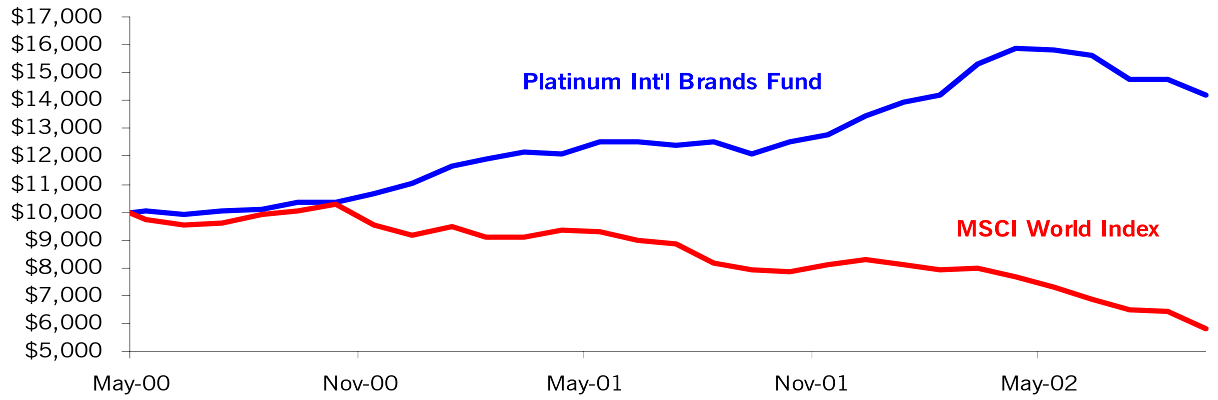
Platinum International Brands Fund

Performance

REDEMPTION PRICE: $1.2951

VALUE OF $10,000 INVESTED SINCE INCEPTION (18 MAY 2000 – 30 SEPTEMBER 2002)



Source: Platinum

The MSCI World Index fell by 15.7% during the quarter. Only five of the nearly 100 branded good stocks that we track performed positively, with many of the retailers losing more than 20% of their value and in some cases up to 40%.

In the quarter, the International Brands Fund fell 9.1%. In our previous quarterly report, we noted that we had become concerned about the relatively high valuations of many major branded goods companies, as investors generally sought out the perceived reliability of earnings from the large well known companies, notably Proctor and Gamble, Coke, Colgate and Anheuser Busch. Accordingly, over the quarter we sold a number of these companies whilst taking the opportunity of lower valuations to add to our positions in Adidas (footwear) and Wella (haircare). The short positions in the portfolio have risen from being less than 5% of the portfolio at the end of the last quarter to around 27% currently, reflecting our growing concerns of deteriorating conditions.

Anecdotes from retailers early in the quarter suggested that consumers, especially in Germany, France and the US, were becoming more cautious. Retailers in turn became more cautious and conscious of their inventory levels, deferring or cancelling orders. In the US, the latter part of the quarter is colloquially known as "Back to School".

This is an important retail period coinciding with a change in seasons, second only to Christmas for some retailers, as students equip themselves with the latest in fashion, sneakers and the now essential mobile phone, ahead of the start of their academic year in October. This year proved to be disappointing to retailers as consumers showed a tendency to be selective, price conscious and a word we heard several times "frugal". Foot Locker, the leading retailer of sneakers, reported significant down trading. Sneakers priced at the US$90-$120 range proved much more popular than the top of the range Nike – Air Jordan's © at US$200, not so long ago the Nike's were "must have", with queues and sell outs for new releases. Adidas, a portfolio stock, was well positioned to benefit from this shift in consumer buying patterns, having recently released a range of new products at these lower price points.

We introduced two new names to the portfolio, Beiersdorf and WH Smith (more on these later). Unfortunately, we were also tempted too early by the 20% fall in value of McDonald's share price, only to have the stock fall another 20% in the recent market downturn. McDonald's is focussing back on the home (US) market with a three part plan to improve performance, including improving quality, cleanliness and service, upgrading a number of outlets especially the drive through, and introducing a 99c menu. We are even more cautious now of any apparently attractive valuations on leading branded goods companies, as conditions look set to become more competitive and the consumer more challenging.

