Platinum Capital® Limited Quarterly Investment Manager's Report

30 September 2016

Markets

The undercurrent in markets for this quarter was the persistent sign that the Chinese economy is responding to the government's initiatives of deficit spending and easy money. This gave impetus to the Emerging Markets (EM) in general, which were further assured by Mrs Yellen's speech at the Jackson Hole symposium in July and subsequently in September, confirming an accommodative Fed and her tendency to let the markets lead. Deferral of tightening is seen as beneficial to EM which are regarded as riskier than the traditional large markets on account of their dependence on foreign investors at the margin, resulting in higher yields and lower valued shares in aggregate. It was also a good quarter for cyclical companies with strong moves in commodities, partly caused by tighter controls over Chinese producers of iron ore and coking coal. Copper, which is often regarded as the barometer of economic health, is however still meandering at low levels.

The developed markets moved sideways with a conspicuous absence of volatility. This was in part due to the selling of options by investors trying to earn what is perceived as low risk income (e.g. selling out-of-the-money calls or out-of-the-money puts in the belief that they are unlikely to be exercised). Investors though are still cautious, with mutual funds being well cashed up at around 5.5% and the defensive names, which we describe as 'certainty trades', still a crowd pleaser.

Performance

(compound pa, to 30 September 2016)

	QUARTER	1YR	3YRS	5YRS	SINCE INCEPTION
Platinum Capital Ltd	6%	0%	9%	14%	12%
MSCI AC* World Index	2%	3%	12%	16%	6%

* Morgan Stanley Capital International All Country

Source: Platinum and MSCI. Refer to note 1.

The portfolio positioning of Platinum Capital Limited (ASX: PMC) is paying off and we are starting to see strong performance. Contributors ranked in terms of dollar gains for the portfolio include Sina (China's leading twittering and news portal), Tencent (China's dominant social network and gaming platform), Lixil (Japanese producer of building products), Samsung Electronics, Rakuten (Japanese e-commerce and finance firm), Qiagen (medical diagnostics), KB Financial and IDFC Bank, most of which were up by around 20% with outliers like Sina and IDFC Bank up by 51% and 77% respectively. The detractors of significance were Sanofi, Casino Guichard (retail), Eni (petroleum), Ericsson and Jiangsu Yanghe (Chinese liquor maker), but the strong performers outperformed the weak by some 2.5 to 1, giving PMC a satisfactory return of 5.9% for the last three months. Against the Index we are still slightly trailing in the 12 month return (0.5% versus 2.7%), but are well ahead for the quarter (5.9% versus 2.5%).

MSCI World Index Regional Performance (AUD)

REGION	QUARTER	1 YEAR
Developed Markets	**2%**	**2%**
Emerging Markets	**6%**	**7%**
United States	**1%**	**5%**
Europe	**3%**	**-6%**
Germany	7%	0%
France	3%	-5%
United Kingdom	1%	-7%
Japan	**6%**	**3%**
Asia ex Japan	**7%**	**7%**
China	11%	4%
Hong Kong	9%	9%
India	3%	-3%
Korea	8%	11%
Australia	5%	12%

Source: MSCI

MSCI World Index Sector Performance (AUD)

SECTOR	QUARTER	1 YEAR
Information Technology	10%	13%
Materials	7%	14%
Financials	4%	-5%
Consumer Discretionary	4%	-2%
Industrials	3%	7%
Energy	-1%	8%
Health Care	-3%	-3%
Consumer Staples	-3%	5%
Telecommunication Services	-4%	3%
Utilities	-6%	2%

Source: MSCI

Net Asset Value

The following PMC net asset value per share (NAV) figures are before and after provision for tax on both realised and unrealised income and gains. The July and August figures have been adjusted for the 4 cent final dividend declared on 19 August 2016 and paid on 13 September 2016.

	PRE-TAX NAV	POST-TAX NAV
30 June 2016	$1.4444	$1.4519
31 July 2016	$1.4464	$1.4422
31 August 2016	$1.4989	$1.4782
30 September 2016	$1.4864	$1.4721

Source: Platinum

Currency

We remain hedged out of the Chinese yuan to protect our Chinese holdings against further Yuan depreciation, have raised our position on the Euro to 18%, on the basis of increasing confidence in growth, and raised the holding in the Norwegian krone to 10% as a proxy on oil and the general improvement in commodity pricing. We find it a preferable long to the Australian dollar which suffers from a chronic current account deficit, even as the terms of trade are improving. Our hedging back into the AUD increased marginally.

