PLATINUM CAPITAL LIMITED

ACN 063 975 431

1998 Annual Report

DIRECTORS
Michael Darling
Philip Pearce
Kerr Neilson
Andrew Clifford
Malcolm Halstead

SECRETARY
Malcolm Halstead

REGISTERED OFFICE
Level 21, Gold Fields House
1 Alfred Street
Sydney NSW 2000
Phone (61 2) 9255 7500

SHARE REGISTRARS
Corporate Registry Services Pty Limited
Level 3, 60 Carrington Street
Sydney NSW 2000
Phone (61 2) 8234 5222

AUDITORS AND TAXATION ADVISORS
PricewaterhouseCoopers
201 Kent Street
Sydney NSW 2000

SOLICITORS
Allen Allen & Hemsley
2 Chifley Square
Sydney NSW 2000

STOCK EXCHANGE LISTING
Official list of the Australian Stock Exchange Limited
Ordinary Shares ASX Code: PMC

INVESTMENT MANAGER
Platinum Asset Management

Kerr Neilson ~ Global, South America
Andrew Clifford ~ Japan, India, North America
Jim Simpson ~ S.E. Asia, Japan, Korea
Doug Huey ~ S.E. Asia
Toby Harrop ~ Europe, Currencies
Rod Sleath ~ Europe
Charles Lanchester ~ Europe
Hugh Giddy ~ North America
Liz Norman ~ Shareholder Liaison

Platinum Asset Management does not guarantee the repayment of capital or the investment performance of the Company

Chairman's report

Investment Performance The Net Asset Value of Platinum Capital grew by 16.5% last year, after allowing for all tax liabilities, both realised and unrealised. On a pre-tax basis, the growth figure was 20.5%.

The table below sets out the performance of Platinum Capital in each of the four years of its operation and compares these figures to the Morgan Stanley Capital World Accumulation (Net Return) Index in A$ (MSCI), which is often used as a benchmark for the performance of international funds.

Platinum Capital's performance last year was the best for the last four years. The range of returns, from 12-20% is fairly consistent and, taking a long-term view, is very much the sort of return parameters to be targeted for equity investment.

The MSCI, both in 1997/98 and for the four years, has out-performed Platinum Capital. The simple reason for this is the Index's heavy weighting in the US equity market which has performed very strongly. In contrast, Platinum has been, and remains, largely uninvested in the US market and retains a net short position. Platinum's portfolio weighting is,

PLATINUM CAPITAL LTD PRE-TAX NAV VERSUS MSCI INDEX (%)

	1994/95	1995/96	1996/97	1997/98	4 YEAR CUMULATIVE
PCL	13.0	12.2	15.9	20.5	77.1
MSCI	14.1	6.7	28.5	41.5	121.3

therefore, radically different from the MSCI, a circumstance which reflects the Investment Manager's value-based criteria for stock selection.

From the point of view of an Australian shareholder, however, Platinum Capital continues to provide the chance for some useful portfolio diversification. The pre-tax return last year of 20.5% compares to the All Ordinaries Accumulation Index increase of 1.6%. Platinum, for most of the year, gave Australian investors foreign currency exposure in a period when the Australian dollar was falling. For some investors, Platinum's radical divergence from the MSCI may also be useful at a time when some nervousness exists about the capacity of the US market to maintain or grow from current levels.

Our goal remains to deliver for investors above average returns over the long-term by following a very disciplined approach to stock selection in markets around the world. At times this might put the company out-of-step with received wisdom, but it is done to give shareholders a better chance to receive the returns they seek.

Share Price The share price continues, in common with many investment companies, to trade at a discount to the underlying value of the company.

In an effort to address this issue, we obtained shareholder approval last year to buy back up to 20% of the issued capital of the company over a 12-month period, rather than the 10% allowed under the Corporations Law.

Over the past year we purchased 2,331,790 shares in the company, equivalent to 2.3% of the issued capital. The company currently has in operation an on-market buy-back which will terminate on 31 December 1998. It is our intention to renew this buy back to give the company power to continue to buy back its own shares.

Most of the shares were purchased at a price equivalent to a discount of about 20% to NAV.

As part of these arrangements, there is on the agenda for the Annual General Meeting a resolution extending the power to purchase up to 20% of the outstanding shares for a further 12 months.

Shareholders will also be aware that after five years of operations, ie. from 31 July 1999, if the market value of shares is at a discount to NAV of greater than 15%, a meeting of shareholders must be called to vote on whether the company should be wound up.

Dividends The company's dividend policy is to pay regular dividends of a level that can be built up over time. In addition, special dividends will be declared to pass on accumulated franking credits.

The total of these franking credits at 30 June 1998 was equivalent to 23.1 cents per share. In addition, if all unrealised tax were to be paid (and this is the basis on which the NAV figure is calculated), a further 12.8 cents per share in franking credits would result.

In February this year, a special dividend of 4 cents per share was declared. Directors are recommending a final regular dividend of 4 cents per share (up from 3 cents per share last year). A further special dividend of 2 cents per share is also recommended. This would bring the total dividend payment for the year to 10 cents per share, all fully-franked.

The company has in operation a dividend re-investment plan which allows a participating shareholder to take the dividend in the form of new shares at a 5% discount to market. In the past, the operation of this plan has been constrained by the law that shares could not be issued below par value (in Platinum Capital's case, $1.00 per share). The Corporations Law amendments, effective 1 July 1998, dispensed with the par value concept and, therefore, your Directors resolved to amend the plan accordingly. A new plan document will be despatched to all shareholders advising of the changes; namely that shares will be issued to plan participants for all future dividend payments at a 5% discount to market. The plan will be operational for the proposed final and special dividends.

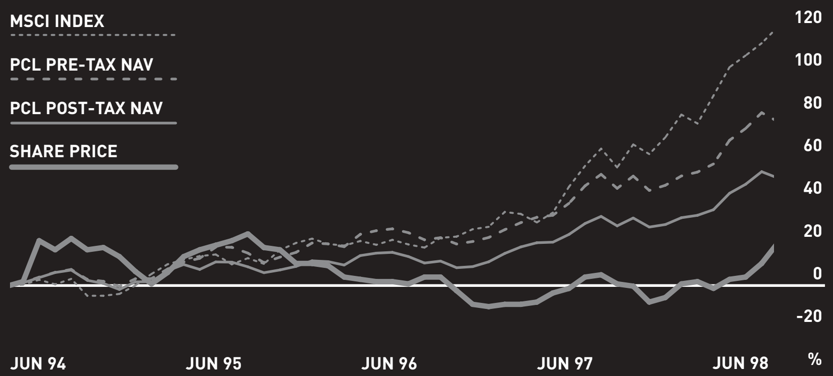
Changes to the Articles Under the Corporations Law amendments effective 1 July 1998, a number of changes have been made to the way in which companies must operate. A resolution has been included on the agenda for the Annual General Meeting which incorporates these changes into the Company's Articles of Association.

Outlook for 1998/99 The Investment Manager remains very concerned about valuations in many western markets. The current negative stance on the US market will be maintained and investments will focus on Europe, Japan and, increasingly, under-valuations in the rest of Asia.

It is not an environment in which managers can afford to be complacent – caution is very much required and additional measures will be taken to protect the portfolio from adverse market movements from time to time.

Michael Darling Chairman

PCL NAV (PRE & POST-TAX), SHARE PRICE VS MSCI INDEX (CUMULATIVE RETURN)



Performance The company has made good headway in raising its Net Asset Value, and through the tax levied at source, has created large franking credits. After a disappointing first half of the year, when some of our holdings became entangled in the Asian contagion ie. investments in Korea and Brazil, the portfolio has risen significantly in the second half. Leading the surge has been our European shares, notably those in France and Italy, which we had accumulated at a time when those markets were considered doubtful contributors to Monetary Union. It may surprise some readers but the holdings in Japan (with that country's sullied image) have given us good returns. As we have conceded in the past, this is a dysfunctional economy and therefore it would be surprising if the financial markets were good at pricing financial assets, hence our ability to earn opportunity rents. The small proportion of holdings in America failed to fully capture that market's advance and the over-hedged position dragged on our performance.

As valuations in the western hemisphere are mostly at unprecedented high levels, we have continued to maintain an over-hedged position against the US market as a form of insurance against that market and western markets in general.

Commentary It has been interesting to witness the gradual souring of the view of the Tiger economies. Late last year, the consensus was that a contraction of imports and a surge in exports (induced by a massive fall in their currencies) would ensure that the region would have no more than a temporary setback. As time has passed, the picture has become increasingly grim. Social harmony has been threatened, unemployment has surged and hunger stalks. Far from being a blip, the disruption is now endemic. The IMF's intervention is being seen as a grand failure and in some circles it is regarded (sadly) in a more sinister light. The consensus forecast is now for a much more gradual recovery with the bottom not quite in sight. Adding to concerns is the poor performance of Japan and the prospect of China falling well short of expectations (see the analysis at the back of this report).

Fear has mutated into perceptions of opportunity in the markets of the west. By late December 1997, the interpretation had started to alter to regard Asia's woes as the west's gain. Cheap imports from Asia and the view that the Federal Reserve Board needs to keep interest rates low (to accommodate Asia, among other things) are seen as favourable stimuli for stock markets. The so-called Goldilocks environment, ("not too hot, not too cold... just right") which allows for slow but steady growth and minimal inflation is leading to valuations not seen even in the booming 1960s (some enthusiasts even argue that the economic cycle has disappeared).

At the same time, stock markets have become extraordinarily dichotomous. The weak are being pummelled while the strong are applauded. It is difficult to find any historic precedent where markets have so differentiated between the two. In particular, we find emerging markets being valued as though they will always have high risk premia and presumably low growth. Quality listed companies in South East Asia and Latin America are now found trading on low trailing PEs, typically 6-12x. Such quality companies have very strong business franchises supported by a history of high profitability and growth and in general, modest levels of debt (lesser companies are being valued more harshly still). The explanation for these low valuations may lie in the fact that their host countries have surrendered their independence to the whims of international capital providers, as we warned in September 1997. However, do investors really believe that these companies have gone ex-growth or that risks have risen to such high levels that they warrant differentials in valuations of the order of half to a third of comparable businesses in the developed world?

Turning to the western markets, we can observe a narrowing of leadership and a preference for large companies with seemingly clear growth prospects. Here one identifies well-known, brand type companies or at an extreme, the likes of internet stocks, mobile telephony and associated businesses. We are being asked to pay high multiples of sales on the basis of prospective customer sign-ups and in some cases dubious assumptions that the present level of gross operating margins will be sustained even when the helter-skelter growth subsides.

For your interest, we show on the following page a valuation table of typical internet stocks. Note the payment for promise. The price to sales ratio highlights the euphoria.

The origins of this dichotomy lies, we believe, in the deflationary tendencies that are so evident. (These in turn have their origins in massive currency imbalances that contributed to the creation of surplus capacity in manufactured goods.) In their attempts to avoid the areas of sloth, investors have charged headlong into the more promising pastures of Europe and the US. Tacit concerns about slowing growth is causing investors to discriminate against smaller sound companies in favour of those with highly visible prospects and predictable growth. In other words, the risk premium attached

TOP TEN HOLDINGS (AS AT 30 JUNE 1998)

STOCK	COUNTRY	INDUSTRY	% HOLDING
Rinascente	Italy	Retail	5.2
Swiss Industrial Group	Switzerland	Packaging/Engineering	3.2
Mikuni Coca Cola	Japan	Bottler	2.9
Douglas	Germany	Retail	2.8
Acuson	US	Medical Equipment	2.8
Sony Corporation	Japan	Electrical Equipment	2.7
Hornbach	Germany	Retail	2.7
Lagardere	France	Media/Defence	2.6
Wella	Germany	Hair Products	2.5
San Paolo	Italy	Banking	2.5
TOTAL			**29.9**

DISPOSITION OF ASSETS

REGION	30 JUNE 1998	30 JUNE 1997
Western Europe	45.7%	31.9%
Japan	25.8%	31.8%
North America	8.3%	2.9%
South America	3.8%	5.6%
Other Asia	2.7%	11.0%
Australia	2.1%	1.1%
Russia and Eastern Europe	0.4%	–
Cash	11.2%	15.7%

COMPANY	MARKET CAP US$ BILLION	SALES US$ MILLION	PRICE TO SALES RATIO x	PRICE CHANGE YEAR TO DATE %
Amazon	6.1	226	27	+312
America Online	23.8	2,464	10	+144
At Home	6.1	7	827	+106
Doubleclick	1.2	54	22	+173
Lycos	1.5	60	24	+91
Netscape	4.0	534	8	+69
Onsale	0.5	117	4	+42
Infoseek	1.2	49	24	+249
Excite	2.4	87	28	+230
Yahoo	8.0	90	89	+150
S&P 500 Index	9,074.0	4,537	2	+18

to smaller companies has risen, even though as a group, they have historically grown the fastest. Given our philosophy to invest in under-priced, neglected stocks, it is inevitable that we find the oppressed more interesting than the lauded. However, we are unwilling to simply buy the deeper value because of the great uncertainties and weak macro-economic factors which will bear down on many businesses for the time being. Our preference is to mostly occupy the middle ground of companies with strong businesses that are growing and where valuations are attractive in a world where the risk free rate (ie. government bonds) is likely to stay at around 5%. In Europe, this growth is often seen in companies engaging in restructuring and rationalisation and/or consumer sensitive companies. In Japan, our focus is very specific with the emphasis split almost evenly between pharmaceuticals, Coca Cola bottlers and exporters/technology stocks. The few holdings we have in the United States are enterprises where profit margins are likely to rise significantly led by new product introductions. Sprinkled throughout the portfolio there are several deep value plays.

Outlook It is true neither that the eastern hemisphere is without interesting opportunities nor that the western hemisphere has found the elixir of ever increasing profits and low risk. Our sense is that at present valuations, the risk adjusted attraction of specific stocks in eastern markets is at least as attractive as those in the west.

While we are very conscious of the economic and social disruption caused by the collapse of confidence in Asia, some very interesting opportunities are emerging. Moreover, changes are being instituted and in particular the illiquidity of the Japanese banking system is now being addressed.