Reviewing the stocks in our proprietary brands index;

• Shares in retailer stocks continued to lose significant value. In an environment where consumers are spending more selectively and cautiously it is probably not surprising that retailers like Tiffany have lost a third of their value. The apparel and electronic retailers have also lost significant value, for example, Best Buy (a US electronics retailer) declined more than 30% and Limited Brands (apparel) lost over a quarter of their value. Perhaps more surprising though is the decline in the supposed defensive supermarket retailers, after all we still have to buy the basics. The German retailer Metro is down 40%, Ahold (an international supermarket company) also losing nearly 40%, and Safeway (a leading US supermarket company) falling 20% in value as investors became more concerned at the increase in discounting and the loss of customers to the major discount stores such as WalMart.

• Tobacco stocks fell as Phillip Morris lowered their earnings expectations for this and next year, highlighting the need to significantly increase promotional expenditure. This relates mainly to the rising cost of providing special offers (get three packs for the price of two) and discounts to compete with cheaper alternatives as consumers shun the "premium brands" in favour of the "discount brands". A trend that we are seeing in a number of consumer's purchases from apparel to cosmetics and even to food items.

• Food companies showed mixed performance, Heinz and Campbell Soup both lost more than 15%, Hershey (US confectionery) managed to hold on for a slight gain of 1%. In Europe, Unilever held their value and Danone (the French dairy/water company) lost 10% in value.

• Notably stronger share price movements came from the household products sector with Colgate up 11%, Alberto-Culver (hair products) up 5%, Clorox and Proctor and Gamble up 2-3%. Reassurances from these companies that earnings growth would be maintained supported these positive outcomes.

Commentary

Perhaps more than anything else this quarter we heard company management discuss the rising costs of competition. Luxury goods companies are competing for fewer tourist dollars as American and Japanese tourists elect to stay home and packaged goods companies are finding consumers more willing to "trade down", that is move from more expensive branded goods to the cheaper brands or generics.

As we discussed in our last report the major companies such as Proctor and Gamble and Unilever, are concentrating their product portfolios, significantly reducing their costs and increasing the advertising and promotional spending behind key brands. At the same time WalMart is benefiting from their reputation for consistently lower prices and is drawing more consumers away from traditional supermarkets. Recently WalMart commented that their sales would be in the range 3-4%, lower than historically achieved and more focussed to basic goods, "household cleaners, underwear and medicine". At the beginning of the year WalMart was forecasting 6-8% growth, this fell to 5-7% in April, 4-6% in July and recently WalMart delivered 3.8% in August. A clear trend of slowing sales that will give rise to increased competition through higher discounting as the smaller competitors try and stem the flow of customers to this leading retailer.

In the US, headline economic statistics report that consumer spending, which accounts for more than two thirds of the US economy, continues to grow. When we look just a little deeper we find mortgage rates at a record 40 year low, with 30 year mortgages now below 6% pa. The US consumer is also being offered financing at 0% and "cash back" discounts to purchase a new vehicle. Faced with the opportunity to refinance the mortgage, perhaps increasing the size of the loan and still pay less per month, *and* purchase a new vehicle at 0%, the US consumer's attention is clearly drawn to these opportunities. Outside of these areas consumer spending is showing significant restraint, decline even. This is now extending to everyday non-essential household items and we even see staple companies such as Kellogg reporting declines in sales of the more discretionary products such as "PopTarts".

In an environment where the consumer is "penny conscious" and growth rates for companies are stalling, weaker brands resort more to price to retain consumers. The brand leaders find the price gap opening up and get drawn into this battle to retain market share. Retailers also turn to the suppliers for support, looking to extract further concessions and discounts in their bid to compete for fewer discretionary consumer euros/dollars. Apart from these consumer, customer and competitor dynamics many branded goods companies are faced with rising input costs with the significant US and Australian drought forcing up grain prices and the difficulties in the Middle East driving up oil and energy costs.