CURRENCY	SEP 2016	JUN 2016
US dollar (USD)	27%	43%
Euro (EUR)	18%	16%
Australian dollar (AUD)	18%	17%
Hong Kong dollar (HKD)	13%	12%
Norwegian krone (NOK)	10%	5%
Indian rupee (INR)	6%	6%
Chinese yuan (CNY)	-3%	-3%
Chinese yuan offshore (CNH)	-8%	-8%

Source: Platinum

Shorting

We raised the short position, principally through buying the now cheap puts on the US market and an Emerging Markets ETF ahead of the likely turbulent political timetable set for the fourth quarter. The individual shorts are still to pay off though positions in consumer staples are gradually falling away. The delta adjusted exposure[1] of our total short positions is close to 19%.

1 Delta adjusted exposure is used where options are employed. Delta is a theoretical measure of the sensitivity of the option price to a change in the price of the underlying asset (usually expressed as a percentage).

Disposition of PMC's Portfolio

REGION	SEP 2016	JUN 2016
Asia	37%	32%
Europe	22%	23%
North America	21%	21%
Japan	13%	11%
Australia	1%	1%
Russia	1%	1%
Africa	<1%	1%
Cash	5%	10%
Shorts	-19%	-17%

Source: Platinum. Refer to note 2.

Changes to the Portfolio

We used the powerful run of some of our Chinese Internet names to realise profits, trimming **Sina** and **Tencent** as well as exiting **CK Hutchison Holdings** and **China Mobile**. However, overall weightings to China increased slightly because of price appreciation and additions early in the quarter to **Ping An Insurance Group**, **PICC** and **Anta Sports**. Other positions exited included **Allegheny Technologies, Ibiden, Suncor Energy, Sberbank, Mitsubishi Tanabe Pharma** and a reduction in **Daiichi Sankyo** (Japanese pharmaceutical company). Of these, Allegheny and Ibiden proved poor investments with their failures to bring big new projects to the market at the level of profitability we had anticipated or hoped; a lesson that in times of weak pricing and slow growth, one is punished for not building in a sufficient margin for error. We juggled around our **gold ETF** to good effect and also used periodic sell-offs to add to the likes of **Kering** (luxury fashion), **Nintendo** (electronic games) and **Wynn Resorts** (casinos), and re-introduced two small positions in neglected cyclicals, **Norilsk Nickel** and **Sumitomo Metal Mining Co** (gold and Nickel).

The interesting company that is new to the portfolio is **58.com**. This is a relatively young Internet company in China that specialises in **online classifieds for second-hand residential properties, rental properties, and blue-collar jobs**. They also provide other classifieds services, an online "yellow pages" directory that advertises diverse services like on-site manicure, house cleaning, furniture removal, wedding photography, etc. across over 30 cities in China. This also helps to drive traffic to the principal website. However, the dominant verticals where the company clearly has market leadership are secondary real estate and jobs. This position came out of a merger with a former competitor, Ganji, and the integration of a much smaller but promising property site, Anjuke.

Helping matters was the tactical error by the former leading property web portal, SouFun, which chose to compete against its customers by establishing its own estate agency sales

force. Its count of agent subscribers has fallen from 250,000 at the peak to approximately 170,000 while 58.com has seen agents flocking to its now enlarged site with more than 550,000 monthly subscribers. SouFun's number and diversity of listings have likewise contracted (though it still has traction in new dwellings) and 58.com is already achieving three times the peak revenues SouFun earned in 2014.