Our recent visit to Japan reinforced our view that companies have become much more conscious of globalisation and the need to make respectable returns on funds employed. Although these lessons are being learned reluctantly, the response one now receives in company meetings is more positive and direct. It does not take a lot of imagination to envisage a scenario which is very positive for the better companies within the country and this should translate into higher returns. Further, we note that even in this dull market (up 2% over six months in A$ terms) we have made good returns from Japanese stocks earning 14% in A$ terms.

In the rest of Asia, we are now starting to take more interest but remain wary about profit transparency.

Within Europe, we are likely to continue to see investors rotating to new areas of excitement as has occurred in Wall Street. The focus will remain on restructuring/rationalisation ideas which are now entering their second phase. As the portfolio composition suggests, several of the domestic-focused retailers meet these criteria.

The US market is showing the same tendencies that we have highlighted in the past with the most popular stocks being attributed ever higher valuations. There is a clear tendency for the smaller stocks to underperform the S&P index. Those with capitalisations of $2 billion or less have typically declined by more than 20% from their 52 week highs; indeed by greater amounts for those with caps below $0.5 billion. Conversely, companies with capitalisations above $20 billion are still close to their 52 week highs.

Conclusion The changes we have made within the portfolio, and the preference for moderately valued companies with growing profits, gives us some comfort in an environment of generally extravagantly priced equities. Further, we will maintain our short against Wall Street and will introduce some hedging of other market indices to periodically provide additional protection.

Diagnostic Products Corporation (USA) Diagnostic Products is a David fighting against the Goliaths of the medical equipment and pharmaceutical sectors. A small, family-run business, it was started in 1971 in the kitchen of the founder to develop tests ("assays") to detect such things as infertility, folic acid, prostate cancer, and thyroid problems. The company has a strong track record of growth but despite compounding sales at over 20% remains small, with less than US$200 million in sales.

In the seventies and eighties, tests were done by combining a patient's blood sample with a radioactive reagent (the key product supplied by the diagnostic company) and measuring the radiation using a standard geiger counter. However, over time the industry has been shifting away from radioactive tests because of safety concerns and the high labour costs of manual testing. Test volumes have been increasing as physicians, wary of litigation, make sure that all relevant tests are carried out. Furthermore, new diseases such as AIDS, and new viral strains, create new sources of demand for tests. But the good growth of the industry has forced a shift to high volume test methods.

Automated testing using non-isotopic antibodies has grown rapidly, with as many as two hundred tests being run on the fastest machines every hour. The equipment involves a carousel to incubate the test tubes containing combined blood/reagent samples. These are fed into a device that fires light photons at the mixtures and measures the reaction, achieving high levels of accuracy. The test tubes are barcoded which eliminates human error and allows minimal labour input. Once the samples are loaded in the carousel, a computer controls the process: the appropriate reagents are added, incubation times monitored, test results measured and reported, and on the company's new machine further tests are ordered and carried out if the results are inconclusive. Once a machine has been leased or bought by a laboratory, supplies of reagents must be ordered frequently to carry out the tests, making this an attractive "razor and blades" business. Indeed, when we visited the company we found them adjacent to Los Angeles airport, a convenient location for shipping reagents with a limited shelf life to laboratories around the world.

The Goliaths of the industry are companies such as Abbott, Roche, Chiron and Johnson & Johnson. With ample resources, these companies were quick to bring automation to the market. Diagnostic Products was late in following the shift in testing and bought an embryonic company, Cirrus Diagnostics, in 1992. This allowed the company to make the transition to automation and over 3,500 "Immulite" machines have now been placed in laboratories around the world. However, although the machine offers one of the widest arrays of tests and superior accuracy, it is less automated than the competition. Equal to the challenge, the company developed a new generation machine which has been introduced ahead of competitor proposed new offerings and appears to exceed their performance. Selling or leasing machines is important because the reagents are specific to each company's machine; the blades cannot be sold if the razor is not sold first. Because the new machine is more automated and suits the major hospitals and laboratories, the demand for reagents will increase significantly.

An exciting development is the scheduled launch next year of the "Immugold" machine which uses a revolutionary diagnostic process for rapid results. Traditional tests normally take more than an hour because the blood has to be incubated with the reagent for a set period. The new technology, patented by Diagnostic Products, detects fluorescence occurring when sample blood molecules bind to the reagent on a thin strip of gold. Initially targeted at emergency rooms and doctors' offices where the rapid results would be in demand, this may also be the accepted testing technology of the future. This very impressive technological advance could have a very significant effect on the value of such a small company.

Although large companies have an advantage in distribution and name recognition, they have no monopoly on major innovations. We would expect to pay handsomely for a company with this record of growth and innovation, and with a predictable, bright future. It seems like a steal on less than 15 times next year's earnings and twice book value (the US market is on 23 times those earnings and almost six times book value).

Wella (Germany) Wella is the largest producer of professional hair care products (salon products) in the world. Their leading position has been built and held through genuine product innovation and technology, as well as maintenance of strong relationships with their clients – hairdressers. The strength of these relationships is witnessed by the fact that each year, over 1.2 million hairdressers pass through Wella training seminars.

The problem for Wella has been to convert their success in the professional hair care market into equal success in the chain store retail arena. To highlight the problem, we can look to L'Oréal which has similar sales in the salon market to Wella (US$1 billion), but in the retail market they are 2.5 times larger. Also, L'Oréal's retail hair care business is highly profitable whereas Wella has historically lost money and is only now near breakeven. With retail sales accounting for 50% of the company's hair care sales, the leverage from rising profitability will be enormous.

Up until the mid-nineties, Wella treated the retail market in the same way as the professional market. This meant high quality innovative technical products but little focus on what the retail market would actually buy. In practice, this meant the R&D team would develop a product, the finance team would determine the total costs of the product and add a margin to reach a suitable price, and the marketing/sales teams would have to sell it. The problem with this strategy was that the retail client is not necessarily interested in paying $20 for a bottle of shampoo, even if it is technically very good! The focus was around the technology, at the expense of market analysis and suitable marketing/product development. Distribution was also carried on in the tradition of the salon business, with the sales force recruited internally with no training or experience in mass market consumer products. It didn't appear to be recognised that selling to supermarket chains is an entirely different concept from selling to hairdressing salons. On top of this, Wella was saddled with an inefficient manufacturing base and cost structure. In Europe alone, there were 13 separate manufacturing plants and 18 major warehousing facilities.

The changes in Wella began in 1991 with a change in senior management. The new management formed a four point strategy:

- Concentration of production and logistics
- Reduction and homogenisation of product range
- Emphasis on hair care business and retail expansion
- Acquisition of well positioned brand-names and companies to support the retail expansion.

Over the following years, an aggressive expansion policy was pursued, largely via acquisitions. At the same time, the production process was shaken-up with the number of plants in Europe being cut from 13 to four, and most importantly, more focus was put on marketing and the development of the retail hair care business.

Probably the most vital action taken at Wella was in late 1993 when mass consumer retailing knowledge was brought in with the hiring of two ex-Procter & Gamble managers. These managers built a team at Wella largely from Procter & Gamble people. The changes at Wella resulting from this action have been immense. Products are now developed from the end user perspective. The rate of old product relaunches and new product launches have been sped up with the result that in 1996, 50% of sales came from products less than two years old, versus 12% in 1994. New sales teams are being trained on a country by country basis to specialise in selling to retailers. Key account managers have also been set up. Marketing budgets and product development budgets have been increased dramatically (funded by savings from more efficient production and logistics).

Despite the positive changes, the wheels fell off the Wella machine in 1995. The rapid expansion, largely through acquisitions, did not come without cost. A 1995 profit warning showed that management had lost control in a number of areas – Russia, China, the UK, and the USA all lost money for Wella. At the same time, there were large temporary costs associated with the consolidation of the manufacturing base in Europe.

Management changed again. New management stopped the policy of expansion by acquisition, and have in fact taken the strong step of closing their retail hair care operations in a number of countries where they don't have a large enough presence to justify the costs (this includes the US market). Controls in other countries have been tightened. In the two years new management have been in control, all the disaster areas have been either turned around or eliminated. At the same time, the cultural changes introduced by the previous regime have been encouraged.

Today, the company is in an envious position. Wella was woken up by one management, then tamed by the current regime. The benefits of the changes, instigated by the Procter & Gamble team recruited during 1994, only started to come through to the accounts in 1996, and continued in 1997. This was evidenced by organic sales growth in the retail hair care business of 14% in 1996 and 11% in 1997. We expect to see continuing strong sales and profit growth from Wella as the retail hair care business benefits from the last seven years of internal development and change.

PLATINUM CAPITAL LIMITED **1998 Financial Statements**

In respect of the year ended 30 June 1998 the Directors of Platinum Capital Limited (the Company) submit the following report made out in accordance with a resolution of the Directors.

DIRECTORS IN OFFICE AT THE DATE OF THIS REPORT

Michael Darling	(Chairman and Non-Executive Director)
Philip Pearce	(Non-Executive Director)
Kerr Neilson	(Managing Director)
Andrew Clifford	(Director)
Malcolm Halstead	(Director and Secretary)

PRINCIPAL ACTIVITY

The principal activity of the Company during the year was the investment of funds internationally into securities of companies which are perceived by the Investment Manager to be undervalued.

TRADING RESULTS

The net profit of the Company for the year was $9,803,000 (1997: $7,738,000) after income tax expense of $4,784,000 (1997: $5,103,000).

DIVIDENDS

In respect of the year ended 30 June 1998 the Directors recommend the payment of a 4 cents per share fully franked final dividend and a 2 cents per share fully franked special dividend payable to Shareholders recorded on the Share Register on 21 October 1998, the Ex-Dividend date.

A special fully franked dividend of 4 cents per share was paid on 20 February 1998.

The fully franked final dividend of 3 cents per share for the year ended 30 June 1997 was paid on 14 October 1997.

REVIEW OF OPERATIONS

Operating Revenue

The operating revenue for the year was $128,944,000 (1997: $110,504,000).

Operating Profit

The operating profit before tax was $14,587,000 (1997: $12,841,000) and $9,803,000 (1997: $7,738,000) after tax.

Taxation

Income tax expense for the year was $4,784,000 (1997: $5,103,000).

CHANGES IN THE STATE OF AFFAIRS

During the year the Company purchased, on market, 2,123,260 of its ordinary shares at an average price of 92.23 cps.

There were no other significant changes in the state of affairs of the Company that occurred during the year not otherwise disclosed in this report or the financial statements.

EVENTS SUBSEQUENT TO BALANCE DATE

Since the end of the year the Directors are not aware of any matter or circumstance not otherwise dealt with in this report or financial statements that has significantly or may significantly affect the operations of the Company, the results of those operations or the state of affairs of the Company in subsequent financial periods.

LIKELY DEVELOPMENTS

The Company will continue to pursue its investment objectives so as to increase the net asset value of the Company.

ROUNDING OFF OF AMOUNTS

The Company is of the kind referred to in the Corporations Law Regulation 3.6.05(6) and, in accordance with section 311 of Corporations Law Regulation 3.6.05, amounts in the financial statements and Directors' Report have been rounded off to the nearest thousand dollars unless specifically stated to be otherwise.

DIRECTORS' BENEFITS

No Director of the Company has, since the end of the previous financial year of the Company, received or become entitled to receive a benefit (other than a benefit included in the total emoluments received or due and receivable by Directors shown in the financial statements) by reason of a contract made by the Company, or a related entity with the Director or with a firm of which the Director is a member, or with an entity in which the Director has a substantial financial interest.

DIRECTORS' INTERESTS IN CONTRACTS

The three Executive Directors are employees of and have a relevant interest in the Investment Manager and accordingly will receive some portion of the Management fee; they do not receive any Directors' remuneration from the Company.

INSURANCE

During the year the Company incurred a premium in respect of a contract for indemnity insurance for the Directors and officers of the Company named in paragraph 1 of this report.

INFORMATION ON DIRECTORS

Michael G. Darling BA Law (Oxon), MBA (Harvard)

Chairman (Age 52)

Relevant interest in 3,300,000 shares in the Company.

Mr Darling has extensive experience in international investment markets and has lived and worked in Japan, Europe, North America and Papua New Guinea.

He is Chairman of resource company Gympie Gold Limited and of portfolio investment company Caledonia Investments Limited. Other Directorships include Pilatus Capital Limited, Art Exhibitions Australia Limited and The Centre for Independent Studies Limited. He is a former Director of the Australian Stock Exchange (1986–87).

Philip A. Pearce BCom

Non-Executive Director (Age 63)

Relevant interest in 10,000 shares.

Other Directorships include Australian Resources Limited, SGIO Insurance Limited, J Boag & Son Limited and NM Rothschild & Sons (Australia) Limited. Formerly he was Chief Financial Executive Officer of Woolworths Limited and Managing Partner of Arthur Andersen & Co.

Kerr Neilson BCom, AIIMR

Managing Director (Age 48)

Relevant interest in 1,152,401 shares.

Appointed as Managing Director upon incorporation. Mr Neilson is an experienced investment analyst and fund manager. He is a Director of Platinum Asset Management, the Company's Investment Manager. Previously to Platinum Asset Management he was an Executive Vice-President at Bankers Trust Australia Limited. Prior to BT he worked in both the UK and South Africa as an investment analyst and fund manager.

Andrew M Clifford BCom(Hons), ASIA, ASA

Director (Age 32)

Relevant interest in 1,002,401 shares.

Appointed a Director of the Company upon incorporation. He is also a Director of Platinum Asset Management, the Company's Investment Manager. Previously to Platinum Asset Management he was a Vice-President at Bankers Trust Australia Limited.

Malcolm Halstead ACA

Director and Secretary (Age 40)

Relevant interest in 992,401 shares.

Appointed a Director of the Company upon incorporation. He is also a Director of Platinum Asset Management, the Company's Investment Manager. Previously to Platinum Asset Management he was a Vice-President at Bankers Trust Australia Limited. Prior to BT he was with Price Waterhouse, Sydney and Thornton Baker, London.

DIRECTORS' MEETINGS

The following table sets out the number of meetings of the Company's Directors held during the year ended 30 June 1998, and the number of meetings held and attended by each Director.

