Platinum Capital® Limited Quarterly Investment Manager's Report

31 December 2012

Platinum®
CAPITAL LIMITED
ABN 51 063 975 431

Performance

As foreshadowed in our previous quarterly, the character of the markets has been changing progressively since the reassurances in August from Mr Draghi, the European Central Bank (ECB) President, regarding Outright Monetary Transactions (OMT) by the ECB. Up until then, the fear-bound markets were characterised by huge outflows from equities into bonds and cash. Within the equity markets there was less willingness to support emerging markets notwithstanding their superior growth prospects and generally, defensives were favoured over anything having a cyclical tinge.

During this quarter, funds have continued to desert equities but with much reduced intensity. Apart from reassurances and actions from each of the major Central Banks to facilitate cheap funding, the economic news has also been reassuring. The US continues to experience a broadening economic recovery (though the fiscal impasse is probably retarding investment) but most important of all, has been the re-acceleration of the Chinese economy. This has immediate benefits for the Pacific Rim but equally benefits the resource producing regions of Africa, Latin America and so on. Crowning this has been the fighting language and actions by the newly elected government in Japan. They are asking the Bank of Japan (BOJ) to target higher prices via inflating the monetary base or face a legislative response. The Japanese yen has subsequently weakened by over 12% against the US dollar and has also fallen against the Korean won and Euro, both important competitors in its export markets.

The anticipatory nature of the global stock market revealed this shift in prospects with a strong quarter, up 3.1% in A$ terms; those that were behind are now in front as the accompanying table attests. The US lagged and was actually down 0.3% for the quarter while among the developing markets the star was China, up 13.1%. For the year, the MSCI World Index gained 14.7%.

The holdings of the Company showed great form as this shift in focus strengthened and was up 7.8% (pre-tax) for the quarter, outperforming the MSCI World Index by a large margin, up 12.2% for the last six months and up 16.6% for the year.

The following Platinum Capital Limited Net Asset Value figures are after provision for tax on both realised and unrealised income and gains.

Net Asset Value

31 October 2012	30 November 2012	31 December 2012
$1.1075	$1.1385	$1.2057

Source: Platinum

MSCI* World Index Regional Performance (AUD)

REGION	QUARTER	1 YEAR
China	13%	21%
France	11%	20%
Germany	9%	29%
Europe	**7%**	**18%**
Australia	7%	21%
Japan	**6%**	**7%**
Asia ex Japan	**6%**	**21%**
Hong Kong	6%	27%
Emerging Markets	**6%**	**17%**
Korea	5%	20%
United Kingdom	4%	14%
Developed Markets	**3%**	**14%**
India	1%	24%
United States	**0%**	**14%**

* Morgan Stanley Capital International
Source: MSCI

MSCI* World Index Sector Performance (AUD)

SECTOR	QUARTER	1 YEAR
Financials	9%	27%
Consumer Discretionary	6%	22%
Industrials	6%	15%
Materials	5%	10%
Consumer Staples	1%	13%
Healthcare	1%	16%
Utilities	0%	1%
Information Technology	-2%	14%
Energy	-2%	1%
Telecommunications Services	-3%	7%

* Morgan Stanley Capital International
Source: MSCI

Currency

There has been little change in the currency exposures over the quarter. We continue to eschew the Australian dollar and the Japanese yen while emphasising the European currencies and US dollar. The weakening of the Yen is important in many respects but suggests that the other Asian currencies will be the recipient of stronger speculative flows than was evident in 2012. The Company's exposure is: US dollar and Hong Kong dollar 41%; Euro and other European currencies 35%; Asian currencies 12%; Canadian dollar 5%; Australian dollar 3% and Japanese yen 3%. The Australian dollar ended the year almost flat against the US dollar at 1.038.

Shorting

Our rising optimism about the re-pricing of specific equities caused us to continue to close positions on weakness and to remove some of the generic share index exposures. We closed the quarter with the lowest short position in years at 10%.

Changes to the Portfolio

Geographical Disposition of Platinum Assets*

REGION	DEC 12	SEP 12
North America	28%	29%
Europe	25%	26%
Asia	22%	20%
Japan	21%	15%
Africa	2%	2%
South America	1%	1%
Australia	0%	1%
Cash	1%	6%
Shorts	10%	15%

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

The biggest change in the portfolio was the raising of exposure to Japan. This was executed through the purchase of several companies that would benefit from greater competitiveness stemming from a weakening Yen such as **Daiken Industries** (world leader in air conditioning), **Mitsubishi Corp** (the largest Japanese trading firm with significant stakes in coal, natural gas and copper resources) and **Hitachi** (a vast engineering conglomerate embarking on a structural makeover). We also took option and futures positions over the broad Topix Index on the basis of the whole market being ludicrously cheap[1] and a huge beneficiary of a weakening currency.

