Platinum Capital® Limited Quarterly Investment Manager's Report

31 December 2013

Platinum®
CAPITAL LIMITED
ABN 51 063 975 431

Performance

Investors will be pleased with the way the year worked out. The key was to have faith that the economic system was gradually mending, that cheap money would persist and that on account of relatively weak demand and abundant capacity, the prospect for a general rise of inflation was remote. While keen advocates of the liquidity argument, we have been surprised by the enthusiastic re-rating of equities but not of the rotation away from defensives towards cyclicals.

When our performance was trailing some two years ago we tested our portfolio to ascertain whether there was **consistency between our investment approach and what we actually owned**. This exercise which is quantitatively based showed that not only was the portfolio totally in keeping with our investment style but that in aggregate the quality of our holdings **was probably the best we had ever achieved**. Quality is defined here by a portfolio comprising companies that have demonstrated above average historic profitability and growth patterns yet employed below average leverage and were on unusually low valuations. It is therefore not surprising that once investors escaped from their mire of fear that they rotated to these types of holdings. This, together with no ownership of the Australian dollar, has allowed the Company to achieve an excellent return that has outpaced the MSCI World Index by 0.8% over the quarter and 7.6% for the year with a respective pre-tax return of 12.9% for the quarter and 50.1% for the year.

MSCI* World Index Regional Performance (AUD)

REGION	QUARTER	1 YEAR
Germany	18%	52%
India	15%	12%
United States	**15%**	**53%**
Developed Markets	**13%**	**47%**
Europe	**12%**	**44%**
United Kingdom	12%	40%
France	11%	47%
Korea	9%	21%
China	8%	20%
Asia ex Japan	**8%**	**20%**
Hong Kong	8%	29%
Japan	**7%**	**48%**
Emerging Markets	**6%**	**13%**
Australia	4%	21%

* Morgan Stanley Capital International
Source: MSCI

MSCI* World Index Sector Performance (AUD)

SECTOR	QUARTER	1 YEAR
Information Technology	16%	47%
Health Care	14%	58%
Industrials	14%	50%
Consumer Discretionary	13%	58%
Telecommunication Services	13%	43%
Financials	12%	42%
Energy	10%	32%
Consumer Staples	10%	37%
Materials	9%	15%
Utilities	7%	28%

* Morgan Stanley Capital International
Source: MSCI

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 2013	30 November 2013	31 December 2013
$1.4347	$1.5086	$1.5625

Source: Platinum

Changes to the Portfolio

Geographical Disposition of Platinum Assets*

REGION	DEC 13	SEP 13
North America	24%	27%
Europe	24%	25%
Asia	24%	25%
Japan	18%	13%
Africa	2%	3%
Australia	1%	1%
South America	1%	1%
Cash	6%	5%
Shorts	10%	14%

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

We used the market's exuberance to shift out of several long-held positions to rebalance the portfolio towards weaker performing drug companies, some relatively deep value Japanese companies and unusually for us, to add to strongly performing internet companies which are out-running our forecasts.

We removed **Adidas** in full, a huge performer up nearly four fold in four years; halved the position in **Micron Technology** which has given us over three fold in a year; sold out **Deutsche Börse** which had only returned its annual dividend; sold all of **Sotheby's** which was helped along by shareholder badgering, and continued to reduce **Amadeus**, **Henkel** and **Bank of America** which have doubled and tripled since they were bought or added to. As we state so frequently, there is nothing wrong with these fine businesses but their prices reflect little doubt and seem unlikely to provide the returns we might earn elsewhere.

China Resources Enterprise was sold down on account of their persisting with their chase for scale in Chinese retailing. We are disappointed to leave this stock on account of their dominant position in beer which is now becoming much more profitable and up-market but are troubled by their aggressive geographic expansion in retailing which is clocking-up large losses. We also disposed of **JSR** (chemicals) and **Aeon** (retailing) in Japan, preferring deeper value plays like **NTT** (telco) and we increased the position in **Mitsubishi Corp** on account of their revenue streams being more resilient than we had initially thought.

We have written in the past about the transformation of several drug stocks and have used price retracements to rebuild **Sanofi** and **Novartis**, while adding to positions in **AstraZeneca** and **Daiichi Sankyo**. The latter two are among the cheapest drug companies around and are set to change.