	Board Meetings		Sub-Committee Meetings	
	Held	Attended	Held	Attended
MG Darling	8	8	1	1
PA Pearce	8	7		
WK Neilson	8	6	1	1
AM Clifford	8	7		
RM Halstead	8	8		

A Sub-Committee consisting of MG Darling and WK Neilson was formed for the purposes of signing the financial statements for the year ended 30 June 1997.

For and on behalf of the Board

MG Darling Director

WK Neilson Director

Sydney 6 August 1998

Corporate governance

BOARD MEMBERSHIP
The Board has a policy of having an equal number of non-Executive and Executive Directors, excluding the Managing Director's role.

The Board may use external advisers to assist in such a process.

The Executive Directors were nominated by the Investment Manager, Platinum Asset Management.

The Managing Director is appointed in accordance with the Investment Management contract with Platinum Asset Management and the Articles of Association. Under the Articles of Association Directors, other than the Managing Director, must retire from office no later than the third Annual General Meeting (AGM) following their last election and they may offer themselves for re-election.

DIRECTORS' ACCESS TO EXTERNAL ADVICE
The Board has a policy of enabling Directors to seek external advice at the Company's expense after first notifying the Board. The Board will review the estimated costs for reasonableness but will not impede the seeking of advice. The Board will not approve for payment costs that are unreasonable in amount.

DIRECTORS' COMPENSATION
The Executive Directors are not remunerated by the Company. The Executive Directors review and determine the remuneration of the non-Executive Directors and may utilise the services of external advisers. It is the policy of the Board to remunerate at market rates commensurate with the responsibilities borne by the non-Executive Directors. The maximum amount of non-Executive Directors' fees is set at $150,000 per annum for the first five years of operation of the Company. Current fees amount to $45,000 per annum.

ETHICAL STANDARDS
The Board has instituted compliance with the Institute of Directors' Code of Conduct.

YEAR 2000
The operations of the Company are outsourced to the Investment Manager, Platinum Asset Management, to the Custodian, State Street Australia Limited and to the Share Registry, Corporate Registry Services Pty Limited. Accordingly any Year 2000 issues affecting the Company result from issues that affect the Investment Manager, Custodian or Share Registry.

The Company commenced its Year 2000 Project in February 1998. It will continue to regularly monitor the resolution of any unresolved issues until it is satisfied that it has minimal or no business exposure to Year 2000 issues.

State Street's aim is to be Year 2000 compliant by 31 December 1998. The Company monitors the Custodian's progress through its Web site and through direct communication with the Custodian.

The Company has received information advising that both the hardware and software used by the Registry, and its computer bureau, is Year 2000 compliant.

Platinum Asset Management regularly updates the Company on its Year 2000 project. The primary Year 2000 risk facing Platinum is technology. Platinum plans to be fully Year 2000 compliant by 31 December 1998. Platinum has advised that all its hardware and operating systems are Year 2000 compliant and that their primary application, HiPortfolio®, has recently released its Year 2000 compliant version. Platinum intends to test this version in the last quarter of 1998.

AUDIT COMMITTEE
The Company does not have an audit committee. It is the Directors' opinion that all matters of significance which would otherwise be dealt with by an audit committee are dealt with by the Board and that as a consequence, a separate audit committee is not warranted.

SIGNIFICANT BUSINESS RISKS
The Company is an Investment Company with a stated purpose and investment mandate. The Board has determined to regularly monitor the investment risks, including various derivative instrument risks, inherent in that investment mandate. This is achieved through regular reporting mechanisms from the Investment Manager to the Board.

Profit and loss account YEAR ENDED 30 JUNE 1998

	Notes	1998 $'000	1997 $'000
OPERATING REVENUE	3	**128,944**	110,504
OPERATING PROFIT/(LOSS)	4	**14,587**	12,841
Income tax attributable to operating profit/(loss)	5	**4,784**	5,103
OPERATING PROFIT/(LOSS) AFTER INCOME TAX		**9,803**	7,738
Amounts transferred from/(to) reserves	11	**3**	(47)
Profit on share buyback	10	**165**	–
Retained earnings at the beginning of the financial period		**8,482**	3,791
Total available for appropriation		**18,453**	11,482
Dividends	18	**9,804**	3,000
RETAINED EARNINGS AT THE END OF THE FINANCIAL YEAR		**8,649**	8,482

Balance sheet AS AT 30 JUNE 1998

	Notes	1998 $'000	1997 $'000
INVESTMENTS	1(c), 6	**119,502**	99,690
CURRENT ASSETS			
Cash at bank	13	**116**	59
Receivables	7	**1,692**	16,064
Future income tax benefit		**43**	43
TOTAL CURRENT ASSETS		**1,851**	16,166
TOTAL ASSETS		**121,353**	115,856
CURRENT LIABILITIES			
Payables	8	**4,635**	2,190
Provisions	9	**10,192**	5,181
TOTAL CURRENT LIABILITIES		**14,827**	7,371
TOTAL LIABILITIES		**14,827**	7,371
NET ASSETS		**106,526**	108,485
SHAREHOLDERS' EQUITY			
Share capital	10	**97,877**	100,000
Reserves	11	**–**	3
Retained earnings		**8,649**	8,482
TOTAL SHAREHOLDERS' EQUITY		**106,526**	108,485

Statement of cash flows YEAR ENDED 30 JUNE 1998

	Notes	1998 $'000 Inflows (Outflows)	1997 $'000 Inflows (Outflows)
CASH FLOWS FROM OPERATING ACTIVITIES			
Dividends received		**2,760**	1,382
Interest received		**429**	250
Cost of purchases of investments and currencies		**(105,279)**	(86,209)
Proceeds from sale of investments and currencies		**125,922**	106,074
Management fees paid		**(1,871)**	(1,667)
Other expenses		**(994)**	(876)
Income tax paid		**(2,645)**	(11,853)
NET CASH FROM OPERATING ACTIVITIES	13(b)	**18,322**	7,101
CASH FLOWS FROM FINANCING ACTIVITIES			
Cost of share buyback		**(1,840)**	–
Dividends paid		**(6,873)**	(5,946)
NET CASH FROM FINANCING ACTIVITIES		**(8,713)**	(5,946)
Net increase/(decrease) in cash held		**9,609**	1,155
Cash held at the beginning of the financial year		**6,979**	5,766
Effects of exchange rate changes on cash		**308**	58
CASH HELD AT 30 JUNE 1998	13(a)	**16,896**	6,979

Notes to and forming part of the financial statements 30 JUNE 1998

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

This general purpose financial report has been prepared in accordance with Accounting Standards and other mandatory professional reporting requirements (Urgent Issues Group Consensus Views) and the Corporations Law.

The accounting policies adopted have been consistently applied by the Company, except as otherwise indicated.

(a) Basis of Accounting

The financial statements have been prepared on the basis of historical cost, except where otherwise stated.

(b) Foreign Currency Translation

Transactions denominated in foreign currencies are translated at the rates of exchange ruling on the date of the transaction. All realised exchange gains and losses are taken to account in the period in which they arise. Foreign currency monetary assets and liabilities existing at balance date are revalued at the rates of exchange ruling at balance date. The resulting unrealised exchange differences are brought to account in determining the Profit or Loss for the year.

(c) Investments

Investments are valued at cost, with the exception of monetary items which are stated at net fair value. Where, in the opinion of Directors, there has been a permanent diminution in the value of an investment, the carrying amount of such an investment is written down to its net fair value.

(d) Risk Management

(i) Currency hedges

Forward foreign exchange contracts, including options on forward contracts, are entered into, in the normal course of investing internationally, as a hedge against the currency risks associated with investments. Contracts open at balance date are accounted for as foreign currency monetary assets and liabilities – refer Note 1(b) above.

Realised and unrealised gains or losses are brought to account in determining the Profit or Loss for the year.

Currency positions are disclosed in Note 16(ii).

(ii) Derivatives

All derivative transactions – futures, options – are for risk management purposes; that is to protect the investment portfolio from either being invested or uninvested. All such contracts are primarily for the purpose of portfolio protection and are aimed at decreasing the level of market risk in the portfolio.

All derivatives are valued at cost. Where, in the opinion of Directors, there has been a permanent diminution in the value of a derivative, the carrying amount of such a derivative is written down to its recoverable amount.

Derivative positions are disclosed in Note 16(i).

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES CONTINUED

(e) Income Recognition
Interest income is recognised on an accruals basis.

Dividend income is brought to account on the applicable ex-dividend date.

Foreign exchange income is recognised as disclosed in Notes 1(b) and (d).

Investment gains and losses are recognised on disposal of an investment, subject to Note 1(c).

(f) Directors' Entitlements
Liabilities for Directors' entitlements to salaries are accrued at nominal amounts calculated on the basis of current salary rates.

Contributions to Directors' superannuation plans are charged as an expense as the contributions are paid or become payable.

(g) Income Tax
Income tax has been brought to account using the liability method of tax effect accounting.

(h) Earnings per Share
Basic earnings per share is determined by dividing the operating profit after income tax by the weighted number of ordinary shares outstanding during the year.

2. COMPARATIVE FIGURES

Where necessary, comparative figures have been adjusted to conform with changes in presentation in the current year.

3. OPERATING REVENUE

	1998 $'000	1997 $'000
Gross proceeds from disposal of investments and currencies	**125,922**	108,638
Dividend income	**2,598**	1,617
Interest income	**424**	249
	128,944	110,504

4. OPERATING PROFIT/(LOSS)

	1998 $'000	1997 $'000
Operating profit/(loss) before income tax has been determined after:		
CREDITING		
– Dividends from other entities	**2,598**	1,617
– Interest	**424**	249
– Net profit on sale of investments	**11,010**	7,513
– Foreign exchange gain/(loss):		
Net profit/(loss) on foreign currency hedging transactions	**1,847**	6,619
Other net foreign exchange profit/(loss)	**1,513**	(704)
Net unrealised profit/(loss) on monetary items	**1,016**	47
CHARGING AS EXPENSE		
– Auditors' remuneration		
Auditing and review	**23**	23
Other	**9**	4
– Investment management fees	**1,890**	1,669
– Share registry, CHESS and custodian fees	**324**	330
– Directors' Remuneration		
Salary	**45**	45
Superannuation	**3**	3
– Permanent diminution in the value of investments	**926**	–

5. INCOME TAX

	1998 $'000	1997 $'000
The aggregate amount of income tax attributable to the financial year differs from the prima facie amount payable on the operating profit/(loss). The difference is reconciled as follows:		
Prima facie income tax on operating profit/(loss) at 36%	**5,251**	4,623
Tax effect on permanent differences which:		
INCREASE TAX PAYABLE		
– Non-deductible expenses	**–**	6
REDUCE TAX PAYABLE		
– Capital Gains Indexation	**(97)**	(326)
– Allowable credits	**(137)**	(86)
– Non-taxable receipts	**(1)**	(9)
– Losses recouped	**(552)**	–
Future income tax benefit not recognised	**333**	892
Under/(over) provision of prior period tax	**(13)**	3
	4,784	5,103

5. INCOME TAX CONTINUED	1998 $'000	1997 $'000
The income tax expense attributable to operating profit/(loss) comprises:		
Current income tax provision	**4,573**	4,911
Deferred income tax provision	**224**	164
Future income tax benefit	**–**	25
Under/(over) provision of prior period tax	**(13)**	3
	4,784	5,103

FUTURE INCOME TAX BENEFIT

Potential future income tax benefits of $3,297,000 (1997: $3,535,000) arising from $7,497,000 (1997: $9,083,000) of quarantined foreign losses and a permanent diminution in the value of investments of $1,662,000 (1997: $736,000) have not been brought to account at balance date as the Directors do not believe it is appropriate to regard realisation of the future income tax benefits as virtually certain.

6. INVESTMENTS	NET FAIR VALUE 1998 $'000	COST/ CARRYING VALUE 1998 $'000	NET FAIR VALUE 1997 $'000	COST/ CARRYING VALUE 1997 $'000
Listed securities	**122,246**	**101,784**	102,705	92,770
Currency hedges	**938**	**938**	(1,482)	–
Cash on deposit (Note 13(a))	**16,780**	**16,780**	6,920	6,920
Total Investment Portfolio (Note 15)	**139,964**	**119,502**	108,143	99,690

7. RECEIVABLES	1998 $'000	1997 $'000
CURRENT		
Proceeds on sale of investments	**1,311**	15,839
Accrued dividends	**356**	194
Accrued interest	**10**	5
Prepayments	**15**	26
	1,692	16,064

Proceeds on sale of investments are usually received between 2 and 5 days after trade date.

Interest is usually received within 3 days of becoming due and receivable and dividends are usually received within approximately 30 days of the ex-dividend date.

The net fair value of receivables approximates their carrying value.

7. RECEIVABLES CONTINUED	1998 $'000	1997 $'000
Denomination of current receivables in foreign currencies:		
Brasilian real	**5**	2,173
British pound	**292**	303
Canadian dollar	**–**	7
French franc	**2**	254
German mark	**1**	20
Italian lira	**7**	63
Japanese yen	**155**	352
Korean won	**–**	84
Spanish peseta	**109**	–
US dollar	**1,105**	12,781
	1,676	16,037

8. PAYABLES	1998 $'000	1997 $'000
CURRENT		
Payables on purchase of investments	**4,050**	1,822
Trade creditors (unsecured)	**355**	314
Unclaimed dividends payable to shareholders	**112**	54
Payable on buyback of shares	**118**	–
	4,635	2,190

Payables on purchase of investments are usually paid between 2 and 5 days after trade date.

Trade creditors are unsecured and payable between 7 and 30 days after being incurred.

The net fair value of payables approximates their carrying value.