There are quirks in the Chinese market that set it apart from the western model, but essentially **listings are free and agents pay a monthly membership fee** of varying amounts to list properties on their books. They can each list up to 40 properties on behalf of sellers and may pay additional sums for **priority placements and real time bidding** for different time slots or customer search characteristics. The crinkles relate to the fact that *properties can be listed multiple times* because sellers *seldom grant exclusivity*. Full description of a property and *exact addresses are rare* and there are cases of *false listings* to induce buyers to make contact with an agent. Because the *buyer pays* the commission on sales, typically 2% to 2.5%, allegiances are tentative and this limits the portal's pricing power. Even so, this is a nascent, though fast growing, market in China with only 2 million second-hand properties changing ownership each year, compared to the new builds of some 9 to 10 million a year. To cement its position with agents, 58.com is working assiduously to *improve its algorithms to identify prospective buyers that best match* both the agent's location and addressable stock of properties. While pleased with the progress they have made, the work ahead and the need for greater discipline of listings lead the management to be more optimistic about their **jobs business** than their property service.

Here we have a willingness by over 300,000 advertisers, **mainly small businesses, to pay a membership fee of some US$600 per year to find candidates for job openings**. Alternatively, subscribers can bid for a fixed number of candidates (either to interview or to view their CVs). One can expect this river of recruiters to keep rising as larger numbers of employers turn to electronic media from traditional placards or signs outside physical premises. There are some 10 million small companies in China! This part of the market is **distinct from the white-collar segment** where 58.com's offering, ChinaHR.com, is a distant third to the category leader, 51job.com, followed by Zhaopin (majority owned by Australian company Seek).

In its helter skelter push for growth, the company is following several other leads like **used-goods trading (zhuanzhuan.com)** with integrated search, review and payment functions in a closed-loop mobile app. At the end of last year, it was seeing five million users per day and experienced hundreds of thousands of new listings each day. There is also a new auto site, after the company hived off its used-car site Guazi (keeping 40%) which dominates the consumer-to-consumer (or C2C) second-hand car market which now comprises some 9.5 million vehicles a year.

These initiatives, and the costs around consolidating its position in the property market where its market share in new and secondary combined may be 16%, makes profit forecasting problematic. The benefits of sharing infrastructure should, however, allow costs to trail well behind the growth in revenues that seem likely to achieve 30% p.a. for a few years. Once established, these types of businesses can generate EBIT margins of 20% or more. There are clearly reservations about execution, given the corpses of many failed verticals of this nature. With a market capitalisation of around US$6 billion or 4.5 times its likely revenues for December 2016, it may not seem inordinately cheap, but consider the valuations of similar businesses elsewhere: Zillow, which is a pure online real estate portal in the US, has a market cap of US$6 billion, while Rightmove, the UK equivalent, has a market cap of US$5 billion. In Australia, REA Group, the owner of realestate.com.au, has a market cap of US$5.5 billion, while that of Autotrader is similar. These companies are engaged in one of the several verticals that 58.com occupies, and are placed in relatively small markets. 58.com has elements of each of these businesses in a vast country where the secondary real and personal property markets are only beginning to grow! Tencent is the largest shareholder with a 22.9% holding.

Commentary

It is very difficult to give sensible commentary on the state of the markets at present. The great stores of wealth reflected in the US, European and Japanese markets have been trading sideways for the last three months, while the excitement has moved to the Emerging Markets, which have been strong. Volatility is at record low levels, partly on account of some investors choosing to use derivative markets to enhance their yield and also on account of the late summer trading lull.

Figures tracking flows reveal that there have been net redemptions out of equities in the US, Europe and Japan, even though some money has switched into ETFs and Emerging Markets.

There has been a conspicuous yawning divergence between rising flows into bonds, up some US$157 billion over the last 12 months and some US$140 billion out of equities. Strangely, cash balances have also contracted and some of this can be traced into commodity funds.

The prospect of several elections/referenda and high apparent valuations may be part of the reason for the markets' stalemate or because of some yet-to-be-discovered broader threat. Indeed the S&P Index as a whole is trading well above its long-term average which is around 16 times GAAP[2] earnings, versus the current rating for 2016 earnings of around 22 times. In addition, profits have now declined for three

2 Generally Accepted Accounting Principles.

successive quarters (US *domestic* profits off by 10.8% from the 2014 peak) and on occasions similar occurrences had presaged an economic downturn. It is too early to say, but the savings rate has been dropping to around 4%, suggesting a loss of a buffer for consumers. There has also been a break in the traditional link between strong net wealth growth, which is at new record levels, and real spending. Household earnings are increasing and, importantly, the lower earners in society are benefiting from rising minimum wages. In the year 2015, the bottom 20% saw income growth of 6.7% while the population as a whole experienced income growth of 5.2%. Also encouraging is that after a prolonged stagnating eight month period to the end of August 2016, temporary employment broke to new highs in September.