In addition to facing rising corn, wheat and energy costs Kellogg purchased Keebler, a leading US biscuit maker (cookies and crackers) with a strong distribution system that delivers direct to stores. In order to reduce the significant debt associated with this transaction, currently around $6 billion, Kellogg has been increasing prices well ahead of inflation. Advertising expenditure has been increased to support the branding and significant reliance is being placed on their sales systems to push products through to the retailer shelves. Anheuser Busch is following a similar strategy, relying on price increases to fund additional brand advertising whilst driving profit growth of more than 10%. We do not believe that the current valuations of these companies adequately reflect the risks of, what is tantamount to, harvesting the equity in the brand. In a similar fashion, L'Oreal cut advertising expenditure to support the growth in profits, believing that the strength of the brands and the distribution system would carry the growth through for a while. It may, for a while, before competitors start to make in-roads and then the likelihood is that even higher costs will be incurred to win back lost consumers.

We see other examples where these packaged goods companies are reacting to a more difficult environment. The practice of surreptitiously reducing the product size, fewer tissues, nappies or snack bars in the pack for the same price is, in our view, damaging to the brand equity. When consumers finally have enough of these packaging and pricing shenanigans and switch, to discover that the "cheap(er)" product isn't really that different, they can be so much more difficulty and costly to win back. It's clear in many product categories that the cost of retrieving a lost consumer is much greater than the marginal extra that was gouged on the way up. The problem for these companies is defining that point prior to the damage being done.

We did see an opportunity to add a leading brand to the portfolio. Beiersdorf is better known for Nivea, having consistently grown this brand by 15% compound annual growth over the past decade. Beiersdorf, through Nivea, has a leading 10% share of the world skin care market and has long been seen as a very attractive acquisition for companies like Proctor and Gamble or L'Oreal. In Germany, given a very difficult consumer environment, Nivea sales in the past quarter fell. This together with indications that Beiersdorf and the major shareholders were not interested in an offer for the company ensured that Beiersdorf fell in value along with the wider sell down of shares in Germany. We commenced buying the share, attracted by the long term growth potential of this brand, the market leading positions and the opportunity to continue to carefully extend this brand into new products (eg. Nivea for Men) and widen distribution.

We have also added WH Smith, a dominant newsagency/bookstore business in the UK, well positioned in prime High Street locations, and a well recognised brand. Although its already strong market position means the ability to grow by adding new stores in the UK is modest, over several years it has improved profitability by refurbishing stores and improving its product range and store operations. WH Smith is also the largest UK newspaper distributor, where efforts to improve efficiency through a new IT system are resulting in profit improvement. We bought shares in this company following a decline in the stock due in part to weakness in a small business of WH Smith's, gift shops in US hotels and airports that are sensitive to the drop in the number of travellers. WH Smith's core UK newsagency operations sell relatively low-priced convenience items – newspapers, cigarettes, bestselling paperbacks and in difficult economic conditions sales of these items should prove more resilient. WH Smith has no debt on the balance sheet, and at the current stock price offers an attractive dividend yield for a holding in a business of relatively low risk.

Outlook

The outlook for consumer branded goods companies is not very encouraging. Concerns surrounding the Middle East will continue to curtail tourism, high levels of consumer indebtedness (mortgages, car loans and credit card debt) in the US economy and rising costs in an environment where price increases are difficult at best, all conspire to make trading difficult for many of our companies. In many cases valuations are also at a relative high point as investors have sought out and paid a premium for the perceived security of reliable earnings. As companies bring down growth expectations and adjust to a harsher environment their valuations should come down to more interesting levels and may even provide us with some compelling opportunities. We will continue to be opportunistic and invest only when we believe the fundamentals are not reflected in the share price.

Simon Trevett
Portfolio Manager