An interesting 'fallen' tech company is **Ibiden**. This Japanese-based manufacturer of intricate packaging of high-end logic chips for Intel, chip-sized packages for mobile devices and any-layer printed circuit boards plus ceramic substrates for catalyst converters, had fallen out-of-favour as its profits tumbled. It had a golden period back in 2006-2008 when it made huge profits in the auto catalyst boom. We are banking on their next boom coming from the growing sophistication and market in mobile devices.

While the market correctly frets about the possible diminution of their market potential in CPU (central processing unit) packaging, on account of slow or no growth in PCs, we can imagine how the rest of their packaging business, where they are the world leader, can become highly profitable. Miniaturisation implies manufacturing complexity and Ibiden has mastered printed circuit boards that run to six levels of connectable stacks, allowing circuit designers improved design flexibility. At present, heavy up-front depreciation accounts for 15% of sales but as utilisation rises and depreciation reverts to lower levels, the published profits will then lever-up significantly.

Shorting

We have been relatively inactive, though towards quarter end we established some puts on the Russell 2000 and S&P 500 Indices on the basis of our technical indicators suggesting that these markets are extended. Partially offsetting this caution is a long position of the Topix Index which we see as being in a very strong bull phase, assisted by the weaker Yen and the prospects of Japanese households entering the stock market with their new tax-shielded savings plans. Individual stock shorts and net index shorts total about 10% of the Company with the out-of-the-money puts giving us leveraged protection to the downside. The Company's net exposure, taking account of cash, is 84%.

Currency

Our currency positions are as follows: US dollar 38%, Euro and European currencies 26%, Asian currencies excluding Japanese yen 18%, Australian dollar 10% and Japanese yen 5%.

Commentary

Some may be confused by all the excitement around 'tapering'. We have just had the outcome of the late December meeting of the Fed and a reduction of buying US government and mortgage-backed bonds is to begin in January, accompanied by the promise of a protracted period of very low short-term rates. Having watched the live coverage of Fed Chairman Bernanke's testimony, it was clear that the Fed is troubled by low price increases in the face of enthusiastic Quantitative Easing (QE). The concern has shifted to the potential of deflation.

Having known a period of chronic inflation in the early 1970s, it is confounding to hear of the need to do everything in one's power to ensure that there **is** an erosion of one's currencies purchasing power. At that time there was over-regulation of most things which reduced competition and led to insular anti-competitive behaviour, be it labour or international trade. The subsequent extended period of deregulation and flourishing global competition, accompanied by the explosive growth of consumer credit was the very antithesis of that earlier period and led to excessive financial leverage. This is being gradually reversed now but stable or falling prices would exacerbate the consumer's ability to reduce this burden and hence the current thinking regarding the difficult choice of punishing the frugal for the benefit of the many.

For all the media coverage, it is nevertheless true that the US economy has achieved job growth of the order of 146,000 per month since October 2009. The underlying numbers show a gross total of 7.8 million new jobs having been created, while 663,000 government-related jobs have been eliminated. Unemployment in the US is now at 7% but as an indication of the politicising of the Federal Reserve, this great achievement is seen as too little by the political elite and media. This four year recovery has witnessed annualised growth of 2.3% which contrasts with more energetic outcomes in previous cycles – but what did we expect?

The more interesting aspect of all this is that US monetary policy has, through transmission effects, forced easy monetary policy on other economies. With the prospect of rates rising in the US, the dollar could rise which will adversely affect the translation of offshore profits (and be a depressant on prices in general). The adverse effect of low inflation for corporations lies in its reduced pricing flexibility and the prospect of a ***reversion of profits to a lower share*** of the economy. At present this is at a record high level and yet the market is placing these earnings on 17 times which itself is above the long-term average of 15 times.

Why so, one asks? **Liquidity** is the most common explanation and we are inclined to believe that until the market becomes more unsettled about **corporate pricing power**, liquidity will reign supreme. Indications of this lie in the all-time record use of margin credit, the switch from cash and bonds into equities and other remarkable developments such as the explosion in the growth of trading in **volatility futures**. There are now Exchange Traded Funds (ETFs) on the VIXS (VIX is the Chicago Board Options Exchange Market Volatility Index) and a plethora of alternative vehicles by which to play it. The product that intrigues us most is the fantastic rise of **Bitcoin** and a host of its emulators – some 27 going by names like Litecoin, Peercoin and Namecoin.