Denomination of current payables in foreign currencies:	1998 $'000	1997 $'000
British pound	**526**	–
French franc	**–**	924
German mark	**1,572**	–
Indonesian rupee	**–**	205
Italian lira	**1,028**	317
Japanese yen	**462**	290
Korean won	**399**	86
Spanish peseta	**110**	–
	4,097	1,822

9. PROVISIONS	1998 $'000	1997 $'000
CURRENT		
Dividends (Note 18)	**5,873**	3,000
Taxation	**3,825**	1,911
Deferred income tax	**494**	270
	10,192	5,181

10. SHARE CAPITAL

AUTHORISED SHARE CAPITAL		
5,000,000,000 Ordinary shares of $1.00 each	**5,000,000**	5,000,000
ISSUED SHARE CAPITAL		
Balance as at 1 July	**100,000**	100,000
Shares cancelled (on market buyback)	**(2,123)**	–
Balance as at 30 June	**97,877**	100,000

At 30 June 1998 there were 97,876,745 (1997: 100,000,005) Ordinary fully paid shares of $1 each on issue.

2,123,260 shares were bought back, representing 2.12% of the issued share capital, for a consideration of $1,958,347 and a net profit of $164,913. The profit has been credited to retained earnings.

11. REVALUATION RESERVE

Balance at 1 July	3	(44)
Amounts transferred (to)/from Profit and Loss account:		
– Unrealised profits/(losses) on revaluation of monetary items	(3)	47
	–	3

12. EARNINGS PER SHARE

Basic earnings per share – cents per share	**9.91**	7.74
Weighted average number of ordinary shares on issue used in the calculation of basic earnings per share	**98,901,146**	100,000,005

There have been no conversions to, calls of, or subscriptions for ordinary shares, or issues of potential ordinary shares during the financial year.

13. NOTES TO THE STATEMENT OF CASH FLOWS	1998 $'000	1997 $'000

(a) RECONCILIATION OF CASH

For the purposes of the Statement of Cash Flows, cash includes deposits at call and cash at bank which are readily convertible to cash on hand.

Cash at the end of the financial year, as shown in the Statement of Cash Flows, is reconciled to the related items in the Balance Sheet as follows:

	1998 $'000	1997 $'000
Cash at bank*	**116**	59
Cash on deposit** (Note 6)	**16,780**	6,920
	16,896	6,979

* Includes $112,006 (1997: $54,000) held in respect of unclaimed dividends on behalf of Shareholders or the Office of State Revenue.

** Includes $3,776,000 (1997: $303,000) on deposit to 'cash cover' derivative contracts' deposits and margin calls. These amounts are held by the relevant derivative exchanges as security and are not available for use by the Company until the derivative contracts are closed out. If losses are realised on the close out of derivative contracts the cash balances are set off against those losses. If profits are realised on the close out of derivative contracts the money is returned to the Company.

The net fair value of cash and deposits approximates their carrying value.

The Company maintains bank accounts at various locations throughout the world to enable the settlement of purchases and sales of investments and to conduct other normal banking transactions. All accounts are at call and the majority bear floating interest rates in the range of 1.5% to 2.65% (1997: 0.25% to 2.50%).

International and Australian deposits at call bear floating interest rates in the range of 0.50% to 5.00% (1997: 1.00% to 2.75%).

International deposits and margin calls at derivative exchanges bear floating interest rates in the range of 0.50% to 2.00% (1997: 1.00% to 3.75%).

13. NOTES TO THE STATEMENT OF CASH FLOWS CONTINUED

	1998 $'000	1997 $'000
(b) RECONCILIATION OF NET CASH FROM OPERATING ACTIVITIES TO OPERATING PROFIT/(LOSS) AFTER INCOME TAX		
Operating profit/(loss) after income tax	**9,803**	7,738
Decrease/(increase) in investment securities	**(9,952)**	14,321
(Increase)/decrease in cash due to exchange rate movements	**(308)**	(58)
Decrease/(increase) in settlements receivable	**14,528**	(9,182)
Decrease/(increase) in dividends receivable	**(162)**	235
Decrease/(increase) in interest receivable	**(5)**	(1)
Decrease/(increase) in prepayments	**11**	11
(Decrease)/increase in accrued expenses	**41**	(32)
(Decrease)/increase in settlements payable	**2,228**	819
(Decrease)/increase in income tax payable	**1,914**	(6,939)
Increase/(decrease) in future income tax benefit	**–**	25
Increase/(decrease) in deferred income tax	**224**	164
NET CASH FROM OPERATING ACTIVITIES	**18,322**	7,101

14. STATEMENT OF NET ASSET VALUE

TAKING INVESTMENTS AT MARKET VALUE* AND PROVIDING FOR REALISED AND UNREALISED TAXES			
Net Asset Value per Balance Sheet (historical cost basis)		**106,526**	108,485
Add	Revaluation of investments	**20,462**	8,453
	Proposed dividends	**5,873**	3,000
Less	Deferred income tax on revaluation of investments	**(6,607)**	(2,378)
Net Asset Value		**126,254**	117,560
Net Asset Value – cents per share		**128.99**	117.56

* All investments, currencies, derivatives are valued at net fair value.

15. INVESTMENT PORTFOLIO

	QUANTITY	NET FAIR VALUE $'000
JAPAN		
Banyu Pharmaceutical	3,000	52
Canon	91,000	3,330
Daiichi Pharmaceutical	131,000	2,784
Fuji Photo Film	62,000	3,477
Iino Kaiun Kaisha	110,000	337
Kinki Coca-Cola Bottling	90,000	1,786
Kita Kyushu Coca-Cola Bottling	2,200	80
Kuraya Yakuhin	31,900	294
Kyocera	15,300	1,205
Mikuni Coca-Cola Bottling	145,000	4,007
Navix Line	295,000	305
Nintendo	13,600	2,048
Sanyo Coca-Cola Bottling	183,190	3,174
Shikoku Coca-Cola Bottling	41,400	721
Sony	26,400	3,663
Suzuken	50,100	1,151
Takefuji	15,900	1,182
Toshiba	252,000	1,659
Yamanouchi Pharmaceutical	93,000	3,121
York Benimaru	39,000	1,182
Osaka Nikkei 225 Sep 98	8	(28)
Simex Nikkei 225 Sep 98	8	(22)
		35,508
OTHER ASIA		
Hong Kong		
Smartone Telecom	40,000	157
		157
India		
Industrial & Credit Corporation of India – GDR	35,400	576
Tata Engineering	30,000	154
		730
Indonesia		
Unilever	160	48
		48
Korea		
Samsung Electronics	43,539	2,164
Samsung Fire & Marine Insurance	2,160	578
		2,742
TOTAL OTHER ASIA		**3,677**

15. INVESTMENT PORTFOLIO CONTINUED	QUANTITY	NET FAIR VALUE $'000
AUSTRALIA		
Boral	205,000	620
Jupiters	400,000	934
Star City Holdings	1,463,140	1,371
		2,925
WESTERN EUROPE		
France		
Bollore Technologies	3,575	1,107
Fonciere Lyonnaise	1,941	491
Lagardere	52,954	3,527
Pernod Ricard	14,650	1,625
St Gobain	4,958	1,471
TF1 (Television Francais)	700	174
Unibail	5,024	1,040
		9,435
Germany		
Douglas Holding	46,200	3,905
Draegerwerk – Preferred	45,549	1,751
Dyckerhoff	150	95
Escada – Preferred	4,620	1,171
Felten & Guilleaume Energietechnik	450	94
Hoechst	8,960	715
Hornbach Baumarkt	22,505	1,796
Hornbach Holding – Preferred	12,575	1,857
Siemens	33,377	3,252
Wella	873	1,390
Wella – Preferred	1,150	2,067
DAX 30 Sep '98	8	(152)
		17,941
Italy		
Istituto Bancario San Paolo di Torino	144,277	3,373
La Rinascente	311,133	4,870
La Rinascente – Preferred	144,986	1,088
La Rinascente – Savings	142,452	1,141
Toro Assicurazioni	20,000	511
		10,983
Spain		
Continente	18,770	687
		687

15. INVESTMENT PORTFOLIO CONTINUED	QUANTITY	NET FAIR VALUE $'000
Switzerland		
Kuhne and Nagel – Bearer	1,528	1,866
Schindler – Participating Certificates	700	1,717
Schindler – Registered	233	582
Schweizersche Industrie Gesellschaft Holdings – Registered	3,384	4,440
Valora Holdings – Registered	7,295	3,100
		11,705
United Kingdom		
Albright & Wilson	222,535	915
Booker	167,497	1,111
J. Sainsbury	137,035	1,960
Pentland Group	430,500	1,268
Pilkington	765,300	2,275
SCAPA Group	468,209	2,402
Signet Group	311,942	361
WPP Group	168,207	1,770
		12,062
TOTAL WESTERN EUROPE		**62,813**
EASTERN EUROPE		
Kazakstan		
Kazakstan Investment Fund – Partly Paid	77,000	587
		587
TOTAL EASTERN EUROPE		**587**
NORTH AMERICA		
Canada		
Indochina Gold	30,900	52
Royal le Page	28,999	198
		250
United States		
Acuson	129,760	3,789
Diagnostic Products	44,300	2,049
Fila Holdings – ADR	14,750	355
Great Lakes Chemical	28,600	1,811
King World Productions	57,934	2,372
Octel	19,150	615
Overseas Shipholding	12,906	422
Qualcomm	2,500	225
Robert Mondavi	13,700	624
S&P 500 Sep 98	54	(1,052)
		11,210
TOTAL NORTH AMERICA		**11,460**

15. INVESTMENT PORTFOLIO CONTINUED	QUANTITY	NET FAIR VALUE $'000
SOUTH AMERICA		
Brasil		
Antartica Paulista – Common	2,265	189
Banco Itau – PN	223,045	204
Cia De Gas De Sao Paulo – PN	860,912	78
Copel – ON	27,900,000	352
Itausa – Investimentos Itau – PN	1,526,300	1,547
Oderbrech – ON	72,800,000	606
Sadia Concordia – PN	183,000	183
Souza Cruz – ON	92,609	1,106
		4,265
Peru		
Bayer Peru – Trabajo	77,287	108
Cerveceria Backus & Johnson – Trabajo	382,809	314
Industrias Pacocha – Trabajo	520,390	182
Peru Real Estate – B Common	776,746	407
		1,011
TOTAL SOUTH AMERICA		**5,276**
LIQUIDS		
Outstanding settlements		(2,383)
Foreign exchange contracts		938
Cash at bank and on deposit		16,780
		15,335
TOTAL INVESTMENT PORTFOLIO (NOTE 16 (I) AND (II))		**137,581**
Accounted for in Payables (payables on purchase of investments)		4,050
Accounted for in Receivables (proceeds on sale of investments)		(1,311)
Accounted for in Receivables (dividends receivable)		(356)
ACCOUNTED FOR IN INVESTMENTS (NOTE 6)		**139,964**

Exchange traded investments' net fair value is determined from the quoted market price less an estimate for realisation costs. Unlisted investments, including monetary items' net fair value, is determined from alternative pricing sources in 'over the counter' markets or by Directors' valuation, less an estimate for realisation costs.

Investments with a total cost of $30,419,000 (1997: $26,986,000) are carried at an amount in excess of their net fair value of $25,259,000 (1997: $20,621,000); refer to Note 1(c). Investment markets are in a continuous state of flux, changing the net fair value of the Company's investments, sometimes to below original cost. The Company is a long-term value investor and short-term fluctuations in the net fair value of investments are not taken to account, other than if they represent a permanent diminution in value.

16. RISK MANAGEMENT

It is the Company's investment objective to seek long term capital growth through value investing internationally in businesses and companies. The Investment Manager may also invest in fixed interest investments, although this is not the primary investment objective. The Company's investments are subject to price (which includes currency, interest rate and market risk), credit and liquidity risks.

The Company's primary risks are related to the investment activities undertaken on its behalf by the Investment Manager. The Company has a policy of not borrowing moneys, other than on a short term basis for settlement, trading and like purposes. The Company's investment restrictions prohibit it from taking positions in futures, options, other derivative products or short sales of securities if the aggregate exposure to those products exceeds 50% of the net asset value of the Company.

The Board monitors the level of risk in the Investment Portfolio regularly through formal Directors' meetings with the Investment Manager. The Investment Manager monitors the risks daily and implements risk management strategies consistent with the invested position as it believes necessary. The effective exposure to currencies and markets is continuously monitored by the Investment Manager and the Company.

The Company is exposed to credit related losses in the event of non-performance by counterparties to financial instruments, but it does not expect any counterparties to fail to meet their obligations given their high credit ratings. Where appropriate, the Company utilises master netting agreements.

The Company is exposed to liquidity risks – the possibility of being unable to obtain the fair market value of an asset or derivative owing to prevailing market conditions – and manages this risk by using derivatives in liquid markets and managing exposure to assets in illiquid markets; although it should be noted that even the most liquid markets can become illiquid in times of severe downward price corrections.

The international investment activities of the Company expose it to currency risk – the possibility of losing money owing to changes in foreign currency exchange rates – and manages this risk through forward currency hedging contracts.

The investment activities of the Company expose it to market risk – the possibility of losing money owing to changes in the market prices of its investments – and manages this risk through derivative hedging contracts.

The Company is exposed to interest rate risks – the possibility of losing money owing to changes in interest rates and, more particularly for the Company, the effect that changes in interest rates have on currency and stock market prices – and manages these as noted above for currency and market risks.

Refer to Note 1 for the Accounting Policies adopted with respect to Derivatives and Currencies.

16. RISK MANAGEMENT CONTINUED

(i) INVESTMENTS AT NET FAIR VALUE AND DERIVATIVES EXPOSURE

	PHYSICAL $'000	FUTURES & OPTIONS $'000	UPSIDE (A) $'000	FUTURES & OPTIONS $'000	DOWN-SIDE (B) $'000
Japan	35,508	(1,410)	34,098	(1,410)	34,098
Other Asia	3,677		3,677		3,677
Australia	2,925		2,925		2,925
Western Europe	62,813	(4,041)	58,772	(4,041)	58,772
Eastern Europe	587		587		587
North America	11,460	(23,780)	(12,320)	(23,780)	(12,320)
South America	5,276		5,276		5,276
	122,246	(29,231)	93,015	(29,231)	93,015
Liquids	15,335	29,231	44,566	29,231	44,566
TOTAL NET FAIR VALUE OF PORTFOLIO	**137,581**	**–**	**137,581**	**–**	**137,581**

The above table categorises the Investment Portfolio in the same way that the Investment Manager does for day-to-day management.