1 Some may disregard this optimism as a 'Platinum-centric' dream. However, the weakening of the Yen is key. It reflects a shift in the thinking of the establishment and is being accompanied by clear shifts in the corporate world. Twenty years of sloth and increasing competition from abroad plus conflicts with its leading trading partner, China, is encouraging change. While the corporate sector is loath to revoke its social security obligation of life-time employment, juggernauts like Hitachi have embarked on a complete corporate restructuring. This is being accompanied by a 'right owner' asset exchange. While admittedly long overdue, our view is that with several leading names now facing insolvency, there is a sense of group acknowledgement for the need for reform. Some may worry that a weaker Yen will retard this change but one can identify a convergence of factors that suggest we are at a point of resolution. Some companies will leave the change too late but the vanguard will benefit hugely, and interestingly, were seeing improving profitability even when the Yen was close to an all-time high.

We have also continued to add to smaller positions mentioned last quarter and to our holdings of Chinese–based Internet stocks. These swooned through the quarter as concerns loomed about the Securities and Exchange Commission (SEC) seeking access to the audit papers produced by China-based associates of the global accounting majors. This is a broader issue than just deregistering these accounting firms and hence causing these Nasdaq-listed Internet stocks to be ineligible for continued listing on an American Stock Exchange. Should this political turf battle go unresolved, most US-based multinationals with operations in China could have inadmissible accounts! We added **Baidu**, China's leading Internet search provider, similar to Google, and **Youku**, the leading web-based Video/TV provider. At a capitalisation of under $3 billion, we suspect this company is unlikely to remain independent as the leviathans of the industry look to bundle their advertising offer along the lines followed by Google with YouTube.

We have also maintained, or added to, our positions in the engineering companies, Foster Wheeler, Jacobs Engineering and KBR on the basis of the inevitable recovery of capital spending in the US on account of the shale hydrocarbon gas and liquids phenomenon. The three **oil service majors** are trading at their lowest ratings of the last 20 years. The principal reason seems to be concern about over-capacity, particularly in pressure pumping in North America, increasing capital intensity and slower than expected recovery in activity in international markets. The upside relies on the planned step-up of drilling in deep water. There is a fairly predictable amount of additional work that will need to be serviced over the coming 2 to 3 years emanating from this planned off-shore activity. At the same time, the three leading companies, who essentially are the only firms with the technical capability to operate at these depths and pressures, are reducing their capital spending. Halliburton and Baker Hughes should now reap the benefits from their re-orientated international footprints. Tight gas activity outside of North America is just starting in the vast shale deposits of China, Saudi Arabia, Argentina and Australia.

These purchases were funded out of partial sales of companies under takeover offers like Nexen Inc and United Brewing Holdings. We also chose to reduce positions in stellar performers, some of which we classified as defensives, like Samsung Electronics and Henkel.

Commentary

As we try to make sense of the year ahead, we run the risk of extrapolating the experiences of the last 12 months. We are of the view that we are entering a very different environment. The behaviour of markets in the last three months have been hinting of this but the overlay of uncertainty from the irresolution of the US budget negotiations has partially obscured this change.

We believe shares will be rewarding in the year ahead based on:

- **Economic factors**
- **A change in risk tolerance**
- **Attractive valuations**

Across the globe the effect of cheap money is working its wonders to re-ignite capitalist instincts. On a GDP weighted basis, the level of Central Bank rates are just over 2.1% compared with about 5% at the onset of the GFC. Industrial production is running close to the peak of 2007/08 and global trade is flourishing with exports up some 30% since 2007. This is not the popular image of world economic affairs but to some extent this is due to the rolling nature of deleveraging that has been taking place over the last five years.

Take for example Ireland; the economy is expanding again, though from a base that is 20% off its nominal peak as surging exports have more than offset government retrenchment. (The fiscal deficit is presently at 8%, down from 30% immediately after the crises). The big difference between Ireland and its more challenged peers in the Euro monetary system is its highly deregulated markets, particularly labour, low corporate taxation and fluid population movements, notably among 'guest workers'. We do not envisage the troubled countries of the Euro zone to respond with such agility principally because of the nettled issues around labour but even here change is afoot. In Ireland, for example, unit labour costs are down 10% since the crises whereas the best comparable performer in the Euro zone is Spain where they are down by 3%, while in countries like Italy and Greece, unit labour costs have continued to rise.