There are of course a handful of differences regarding this protracted recovery from earlier ones: high household debt, low nominal growth, weak productivity – even though one suspects it is being under-recorded by dint of new technologies. The question is though, why individuals should suddenly become more cautious. Age alone does not necessarily cause economic expansion to come to a halt.

Offsetting this is the present low threat of rising inflation and its associated party-spoiler, strongly rising interest rates. In any case, companies are more intent on reducing their share count than investing in much new capacity with share buybacks running at some US$60 billion a month which, together with dividends, mean that listed companies distributed over 100% of their attributable profits in the first half of 2016 against a longer term tendency of 80%. There are other positives like housing starts trailing household formation, consumer confidence at multi-year highs and in line with pre-Lehman levels, bank credit is rising and of course, it is very cheap!

Europe and Japan also look more positive than the popular press would have you believe, with prices having stabilised and now arguably rising (producer prices in both regions have turned higher). Consumers are getting on with their lives as evidenced by the OECD's leading global indicator turning positive. The great hope is for higher government spending to offset the private sector's caution, the so-called fiscal response. This seems more prospective in the US than in Europe and has indeed been very evident in China where the government has clearly augmented its monetary ease with a rise in deficit spending from last year's 3% to perhaps over 5% this year, and much to the relief of all, is seeing a clear response with accelerating growth. Europe will be likely very late to this increased deficit spending game because of the huge differences in the region's economic credentials and a distrust of members' reliability to hold the deficit line. Japan has recently announced a policy shift from targeting the acquisition of a fixed amount of bonds in Yen terms to one of targeting an interest rate level for the 10 year bond, with this rate set at zero.

The trouble in all cases is that with debt being so high in developed markets, the efficacy of low rates is muted in terms of spurring capital expenditure and **may even have the perverse effect of driving citizens to raise their savings** because of the now miserable returns on their savings and the stark realisation that their retirement accounts look rather meagre. Think of those 45% of *American families* who have ***no*** private provision for retirement whatsoever. If one looks at the pyramid of age cohorts of the US population, one sees that there are some 20 million men and women in each of the 5-year age cohorts from 45 years to 65 years, suggesting perhaps that close to half of these 60 to 80 million people may be glumly cogitating the deprivation of depending on US state pensions in the relatively near future. None of this leads one to see consumer spending being particularly robust! We can expect a fiscal response (as we noted last quarter), but with governments having already been the back stop for private debt, they are now typically 70% more indebted than before the Lehman crisis, and this will play on minds.

Outlook

While there are cross-currents to obscure one's view, one should not become unduly focused on the US and the outcome of its election. The economic recovery in China, continuing strong growth in most of Asia and ongoing improvements in Europe are most encouraging. There has been an evident change of heart by investors with a willingness to leave the 'certainty trades', and to look further afield. We sense there is **a move afoot towards real or inflation assets and away from financial/safety assets, like bonds**. Dispersion between the best and the worst performers is starting to widen. We are very comfortable with our positioning for the coming months.

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Notes

1. The investment returns are calculated using PMC's pre-tax net asset value (as released to the ASX) and represent the combined income and capital return of the investments for the specified period. Please note that the results are not calculated from PMC's share price.

   The investment returns shown are historical and no warranty can be given for future performance. You should be aware that historical performance is not a reliable indicator of future performance. Due to the volatility in the underlying assets of PMC and other risk factors associated with investing, investment returns can be negative (particularly in the short-term).

   The portfolio inception date for PMC is 29 June 1994.

   It should be noted that Platinum does not invest by reference to the weightings of the MSCI All Country World Net Index (A$) (the "Index") or any other indices or benchmarks. Underlying assets are chosen through Platinum's individual stock selection process and, as a result, holdings will vary considerably to the make-up of the Index. Index information is provided as a reference only.

   (NB: The gross MSCI Index was used prior to 31 December 1998 as the net MSCI Index did not exist.)

2. Regional exposures (i.e. the positions listed other than "cash" and "shorts") represent any and all physical holdings, long derivatives (stock and index), and fixed income securities.

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