The physical column simply shows the location of the Company's investments.

(a) The 'upside' column is an approximation of the Portfolio's exposure to upward movements in markets. This is calculated by making two adjustments to the physical position. The first is to subtract, from the physical position, any short (sold) and add any long (bought) positions in shares or share index futures. For example, if 5% of the Portfolio was invested in Japan but there was a 2% short position in Nikkei futures, then the upside column would show 3%. Conceivably the figure could show a negative exposure which would indicate the Portfolio was net short the Japanese market. The second adjustment is for options held to buy shares (bought calls). A call option with the premium representing 0.5% of the Portfolio to buy shares in Toyota worth, say, 3% of the Portfolio would require an additional 2.5% to be added to the Japanese exposure (thus determining underlying exposure).

(b) The 'downside' column is an approximation of the Portfolio's exposure to downward moves in the market. It is calculated by adjusting the 'physical' position for any short or long positions in shares or share index futures and bought put options. It is not necessary to adjust for call options as only the option premium (already included in 'physical') is at risk, not the underlying holding callable by the option.

The Company uses futures contracts in liquid markets and generally utilises short-dated contracts; those with 90-day maturities. The existing derivative positions' maturity dates range from 72 days to 80 days. Initial margin requirements and daily variation margin requirements on futures contracts are met in cash. Futures contracts have little credit risk as they are traded on recognised exchanges.

The Company uses Exchange Traded and Over The Counter Options where the maximum potential loss is paid up-front by way of a premium. There is little credit risk attached to these instruments as they are traded on recognised exchanges or with high credit rating counterparties.

16. RISK MANAGEMENT CONTINUED

(ii) CURRENCY EXPOSURE AT NET FAIR VALUE

	PHYSICAL $'000	BOUGHT $'000	SOLD $'000	NET EXPOSURE $'000
Japan	37,284	14,921	(50,370)	1,835
Other Asia	2,554	14	(55)	2,513
Australia	3,899	60,511	(19,299)	45,111
Western Europe	70,361	5,611		75,972
North America	18,183	66,210	(77,543)	6,850
South America	5,300			5,300
TOTAL NET FAIR VALUE OF PORTFOLIO	**137,581**	**147,267**	**(147,267)**	**137,581**

The above table categorises the investments in the Portfolio into the currencies that the securities are issued in. For example a security issued by a Japanese company in US$ will be categorised as a US$ exposure.

Forward foreign currency contracts and options on forward currency contracts are adjusted against the 'physical' column to arrive at a net exposure to each currency grouping.

The Company generally utilises short-dated (90-day maturities) currency agreements with high credit rated counterparties.

The existing currency hedging positions' maturity dates range from 15 days to 86 days.

(iii) INTEREST RATE EXPOSURE

The Company had no fixed interest investments or derivatives thereon at balance date.

Refer to Note 13(a) for information on short-term interest rates.

17. FRANKING ACCOUNT

		1998 $'000	1997 $'000
Opening Balance – Class C		**18,475**	12,731
On dividends received:	Franked at 36%	**5**	8
On tax paid and payable:	1996–97	**–**	8,730
	1997–98	**8,128**	–
Prior year tax provision – franking adjustment		**(23)**	6
Special dividend paid franked @ 36%		**(3,931)**	–
Proposed dividends franked @ 36%		**(5,873)**	(3,000)
		16,781	18,475
Amount of retained earnings that could be distributed as dividends and be franked out of existing credits or out of franking credits arising from the payment of income tax in the period subsequent to 30 June 1998 after deducting franking credits applicable to any proposed dividends:			
Accumulated profits		**8,649**	8,482
Amounts transferred to/(from) reserves		**–**	3
		8,649	8,485

18. DIVIDENDS (FULLY FRANKED)

	1998 CPS	1998 $'000	1997 CPS	1997 $'000
Paid – Special fully franked @ 36%	**4.00**	**3,931**	–	–
Proposed – fully franked @ 36%				
– Final	**4.00**	**3,915**	3.00	3,000
– Special	**2.00**	**1,958**	–	–
	10.00	**9,804**	3.00	3,000

19. INVESTMENT MANAGER

(a) The Investment Manager is Platinum Asset Management. It receives a monthly management fee for investment services provided in accordance with the Investment Management Agreement. This agreement provides for a management fee payable monthly and calculated at 1.5% per annum of the Portfolio Value.

(b) Additionally a Bonus (Performance) fee is payable at 10% of the amount by which the Portfolio's annual performance exceeds the return achieved by the MSCI plus 5%. (MSCI is the Morgan Stanley Capital International World Accumulation Net Return Index in A$.) Where the Portfolio's annual performance is less than the MSCI the amount of the underperformance is aggregated and carried forward and deducted from the annual performance in the subsequent year before calculating any Bonus fee for that year.

The aggregate of underperformance is carried forward until a Bonus fee becomes payable.

Notes to and forming part of the financial statements 30 JUNE 1998

19. INVESTMENT MANAGER CONTINUED

(c) At 30 June 1998 the cumulative pre-tax performance of the Portfolio for management fee calculation purposes was 22.75% and the corresponding MSCI was 41.58%. Accordingly, a performance fee has not been accrued.

The 22.75% represents an underperformance against the MSCI of 18.83%; this amount will be carried forward as a deduction against subsequent years' performance fee calculations.

(d) The Investment Manager is to be paid a lump sum termination fee of 1.5% calculated on the value of the Portfolio on the 1st day of the month in which termination is effective. The fee is not payable if the termination results from the default or insolvency of the Investment Manager. Additionally a Bonus fee is payable for the period from the last calculation of the Bonus fee (as described in (b) above) to the date of termination.

	1998 $'000	1997 $'000
Amounts paid and payable to the Investment Manager for the year	**1,890**	1,669

20. CONTINGENT LIABILITIES AND COMMITMENTS FOR EXPENDITURE

No contingent liabilities exist at balance date.

The Company has commitments for uncalled share capital on investments of $372,000 (1997: $Nil).

21. SEGMENT INFORMATION

The Company was predominantly engaged in investment activities on world markets and derived revenue from sale of investments, interest and dividends. The Investment Manager does not invest with any predetermined asset allocation ranges as it uses a stock selection methodology. Accordingly the results of the Company are a function of the Investment Portfolio and its make-up is a function of the stock selection process. As the investment portfolio's composition varies dependent on stock selection decisions it is not considered appropriate to allocate revenues to some predetermined contrived segment, which would be contradictory to the investment objective of the Company.

22. SUBSEQUENT EVENTS

No significant events have occurred since balance date which would impact the financial position of the Company as at 30 June 1998 and the results for the year ended on that date.

23. RELATED PARTY INFORMATION

(a) DIRECTORS
The Directors named in the attached Directors' Report each held office as a Director of the Company throughout the financial year to 30 June 1998.

(b) DIRECTORS' REMUNERATION
Remuneration received or receivable by the Directors of the Company, including aggregate amounts paid to superannuation plans, is disclosed in Note 4 to the Accounts. The number of Directors of the Company included in the figures disclosed in Note 4 to the Accounts are shown below in their relevant income bands:

	1998 $'000	1997 $'000
$20,000 – $29,999	2	2

The three Executive Directors are employees of and have a relevant interest in the Investment Manager and accordingly will receive some portion of the Management fee; they do not receive any Directors' remuneration from the Company.

The aggregate number of shares and share options held by Directors of the Company and their Director-related entities at balance date:

	1998 ORDINARY SHARES	1997 ORDINARY SHARES
MG Darling	**3,300,000**	3,300,000
PA Pearce	**10,000**	10,000
WK Neilson	**1,152,401**	1,152,401
AM Clifford	**1,002,401**	1,002,401
RM Halstead	**992,401**	992,401

Directors' statement

In accordance with a resolution of the Directors of Platinum Capital Limited, in the opinion of the Directors:

(a) the accounts of the Company are drawn up so as to give a true and fair view of the profit of the Company for the year ended 30 June 1998 and the state of affairs of the Company as at 30 June 1998;

(b) at the date of this statement there are reasonable grounds to believe that the Company will be able to pay its debts as when they fall due; and

(c) the accounts of the Company have been made out in accordance with Divisions 4A and 4B of the Corporations Law and so to give a true and fair view of the profit of the Company for the year ended 30 June 1998 and the state of affairs of the Company as at 30 June 1998.

For and on behalf of the Board

MG Darling Director

WK Neilson Director

Sydney 6 August 1998

Independent audit report TO THE MEMBERS OF PLATINUM CAPITAL LIMITED

SCOPE

We have audited the financial statements of Platinum Capital Limited (the Company) for the period ended 30 June 1998 as set out on pages 24 to 45. The Company's Directors are responsible for the preparation and presentation of these financial statements and information contained therein. We have conducted an independent audit of these financial statements in order to express an opinion on them to the members of the Company.

Our audit has been conducted in accordance with the Australian Auditing Standards to provide reasonable assurance as to whether the financial statements are free of material misstatement. Our procedures included examination, on a test basis, of evidence supporting the amounts and other disclosures in the financial statements, and the evaluation of accounting policies and significant accounting estimates. These procedures have been undertaken to form an opinion as to whether, in all material respects, the financial statements are presented fairly in accordance with Accounting Standards, other mandatory professional reporting requirements, being Urgent Issues Group Consensus Views, and the Corporations Law so as to present a view which is consistent with our understanding of the Company's state of affairs, the results of its operations and their cash flows.

The audit opinion expressed in this report has been formed on the above basis.

AUDIT OPINION

In our opinion the financial statements of the Company are properly drawn up:

(a) so as to give a true and fair view of:

(i) the state of affairs of the Company as at 30 June 1998 and its results and cash flows for the financial year ended on that date; and

(ii) the other matters required by Divisions 4, 4A and 4B of Part 3.6 of the Corporations Law to be dealt with in the financial statements;

(b) in accordance with the provisions of the Corporations Law; and

(c) in accordance with applicable Accounting Standards and other mandatory professional reporting requirements.

PricewaterhouseCoopers
Chartered Accountants

PK Merrett Partner

Sydney 6 August 1998

Shareholder information

SUBSTANTIAL SHAREHOLDERS

The Company's Register of Substantial Shareholders, prepared in accordance with section 715 of the Corporations Law, recorded the following information as at 31 July 1998.

NAME	NUMBER OF SHARES	CLASS OF SHARE
Questor Financial Services Limited	8,679,544	ordinary
Telstra Super Pty Limited	5,000,000	ordinary

DISTRIBUTION OF SECURITIES	CLASS OF EQUITY SECURITY ORDINARY
(i) Distribution schedule of holdings	
1–1,000	136
1,001–5,000	2,100
5,001–10,000	1,238
10,001 and over	1,369
Total number of holders	4,843
(ii) Number of holders of less than a marketable parcel	20
(iii) Percentage held by the 20 largest holders	38.35%

TWENTY LARGEST SHAREHOLDERS

The names of the twenty largest holders of each class of equity securities as at 31 July 1998 are listed below.

	NUMBER OF SHARES	%
Questor Financial Services Limited	8,588,240	8.77
Perpetual Trustee Company Ltd	7,332,623	7.49
National Nominees Limited	7,021,477	7.17
Caledonia Investments Limited	3,050,000	3.12
Perpetual Trustee Company Ltd	1,505,485	1.54
RPG Management Pty Limited	1,404,418	1.43
Groote Eylandt Aboriginal Trust Inc	1,362,202	1.39
Cox Bros Coffs Harbour Pty Limited	1,000,000	1.02
Platinum Asset Management Limited	952,400	0.97
Merrill Lynch (Australia) Nominees Pty Limited	935,770	0.96
Mr John Hall	679,000	0.69
Austrust Limited	650,060	0.66
ANZ Nominees Limited	504,500	0.52
Banque Nationale De Paris	486,144	0.50
Perpetual Custodians Limited	460,277	0.47
Mr Gregory Mitchell Maughan	350,000	0.36
Somoke Pty Limited	336,100	0.34
Mrs Rosanna Castellana	312,500	0.32
ANZ Nominees Limited	309,885	0.32
Waipaoa Station Limited	301,089	0.31

Shareholder information

VOTING RIGHTS

Ordinary Shares

On a show of hands, every member present in person or represented by a proxy or representative shall have one vote and on a poll every member who is present in person or represented by a proxy or representative shall have one vote for every share held by them.

FINANCIAL CALENDAR

Annual General Meeting	**20 October 1998**
Ordinary Shares trade Ex-Dividend	**21 October 1998**
Record (books close) date for Final and Special dividends	**29 October 1998**
Final and Special dividends paid	**6 November 1998**

These dates are indicative and may be changed.

ADDITIONAL INFORMATION
IN ACCORDANCE WITH THE ASX LISTING REQUIREMENTS FOR THE COMPANY

1. The total number of securities transactions entered into during the reporting period, together with total brokerage paid during the reporting period:
Number of transactions – 997 Total brokerage paid – $658,862

2. Shareholders may review a list of investments acquired or disposed of by the Company in the reporting period at the Registered Office.

3. A listing of the Investment Portfolio may be found in Note 15 to the Accounts.

4. A summary of the fees paid or payable to the Investment Manager may be found in Note 19 to the Accounts.

5. A summary of the salient provisions of the Investment Management Contract are as follows:

(a) the Investment Manager will invest the Portfolio in accordance with the investment objectives and restrictions of the Company and subject to the Articles, the Management Agreement, the ASX Listing Rules, the Corporations Law and investment restrictions and directions from the Company;

(b) confer with the Company at regular intervals;

(c) administer the borrowings of the Company;

(d) the Investment Manager may appoint the Managing Director of the Company;

(e) the Investment Manager is required to publish the Net Asset Value of the Company monthly at the ASX and in an Australian national daily newspaper;

(f) the Agreement will continue for a term of 5 years, the Investment Manager cannot retire in the first three years but thereafter may retire after giving six months notice;

(g) the Agreement may be terminated or renewed by the Members of the Company in General Meeting at the end of each 5-year term; and

(h) the Agreement may be immediately terminated by the Company in the event of:

(i) a breach of a material obligation by the Investment Manager;

(ii) the Investment Manager going into liquidation or having an administrator or receiver appointed.