We have expressed our positive views on the US economy in earlier reports with the recovery in house values and building activity, credit growth, the bonanza from tight oil and gas, the inevitability of an investment recovery and the likely return of some manufacturing jobs onshore.

More broadly, the governments of the large developing economies like China, India and Russia are also taking measures that attempt to correct some of the imbalances that have evolved. While they will be challenged to meet their ambitious growth targets, the ubiquity of the web and wireless adds to the urgency for action among the ruling elite. While world growth will be mottled, in aggregate we can expect an overall rise of say 2.5-3% in real terms. So on the one hand, growth in parts of the developed world may be elusive on account of continuing deleveraging and the withdrawal of government supplementary spending. However, the continuing growth in the developing world with its concomitant need for natural resources will give rise to many favourable investment opportunities.

From this perspective there is a high probability that we are on the **cusp of a redirection of investment flows**. Investor confidence is generally improving as evidenced by falling volatility and a dramatic divergence of stock price behaviour in stark contrast to 2011 when convergence prevailed. Bonds have enjoyed an unusually long bull market, culminating in a **fear-driven crescendo** of retail flows to a ballooning population of bond funds. With the concerted efforts by the Central Banks of the US, Euro zone, Britain and now Japan to suppress interest rates and their currencies, it seems highly likely that **bond markets are about to face more challenging times**. While evidence of rising inflation is still remote, and the general view is that it is unlikely to reveal itself until resource utilisation is more intense, it is interesting that **house prices are drifting upwards.**

A country that may be an interesting lead indicator is New Zealand. In this small, yet open economy, where new supply of housing has admittedly been constrained, house prices are about 10% above their pre-crises peak levels. Credit growth in the last year has been modest at 5%, retail sales are soft, unemployment is at similar levels to those during the Asia crises at 7.3% and exports are struggling. Strangely, house prices elsewhere are also tending to creep upwards in the face of stagnant real incomes. We suspect that the full effects of concerted liquidity creation by Central Banks will only be appreciated well after the event.

While investors have been forsaking the stock market in droves, the companies themselves have been notably active in buying back shares and more recently in the US, raising their dividend payouts. From the beginning of 2006, cumulative flows out of equities in the US have been estimated at about US$550 billion, while corresponding flows into bonds have been over US$1 trillion.

The interesting question is the extent to which a rise in bond yields might have a negative effect on equity valuations. Our view is that there is **significant scope for yields to back-up before the yield on bonds adversely affects equities**. The key observation is that bond yields are at record lows as a consequence of **extreme risk aversion**.

As confidence gradually returns, the willingness of investors to lend to their governments in exchange for say 1.8% pa for 10 years will subside. Investors can point to about half of listed stocks in the developed world that offer dividend yields greater than their government's bonds. Admittedly this has been true in Japan for some years to no avail but the difference lies in the concerted effort to create liquidity. In addition, sceptical investors like Platinum cannot figure out how the explosion of the money-base will not result in fears about inflation. Even now, prices keep rising with seemingly low capacity utilisation. This leaves bond holders poorly rewarded at current yields. Do note that even without heavy printing, consumer prices in the US since World War II have risen by 3.6% pa compound!

The last building block for **our optimism lies in compelling valuations**. We have recurrently voiced our concerns about the sustainability of record corporate profitability, and the need in some cases to normalise valuations for this factor. However, there are many areas where this is less evident. In the case of Japan, profitability has been suppressed by the high value of the Yen. Even in the face of this burden, remarkably, profitability has been rising and now with the Yen weakening, there will be groups of companies that really flourish. In addition, the flow back of funds can be expected to be particularly sharp as domestic investors flee from bonds and foreign investors scamper to get their weightings back to the benchmark. Even though foreigners have been accounting for the majority of turnover in the Tokyo market for some time now, surveys show that they were underweight, though keen buyers into the year's end.

All our quant work, some of which has been shown in earlier quarterlies, shows most markets to be attractively priced and within markets, some sectors are compellingly cheap. We believe our exposure to these will reward us in the months ahead.

Outlook

We believe the leadership of the markets will continue to rotate in the manner first seen in the last five months of 2012 with the defensive leaders losing their position to more cyclical sectors as excessive fear is replaced with growing confidence. That there will be periodic swoons is highly likely but that the emphasis will be on opportunities rather than risks. At this stage we are not calling for the start of a generalised bull market in equities but believe that upper bands will be challenged in specific markets. Should the BOJ succeed in weakening the Yen, Japanese stocks could astound investors. Some emerging markets could make new highs.

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