that will be at the expense of the competitiveness of US companies. However, this is not upper most in our minds. What is more relevant is the potential of profit growth elsewhere and the prices we are being asked to pay to participate. By our reckoning, the companies we have been acquiring offer superior value on a risk adjusted medium term basis.

Where companies have done all one could have asked of them in terms of fair and open disclosure, and matched this with a near faultless execution of their strategies, it is always difficult to bring oneself to sell. We have nevertheless done so by exiting great performers like **Henkel**, **Roche**, **Bayer AG** and **Naver** to make way for companies with less favoured valuations. We also sold out of a recent acquisition, **LinkedIn**, after its quick upward burst, and exited **Pernod Ricard**, **Bangkok Bank**, **Bank of America**, **Jacobs Engineering**, **Marvell** and **Trulia**. We cut **Hindalco** and **Baidu** after strong runs.

Last quarter we described our enthusiasm for some of the Chinese general and life insurers, to which we have continued to add. We have also been buying the white spirit companies in China and added to our existing holdings in Korea and introduced Korea Electric Power.

Following the crackdown on corruption and the lavish lifestyles of the ruling elite, there has been a huge shift in the price and patterns of consumption of the traditional Chinese firewater, *Baijiu*. This is an inappropriate description for the leading brand **Kweichow Moutai**, which only sells product that has been matured for at least three years and is in fact a highly prized drink among *aficionados*. What attracts us most is its great pedigree, remarkable brand strength and unparalleled profitability.

Putting substance to these claims one can observe that even as sales to officials have been severely curtailed, improved availability has seen the general public fully absorbing available supply. Selling at Rmb 900 (approximately US$160) per 500ml bottle (53% proof), the company is able to earn a TAXED margin of 50% on sales. Return on assets is more modest on account of large stock holdings. Aged stocks have been growing ahead of sales which bodes well for future premium pricing and gives head room for continuing growth. Some market observers are concerned about a repeat of the last down-cycle but we believe the circumstances that the industry now faces are very different to those that prevailed during the Asian crises of 1999.

Korea Electric Power (KEPCO) is a very different story of a regulated utility that has been deprived of earning its entitled return on assets. Changes are afoot both within the company and among the bureaucracy that suggest this can change. Most importantly, as the company rebalances its power load back in-house with nuclear and coal, and uses less expensive gas fired IPP sourced capacity, profits will lift. In addition, there have been hints that the regulator is prepared to countenance greater pricing flexibility on account of official concerns about the indebtedness of government-owned entities. This is connected to the awareness of the need for change lest Korea further follows in the footsteps of Japan.

After the changes we have made to the portfolio, what are we broadly exposed to?

PORTFOLIO EXPOSURE

REGION	EXPOSURE
China financials (insurers – no banks)	4%
China consumer (jewellery, drinks, China Mobile)	3%
China Internet (Tencent, Baidu, Sina)	6%
China Sub-Total	**13%**
Korea (Samsung Electronics, KB Financial, KEPCO)	7%
India (financials and infrastructure)	3%
Japan (exporters / domestics: 70%/30%)	14%
North American metals / resources (Alcoa, Allegheny Technologies, Canadian Oil Sands)	11%
North American investment (Baker Hughes, Foster Wheeler, KBR)	5%
Western Hemisphere technology (Intel, Ericsson, Ciena, Microsoft)	9%
Western Hemisphere Internet (Google, eBay, Schibsted, Yandex)	7%
European consumer / drug companies	15%
European banks	5%
Other (Brazil, Malaysia etc)	3%
TOTAL	**92%**

Source: Platinum

Though somewhat arbitrary, we would reckon that about 25% to 30% of the portfolio is in cyclical companies (being mainly metals, investment and Japanese exporters). In a world of suppressed interest rates, **long duration assets have particular appeal** and this endorses many of the other holdings within the portfolio. Our net invested position is 79%. We have raised cash levels to 8%.

Shorting

The short positions have been raised to 13%.

Currency

The US dollar (including the Hong Kong dollar) is our principal currency hedge at 68%. We have no Australian dollar and little exposure to the Japanese yen.

Commentary

It is likely that the threat of rising rates in the US creates a **negative feed-back loop via a stronger US dollar**. In the last quarter the marker of the US dollar, the DXY index, rose by 8% which was matched by a similar setback in the Russell 2000 Index. Risk has been taken-off with hedging activity increased. From here individual stock picking is likely to become even more important with the underlying trend no longer being so helpful. Rates, at the short end, seem likely to be raised ever so gradually in the US on account of insipid growth and the fact that the **Central Banks of Europe, Japan, China and India are, if anything, still going the other way!**

As noted above our focus on Asia is driven by **valuations** and the fact that there is **reform** taking place that should, in time, release further growth potential. It is noticeable that the **Chinese authorities** were trying to deflate the property market gradually with modifications to purchase restrictions and the like. Transaction volumes in the primary market have fallen by some 20% (though prices in the big four cities have barely weakened) while in the second and third tier cities, solid discounts are on offer. Thus far the fallout from the property market has been mild and reported non-performing loans are still very low, albeit on a rising trend. It is in areas such as construction machinery that one is seeing evident stress with members of our investment team reporting meeting some very sad dealers during their September field trip.

The exciting development is the opening up a reciprocal market between Hong Kong and Shanghai (the so-called 'through train'). This will initially involve the allocation of a quota which will allow foreign investors to purchase shares on the Shanghai Exchange and likewise for Chinese mainlanders to acquire shares listed in Hong Kong. Essentially this is the **beginning of an opening of the capital account of China** and will give investors the greater choice of the A share market on the mainland. Where there are dual listings, typically mainland shares trade at a significant discount to those in Hong Kong.

One has read some concerns about the follow-through of reforms subsequent to India's Prime Minister Modi's assumption of power. We are getting much more positive feedback about a business-like cultural shift that has been imposed on the ministries in Delhi. For example, objections among ministries are required to be voiced within 15 working days or may face forfeiture; a Central Government expenditure management committee was established in August charged with reducing waste at the centre; the Agricultural support system is under review; prices and tariffs are being reviewed and petty impositions on the citizenry such as notarisation of identity is being eliminated to reduce rent-seeking at the street level.

Most encouraging to long-standing observers of India is Modi's declaration in Washington at the end of September that the **State 'has no business of being in business'**. This is profound rejection of the opposition Congress party's long standing approach of intervention and subsidy.

There are, however, many sticking points. Most important of all is the **magnitude of the work load on a very narrow group of decision makers surrounding Modi**. There is also heavy wrangling ahead to try to implement a general sales tax and to gradually wind-back subsidies on food and energy. There is then the necessity of dealing with the re-auctioning of the coal blocks and the allocation of gas to tens of gigawatts of stranded electrical generation capacity.

We have written often about the **gradual shift in corporate culture in Japan** and are seeing similar changes taking place in Korea. On balance the business environment in Asia is at least as positive as we can observe in the Western hemisphere and we find the valuations more compelling.

Outlook

That there will be some volatility in markets seems likely but the hunt for duration in a world facing low inflation and growth against a back drop of very cheap money, suggests that real assets (shares) will continue to attract investors. The portfolio management challenge will be to achieve the correct balance between predictable earnings growth and the low valuation being placed on companies with less certain outlooks.

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