Keep your eyes on the stars,
and your feet on the ground.

THEODORE ROOSEVELT

PLATINUM CAPITAL LIMITED

Stargazing

Designed and produced by 3C

Illustrated by Lionel Portier: Some illustrations re-published with permission from Le Monde, Paris.

PLATINUM CAPITAL LIMITED

Stargazing

A close look at the regional market forces that shape the world economy.

PREFACE

In keeping with our practice of using the annual report to give shareholders a deeper insight into the workings of markets, we have again included some supplementary articles in this report.

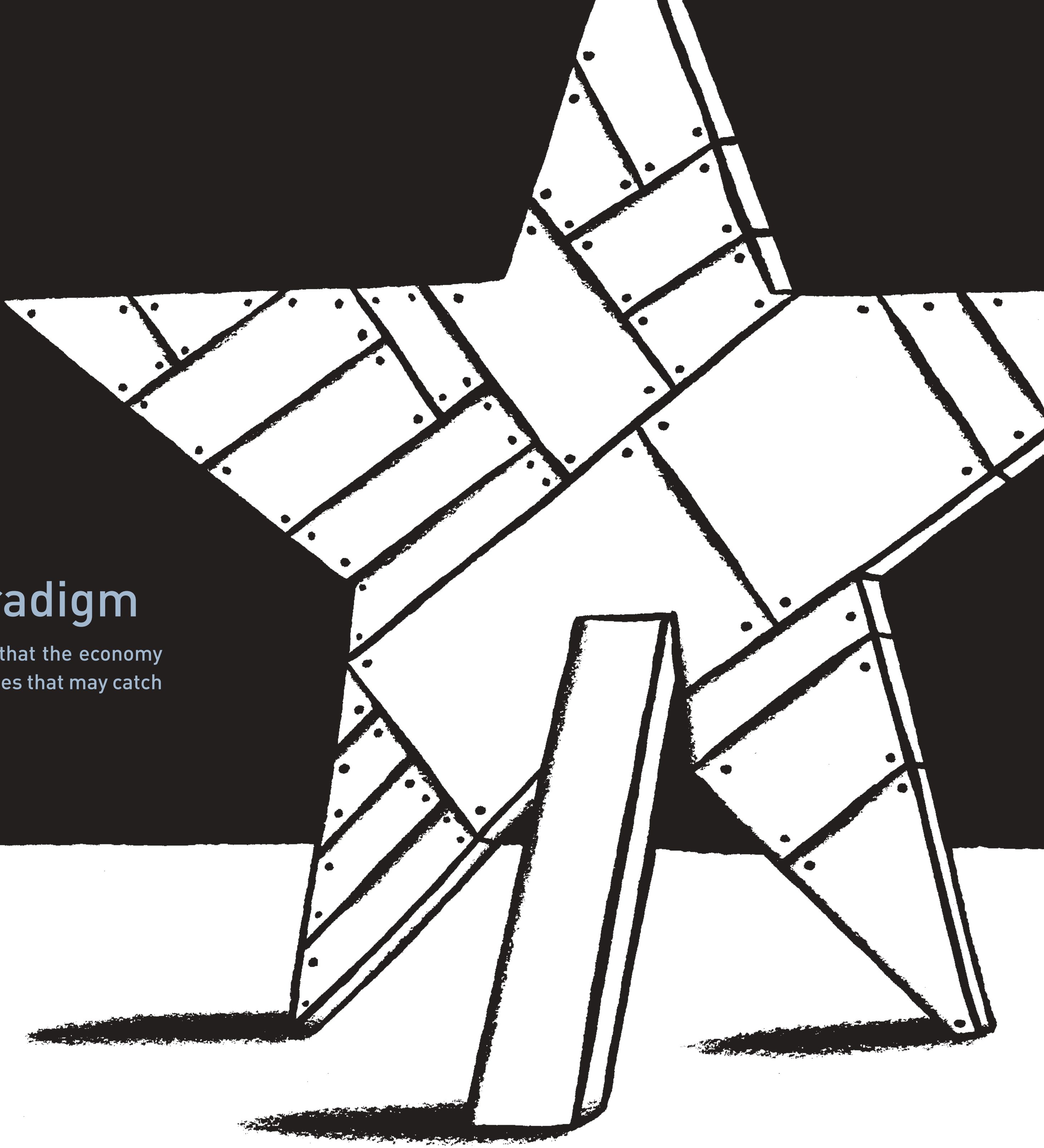
This year we have asked each of the analyst groups to make a contribution covering areas of interest. Hugh Giddy has written a somewhat technical piece on the distortions to earnings caused by expedient treatment of stock options among US companies. He also raises the interesting issue of the stimulus that has been given to that economy by individuals going increasingly into debt. It is an article that will appeal to readers who don't normally buy into the notion that "you get what you pay for".

Toby Harrop and Rod Sleath highlight the transformations that have taken place in Europe in the nineties and the prospect of further major integration as a consequence of the interaction of globalisation and Monetary Union. Their view is that though share prices have risen strongly, the prospects for greater ownership of shares among European investors will swamp any supply that is offered; hence valuations are likely to stay high.

Though South East Asia is obviously a point of concern, it is unlikely to achieve much improvement without Japan showing signs of economic revival. Andrew Clifford and Doug Huey draw readers' attention to the problems facing China. This colossus is in the midst of conversion to a fully market-led economy and yet finds itself facing significant hurdles.

We find the spectrum of social and political currents that shape the world economy a fascinating object of study and we'd like to share with you our observations of it. We have tried to keep the language as free of jargon as possible, but you must remember that we are analysts, not writers.

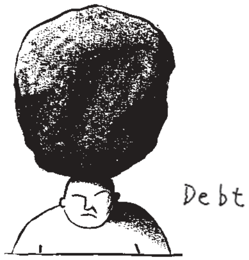
Kerr Neilson Managing Director



USA Behind the new paradigm

For some time most US commentators have gushed that the economy is near perfect. This essay explores some of the realities that may catch up with the economy and with Wall Street.

One of the most remarkable features of recent decades has been the rapid rise in indebtedness. The US has now become the world's biggest debtor, having not long ago been the biggest creditor country.



USA **Behind the new paradigm** For some time most US commentators have gushed that the economy is near perfect. We read of the "Goldilocks economy", an economy which, like the porridge, is neither too hot to fuel inflation or create "bottlenecks", nor too cold to suppress job creation and continuing investment. Jack Nicholson is not the only one to utter the phrase: "This is as good as it gets", reminiscent of Voltaire's Dr Pangloss. Such optimism has been powering the US stock market, which continues to surprise with its vitality and longevity. This essay explores some of the realities that may catch up with the economy and with Wall Street. The economy has performed well, but one of the key drivers of consumption and hence the economy has been debt. We believe that attitudes to debt may be changing as people become accustomed to low inflation. Similarly, underlying the strength in the stock market is strong earnings growth and the popular idea of "shareholder value creation". We are convinced that the earnings growth has been overstated and are sceptical of some shareholder value buzzwords such as share buybacks. The apparent reality has diverged from the underlying truth: the strong economy is partly the result of debt financed growth which may be difficult to sustain; soaring share prices do not always reflect the actual progress of the businesses.

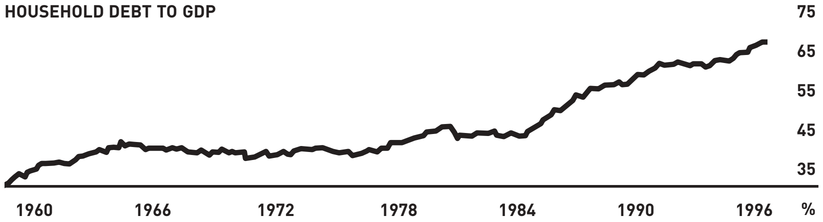
US economic performance has been impressive: after seven years of economic expansion, shortages that traditionally caused higher prices have not materialised. Unemployment is now at 4.5% of the labour force, yet wage rises seem to be contained and seem more likely to curtail profits than spur price rises. Such inflation as there is is in the services sector; goods prices in much of the developed world are static or falling.

There are many possible contributory factors to such quiescent inflation. Labour insecurity, improving labour productivity, the benefits of new technology, vigilant central banks, the strength of the dollar, weak commodity prices and a virtuous circle of low inflation expectations may well be part of the explanation. However, the key economic feature that has suppressed prices is probably the massive investment in new capacity. Throughout Asia, factories were built premised on rosy scenarios of continuing fast growth. In the US, business investment has been growing at a double digit rate for several years. During 1998, demand has been very strong yet capacity utilisation has gradually fallen as it was being added at a faster rate than demand. We would prefer here to consider the implications of low inflation rather than investigate its origins. The most important change may be on borrowers' view of debt; inflation often obscures the risks associated with debt.

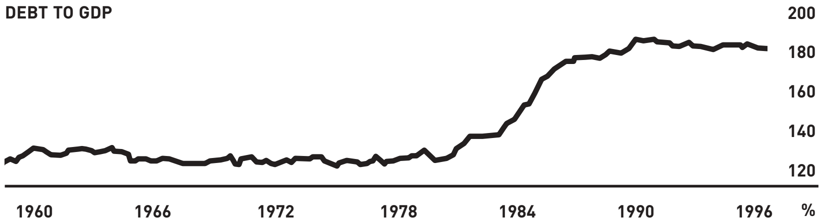
David Fischer's remarkable book, *The Great Wave*, demonstrates that, since the thirteenth century, prices have been stable in aggregate for periods of up to 80 years, interspersed by waves of inflation. The twentieth century is possibly unique: price rises or inflation have far exceeded previous inflationary periods. However, people are now becoming accustomed to more stable prices. In Japan, prices are essentially no higher now than at the beginning of the decade. However, it is doubtful whether people are prepared for price stability – which entails price declines countering price rises elsewhere - or deflation – implying widespread price declines.

One of the most remarkable features of recent decades has been the rapid rise in indebtedness. A familiar feature of the 1980s was a huge rise in government deficits. Leverage also became popular in the corporate sector with innovative financings and the issuance of junk debt, and household borrowings have risen steadily. This has been reflected in the current account of the US and the US becoming the world's biggest debtor, having not long ago been the biggest creditor country. Financial deregulation has spawned a multitude of new ways of providing credit. US banks are falling over each other to win new credit card customers. In 1991, credit card purveyors mailed 975 million solicitations; by 1995, these mailings had exploded to

FOLLOWING THE EXPLOSION IN INFLATION IN THE SEVENTIES HOUSEHOLD DEBT GREW MUCH FASTER THAN INCOME IN THE EIGHTIES

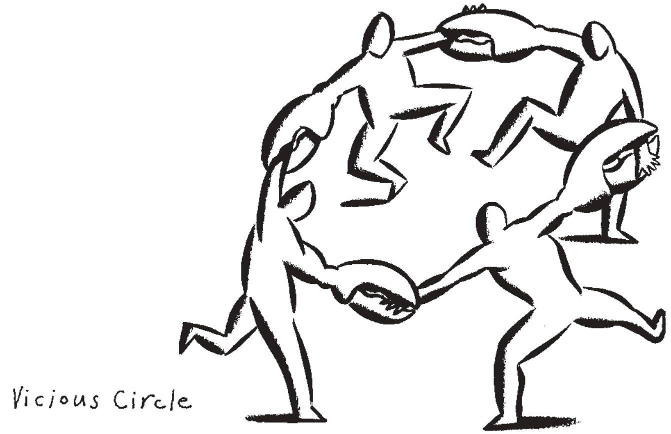


... AND TOTAL US DEBT MUSHROOMED



3 billion (astonishingly, more than ten for every man, woman and child, most of whom already have multiple cards). Incentives such as no annual fee, reward points, and introductory low interest rates are provided. Retailers are also luring consumers into debt in order to boost their own sales. Auto dealers have popularised leasing, and stores offer "interest free credit", "nothing to pay for 12 months" and "no deposit finance". In effect, consumption is being brought forward, as households will be able to buy now what they may have previously waited and saved to buy. Without the explosion in debt, economic growth would undoubtedly have been lower over the past 15 years.

Inflation is a great ally of a spendthrift and borrower. Price rises create an incentive to make purchases sooner, and the destruction of the value of money makes the repayment of a loan less onerous. How will people behave with the prospect of falling prices? Debt immediately loses much of its appeal: collateral values may decline and delayed repayment of principal is no longer advantageous. Even though interest rates fall and make debt service easier (where rates are variable but most debt – such as mortgage debt and government bonds – is fixed rate), they usually cannot fall enough to compensate for lower prices, as may be the case in Japan today.

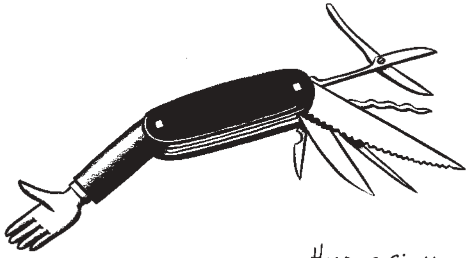


High expectations from investors and excessive focus on quarterly earnings results have placed growing pressure on managements to deliver seemingly perpetual growth in reported earnings.

Discussions of low inflation almost invariably focus on the benefits. As inflation expectations adjust downwards, behaviour may change in a way that is more disturbing. If prices seem more likely to fall than to rise there is reason to defer rather than bring forward purchases. It is no coincidence that as debt grew quickly in the 1980s, consumption boomed at the same time. Consumption growth will surely slow as people repay debts and avoid "buy now, pay later" offers. Real estate will also be affected: investors seem content with net rental yields as low as 3% despite borrowing at more than double that, justifying the gap in terms of an expected capital gain. Should property prices become more stable (as they have been through much of history), rental yields might need to rise in the face of declining borrowing costs. The business landscape changes too. Profits cannot be earned by simply holding inventory. If sales decline because prices are falling, it is difficult to reduce costs sufficiently so that profits do not decline as well. If sales decline because ruses to borrow future sales with cheap or free finance no longer work, profits will fall substantially.

