Platinum Capital® Limited Quarterly Investment Manager's Report

31 December 2014

Platinum®
CAPITAL LIMITED

ABN 51 063 975 431

Performance

Among developed markets there has been one predominant winner in 2014: the USA. Now several years into its recovery, the US economy has continued to expand with strong employment and personal income growth accompanied by a cautious rise in consumer credit. This has seen the stock market continue to roll higher on reasonable earnings growth, but also on a higher valuation being attributed to those earnings.

By contrast, the problems around a common currency, without a common tax collector, have caused Europe to splutter along as members of the European Union (EU) rebalance their economies to direct more activity to meet external demand at the cost of domestic consumption. This achievement of broad current account surpluses, aided by lower energy costs, sets the scene for more vigour in the year ahead, but, in the face of tepid bank lending, the Euro Stoxx Index has been unwilling to pay-up for the promise of a more competitively placed Europe.

With the exception of Malaysia and Australia, Asia is a huge beneficiary of lower energy costs, but thus far the markets seem to have responded principally to promises of reform and lower interest rates. This was most evident in the Indian and Chinese markets which have even outpaced Wall Street notwithstanding the complications that reforms engender. The Japanese and Korean markets have been relatively flat, perhaps reflecting their weaker resolve to change.

From a shorter term perspective, the final quarter of the year revealed the caution that still haunts markets. Concerns about slowing growth, particularly in China and Germany, culminated in a sharp correction in October, but the prospect of more policy action and the benefits of lower energy costs enabled markets to recover by year end. Energy and energy producing nations fared less well as the Organisation of the Petroleum Exporting Countries (OPEC) meeting in November revealed little cohesion on price support measures for oil. The pain was felt in Russia and its currency, the Rouble, as well as in the high yield debt markets where over US$320 billion has been raised by shale drillers over the last five years. There are obviously further-reaching implications for suppliers and producers in the oil and gas industry, but our reckoning is that these will be localised losses rather than more widespread problems.

Overall, the MSCI AC World Index had a good year and, when assessed in Australian dollars, the returns were magnified, achieving 13.9% for the year and 7.4% for the quarter.

The Company returned 6.0% (pre-tax) for the year and 4.0% for the quarter. We achieved less than the Index principally because of our low weighting in the pre-eminent and strongest performing component of the Index, the US market (52% weighting and +23% return for the year). We also have some exposure to Russian shares, oil sands producers as well as those engineering businesses that were to have benefitted from the investment bonanza in plant building and extraction. Some offsetting benefits were gained from holdings in Asia.

Currency

The US dollar has remained our principal currency position at 78% (which includes 12% in the Hong Kong dollar).

We hold no Japanese yen or Australian dollar and are partially hedged out of the Euro, the Chinese renminbi and the Korean won.

Shorting

Our short positions remain in place to reduce the volatility within the portfolio, though weaker prices encouraged us to reduce some of our stock-specific hedges in October. We also reduced our index hedging on account of the lower oil price. The International Monetary Fund (IMF) calculates that the US$40 fall in the crude price can add half a percentage point net to global growth; large energy producers are clearly losers, **but the benefits to consumer incomes in energy deficient countries, and the latitude it grants their Central Banks to better tailor policies to domestic conditions, are profound.** As the weakness in the price of hydrocarbons can be largely attributed to the additional supply from American shales, and Russian and Iraqi oil fields, one can expect American shale production to ease back, but our assessment is that we may enjoy soft hydrocarbon prices for 12 to 18 months.

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

Net Asset Value

	PRE-TAX	POST-TAX
31 October 2014	$1.5928	$1.4795
30 November 2014	$1.6738	$1.5364
31 December 2014	$1.6485	$1.5563

Source: Platinum

MSCI* World Index Regional Performance (AUD)

REGION	QUARTER	1 YEAR
Developed Markets	**8%**	**15%**
Emerging Markets	**2%**	**7%**
United States	**12%**	**23%**
Europe	**2%**	**1%**
Germany	7%	-2%
France	0%	-2%
United Kingdom	2%	3%
Japan	**4%**	**5%**
Asia ex Japan	**7%**	**15%**
Korea	-2%	-3%
China	15%	18%
Hong Kong	10%	15%
India	6%	35%
Australia	3%	6%

* Morgan Stanley Capital International

Source: MSCI

MSCI* World Index Sector Performance (AUD)

SECTOR	QUARTER	1 YEAR
Consumer Discretionary	13%	13%
Information Technology	11%	26%
Utilities	10%	24%
Consumer Staples	10%	16%
Health Care	10%	29%
Financials	9%	13%
Industrials	8%	10%
Telecommunication Services	4%	7%
Materials	1%	1%
Energy	-10%	-5%

* Morgan Stanley Capital International

Source: MSCI

Changes to the Portfolio

Geographical Disposition of Platinum Assets*

REGION	DEC 14	SEP 14
Asia	37%	29%
North America	24%	22%
Europe	22%	22%
Japan	8%	12%
Africa	2%	3%
Russia	1%	3%
Australia	1%	1%
Cash	5%	8%
Shorts	7%	13%

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

Source: Platinum

The principal actions were to cut our exposure to metals and Japan, and to add to IT companies in the US and utilities in Asia.