This is a truly remarkable phenomenon. In the face of a meltdown in the gold price (off from $1,811 to $1,200 per ounce in 30 months), this *digital currency* has risen in price from $12 to over $1,000 and now back to $700 in a single year. It is a remarkably clever concept, seductively so for tech geeks. There is a limit to the number of coins that can be produced, which is 21 million, and over half are already in circulation at a *value* of US$7 billion. Every transaction in the history of the Bitcoin economy is recorded on a distributed public log – the innovation of the Bitcoin system – and one records/transfers one's own holdings by virtue of public/private key encryption. The integrity of the log is enforced by the implementation of a **hashing algorithm** to form a mathematical puzzle that is used to both produce new coins and to verify transactions. Importantly, pending transactions that are yet to find their way onto the public log are packaged into blocks (at the discretion of the miner) and are verified/audited by means of solving a progressively more complicated calculation[1] to a standard algorithm. The so-called **miner** who solves the problem first is rewarded with an ever decreasing amount of new coinage[2] and in some instances may get a transaction fee from transactors who wish to expedite the recording of their transaction[3].

This open system thus breeds in an environment of frenetically competitive mathematical-problem solving which results in the reward of acquiring Bitcoins. It is this vibrant competition that is supposed to nurture the system and ensure that all transactions are verified and added to the log, ultimately proving their authenticity and disallowing the double spending of Bitcoins.

Once a block has been mined (solved), the block is broadcast to the network and added to the public record[4]. As the solution to the working block's puzzle is dependent on the solution (hash) of the previous block, this systematically forms a **chain of blocks** that expands as usage grows, with each transaction carried in subsequent blocks. Furthermore, to modify the block chain at a point in time would incur immense (and practically infeasible) computational expense as each subsequent block will need to be re-solved[5]. The difficulty in modifying the public record is a central feature to the Bitcoin system and allows its participants to place trust in the digital protocol, as opposed to being in the hands of government.

1 The complexity scales up or down depending on the amount of computing power on the network by way of an adaptive algorithm.

2 Hence the upper limit on the number of Bitcoins that can be 'mined'. This works out to be 21 million.

3 There is a limit to the number of transactions that can be packaged in a block. To incentivise a miner to include a transaction in the current working block (as opposed to subsequent blocks which may be some time away from being mined), one may offer a transaction fee.

4 Of course a block needs to be accepted by the broader Bitcoin network i.e. the solution to the mathematical puzzle must be verified by other miners who ultimately signal acceptance by beginning work on the next block.

5 If one were to obtain >50% of the computing power on the network, given enough time, one would eventually be able to 'fork' the public log with one's own version of history. To achieve more than half of the current computing capacity of five million giga hashes per second, we estimate that one would need to spend $50 million if one could lay one's hands on suitable gear.

To a novice this all seems a rather cumbersome way to record one's payments when there are cheap or free traditional means of exchange. The difficulty of tracing transactions has been the principal driver in the use of Bitcoins thus far. However, for on-line commerce, the case is made that transaction fees are too high with card-based settlements, that Bitcoin ensures that there are no charge-backs to the merchant and that Bitcoin is unimpeded by government snooping. However, Bitcoin has its own short comings, the confirmation of transactions typically take 10 minutes and sometimes a lot longer; fees, though still infinitesimal, may need to grow to keep miners motivated as the number of coins reaches the termination number and the integrity of the system depends on no one having more than 50% of the current computing power on the network. More prosaic issues like the huge swings in the value of this fiat medium of exchange, the absence of income on deposits, the perceived need to protect consumers and the loss of seigniorage[6] (by the State), do not seem to bother the aficionados. They have their eyes firmly set on the low cost of acquiring the ASIC-based algorithm solvers and the excitement of the chase to mine coins.

Governments are already responding with well-publicised raids of some sites that were deemed to be trading in illicit goods, while China has banned further trade in Bitcoins and the Norwegians are treating gains as taxable. One suspects that the heavy hand of State will **nip this Tulip in the bud** and if not, it will probably prove an interesting marker for current market excesses, complementary to the art market and high-end property.

Outlook

It troubles us that re-rating of equities has been the principal driver behind some stocks this last year. Earnings must follow to validate these valuations or these stocks will come under pressure. Fortunately, we are stock pickers and as was indicated in the introduction there are several sectors that have been left behind. There has also been significant divergence among companies which gives rise to interesting investments.

We remain committed to our principal themes of a resurgence of the internet software providers, led by social media; the credit recovery of Western banks and a turning interest rate cycle for emerging market banks; capital spending opportunities related to investment in shale gas and oil; the valuation and growth case for the pharmaceutical companies and the continuing improvement in the structure and profitability of Japanese companies.

Kerr Neilson
Managing Director

6 The difference between the value of money and the cost to produce and distribute it.

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