This brings us to our second area of interest: the true nature of profits and shareholder value creation. High expectations from investors and excessive focus on quarterly earnings results have placed growing pressure

Many companies have taken on debt to do buybacks, and in aggregate we have found that companies issue more shares than they buy back. It is often hard to see any 'value creation' except for senior executives.



on managements to deliver seemingly perpetual growth in reported earnings. In consequence, accounting techniques have been employed that flatter earnings in the US, and investors seldom carefully assess the quality of those earnings. Amidst the hoopla of restructuring (to build shareholder value) and mergers, there are often large non-recurring costs for redundancies, inventory write-downs, merger integration expenses and so forth. Because they are labelled "non-recurring", they are often ignored or excluded from research analysis, and share prices indicate that investors accept this treatment. Nevertheless, they are a cost to shareholders. These costs mean that money is spent by the firm, effectively shareholders' money.

Investors are rewarded for their ownership stake in companies in two ways. Companies pay out a portion of earnings as dividends, the balance is retained for reinvestment in the business. These retentions add to book value or the owners' equity in the business. If one were to add theoretical retentions to the book value of the Standard and Poor's 500 index, since 1983 book value would have increased from $117 to about $330 in 1997. The actual figure is less than $200.

The difference is largely attributable to major write offs, and one of the most common "non-recurring" costs has been the provision for post-retirement healthcare. In the early 1980s, companies negotiated with unions and employees to cover medical costs after retirement rather than provide the wage increases which were demanded. Higher wage costs would have affected earnings directly but the healthcare costs had only a minor effect on

reported profits. Both options would probably have had the same effect on the true, underlying value of the business. Only when the accounting rules were changed in 1992 did the post-retirement healthcare costs become apparent. Today's accounting allows a similar misrepresentation: stock options are not charged to earnings even though they undoubtedly affect the value of the business and real underlying profits.

Stock options have been around for a long time, and were last popular during the bull market of the 1960s. Options were traditionally welcomed, as shareholders wanted management to act in their interests. However, in the 1990s option issuance has been leading to excessive rewards for executives, and executives are able to conceal the extent of their greed because only the salary portion of their package is reported as affecting earnings. It is difficult to precisely quantify the value of such options, and because the exercise price is the same as the market price at the time of grant, options have no apparent value. However, most options have a ten year life; as the company grows through retentions options are likely to become valuable. The cost to shareholders is that the exercise of options results in the issuance of more shares, diluting their stake and hence reducing the underlying value attached to that stake. Most companies attempt to counter this dilution by buying back shares, inevitably at a higher price than the option exercise price. Buybacks are often announced with great fanfare because the naïve view is that buybacks create value for shareholders. This is true in some cases, and we would favour buybacks by some US companies, as we would buybacks by many cash rich Japanese companies. However, in the US many companies have taken on debt to do buybacks, and in aggregate we have found that companies issue more shares than they buy back. It is often hard to see any "value creation", except for senior executives.

Even though options clearly form a part of compensation expense, they are not recorded as such. The US tax authorities even credit companies when options are exercised as though an expense has been incurred. In the case of Microsoft, a major options issuer, the tax benefit in the most recent nine months was $910 million, up from $482 million the previous year. Accounting authorities attempted to introduce a standard for expensing options but met such concerted opposition that a version of the potential expense appears only in the notes to the accounts.

The true cost of options has garnered some of the limelight in recent financial articles. A report by Smithers & Co, an independent research firm, caused considerable controversy. The report tries to measure the cost of currently issued options and the change in value of outstanding options. From a theoretical point of view, this is a sound approach, but the conclusions are unpalatable for the many who believe strongly in the apparent US corporate renaissance. Using a large sample, Smithers found that, if options were properly accounted, profits would have been 30% lower than reported in 1995, and 34% lower than reported in 1996.

The hundred large companies sampled by Smithers are listed, with an indication of the effect on 1996 profits were options to have been fully expensed (in actuality, effectively ignored). Several major companies would have registered losses rather than profits, and for many others published profits are more than double Smithers' adjusted profits. In the former group are Cisco, Dell, Intel, Microsoft, Monsanto, Texas Instruments, and Unocal; while the latter group includes such familiar names as Chase Manhattan, Coca Cola, Gillette, Merrill Lynch, Oracle, Walt Disney and Warner Lambert.

Stockbroking firms challenge such pessimistic sentiments. Although admitting that options are a form of compensation expense, and that some technology company profits would completely evaporate if options were accounted for, brokerage research tends to dismiss the Smithers conclusions as extreme. Brokers tend to accept the disclosures mandated under accounting rules, and conclude that profits are overstated by between 1% and 5%, depending upon calculation methods and samples. However, for technical reasons, the potential costs disclosed by companies are almost inevitably understated.

The original reason justifying options seems to have been forgotten. Options were intended to align the interests of management with shareholders. Instead, options seem to have spawned an orgy of greed. Options seem to be granted in years of poor performance (for future motivation?) as liberally as in good years. Managements have benefited from the declines in inflation and interest rates, lifting most share prices far beyond the gains that could be attributed to company performance. Options are a one way ticket; if the share price falls, management do not suffer. Indeed, during the 1990s there have been about 300 instances of option repricings following poor share price performance. Why not simply issue shares to management? Management become shareholders with a vested interest in the business rather than just the share price. However, fewer shares would be issued than options, and the awards would have to be expensed, surely an unpopular course. Shamefully, the accounting treatment favours fixed awards (as those are not expensed) over variable, performance-based awards (which would count as compensation expense).

Options have contributed to rapidly escalating levels of pay for executives. Computer Associates, a successful software company, recently provided us with a startling, but not isolated, example of excessive rewards. The company's share price traded above $55.30 for 60 days in a 12 month period. This triggered the award of 20 million shares to three executives, worth an aggregate of $1.1 billion. The company has incurred a charge of $675 million after tax, more than half the level of profits last year ($1.2 billion) and a significant portion of sales ($4.7 billion). As we go to press, the market has reduced the value of the award to about $800 million by marking-down the share price. By contrast, wage growth for average workers, still concerned about potential layoffs, has barely exceeded inflation. Inequality is rising in the US. Most strategists focus on aggregate figures, which suggest prosperity that many enthuse is unprecedented. During the nineties, debt service burdens have increased for the sub-$50,000 households (in an environment of significantly lower interest rates), while falling for households with incomes over $50,000. Despite very low levels of unemployment, personal bankruptcies and credit card delinquencies have steadily risen over the past few years. It is impossible to assert causation between this growing inequality and rising divorce rates, health problems such as obesity and high levels of violent crime. However, the correlation exists and echoes past eras of inequality (for more on this, read David Fischer's, *The Great Wave*). The social costs to such self-righteous, greedy capitalism and the associated divergence in prosperity will only be recognised in hindsight.

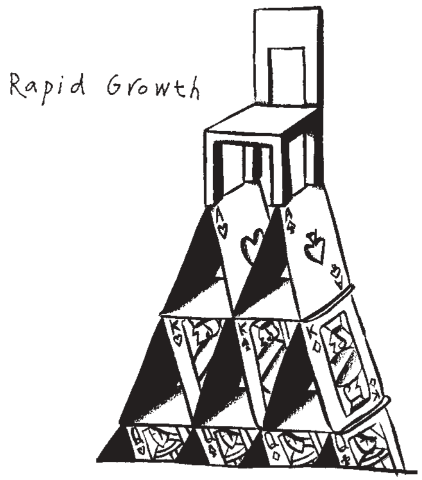
Hugh Giddy Investment Manager, North America

ASIA Reflections on China

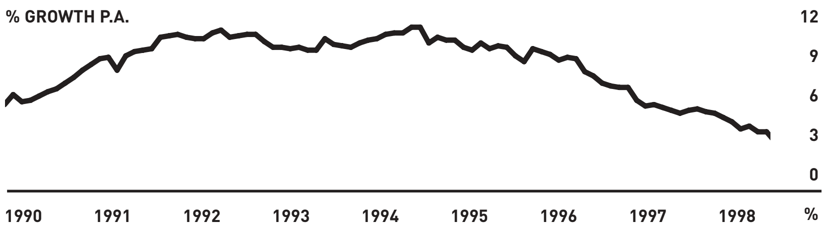
With Japan in recession and much of Asia in crisis the question that is yet to be answered is how China will weather the storm that has engulfed its neighbours.

With Japan in recession and much of Asia in crisis, the question that is yet to be answered is how China will weather the storm that has engulfed its neighbours. There is no question that the Chinese economy is slowing as evidenced by electricity and energy consumption, and this in itself is not surprising given years of extraordinarily rapid growth in industrial production. A period of slower growth would not be unusual. The issue is whether China will hit a brick wall in the fashion of the former "tiger economies" with a severe contraction in economic growth and the resultant social upheaval. Such an event would be a significant loss of activity and stability to the region's economy and would have serious ramifications for regional currency and share markets, including the Australian dollar.

A severe contraction in economic growth in China and the resultant social upheaval would mean a serious loss of stability to the region's economy.



ELECTRICITY GENERATION IN CHINA



China faces a number of problems. The export sector has been the great success story of recent years with US$91 billion having been added to export receipts since 1993, representing a doubling of exports. In 1997, the rise in exports contributed one third of China's growth. China has been the ultimate destination for those wanting a low cost manufacturing base. A plentiful supply of labour available at around US$100 per month (much the same level as when we first visited Guangdong factories in 1989) has been the key. But recent export numbers show a slowing and anecdotal evidence from exporters also suggests tougher times ahead. The main problem is that China's output prices are falling as a result of excess manufacturing capacity in the region and the strength of the Chinese currency.

Although there has been much discussion about the effect of the devaluation of regional currencies, it is often overlooked that the Chinese yuan has been strong against the currencies of developed countries to whom it exports. The yuan is pegged to the US dollar and as such has been appreciating against the Japanese yen and the major European currencies since early 1995. The differential in price inflation between China and the US has meant that Chinese exports have become less competitive. Moreover, as many of these goods are low value added, exporters are susceptible to international price moves and hence export prices have been falling. The devaluation of regional currencies only adds to these woes, and the full effects will be felt once normal trade finance links are re-established.

The other great impetus in China has been foreign direct investment. A wave of US$172 billion has entered the country since 1993, seeking to capitalise on one billion plus consumers. Unfortunately this has been an unpleasant experience for most. Few foreigners have profited from their investment. Not surprisingly, foreign investment approvals are falling away.

Perhaps the most interesting case study is beer. It is hard to find a serious brewer around the world that has not set up in China. And yet, it is our understanding that there is only one foreign brewing joint venture that is making money, while many are racking up horrific losses. The problems of the foreign brewers are numerous. Competitors include local state owned breweries which operate without regard for cost of capital. The price of beer is typically around 16 cents (US) a litre which is probably below the cash cost of production for the foreign operators. Certainly the foreign product is of a much better quality but the consumer is highly price sensitive and is not interested in paying up. To date, attempts to brand have failed. Lack of distribution infrastructure has hindered national coverage and kept the brewers trapped in their local region. Unco-operative joint venture partners (JVs are required to do any local business in China) are another headache. And finally, the massive increase in capacity put in place by the foreigners means additional pressure.

Interestingly, many of the China success stories for foreigners have come from the small Hong Kong entrepreneurs who have been more adept at negotiating the difficult environment. Examples include Tingyi who lead their multinational competitors such as Nestlé and Nissin Food in the instant noodle market, and Legend who currently lead the PC market ahead of the likes of IBM and Compaq. Often the position of these type of companies is difficult to sustain as competitors mimic their success, but nevertheless, it is indicative of the business landscape in China.

The difficulties illustrated above, together with the withdrawal of international banking capital from Hong Kong (which has been one of the

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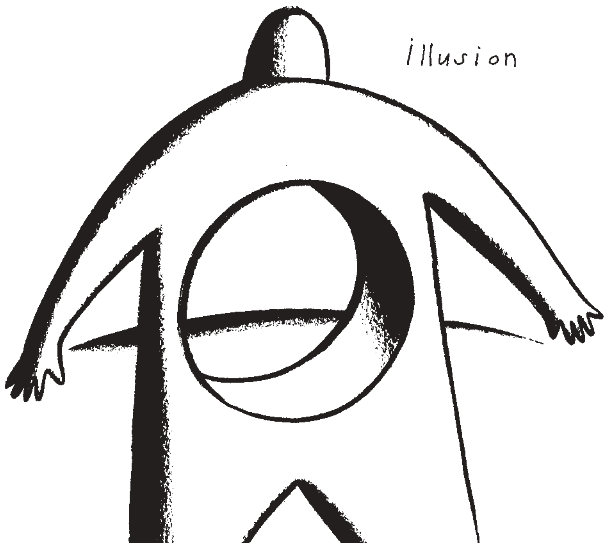

major sources of capital for China) points to little help from foreign investment from here on. Domestic entrepreneurs are unlikely to fill the gap, mainly because of the low levels of capacity utilisation in the manufacturing sector (estimated at 60%). Additional problems for investment include availability of loans as the banks are unwilling to lend given their weak balance sheets as they enter a period of reform and uncertainty. Interest rates remain high, and although official lending rates are set at around 7%, in reality funds are only available at above 11%. With virtually no inflation - the implied real yield is stifling. Without the significant driver of rising investment, which accounts for one third of GNP, the economy faces a strong headwind.

Another gap that needs to be filled is the one left by a massive building boom that has created an enormous oversupply of residential and office property. At the end of 1997 there was unsold stock of residential apartments estimated at 65 million square metres. This compares with total sales in 1997 of approximately 60 million square metres. Sadly the stock is predominantly mid to high end properties and is unaffordable by the average household. Occupancy rates in the Shanghai office market have fallen below 50% of the existing stock of 4.5 million square metres. Construction in progress, if completed, will add a further 2.5 million square metres over the next two to three years.

Finally, the consumer is an unlikely source of growth despite accounting for half of the economy. The individual faces considerable uncertainty. Reform of state owned enterprises threatens to create additional unemployment. Reform of the housing market will require households to pay market based rents. This is tantamount to a tax increase. But with China's economy teetering on the edge of deflation, the greatest threat to consumption comes from falling prices. Once individuals come to believe in falling prices, the tendency may be to defer expenditure. This has been a major cause of Japan's poor growth in recent years.