We have made some reasonable returns from the metal theme, particularly aluminium, but prices moved quickly and started to over-anticipate prospects in companies like **Hindalco** which we trimmed along with the nickel plays.

There was a bid from the oil services company Halliburton for **Baker Hughes** in November which caused a strong price lift allowing us to exit our holding.

In Japan we sold all of **NTT** after a good run and also sold out of **Mitsubishi Corporation** and **Mitsubishi UFJ Financial Group**, believing that we can use the funds to better effect elsewhere.

With all the excitement surrounding the Internet plays, it has surprised us that some of the great stocks of the tech boom of 2000 have become somewhat neglected. Each has its own threats regarding substitution but, on careful analysis, these companies reveal unusually fine business characteristics, and yet in the face of such uncertainties companies like **Oracle** and **Cisco** had become priced as sub-par businesses. While it may seem improbable that well-known brands like these should be misunderstood, we can mount a strong argument why they should both grow and remain decidedly more profitable than the typical company in the S&P 500 Index. Bolstering our confidence is the experience we have had with **Intel**, which has outperformed considerably over the last 12 months.

Lastly, our new investments in Asia are targeting infrastructure in India and China. The companies themselves are fine, but out-of-favour, because they are seen as dull. As you would have read in these reports on countless occasions, dull is delightful if the price is right. Here we can buy electricity generating or gas transmission capacity for little more than book value with the prospect of significant growth in demand reaching out into the distant future. They are not highly levered and are presently earning weak returns for transient reasons. In the case of India, even if the economic promise of the Bharatiya Janata Party (BJP) falls short of current ecstatic expectations, these companies are still likely to be bigger and more profitable in the years ahead.

Commentary

From media coverage one might derive the notion that deflation is some sort of insidious disease. It may then surprise some readers that there are **historical precedents of long periods of stable prices**[1] with wave-like tendencies, that differ in amplitude and duration with no periodicity. To the ardent monetarist it may also come as a surprise that two of these waves of stable prices were accompanied by large injections of additional money in the form of precious metal discoveries. The point being made here is that **the scare of flat or falling prices** is normally misplaced as implicitly it **reflects improving purchasing power by the populace** (higher real incomes). The threat in modern economies lies in the extravagant and persistent rise in the use of credit as well as growing labour dependency[2] which was absent in these earlier episodes.

For those who buy into the **argument that deflation leads to deferment of consumption**, we can point to Japan and find **no supporting evidence whatsoever**. The fact is that incomes fell from 1995; savings were drawn down to mitigate the income squeeze and expenditure patterns altered in favour of the likes of communication, recreation and household effects at the expense of clothing, housing and food.

1 For elaboration, perhaps read David Hackett Fischer's book, *The Great Wave: Price Revolutions and the Rhythm of History*. He points to four great waves of inflation in the West since 1200 AD. He calls them price revolutions that took place during medieval times, the 16th, 18th and 20th centuries. Each of the first three waves was followed by a protracted time of price stability. The price revolutions were associated with lagging real incomes, social instability and insecurity. By contrast, the periods of stable prices saw interest rates progressively fall and spawned the Renaissance, the Enlightenment and the great Industrialisation surge of the Victorian era. The most interesting and perhaps relevant period was that of the 19th Century. Here we saw real wages rise by about threefold and interest rates more than halve variously from 4 and 6% in the Netherlands, France, Britain and the USA. Rents expressed as a percentage of sale prices of land were relatively flat while share prices compounded up by 4 to 5.5% per annum in markets such as the US, Britain and France. The most intriguing point was that the supply of specie – gold and silver – grew dramatically – sixfold – in the US from 1830 to 1850, while world production of gold and silver looks to have risen by nearly tenfold over the century. During the period of the American Civil War, prices escalated but subsequently fell back to complete **a century of FLAT prices**.

2 This is a measure of those below or above the working age supported by those between 15 and 65 years old. This ratio or burden on those in the workforce started to increase in many Western countries from about 2010. Countries like Japan and China are projected to face a steady but sharp rise in dependency as the pool of workers shrinks. Japan could find there is one dependent for each worker by 2050.

The phenomenon of a national debt blow-out is most evident in Japan where the rise of the debt burden has way outpaced the growth in the nominal economy. Economic theory holds that inflation can resolve part of this problem by debt becoming a smaller proportion of the economy when the latter is being inflated by a general rise in prices (inflation). In fact, Japan has seen debt rise in real terms and it continues to climb at a time when the ratio of retirees to workers has grown. The government has been meeting its budget deficit by issuing Yen-denominated bonds which have been purchased almost exclusively by the local populace, but in turn the Bank of Japan has in recent times been buying – monetising – well over 100% of this new issuance. An eventual **default should thus fall on the locals via a sharp deterioration in their global purchasing power**, with the greatest pain likely to be felt by the older members of the community (i.e. there is a redistribution mechanism at work).

Globally, the same experiment is being conducted with quantitative easing (QE). Like in the 1930s, the game was won by those who chose to devalue early; living standards fell faster than those of their competitors, allowing a competitive advantage to support jobs and transfer the pressure via the currency to their principal competitors.

An interesting discussion then arises from the behaviour of governments following the global financial crisis (GFC). Vast quantities of debt were issued to pay for blow-outs in deficit spending as governments tried to fill the void created by the private sector's retrenchment. To some, the surprise has been the lack of pricing power of labour, in particular, which when combined with plentiful supply of commodities, including oil, has seen inflation undershooting expectations and in some quarters disappointing policy makers.

The nexus between Central Banks and their governments, notwithstanding supposed independence, seems likely to result in an over-dependence on monetary policy. In plain English, one might expect the Central Banks to over-react to price stability in order to placate popular demands so as to be seen to be doing something.

The **framework we have chosen** to adopt is that the **excess supply of most commodities** combined with begrudging **lending policies** by the banks and, in most instances, reluctant borrowing by firms and individuals **will lead to weak prices (low inflation)**. However, the hunger for yield has persuaded investors to take more risk. By forcing down yields, Central Banks have encouraged a narrowing of the risk premium between good quality and lower quality borrowers. This in turn has allowed risky borrowers to raise medium-term funding at a lower cost than the price traditionally paid by sovereign borrowers, as noted in our June 2014 report.

Among lenders are those exposed to the oil patch with the estimated US$320 billion raised in the last five years and which is now trading below face value. The other surprise from weak oil and other commodities is showing up in the finances of large petro carbon producing nations like Russia where the private sector has borrowed abroad in external currencies to now find their revenues diminished and yet their foreign loans translated into multiples of what they imagined they had borrowed. The damage occurring seems confined to the fringes because most of the new debt created since 2008 has been incurred by governments with their unique fall-back of being able to meet their obligations through taxation. With the policy of Central Banks buying part of the outstanding stock of their government bonds and thus increasing the level of liquidity within their system (QE), this for the most part has been a redistribution exercise. The **transfer of wealth is from those holding paper assets** to those holding real assets like shares and property. Those with paper assets are experiencing a net loss in wealth with their purchasing power, as measured by a basket of currencies, having fallen.

In essence, the danger of these policies resides in the **type of borrower**. If it is a government borrowing in its own currency, like Japan or perhaps Russia, the consequences of a dislocation are likely to be far less severe than when there is a credit binge by the private sector. The dislocation becomes all the more traumatic when the borrowers have mismatched currencies or built their assumptions upon rosy views about commodity prices and the like. **Very simply, excess use of credit leads to busts**, but thus far the low cost of borrowing is mainly confined to **a relatively small fringe of borrowers**. There is still a great deal of caution which is contributing to slow growth, but ironically probably suggests there is less risk than is presently perceived.

Outlook

We remain optimistic and take comfort in several factors. Volatile markets and persistent switching by pension and life insurance companies from equities to bonds mark wariness by investors. This is puzzling in light of the growth of the US economy and the broadening health, if not growth, in Europe as the problematic members have all developed current account surpluses. The US$40 fall in the oil price is a resounding benefit to consumers across the globe, not least for energy-deficient countries like India and most of Asia, other than Malaysia and Australia. Importantly, lower energy costs will impinge on the US Federal Reserve Bank's tightening agenda and improve many emerging economies' independence to follow monetary policies that better suit local needs. In other words, even if the US Federal Reserve does start tightening to ward-off pressure emanating from, say, a tight labour market, the lower oil price will allow some Asian countries to cut rates.

The portfolio has been progressively tilting towards Asia. We can still find shares to buy in the West, but within the reform-minded countries of Asia there are bargains. Having been the leader of the pack on account of its earlier recovery, the US market may now surrender leadership to others. The two factors we will be watching are its tightening labour market and the suppressant effect emanating from a strong US dollar on Wall Street earnings. By contrast, China looks to be starting a new bull market fuelled by reform and easier monetary policy, while India could experience lower interest rates as inflation drops.

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