The problems are many, and relatively easy to appreciate. What is more difficult to envisage are the impulses that prevent the economy from becoming stagnant. One sector that stands out as having the potential to save the Chinese economy is the government. The prescription would be for aggressive spending on infrastructure: roads, railways, power stations. Unlike Japan where similar expenditures have had little effect in creating a sustainable recovery, in China such infrastructure is sorely needed. The second part of the prescription would be to pursue easier monetary policy and lower interest rates. It should be said that the Chinese authorities are moving in this direction, albeit slowly.

Unfortunately these initiatives are being taken against an unstable back-drop. This relates to the well aired twin problems of the state owned enterprises (SOEs) and the banking system. The SOEs are having to face up to the harsh realities of a highly competitive domestic economy. Hitherto, they have served their dual function of providing goods as well as a social safety net. In the new order, this latter function will have to be addressed more directly and in the meantime, an estimated ten million workers face unemployment. At the same time, the banks face enormous bad debt which could be as high as US$200 billion or 22% of GNP. So while the government may choose to deficit spend the country out of trouble, the cumulative problems of the past are significant.

The major problem is that a policy stance of easy fiscal and monetary policy could result in a weak currency. This has its attractions not only as it would boost export competitiveness, but would also help to prevent prices falling in local currency.

However, the government is committed to holding the current exchange rate. Although much is made of the capital account being closed, pressure on the exchange rate is nearly always caused by the loss of confidence by locals. With a closed capital account, it will be the exporters and importers who will be the major cause of leakage of funds across the exchange rate. That said, China's foreign reserves amount to US$140 billion, equal to seven months worth of imports, giving authorities time to see whether existing policies will work. But by doing so, China is effectively taking the burden of the region's problems on its own shoulders. If the currency could be devalued without the loss of confidence this has caused elsewhere, it would make for a much easier environment for the economy to adjust. There has been much said about the international goodwill that the stable exchange rate policy has bought China, but if the domestic economy is threatened the policy will undoubtedly be changed.

The difficulty with the above discussion is trying to quantify the many variables into a tight conclusion about China's future growth. The factors that have driven China's growth historically; foreign investment, exports, construction, and the consumer, are likely to see a period of slower growth and contraction. Government spending may well fill the gap left by the private sector. The government's policy to hold the exchange rate however will partially offset its effectiveness. Eventually, the yuan may well be devalued, but this needn't wreak havoc on the region if it is part of a policy package that encourages domestic demand in China. One external factor that would considerably improve the prospects for China (and the

While the government may choose to deficit spend the country out of trouble, the cumulative problems of the past are significant.

region) would be a recovery of domestic demand in Japan. On balance, it is probable that China is in for a period of considerably lower growth, certainly less than the 8% target that has been set by Beijing. This may include a short period of economic contraction but a crunch of the nature faced by its neighbours is unlikely given the government's potential to boost activity.

How does this translate to our investment stance for China and the region? As always, we are looking for undervalued companies and it is exactly this type of environment which will result in companies being significantly mispriced. But given the uncertainty involved, a significant mispricing is required to provide an adequate return. Our current search is focused on finding businesses with strong positions in their respective market places, healthy balance sheets, and good management, that will ensure their survival through a protracted economic downturn.

Andrew Clifford & Doug Huey Investment Managers, Asia

EUROPE The momentum waltz

The changes in Europe wrought by globalisation and the process of European Monetary Union have been matched only by the alacrity with which many of Europe's companies have embraced the new environment.

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EUROPE The momentum waltz

For investors, Europe has offered a fascinating series of opportunities (and pitfalls) in the 1990s. The twin forces of globalisation and the formation of a common currency, ie. monetary union, have exerted extraordinary pressures. No firm can ignore them for all are affected. For most, it has expedited change that was being nurtured through the eighties. The stock markets of Europe have thrived in this cauldron of opportunity, producing stunning rises. These pages suggest a few reasons for this whilst considering the prospects for European companies in the coming years.

As was the case in other regions of the world, the major EU economies found themselves at the end of the eighties at an inflection point. What should have been a period of recuperation after an investment and property boom, was in fact the beginning of the Reunification boom in Germany. There was no time for the normal interest rate surge used by central banks to cool things off, instead the custodians of the currency were ignored in this euphoric period of the dismantling of the Berlin Wall. To heighten the drama, the government of the day chose to further ignore the advice of the Bundesbank and followed the politically expedient course of linking the mighty deutsche mark to the weary old östmark at the exchange rate of one for one. Further, to rapidly raise the eastern lands' living standards, a massive investment programme was launched. This unleashed a renewed surge of growth that carried Germany and much of Europe with it. Wage inflation, over-investment and general excess were thus more pronounced when Western Europe eventually entered recession in 1991.

At that time there were other factors impinging on Europe. Not least the banking crisis in the USA. This made for a strong deutsche mark when the EU economy was already suffering from uncompetitive labour costs and rapidly worsening unemployment. At the very time when economic policy should have been relaxed, the convergence requirements of the proposed Economic and Monetary Union (EMU) began to bite. The Maastricht Treaty, signed in 1990, stipulated strict guidelines for government deficits and inflation rates. Meeting these requirements in the mid-1990s necessitated tightening fiscal policy (ie. lower government spending) and holding interest rates high to crush inflation out of the EU economies. Thus policies appropriate to the EMU project but inappropriate to the state of the economy conspired to prolong the recession on the continent.

The effect on corporate profits was drastic. The banks suffered from the excessive property lending of the late eighties and early nineties as commercial property values fell 40% and vacancy rates soared. Industrial companies suffered from the lack of domestic demand combined with an expensive currency which was disastrous to exports. In addition, there was freer access to European markets by lower cost countries in both South East Asia and now in Eastern Europe. No less traumatic were the inroads made by US companies who had been reinvigorated by the savage restructuring of the previous decade. The response of the major European companies was to drastically increase the pace of change which had begun slowly in the late 1980s. Now they undertook major restructuring programmes - both operationally and financially.

The first step was on the cost side. To remain competitive, European manufacturers had to reduce their cost of production. Hence the move to outsourcing formerly sacrosanct activities, and the geographic relocation of elements of the production process. The resulting reduction in the European labour force (through job losses and an increase in temporary/part time work) has seen European labour costs typically fall from

22% of sales in the early 1990s to 19% of sales today. In addition, companies have reduced costs through the introduction of centralised purchasing, consolidation of warehousing and logistics functions (made easier by the "single Europe"), and a reduction of bloated administrative structures.

The second step has been an entire review of the positioning and profit potential of the corporation's divisions. Where the eighties saw a rash of diversification, the nineties has seen consolidation. This has been reflected in a surge of merging and exchanging businesses (particularly among large enterprises) as companies strengthen their "core competencies" and divest non-core activities. The financial sector is in the vanguard of this movement and it will continue in such activities as utilities (telephony, water, electricity), entertainment (notably TV) and so on as the continent is treated as a single market.

The increasing focus on positioning and profitability has led to the wholesale adoption of EVA (Enterprise Value Added) as a tool for identifying underperforming activities. EVA is about measuring the returns made in a business against the cost of the capital employed in that business. Increasingly, managerial compensation is linked to divisional and company returns. The logical next step for companies measuring their performance using EVA is to lower their cost of capital employed. This can be done by adjusting their level of debt versus equity. If European companies were to raise financial gearing to the same level as the US listed sector, some US$2 trillion of equity would be freed. US$2 trillion represents a quarter of the combined market capitalisation of the EU! The present "inefficient" use of equity lends financial credence to ongoing mergers and acquisitions, and suggests large scale share buybacks can become common in Europe.

The strategic repositioning of businesses is ongoing. As further corporate activity takes place it in turn leads to increased emphasis on cost cutting as economies of scale are realised. Management are rewarded on their improving returns and this is reinforced by share price performance in the stock market. A virtuous circle is formed and it feeds on itself. As we have seen in the US, this process can be prolonged with returns on capital reaching much higher levels than would have seemed possible early on in the restructuring.

It is worth remembering that European companies are in a stronger position at this time of adjustment than US firms were in the mid-eighties. Historically generous tax treatment of depreciation (and expensive labour) has led to an installed base of modern plant and machinery. Also, European corporates' balance sheets are stronger than those of their US counterparts were at the end of the eighties.

The improving profitability and strong stock markets have not escaped the attention of private investors. European asset holders - households, insurance and pension funds and more recently mutual funds - have historically been more focused on bonds and cash accounts rather than shares. In Germany, commentators refer (or referred) to the lack of an "equity culture" - whether this means that corporates were in the habit of close relationships with their banks (debt funded) or that stock ownership was not popular with the individual is something of a "chicken and egg" discussion. In Italy, it is clear that shares in a mistrusted and secretive corporate landscape, could not compete with tax-efficient and high yielding government bonds. As inflation has diminished so too have bond yields, and the hunger for yield in Italy has resulted in its mutual fund industry being the fastest growing in the world.

Pension funds in the UK invest 76% of their assets in shares (end 1996 figures) and US pension funds had a weighting of 58%. These weightings dwarf the allocation of pension funds for example in Germany (8%) and Italy (3%). Similarly the large continental insurance companies have between 3% (Germany) and 26% (France) of assets invested in shares versus well over half the assets for UK insurers. Mutual funds tell a similar story - in 1997 German mutual funds had US$56 billion in shares, French US$69 billion, and Italian US$42 billion. This compares to US$203 billion in UK mutual funds and US$2,368 billion in the US funds.

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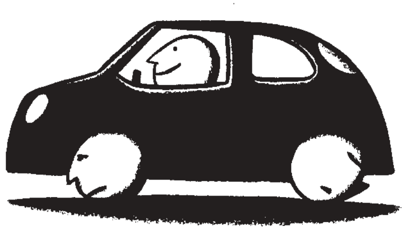

Capitalism is nothing if not a cycle of creation and destruction (the latter being essential to the former). The social costs will become more apparent as the process advances.

As long as bond and cash yields remain low, and stock markets remain strong, increasing volumes of money will continue to be diverted to equities. Governments are also playing a role through both tax inducements and large privatisations. The offerings from France Telecom and Deutsche Telekom alone raised US$24 billion and introduced over five million European inhabitants to equity investment. Over the medium to long term, individual and government knowledge of the risks posed to their current state pension system by a rapidly ageing population will also support flows into equity markets.

Morgan Stanley in a recent study has come up with a number even they are astonished by. They calculate that over the 12 years from today to 2010, there will be a gross demand for European shares of US$13 trillion (ie. US$13,000 billion!). For context, this is 1.5 times the current market capitalisation of European stock markets. Domestic liquidity flows should provide support for high valuations in Europe.

The impact on Europe of the move toward EMU represents something of a paradox. One of the core motivations of "Euroland" in a general sense is the preservation of interventionist forces in the economy. Whilst they accept the necessity of a capitalist system, European governments have been reluctant to embrace the "laissez faire" capitalism of the US or UK.

Whilst the official direction is toward protecting and promoting the "European way", the real impact is a reduction in government influence and the creation of a set of European companies which are behaving less "European" than ever. One conclusion is that while globalisation is the key issue driving the improvement in European profitability, the EMU process both acts as a catalyst for the improvement and removes many of the shackles of individual states on local companies. Europe has implicitly accepted the need for globally competitive companies which requires them to produce profitability consistent with their strength.

Among the most contentious issues in the European Union has been the extent of political union which member states are willing to accept. One of the principle criticisms of the EMU project is that an economic union is unworkable without a political union. EMU clearly requires more smoothly functioning labour markets, greater flexibility in the micro-economic profile of the member states and better mechanisms to cope with "asymmetric shocks" in the economy. (For example, a booming economy in Italy may call for tighter monetary policy but if this is counter to the policy of the core, Germany and France, remedial choices are limited.) It is therefore probable that the supply side reforms necessary to cope with centralised monetary policy and less fiscal flexibility will favour the movement toward more centralised government.

Considerable micro-economic reform is still required to compete with the brutally competitive US system. Today, non-wage labour costs (payroll tax, social security contributions etc) are a significant impediment to job creation. While the average worker is paid about US$20 per hour in both the US and Italy, the US company has to pay on-costs of US$8 per hour, while the Italian company pays an extra US$21 per hour. Tax rates are high enough to stifle entrepreneurial flair. In Germany an average production worker toils until late August each year to pay his taxes and social contributions, while his American counterpart works only until mid-May for the government. Shops in the US and UK are open for about 95 hours a week compared to under 70 hours in Germany. If the effect of the EMU process is to eventually create a "supply side revolution", then its contribution to corporate profitability will be positive indeed.

Share prices in Europe have performed remarkably well in recent years and some observers may question the sustainability of the rise. The argument may be that "yes, it's a good story but that's why the German DAX has more than doubled in the last 24 months - so don't start inventing good reasons now!!" Of concern to others may be that the applause for the move toward greater profitability may muffle the cries of despair of the casualties of this process. Sadly, capitalism is nothing if not a cycle of creation and destruction (the latter being essential to the former). The social costs will become more apparent as the process advances but it seems improbable that the electorate will accept the harsh winner-takes-all model that epitomises the US.

To make money in this period of change, it is crucial to identify strong companies that are improving their position but where the stock market underestimates the potential or value (or both) of future profit growth. Investing in “cheap” but poorly positioned companies will be a most damaging strategy.

There are still a good number of strategically well positioned enterprises (with fine operating management, great technology and excellent distribution) that are earning well below par returns on operating assets. The new focus on converting a good business position into good returns for shareholders should not be underestimated. Finally, it should be remembered that buying stocks is not the same as buying an index of share prices. Undoubtedly there are areas of excessive optimism in European stock markets but the issue for Platinum Capital is that there are many stocks which look to have great potential at current prices.

The changes which have taken place and continue to take place in European business from a shareholder’s perspective are profound, and in hindsight explain a lot of the impressive returns in stock markets in recent years. To overlook the fact that this powerful process is ongoing would be to forego the chance of some exciting investment opportunities in the coming years.

Rod Sleath & Toby Harrop Investment Managers, Europe